ShareAction»

By email to pensions.review@hmtreasury.gov.uk

25 September 2024

Pensions Investment Review: Call for Evidence

ShareAction is a UK registered charity that works to build a financial system that serves our planet and its people. ShareAction works to define the highest standards for responsible investment, mobilising investors to take action to improve labour standards, tackle climate change and the biodiversity crisis, and address pressing global health issues. We have strong relationships with financial regulators, government bodies, investors and asset owners such as pension funds, charities and universities with significant endowments. ShareAction was previously called Fair Pensions and we have been advocating for fiduciary duty reform and pensions reform generally for over 10 years.

We write in response to the Call for Evidence published on 4 September 2024. We are pleased to respond briefly to this Call for Evidence and would be delighted to discuss anything in this submission and the documents to which we refer.

We are not responding to the Call for Evidence survey; instead we are submitting this standalone document to the Pensions Review email address and we will also send this submission to officials at HM Treasury and the Department for Work and Pensions.

The pensions review process

1. We welcome the new government's decision to launch a pensions review, and we support the goals of boosting investment, increasing saver returns and seeking the benefits of consolidation.

2. We are concerned that Phase 1 is being rushed and that the main focus to date has been to seek industry views and support, to the potential detriment of a broader range of stakeholders including consumer groups, civil society organisations and other independent experts. Together with the Finance Innovation Lab and Make My Money Matter we have written to the Minister for Pensions to express our support for the pensions review whilst highlighting some of our concerns.[1]

3. We acknowledge that many of the points that we raise in this submission may be more relevant to Phase 2 of the pensions review. We look forward to engaging with HMT and DWP at this later stage, and in particular in discussions on fiduciary duty reform, a critical element in supporting sustainable returns for savers, boosting investment, and supporting responsible investment.

Climate change and green growth

4. We are concerned that the Terms of Reference for the pensions review does not mention responsible investment. UK pension funds hold over £3 trillion in assets and are major investors. Unfortunately, many pension funds are not only failing to adequately manage climate risks and

[1] https://shareaction.org/policies/responsible-investment-proposals-for-pensions-reform

other systemic risks such as biodiversity loss, but they are actively contributing to them through continued investment in fossil fuel expansion and deforestation. This near-sighted approach poses a real threat to the UK's future economic stability and UK savers' quality of life in retirement.

5. A recent report by the Office for Budget Responsibility identifies three key risks to the long-term fiscal outlook, one of which is climate change. The report states that these and other pressures would eventually put the public finances on an unsustainable path with debt potentially rising to over 300% of GDP. This rise in debt could be partly alleviated through the following actions: limiting the rise in global temperatures; improving the health of the population; and boosting the productive potential of the economy.[2] Enabling pension funds to appropriately take such factors into account in their investment decision-making would benefit pensions savers in the longer term and also help the UK to mitigate these risks.

6. The Terms of Reference for the pensions review does not mention green growth which is surprising at a time when the government is seeking to boost productive investment and growth. Research by the Energy and Climate Intelligence Unit and the CBI concluded that even under the Sunak government the net zero sector outperformed the economy generally:
    i. The UK's net zero economy grew 9% in 2023, in stark contrast to the 0.1% growth seen in the economy overall.
    ii. The net zero sector contributed £74 billion of gross value-added, and net zero businesses attracted £14 billion of foreign direct investment.
    iii. Jobs in the net zero economy are highly productive, generating £114,300 in economic activity. Net zero jobs are better paid by almost £10,000.[3]

Fiduciary duty reform

7. There is currently a fairly broad consensus that the current conception of fiduciary duty is not fit for purpose given current and future challenges, particularly climate change. Such concerns have been raised in submissions to the Work and Pensions Select Committee recent evidence session on fiduciary duty and at the DWP's first roundtable on fiduciary duty.

8. The Financial Markets Law Committee produced a helpful clarification of some aspects of the law in their report "Pension Fund Trustees and Fiduciary Duties – Decision-making in the context of Sustainability and the subject of Climate Change"[4]. However, such guidance does not provide legal certainty for pension trustees in relation to climate change and other sustainability issues. We understand that for legal reasons the FMLC's report cannot even be publicly endorsed by TPR and we are not aware of any plans to incorporate the full guidance from the FMLC report into the TPR Toolkit.

[2] https://obr.uk/docs/dlm_uploads/Fiscal-risks-and-sustainability-report-September-2024.pdf
[3] https://eciu.net/analysis/reports/2024/the-uks-net-zero-economy-2024
[4] https://fmlc.org/publications/paper-pension-fund-trustees-and-fiduciary-duties-decision-making-in-the-context-of-sustainability-and-the-subject-of-climate-change/

9. The FMLC report itself noted that current legislation and regulation does not address all the risk; that legal and investment analysis will continue to develop in the years to come; and that it is important that this happens.[5] Current and anticipated regulatory changes that will require an evolution in the fiduciary duty of pension trustees are:
    i. Labour has committed to introduce mandatory transition plans for UK pension schemes that align with the 1.5°C goal of the Paris Agreement.[6] This would be a significant change, requiring pension schemes to take much stronger action in relation to climate change.
    ii. TCFD and TNFD will bring increasing mandatory requirements. The UK government has formally endorsed the TCFD framework and has mandated TCFD-aligned disclosure for large entities. TNFD reporting is not currently mandatory but is expected to become mandatory in the future. Such disclosures may have repercussions for future investment decisions.
    iii. The DWP's Taskforce on Social Factors has published guidance and recommendations to help pension schemes trustees better understand and assess social factors in their investment decisions and stewardship. However, our understanding from pension trustees is that consideration of social factors remains challenging and is also perceived to be riskier under the current legal framework.

10. ShareAction favours a change in the law as the most effective means of definitively addressing the real and perceived legal obstacles to responsible investment. Other methods such as clarifications and guidance have been tried but have failed to bring about the degree of behavioural change needed. Fiduciary duty should be updated to integrate consideration of the impact of a scheme's investments alongside the existing duty to balance risk against return. Such changes in the law would provide absolute reassurance to a pension fund wanting to pursue responsible policies that it is permissible, indeed desirable, to do so. Our briefing paper "In All Our Best Interests – Reforming Fiduciary Duty for the 21st Century" sets out why policymakers should clarify and expand fiduciary duty.[7]

11. Elements of fiduciary duty are already on a statutory footing, in an abbreviated form, via Regulation 4 of the Occupational Pension Scheme (Investment) Regulations 2005 which refers to 'best interests' but does not define the term. We suggest amending Regulation 4 of the Occupational Pension Scheme (Investment) Regulations 2005 to introduce a definition of 'best interests' as meaning to act in a way that has regard to the following four factors:
    i. The likely consequences of any investment activities in the long term;
    ii. The impact of any investment activities on the financial system, the economy, communities and the environment;
    iii. Environmental, social and governance risks and opportunities (including, but not limited to, climate change); and
    iv. The views of beneficiaries.

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[5] https://fmlc.org/wp-content/uploads/2024/02/Paper-Pension-Fund-Trustees-and-Fiduciary-Duties-Decision-making-in-the-context-of-Sustainability-and-the-subject-of-Climate-Change-6-February-2024.pdf paragraphs 6.3 and 11.9

[6] https://labour.org.uk/change/make-britain-a-clean-energy-superpower/
"Labour will make the UK the green finance capital of the world, mandating UK-regulated financial institutions – including banks, asset managers, pension funds, and insurers – and FTSE 100 companies to develop and implement credible transition plans that align with the 1.5°C goal of the Paris Agreement"

[7] https://shareaction.org/policies/in-all-our-best-interests-reforming-fiduciary-duty-for-the-21st-century

12. There is much confusion about the extent to which fiduciary investors, particularly those providing pensions, should engage with their beneficiaries and ascertain their views. ShareAction's Responsible Investment Bill sets out our suggested approach to this, setting out clear duties for fiduciary investors to understand their beneficiaries' views whilst upholding the principle that fiduciary investors retain full discretion on whether or not to act on these views.[8]

Wider pensions reform

13. We are pleased that pensions reform is now a political priority. It is crucial that pensions reform ensures that all citizens can look forward to adequate pensions throughout retirement, and that pension fund investments help us to achieve a just transition to a truly sustainable and productive economy.

14. In collaboration with other civil society organisations we have produced a joint briefing which sets out pensions reforms that would deliver on these interlocking objectives, including:
    i. Boost pension savings and the state pension to ensure adequate retirement incomes for all and support a fairer, stronger economy.
    ii. Make pension funds longer-term investors.
    iii. Support pension funds to drive green investment in the UK.
    iv. Green the system and phase out fossil fuel investment.
    v. Enhance transparency and accountability.[9]

15. Together with a number of other signatories, ShareAction has recently written to HM Treasury urging ministers to expedite plans to regulate all activities of investment consultants. Investment consultants play a key role in determining the investment strategies of pension schemes, but the industry has faced criticism for issues including lack of consideration of ESG issues; using economic models that underestimate the risks of climate change; and giving standardised advice rather than thinking through what was best for the individual pension fund.[10]

Consolidation

16. In principle, ShareAction is in favour of consolidation given the potential for better investment decision-making and higher returns, and we welcome the general trend towards consolidation where this is in the interests of members and leads to improved outcomes for members.

17. However, scale does not always result in high quality schemes and small schemes do not always result in poor value for members. As noted by the PLSA in a previous call for evidence: "There are smaller schemes that are well run and provide good value for money for members ….. Conversely, there are larger schemes which suffer from instances of poorer governance or homogenised, largely mainstream, investments."[11]

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[8] https://shareaction.org/policies/responsible-investment-bill-the-change-we-need
[9] https://shareaction.org/policies/better-pensions-for-all-proposals-for-reform
[10] https://shareaction.org/policies/hm-treasury-should-expedite-the-regulation-of-investment-consultants
[11] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2021/Future-of-the-DC-Pension-Market-The-case-for-greater-consolidation-Jul-21.pdf

18. TPR's recent research has shown that bigger schemes do not necessarily mean better compliance with their ESG duties, in particular for pooled funds: "Where schemes are invested in pooled funds, a number of trustees highlighted they had limited ability to influence underlying managers on decisions related to ESG."[12]

19. It will be important to ensure that there is broad acceptance and support for consolidation, not just from the pensions industry but from employers, trade unions and, most importantly, employees.

20. One way to help reduce risks and ensure that consolidation focuses on delivering tangible benefits to pension savers would be to ensure that the resulting larger consolidated funds are run on a not-for profit basis, focused on the interests of their members.

Costs vs value

21. In relation to government interventions designed to encourage pension schemes to seek a wider range of asset classes we would like to see more detail on the specific proposals and the impact assessments for any proposed changes.

22. In such a context it is clearly vital to look at risks and returns in addition to costs and value. For example, although the returns from private equity may be higher from particular funds, the risks tend to be significantly higher than for other asset classes and the management fees are much higher (e.g. 2% management fees payable to PE firms, plus additional due diligence costs etc., versus 0.15% OCF payable to Vanguard for a tracker fund).

23. The key financial factor when comparing different asset classes is the risk-adjusted net returns. However, in accordance with the guidance in the recent FMLC report on fiduciary duty there should be consideration of both "numbers and narrative", where the narrative may include a risk expressed in words.

Investing in the UK

24. In principle, ShareAction is in favour of encouraging investment in the UK and of enabling pension schemes to invest in the UK. This should help drive UK growth and is usually popular with pension scheme members, for example where LGPS invest in local initiatives that boost the local economy.

25. Asset allocation and the drivers of asset allocation changes are complex, and the government will need to consider these carefully if it is to successfully promote pension scheme investment in UK assets. A recent report by PPI comments that "mapping the assets of the UK pension sector is like trying to nail 20 jellies to a wall"[13].

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[12] https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/market-oversight-esg

[13] https://www.pensionspolicyinstitute.org.uk/media/c00dra0k/20240909-ppi-pension-scheme-assets-main-report-final.pdf

26. Relative financial performance has been a key factor causing UK pension schemes to invest outside the UK. In recent years, returns from UK stock markets have been lower than in the US and the EU. More money is therefore being invested into US stocks (for example, the "Magnificent Seven") than into UK equities.

27. One of the problems for pension funds is identifying good investment prospects in the UK. Helpfully, the Pensions and Lifetime Savings Association has recently produced a report entitled "Pensions and growth: creating a pipeline of investable UK opportunities". The report notes that mobilising pension fund investment into UK productive finance has the potential to result in significant, tangible, real-world benefits for society. Key projects include green projects such as investment in wind and solar, and scaling up the market for heat pumps and electric vehicles. The paper also includes proposals for government policies such as planning reform which will help make these assets more investable.[14]

28. Place-based impact investing or local impact investing could also be encouraged. Place-based impact investing has been defined as "Investments made with the intention to yield appropriate risk-adjusted financial returns as well as positive local impact, with a focus on addressing the needs of specific places to enhance local economic resilience, prosperity and sustainable development."[15] An example of this is the Greater Manchester Pension Fund which has achieved good financial returns from backing projects which also had positive employment, social and physical fabric impacts.

29. If the government were to pursue policies that would make UK investments more attractive in the short-, medium- and long-term this should enable higher levels of investment, including by UK pension schemes.

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[14] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2024/Pensions-and-Growth-Report-PLSA-2024.pdf
[15] https://www.impactinvest.org.uk/learning-hub/place-based-impact-investing/what-is-place-based-impact-investing/