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the movement for **Responsible Investment**

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11 May 2017

Dear Sir or Madam,

Green Paper on Security and Sustainability in Defined Benefit Pension Schemes

I am writing to respond to the Green Paper on Security and Sustainability in Defined Benefit Pension Schemes 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 26,000 individual supporters. We work with institutional investors to promote stewardship and engagement, and we also conduct annual industry-wide surveys to rank them on these activities. We have extensive experience of research and policy development on barriers to long-termism, and fed into the 2012 Kay Review, the related BIS Select Committee, the Law Commission's review of trustees' fiduciary duty and the recent BEIS Select Committee on corporate governance.

I have responded to Questions 2 and 3 of the Green Paper below, which cover the areas to which we can add most value.

Question 2
Do members need to understand the funding position of their scheme, and if so what information would be helpful?

a) Should schemes do more to keep their members informed about the funding position of their schemes?

It is important for members to have a reasonable understanding of the funding position of their schemes and schemes should communicate with their members about this issue in a comprehensible way. Since the PPF only offers a percentage of the promised benefits if schemes fail, individuals should have a good grasp of the likelihood of this happening, so they can plan for their future accordingly. Members may consider a cash buy out in exchange for their benefits, and it will be difficult for them to make good decisions if they have little understanding of the funding position of the scheme. We acknowledge that it will be difficult for schemes to communicate this information clearly and at the right level of detail without unnecessarily alarming members, and it may be helpful for The Pensions Regulator to issue guidance on how this can best be done.

b) Do we need Government communications to provide information to the wider public and media about the degree of certainty and risk in the regime?

- What difference could this make?

As noted in this Green Paper, there is a great deal of negative press about the state of DB pensions, often focusing on the valuation of schemes' liabilities on a buyout basis. A blog published last year[1] by Andrew Warwick-Thompson, Executive Director for Regulatory Policy at The Pensions Regulator, did a good job of explaining in accessible terms why these figures are only of "academic interest to the majority of schemes". We think it would be helpful for the Government to focus on addressing these misconceptions in a wider forum to avoid the potentially negative impacts on member outcomes discussed in this Green Paper.

Question 3
Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main drivers of these behaviours and how could they be changed?

There is certainly evidence to suggest that pension funds in general are taking a short-termist approach to investment, and that this may not be in the best interests of the ultimate beneficiaries. While many pension funds have investment horizons of multiple decades, pension fund investors say they stay invested on average for a little more than four and a half years. 22% of funds say they have a time horizon of five to 10 years, but 51% of funds have a time frame of five years or less, with 8% of these having a time horizon of just six to 12 months. 20% of funds say they have no specific timeframe for holding investments.[2] To put this in context, a timeframe of five years is usually suggested as the minimum for equity market investment, on the basis this allows investors to experience the ups and downs of a normal market cycle.[3] Analysis by Ritholtz Wealth Management of the S&P 500 between 1927 and 2014 shows the benchmark US index recording positive returns across 88% of all five-year periods. That figure rises to 94% for 10-year periods, while there has yet to be a negative return over a 20-year timeframe.[4]

Our 2015 report *Realigning Interests, Reducing Regulation* (RIRR)[5] echoed the 2012 Kay Review's findings that high levels of intermediation in the investment chain may be strong drivers of short-term decision making. Investment horizons are often misaligned, with survey results finding that 25% of mandates for equity investments are for 3 years or less, meaning that there is little incentive for asset managers to invest for the long-term.[6] In addition,

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1 Warwick-Thompson, A. (September 2016). 'DB deficits – the real story'. Available online at: https://blog.thepensionsregulator.gov.uk/2016/09/29/db-pension-scheme-deficits/#more-239 [accessed 10 May 2017].

2 Schroders (2016). Global Investor Study 2016 – Plan Sponsors, p4. Available online at: http://www.schroders.com/en/sysglobalassets/digital/insights/2016/pdfs/global-investors-study-pension-funds.pdf [accessed 10 May 2017].

3 Schroders (2016). Global Investor Study 2016, p4. Available online at: http://www.schroders.com/fr/sysglobalassets/digital/insights/pdfs/2016/sgis-2016/sgis-investment-outcomes-full-report.pdf [accessed 10 May 2017].

4 Ibid, p4.

5 ShareAction. (June 2015.) *Realigning Interests, Reducing Regulation*. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 10 May 2017].

6 NAPF (November 2014). 'NAPF Engagement Survey: pension funds' engagement with investee companies'. Available online at:

contracts between manager and investor are usually primarily focused on benchmarks rather than investment strategies. As the 2012 Kay Review explains: "The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company's securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business".[7]

Clark and Monk concluded in their 2012 paper 'Principles and Policies for In-House Asset Management' that "the portfolio a long-term investor would like to hold and the portfolios that long-term investors actually hold are quite different due to an over-reliance on short term asset managers… realizing the advantages of being a long-term investor will inevitably require some level of insourcing due to broken agency problems'.[8] This conclusion was echoed by several of the individuals we interviewed for the RIRR report, for example: 'The in-house model is also better suited to focusing on the long term and putting beneficiaries' interests first, rather than changing asset managers all the time and chasing the star performers in a particular year, who may not do well the next year.'[9]

The regulatory requirement for trustees to take advice from investment consultants may also contribute to the problem of short-termism, as investment consultants tend to be incentivised to encourage their clients to switch asset managers frequently. In terms of considering the effect of investment consultant advice on trustee consideration of environmental, social and governance financially material factors, which are often most relevant to investment performance over the medium to long term, the UNEP FI report *Fiduciary Duty in the 21st Century* stated the following: "A recurring theme in the interviews was that the advice being given by these consultants and advisers… is often based on a very narrow interpretation of fiduciary duty. Interviewees commented that most lawyers and consultants tend to advise their clients that the law requires them to have exclusive focus on financial returns, often in the erroneous belief that taking account of [environmental, social and governance (ESG)] issues will have a negative impact on investment returns. One interviewee noted: 'they find it easier to say 'no' when asked about these issues'."[10]

This misalignment of incentives is particularly problematic given that surveys indicate that many trustees are failing to challenge their managers and consultants on their decision-making and advice. A 2016 study found that many trustees of DB schemes are failing to challenge their investment consultants, and attributed this to group think. The report said 59% of DB trustees do not frequently consider alternatives to the investment consultant's recommendations, 42% of whom have never personally challenged the advice of their investment consultant. It found that this may result in benchmarks not being aligned to schemes' objectives and increased demands on corporate sponsors. Trustees are also heavily reliant on the group to inform their decision-making process, with 59% thinking the opinions of other trustees are 'very' or 'extremely' important and another 24% thinking they

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http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0412_NAPF_engagement_survey_2014.pdf (accessed 10 May 2017).

[7] Kay, J. (July 2012). The Kay Review of UK Equity Markets and Long-Term Decision Making. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-marketsfinal-report.pdf [accessed 10 May 2017].

[8] Clark, G. and Monk, A. (2012). 'Principles and Policies for In-House Asset Management.' Available online at: http://www.ifswf.org/sites/default/files/Publications/wp079_0.pdf [accessed 10 May 2017].

[9] ShareAction. (June 2015.) *Realigning Interests, Reducing Regulation*, p33. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 10 May 2017].

[10] UNEP FI (2015). *Fiduciary Duty in the 21st Century*, p18. Available online at: http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf [accessed 10 May 2017]. p18

are 'fairly' important.[11] 2015 research from The Pensions Regulator said "it was rare that the trustee board disagreed with its external advisors. Across all of the advisor types, the majority of schemes indicated that they rarely (58%) or never (24%) disagreed with this advisor (with 14% sometimes disagreeing and 1% always disagreeing)."[12] These findings are supported by the FCA's recent review of the asset management industry.

We believe there may also be some confusion concerning the legal position where trustees delegate to their asset managers. During the course of our research for a report on the extent to which climate risk is considered in pension investments, 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, a 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".[13]

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 not be held responsible for the acts or defaults of asset managers only so long as they have 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 relevant statutory obligations.[14] It is concerning that some trustees do not appear to have the skills or resources necessary to undertake these important aspects of their duties.

As discussed in more detail elsewhere (and set out in full in the 'Summary of recommendations' section at the end of this response, these behaviours could be changed by introducing mandatory trustee training to improve skills and knowledge; supporting the FCA to introduce a strengthened duty on asset managers to act in clients' best interests; driving consolidation of smaller schemes to improve governance, internal resources and buying power; and irmproving transparency to allow members or civil society organisations to identify and challenge scheme strategy or decisions that do not seem to be in members' best interests.

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[11] Clacher, Dr I. (2016). *Governance and Groupthink in UK Defined Benefit Pension Schemes. Available online at:* https://www.seic.com/enUK/institutions/16887.htm [accessed 10 May 2017].

[12] 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 10 May 2017].

[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/ClimateInvestmentDutiesInvestorReport.pdf [accessed 10 May 2017].

[14] Section 34(6), Pensions Act 1995.

a) Do trustees/funds have adequate and sufficient investment options on offer in the market?

- Is there anything Government could do to address any issues?

Not answered.

b) Do members need to understand the investment decisions that are being made?

- If yes, are there any specific decisions that need articulating?

It is often said that DB members should have little rights to information or influence over the decisions made by the trustees of their pension scheme, on the basis that the employer bears all the risks of investment. However, DB members are exposed to the risk that their expectations for retirement are not met due to a scheme failure (or a closure of the scheme to future accrual). Ultimately, it is still members' money that is being invested and they should be given the right to information about how decisions are made on their behalf.

As with DC schemes, we would recommend:

- Giving savers the right to receive a response to reasonable requests for information, including the reasons for decisions made by the scheme. This right should cover information about a scheme's investments.
- Requiring schemes to publish an annual report that sets out: accessible information in plain English on the scheme's equity and other holdings; how decision-makers have considered an assessment of key strategic risks and how they are being managed to protect members' long-term outcomes; and a clear statement of the scheme's approach to responsible investment and good stewardship, and how this approach has been implemented.
- Requiring fund managers to supply the investment information outlined above to trustees in a short consumer-friendly report, which trustees could put on their website.

c) Would it be appropriate for the Regulator to take a lead in influencing or determining an acceptable overall level of risk for a scheme in a more open and transparent way?

Not answered.

d) Would asset pooling or scheme consolidation help schemes to access better investment opportunities?

Although we have not directly answered the questions on consolidation in this Green Paper, we would support the Government taking action to facilitate consolidation of smaller DB schemes. Operating at scale should allow schemes to invest in a wider range of asset classes and take an approach more focused on the long term. It should also enable more adequately skilled governing bodies, sufficient internal support, economies of scale and better bargaining power. Additionally, costs per saver can be brought down when there are

more beneficiaries in a scheme to bear them. 2016 research from the PLSA indicates costs for operating defined benefit (DB) schemes have increased by 37% in one year, but costs for smaller schemes are 63% higher year on year.[15] In countries, such as Australia, where there is scale in the pensions sector, pension operating costs are around 40 per cent lower than in the UK.[16]

The countries examined in our 2015 *Realigning Interests, Reducing Regulation* report,[17] chosen due to the excellent reputation of their pension systems, all had a higher proportion of large schemes when compared with the UK. The Dutch central bank (the DNB), for example, has been active in seeking to reduce the number of schemes in the Netherlands. In 2013, it was announced that the number of pension funds was set to drop to 265, having fallen from more than 800 in 2005 to the current total of 325. Following a survey into the risk that small and shrinking pension funds would no longer be able to pay promised pensions in the medium term, the DNB further identified 60 "potentially vulnerable schemes", which it said should consider their future as independent organisations. These pension funds – with assets ranging from €50m to €2bn – were selected according to their ability to amend their funding level through contribution changes, the average age of their participants as well as cost levels. Jan-Jaap Dahmeijer, project leader for vulnerable schemes at DNB, explained that any decision would be up to a pension fund's board, and that consolidation was not a goal in itself. "What matters is that things work," he said last year. "Even a large pension fund is not a guarantee for this."[18]

In Australia, schemes have to assess and report to the regulator annually on whether insufficient scale in terms of beneficiaries or assets means the financial interests of their beneficiaries are compromised compared to the beneficiaries of products in other schemes. Therefore, small schemes that are working well are not forced to merge or transfer beneficiaries to a different scheme; but they must justify how they are overcoming the inherent disadvantages of operating at a small scale. The number of schemes fell from 5,000 in the mid-1990s to 500 by the end of 2009 and the average scheme size in Australia is 26,000 beneficiaries compared with 2,500 beneficiaries in the UK.[19]

To show what can be done when pension funds are operating at scale and have good governance structures in place, it is worth looking at IFM investors, an asset manager created in 1998 and jointly owned by a group of thirty Australian industry (non-profit) funds who sought better value for their beneficiaries than what was available on the market. It is still owned by many of the ultimate investors in its products but operates independently from the pension funds. The organisation is free of conflicts of interest associated with shareholders in a pension provision context. Thanks to IFM, the not-for-profit industry superannuation funds have led the way on long-term investing, for example in alternative,

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[15] PLSA (December 2016). 'Cost of running a defined benefit scheme up by 37% year on year'. Available online at: http://www.plsa.co.uk/PressCentre/Press_releases/0542-Cost-of-running-a-defined-benefit-scheme-up-by-37-percent-year-on-year.aspx [accessed 10 May 2017].

[16] Centre for Policy Studies (November 2013). 'The Local Government Pension Scheme: Opportunity Knocks'. Available online at: http://www.cps.org.uk/files/reports/original/131125093257-LocalGovernmentPensionSchemeOpportunityKnocksV2.pdf [accessed 10 May 2017].

[17] ShareAction. (June 2015.) *Realigning Interests, Reducing Regulation*, p33. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 10 May 2017].

[18] Preenman, L (March 2015). IPE, 'Best hands on deck: The consolidation of Dutch pension funds'. Available online at: https://www.ipe.com/pensions/pensions-in/netherlands/best-hands-on-deck-the-consolidation-of-dutch-pension-funds/10006890.fullarticle [accessed 10 May 2017].

[19] ShareAction. (June 2015.) *Realigning Interests, Reducing Regulation*, p29. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 10 May 2017].

unlisted assets such as infrastructure.[20] In Australian non-profit funds, the majority of trustees are elected by employers or beneficiaries or appointed by unions or employer groups. These non-profits have outperformed their for-profit appointed trustee competitors on virtually every important criteria of superannuation performance over a long period. They generated risk-adjusted returns that were on average 2.4% higher per annum on a risk adjusted basis than the retail pension funds over the last decade.[21]

It could take a very long time for market consolidation to happen without regulatory intervention, particularly considering the large number of small schemes in the UK. Single employer trusts are relatively immune from the market forces which drive consolidation in the master trust sector. As a Centre for Policy Studies report points out: "it is naïve to expect professional trustees to be pursing scheme consolidation ("scaling up") with enthusiasm; it runs contrary to their interests. Fewer schemes means less business; ultimately, trustees are agents and, even with the best will in the world, it is nigh impossible to perfectly align their interests with those of their principals (the scheme members)."[22] The same principle applies to third-party advisors.

e) Is regulation (including liability measurement requirements) incentivising overly risk-averse behaviours/decisions that result in sub-optimal investment strategies?

- If yes, which regulations and how do they impact on these decisions?

Not answered.

f) Are you aware of evidence of herding or poor advice from the intermediaries and advisors?

Please see the main part of Question 3.

g) Are measures needed to improve trustee decision making: skills such as enhanced training, more Regulator guidance, or the professionalisation of trustees?

We believe it would be helpful to make training for trustees compulsory, with completion of this training monitored by the Pensions Regulator. The countries examined in our RIRR report which showed best practice in pensions (Australia, the Netherlands, and Denmark), made training compulsory for all individuals with pension scheme governance responsibilities, with the regulator usually taking a facilitating role. It would be difficult to argue against mandatory trustee training, given the potential saver detriment resulting from poor trustee governance, and personal liability trustees themselves may have for breaches of trust. This could include making it mandatory for trustees to pass all modules in the Trustee toolkit within six months of taking up their post, and requiring them to complete

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[20] ShareAction. (June 2015.) *Realigning Interests, Reducing Regulation*, p34. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 10 May 2017].

[21] Ibid, p34.

[22] CPS (June 2012). 'Put the saver first: catalysing a savings culture'. Available online at: http://www.cps.org.uk/files/reports/original/120613094539-Putthesaverfirstabridgedversion.pdf [accessed 11 May 2017].

regular training during the remainder of their time in the role, to ensure they are staying up to date with industry practice.

In particular, the training should address ways of combatting groupthink and 'herding'. Solutions identified in the 2016 study of DB pension funds mentioned above included appointing someone to the role of 'devil's advocate', asking participants to engage in the debate without expressing personal opinions, splitting the board into subcommittees to tackle the same decision separately, and seeking alternative views from other experts.[23] The training for member-nominated trustees (MNTs) should be tailored to ensure that they have the confidence and ability to ask challenging questions.

However, we would be cautious about requiring all trustees to have formal qualifications, as this is likely to limit the pool of candidates and could restrict the ability of beneficiaries to be represented at board level. We would certainly argue against proposals to professionalise all trustees. 2015 research from The Pensions Regulator showed that diversity is a key benefit of the trustee model and all types of trustees, whether lay or professional, have something valuable to bring to the running of pension schemes. Research gathered for ShareAction's RIRR report found the same: MNTs or individuals with experience of working with them, repeatedly said in interviews that despite not being pensions or investment experts, MNTs would often ask difficult questions of providers. Several interviewees and roundtable participants said MNTs can be less reticent to ask questions that seem 'silly', or obvious, compared with professional trustees with a reputation to uphold. During interviews, ShareAction heard numerous examples of MNTs making a difference to outcomes, including fighting for cost savings resulting from a scheme merger to be passed onto beneficiaries; initiating the formation of subcommittees, for example on audit, investment or administration; putting contracts for professional advisors out to tender, resulting in fee savings; and acting as an approachable point of contact for other beneficiaries, who were nervous about asking questions to professional representatives of the scheme.[24]

The Pensions Regulator's 2015 research found that lack of time was a key barrier to some trustees taking up training. Interviewees in the research conducted for our RIRR report emphasised that lay trustees need to be given time off by employers for training as well as to attend board meetings. We would recommend 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. In our research for RIRR, roundtable attendees agreed that employers could be reimbursed from the scheme for the paid hours that an MNT spends on pension scheme duties. The skills and knowledge that the employee would build up could be emphasised to the employer. Training could even be accredited by recognised bodies so that it would count towards continuing professional development requirements or points that employees in certain sectors or companies have to accrue.[25]

Summary of recommendations

One significant cause of the issues identified in this Green Paper is the heavily intermediated chain in pensions investing. Asset managers and investment consultants are often incentivised to focus on short-term returns and many trustees lack the knowledge and

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[23] Clacher, Dr I. (2016). *Governance and Groupthink in UK Defined Benefit Pension Schemes. Available online at:* https://www.seic.com/enUK/institutions/16887.htm [accessed 10 May 2017].

[24] ShareAction. (June 2015.) *Realigning Interests, Reducing Regulation*, p19. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 10 May 2017].

[25] Ibid, p28.

confidence to challenge them. This dynamic often results in decision-making being fully delegated to market participants that are not required to, and often do not, act in the best interests of the ultimate beneficiaries.

These problems could be addressed by: introducing mandatory trustee training to improve skills and knowledge; supporting the FCA to introduce a strengthened duty on asset managers to act in clients' best interests; driving consolidation of smaller schemes to improve governance, internal resources and buying power; and better transparency to allow members or civil society organisations to identify and challenge scheme strategy or decisions that do not seem to be in members' best interests.

We would recommend:

- Supporting trustees to challenge suppliers by:

    - Requiring trustees to undertake training on key skills and knowledge mandatory. This could include making it mandatory for trustees to pass all modules in the Trustee toolkit within six months of taking up their post, and requiring them to complete regular training during the remainder of their time in the role, to ensure they are staying up to date with industry practice. In particular, the training should address ways of combatting groupthink and 'herding'. The training for MNTs should be tailored to ensure that they have the confidence and ability to ask challenging questions. Lay trustees should be given time off by employers for training as well as to attend board meetings.
    - Supporting the FCA to introduce its proposed strengthened duty on asset managers to act in clients' best interests. Doing so would ensure that there is no 'gap' in the investment chain in respect of fiduciary duties and would help to eradicate some of the rent extraction and non-competitive behaviour in the asset management industry.

- Driving consolidation by:

    - Considering examples such as the Netherlands and Australia, where schemes were pushed towards consolidation via non-interventionist means, such as requiring them to assess and report to the regulator annually on whether insufficient scale in terms of beneficiaries or assets meant the financial interests of their beneficiaries were compromised relative to other schemes.

- Improving transparency by:

    - Giving savers the right to receive a response to reasonable requests for information, including the reasons for decisions made by the scheme. This right should cover information about a scheme's investments.
    - Requiring schemes to publish an annual report that sets out: accessible information in plain English on the scheme's equity and other holdings; how decision-makers have considered an assessment of key strategic risks and how they are being managed to protect members' long-term outcomes; and a clear statement of the scheme's approach to Responsible Investment and good stewardship, and how this approach has been implemented.
    - Requiring fund managers to supply the investment information outlined above to trustees in a short consumer-friendly report, which trustees could put on their website.

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

Yours sincerely,

Rachel Haworth

Policy Officer