Department for Work & Pensions

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Minister for Pensions

Mary Creagh MP
Chair, Environmental Audit Committee
House of Commons

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Dear Mary,

Thank you for inviting me to respond on a number of questions in relation to the Environmental Audit Committee's inquiry on Green Finance. I apologise that I will be unable to attend the evidence session on 21 February, due to other, urgent business.

I am grateful to Fiona Walker, Deputy Director in Private Pensions and Head of Automatic Enrolment and Defined Contribution, who has offered to attend in my place.

I set out responses in the attached on the points where I understand you were interested in hearing the Departmental position.

Yours sincerely,

Guy Opperman

The work the Department is doing

The legislative context

1. The Department for Work and Pensions has a key role in setting the legislative framework in which occupational pension schemes operate. Whilst we do not seek to encourage or direct pension schemes to invest in any particular way, we recognise that this framework will set the context within which long-term investment decisions are made.
2. Both occupational pension schemes and personal pension providers have a clear, fiduciary duty to invest in the long-term best interests of their members, and not in support of Government policy. However, this does not preclude 'green' investment – often it will be precisely the kind of investment which it is in members' long-term best interests for trustees and providers to select.
3. Therefore pension schemes have the potential to invest significantly in decarbonisation and upgrading national and international infrastructure to address the causes and effects of climate change.

The Law Commission's reports

4. The Law Commission's 2014 report, Fiduciary Duties of Investment Intermediaries, concluded that trustees of occupational pension schemes already have a fiduciary duty under trust law to take account of any and all financially material risks. Given that there is a broad scientific and public policy consensus that climate change is such a risk, then trustees already have a duty to take account of it.
5. The Law Commission concluded in 2014 that some confusion on this point may stem from Government regulation. This requires that trustees set out, in the Statement of Investment Principles which they are required by law to review no less frequently than every three years:

   > 'the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.'[1]

6. This has the potential to cause confusion on two counts – first, it conflates ethical considerations with social and environmental issues. As noted above, environmental considerations (and by extension social issues too) will often constitute financially material risks. Second, the requirement suggests that there will be cases where no social or environmental considerations will be financially material. We believe such instances will be rare if they exist at all.

[1] Regulation 2 of the Occupational Pensions Schemes (Investment) Regulations (SI 2005/3378)

7. We hoped that the publication of guidance on this point by The Pensions Regulator would address trustee confusion about their duties. However, recent research (see Q1 below) has suggested that a lack of attention and outright misunderstanding remain widespread among Trustees.
8. Therefore in response to a second report, ‘Pensions funds and social investment’, produced by the Law Commission last year, the Government has committed to consult on policy and regulations during 2018 and, subject to the outcome of that consultation, bring forward legislation that clarifies this point for Parliamentary approval at the earliest reasonable opportunity.

Next steps

9. The Department’s current plans are to launch the consultation in May or June 2018. Rather than minor technical amendments, we have committed to introducing regulations which are as effective as possible in delivering the right level of evaluation and consideration by trustees.
10. Options under consideration for consultation include:
    - requiring trustees to evaluate not just how they intend to take account of financially material risks but, when they revisit their Statement of Investment Principles, to review how they ensured those considerations were taken into account;
    - specifically highlighting particular considerations, such as climate change or corporate governance, for which trustees are required to have a particular policy;
    - requiring trustees to publish the statement of investment principles, or make it available to all on request, and to tell members that the Statement of Investment Principles is available.

Questions asked by the committee

Q1. What is the Department's view of the way Fiduciary Duty is interpreted by pension funds in the UK in respect of climate change (and wider environment, social and governance factors) and the guidance provided by The Pensions Regulator and the FCA?

11. We are aware of relatively little robust research on the way that pension schemes interpret these risks. A range of best practice material has been published by a number of industry bodies, including the Pensions and Lifetime Savings Association and the Institute and Faculty of Actuaries. Some self-selecting surveys – for example, including those conducted by the PLSA - have tended to suggest that knowledge and awareness of the issues are high among trustees.

12. But other self-selecting surveys, such as that carried out by the trade magazine Professional Pensions have suggested continuing widespread misunderstanding. These found that 53% of trustees, scheme managers and pension professionals did not see climate change as a financially material risk to their own or their clients' portfolios.

13. This finding, if accurate, is concerning. Similar, qualitative research by the pensions law firm Sackers[2] indicated that many trustees did not pay significant attention to environmental, social and corporate governance (ESG) issues:

    > ‘[Trustees]… consider ESG (Environmental, Social and Corporate Governance factors) and external governance reviews to be low priorities. Some participants were not sure what ESG meant… Some see ESG as a distraction or potentially detrimental to achieving the scheme’s goals.’

14. Whilst there are clearly trustees who understand the issues, are actively engaging with them and are reviewing and where necessary amending their investment strategies accordingly, good practice appears to be far from universal.

Q2. Is the Department content that trust and contract-based pensions are currently being regulated consistently by the FCA and tPR in this respect?

15. Occupational pension schemes (trust-based schemes) and personal pensions (contract-based schemes) start from a very different position.

16. Trustees of occupational schemes have an explicit fiduciary duty to their members, and wide discretion in the actions they may take in members’ best interests. Providers of personal pensions are parties to a contract with the member, and cannot vary terms except as the contract permits. Rightly, the member benefits from protections in law to compensate for the power imbalance in the contract, and that limits providers’ freedom to write contracts very broadly.

17. The trustees of occupational schemes are predominantly lay trustees, whilst the providers of personal pensions are individually approved and generally subject to the FCA’s Senior Managers’ Certification Regime.

18. Finally, the nature of the markets are different. There are almost 30,000 occupational DC schemes, and another 6,000 occupational DB schemes. Whilst there are many providers of self-invested personal pensions, large and small, there are only around 10 to 15 workplace personal pension providers who are actively taking on members.

19. These factors, combined, have tended to mean that day-to-day oversight of personal pension providers is greater overall, but is less prescriptive around core

[2] Effective Governance – the Art of Balance (2017). Sackers/Winmark. - https://www.sackers.com/publication/effective-governance-the-art-of-balance/

scheme activities, such as the selection of investments. Day-to-day oversight of occupational pension schemes is lower, but with increased requirements for schemes to have policies in technical areas, and greater provision of guidance.

20. These factors help to explain why there is an explicit requirement for occupational pension schemes to produce a Statement of Investment Principles which currently includes policies in relation to environmental, social and ethical issues, but there is no equivalent duty on personal pension scheme providers.

21. However, the two halves of the pensions market are converging, with personal pension schemes being used as workplace pensions for automatic enrolment, and multi-employer occupational pension schemes being established and run by traditional personal pension providers. Since the provider of a workplace pension might equally well be a personal pension provider regulated by the FCA or an occupational scheme regulated by The Pensions Regulator, there is an argument for continued harmonisation of legislation, and increased collaboration between these bodies.

22. The Department and the FCA do accordingly consult with one another on upcoming legislation and seek to align legislation and rules wherever practical to limit the scope of regulatory arbitrage.

23. The Law Commission's second report on this subject, published last year, made a number of recommendations for the Financial Conduct Authority as well as for the Department. This includes a proposal that the FCA make rules requiring Independent Governance Committees (IGCs) which were established in 2015 to oversee workplace personal pension providers, to review how the providers take account of financially material risks. The FCA are considering their response to this and other recommendations.

24. However, as the FCA is an independent regulator and not sponsored by the DWP it therefore would not be appropriate for us to comment on whether or when the FCA should accept the Law Commission's recommendations and harmonise its own rules.

Q3. The Department has previously expressed concern about self-selecting sample groups taking part in beneficiary surveys. What approach has the Department recommended to date for engagement with beneficiaries? What part should Statements of Investor Principles play in this?

25. We should first highlight that we see effective communication with members as a key part of maximising long-term investment returns and minimising long-term risks. That communication should be two-way as much as reasonably possible. Engaged members have an important role to play in ensuring that trustees make

decisions about investment with members' best interests in mind, and are able to justify those decisions when asked to.

26. The Government is taking forward a number of activities to assist and enable members to engage with pension saving. In particular, we have committed to introduce the pensions dashboard from 2019 – this has the potential to enable members to see all their pension savings in one place, significantly simplifying the process of access personalised information.

27. The Department also consulted last year on legislation that will require trustees of Defined Contribution (DC) occupational schemes to disclose on request the 'pooled funds' in which members are invested, and to tell members annually that this information is available.

28. This will allow members to identify those managing investments on their behalf, the fund's objectives and top holdings. It will also enable members to identify and access other publicly available information about the policies of the investment managers in relation to voting, engagement, and sustainable and responsible investment. Armed with this information, members will be vastly better informed to engage as stakeholders with those who manage their pension savings on their behalf. The Government intends to lay legislation to achieve these change before Parliament in the very near future.

29. Turning to the Committee's specific question, we have already referred to our thinking on whether members and others should have easier access to schemes' Statement of Investment Principles. We also indicated in the Interim Government Response to the Law Commission's second report that we wanted savers to have their say on where their money is invested.

30. The Department is actively considering how best to achieve this in practice. For example, it is noteworthy that trustees of occupational schemes have a duty to consult the sponsoring employer on their Statement of Investment Principles, but there is no equivalent duty to consult with scheme beneficiaries.

31. Nevertheless, we are mindful that trustees' duties are to their whole membership. The Pensions Regulator's DC guidance makes clear that it is appropriate for trustees to carry out beneficiary surveys where the sample group self-selects. However a decision, on purely ethical grounds, to invest or divest in an asset on the basis of a low-response self-selecting member survey alone, would rarely be justified.

32. This reflects the Law Commission's conclusions on the point, following their comprehensive review between 2013 and 2014 which found that:

- Trustees are required to take account of financially material risks.
- But in cases where the concerns are not financially material – for example, they might be primarily ethical – trustees are only *permitted* to do so where they have *good reason to think that scheme members share the concern*.

33. The Law Commission also made clear that this need not be 100% agreement. Where a majority are opposed to (or favour) an investment while the rest remain neutral, that may be enough. But where a majority think that the investment or disinvestment should take place, whilst a minority disagree strongly, that would not be sufficient cause to act on the majority member view on purely ethical grounds.

34. As the Department said in the Interim Government response, a survey is one aspect of best practice to gauge member views to inform the design of investment strategies. However, other approaches are important to assess the likely views of member groups who are less engaged and less likely to respond to surveys but may nevertheless be opposed to a particular investment or divestment.

35. The Pensions Regulator advocate other supplementary approaches such as focus groups, forums and member panels. The important point is that these approaches should investigate the views of the broad swathe of the membership – not just the members with strong views who put themselves forward.

36. Finally, it is worth highlighting the Law Commission's view that survey evidence is not necessarily even required.

> In some cases trustees may be able to make assumptions: an example might be activities which contravene international conventions, such as manufacturing cluster bombs. The fact that these are banned by the Convention on Cluster Munitions, ratified by the UK, may give trustees reason to think that most people would consider them to be wrong. [3]

Q4. What work has the Department done so far arising out of the Task Force on Climate-related Financial Disclosures? Does the Government's statement that it will encourage companies to adopt the recommendations extend to pension schemes?

37. The Department is mindful of the Taskforce on Climate-related Financial Disclosure's (TCFD) recommendations that trustees might, on a voluntary basis, carry out their own climate-related disclosures. We are supportive of institutional investors choosing to carry out such disclosures.

38. However, an institutional investor's climate risks are the risks of its own holdings. Therefore by their very nature institutional investors including pension schemes are reliant on the adoption of TCFD by a broad cross-section of the listed firms in

[3] "Is it always about the money?" Pension trustees' duties when setting an investment strategy: Guidance from the Law Commission - https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/

which they invest, if they are to carry out the disclosures on the basis advocated by TCFD.

39. To remedy this, we see pension schemes, like other long-term institutional investors, as having an important role on the demand side of TCFD, by requesting disclosure of climate-related risks from the firms in which they invest. This is an area that the Department will seek to highlight in its engagement with pension schemes.

40. Trustees also have broader opportunities to wield significant influence on the demand side. A key aspect of maximising long-term member returns is through engagement with the firms in which schemes hold a significant stake.

41. That engagement should not be limited to voting at AGMs, but can take place throughout the reporting year. This will allow trustees to satisfy themselves that the risks and issues which act as an impediment to member returns, including but not limited to climate change, are being taken into account. Again, in line with the Law Commission's report last year, we propose to amend the relevant legislation to make this clear and the intention is to include proposals in this area in the upcoming consultation.

42. DWP works closely with the Department for Business, Energy and Industrial Strategy and HM Treasury on green finance policy, and will continue to do so in reviewing and responding to the Green Finance Taskforce recommendations, including those related to the TCFD recommendations.

Q5. The Committee has heard some evidence that the incentive structures for investment managers can focus on short-term gains over the long term interests of beneficiaries. What has the Department done to examine this issue in the context of the sustainability of investments?

43. Committee members will be aware that pension scheme members mostly pay charges on a broadly similar basis to other investors – namely through an *ad valorem*, or a percentage funds under management charge.

44. There is however another class of costs, termed transaction costs, which are typically incurred as a percentage of assets traded. There may be incentives to turnover assets here, and possible conflicts of interest, which the MIFID II directive has sought to address.

45. Both the Department and the FCA are taking action in this area. The FCA brought rules into force at the beginning of this year to require asset managers, for the first time, to disclose transaction costs to Defined Contribution pension scheme trustees and Independent Governance Committees. Defined Benefit scheme trustees will also have similar information under the MIFID II directive, and retail investors will have access to this data via the PRIIPs regulation.

46. Very high level data on this subject such as turnover rates, has historically been available via fund annual reports, but these new disclosure requirements will give institutional investors a standardised and complete insight into the cost implications of that churn. DWP will very shortly lay legislation to ensure that information is published and given to DC pension scheme members too.

47. Finally, we warmly endorse the progress made by the independent Institutional Disclosure Working Group established by the FCA, in developing templates to assist trustees in disaggregating and pinpointing those costs.

48. Returning to our opening theme, the Department does not seek to prescribe or advocate a particular investment approach. Whilst we have no wish to discourage trustees who choose to invest in high turnover funds where these are assessed as being appropriate, we believe it is important that trustees and members of those funds are informed.

49. In conclusion, given that pension scheme trustees are the ultimate long term investors, it will very often make sense for them to buy, hold and engage with the firms in which they invest. It will also very often make sense for them to invest in long-term green infrastructure. To assist with this, the Department is committed to removing barriers that evidence suggests might constrain trustees in appropriately considering and taking account of environmental, social and corporate governance factors, including climate change.

50. The Department will also continue to work closely with the Pensions Regulator and the FCA to take appropriate and co-ordinated action in this important area.