HOUSE OF COMMONS

Work and Pensions Committee

Oral evidence: Fiduciary duties, HC 486

Wednesday 21 February 2024

Ordered by the House of Commons to be published on 21 February 2024.

Watch the meeting

Members present: Sir Stephen Timms (Chair); Debbie Abrahams; Siobhan Baillie; Selaine Saxby; Sir Desmond Swayne.

Questions 1 - 46

Witnesses

I: Lewis Johnston, Director of Policy, ShareAction; Tony Burdon, CEO, Make My Money Matter; Charlotte O'Leary, CEO, Pensions for Purpose; and James Alexander, Chief Executive, UK Sustainable Investment and Finance Association.

II: Carol Young, Chief Executive, Universities Superannuation Scheme; Nigel Peaple, Director of Policy and Advocacy, Pensions and Lifetime Savings Association; Rachel Croft, Council Member, Association of Professional Pension Trustees; and Debbie Webb, Chair of the Pensions Board, Institute and Faculty of Actuaries.

Written evidence from witnesses:

FYD0001 Make My Money Matter

FYD0004 Share Action

FYD0005 Pension and Lifetime Savings Association

FYD0008 Pensions for Purpose

FYD0009 Association of Professional Pension Trustees

FYD00011 UK Sustainable Investment and Finance Association

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Examination of witnesses

Witnesses: Lewis Johnston, Tony Burdon, Charlotte O'Leary and James Alexander.

Q1 **Chair:** Welcome, everybody, to the Work and Pensions Select Committee for a one-off evidence session on the topic of fiduciary duties. A very warm welcome to our first panel. Thank you all for being here. Can I ask each of you to tell us very briefly who you are?

Lewis Johnston: My name is Lewis Johnston. I am Director of Policy at ShareAction. We are an organisation that works to make sure that the financial system works for everyone, and for people and planet.

Tony Burdon: I am Tony Burdon. I am the CEO of Make My Money Matter. We are a campaign that engages people and organisations with their money, including pensions, and tries to drive those investments into more sustainable approaches.

Charlotte O'Leary: My name is Charlotte O'Leary. I am the CEO at Pensions for Purpose. We are a profit-for-purpose organisation—a B corporation—that works with all actors in the investment chain, from pension funds all the way through to asset managers. This particular topic is very close to our hearts and something we see with a number of our members.

James Alexander: I am James Alexander, the Chief Executive of the UK Sustainable Investment and Finance Association, known as UKSIF. We are the membership network for sustainable finance in the UK and our members include banks, pension funds, asset managers, data providers and others involved in the investment industry. We have 320 members and they manage £19 trillion of assets.

Q2 **Chair:** Thank you all for being with us. Let me put the first question to you. Can each of you tell us what evidence you think there is that pension trustees' fiduciary duties are problematic for addressing climate change in their investment decisions, what you think should be done about it, and what the consequences will be if nothing is done?

Lewis Johnston: As I said, we at ShareAction are committed to ensuring that the financial system works for people in all the ways that matter to them. Financial return is obviously a key part of that, but other impacts are too, including climate change but also wider social factors.

Pensions are such a crucial part of the investment system, precisely because they are the point at which most people are connected to the financial system—to the capital markets. I guess you can think of there being three ways in which pension investments operate. They enable commercial activities and projects, they obtain a return from those commercial activities and projects to pay a retirement income to their members, and they also have an impact on their members' interests through the impacts of the activities that they finance.

The problem is that at the moment fiduciary duty is framed in such a way that trustees are unable to take a full account of the impacts on their members of some of the activities that they invest in. We are emphatic that the centre point of all of this has to be the member of a pension scheme—it is their interests that trustees are there to serve—and the way that the law is currently framed prevents trustees from fully exercising that duty.

Q3 **Chair:** Can I press you on that? Do you think it is the law itself, or is it the understanding of the law that is the problem?

Lewis Johnston: I think it is both, but ultimately I think it is the law itself. It is framed almost as an outside-in approach, whereby the scheme trustees assess return and risk, and balance them in terms of the impact of the outside world on the returns of the scheme. What it disregards is the agency and role of the scheme in shaping the effects and impacts in the real world. I think that is a really important distinction. I certainly think that there needs to be a change in the law in that respect.

I have explained how we see the problem. The evidence for that is manifold, but one of the most convincing elements is the fact that pension schemes are reflective of the wider economy, and the wider economy is not aligned with or consistent with a Paris-aligned approach and a net zero transition at the moment. There is a passivity built into the system of pension scheme investments. Rather than pension schemes actively working to shape the world into which their members will retire, they are passively almost buffeted by the wider financial system and the economy in which they are investing.

If you were to see a change in the law so that pension trustees were required to co-manage risk, return and impacts, that would enable them to take a much more comprehensive view of how what they do and their investment strategies impact on their members and, ultimately, really empower them to act in the best interests of those members.

Tony Burdon: Our view is that we currently have a pension system whose investments are destroying the very retirement of people who are saving into those schemes. Today, we launched our 2024 "Climate Action Report". It ranks the top 20 defined-contribution workplace pension providers against a range of climate actions. I will briefly show our table that ranks them.

All these pension funds, from Aviva to The People's Pension, have made net zero commitments, and you will see a range of measures. What I want to draw your attention to is that on fossil fuels and deforestation, almost all the providers get red marks. We are seeing that all of our schemes are investing in oil and gas companies that are planning expansion, which will break any chance of achieving the limiting of global warming to 1.5°.

I will say a little bit more about temperature rises and the potential impacts, because that will affect returns in the future and the wellbeing of pensioners in the future. Take food production. At 1.5° of global warming, we are already seeing reductions in crop production across the world. At 2°C, maize, for instance, has a 50% chance of a global crop failure. At 3° we get ecosystem collapse. We are going to see some massive shocks on the global economy and the investments of pension savers, and that is not including the effect of tipping points, where you get compounding impacts coming together. This is extremely worrying.

When you have a set of scenarios like that, with temperature rises, and you couple that with trustee capacity and risk aversion, and climate risk advice that we have seen evidence of—Carbon Tracker and others have exposed this; investment consultants such as Aon, Mercer and Hymans Robertson are advising trustees that the future impacts of these temperature rises are marginal on GDP and therefore marginal on future returns—we have a context where trustees are not properly taking into account future impacts. They are investing more in the short term and that is undermining the future of pension savers. That mix of trustee capability, understanding of climate impacts, and poor advice from some investment consultants is compounding very serious risks to the future of the younger generation and their savings.

Charlotte O'Leary: I will give you some practical examples based on our work with pension funds, asset managers and consultants. On fiduciary duty, we think it is permissive, but permissive does not mean that it is working. We see a number of pension schemes, usually those that are very well resourced and have good governance structures and budget resource, being able to take advantage and do a lot more on the systemic risks and opportunities—and I will emphasise opportunities.

Q4 **Chair:** Can I pick you up on that just to make sure that I have understood your position correctly? I think you are saying that you think that the law as it stands is okay, but it is the way that people are understanding and interpreting it that needs to—

Charlotte O'Leary: The interpretation is leading to problems. Such a wide disparity between those that are investing in line with what we are trying to achieve from a climate change perspective and those that are not considering at all means that there is something fundamentally wrong in either the interpretation—I am not coming from a legal background—or the law itself.

Our view is that it is the interpretation, based on the training that we give to trustees, but it is also capacity. I think you are all aware of the FMLC report that came out. One of the key things in that is that pension funds are actors in a system—they are not divorced from it; they cannot make separate decisions—and at the moment, they are being put at odds with what the system is trying to achieve.

One thing that we have suggested is guidance for trustees to aid them in their decision making, but also an understanding that they rely heavily on their advisers, who are themselves companies, and they also invest in companies and their sponsors are companies. One of the things that I have suggested as a consideration is changes to the Companies Act to align what we are trying to get trustees to do with what companies are doing. There is the Better Business Act campaign, which is about changing section 172 to align company director responsibilities so they are not about short-term profit maximisation.

So we are suggesting two clear things: guidance for trustees, which we think needs to come from TPR, and changes to the Companies Act.

James Alexander: The liabilities of pension funds now extend an extremely long way into the future—many of members have liabilities running past 2100—and that long-term thinking is one of the key challenges that pension funds need to grapple with. We deal with a lot of pension funds and their trustees. Being a pension fund trustee is an extremely difficult job. The range of different pieces that need to be considered is enormous. The regulation that they have to comply with is substantial, much of it for good reason. As a result, pension fund trustees often take advice on how to best discharge their duties as trustees.

That is where one of the challenges lies: inconsistent interpretation of fiduciary duties by trustees, often because of the investment advice that they receive on how to interpret fiduciary duties. Some take a strong view that only financial factors in their purest sense should be considered, and they are often short-term financial factors. Others take a different approach, which would be more aligned with considering the long-term sustainability and climate impacts of investments as well as other things.

That is where we want to see more clarity and clarification of fiduciary duties in the context of considering the wider economy and the system that the pension fund is operating in. By its very nature, a pension fund is not divorced from the economy; it is a part of the economy, and what happens to the economy has a massive impact on it and its future success. In that context, we think pension funds and their trustees need to think about fiduciary duties in the way that they are currently drafted, but interpret them in a way that suggests that many more factors are financial factors than are frequently considered.

The Financial Markets Law Committee report that Charlotte mentioned does an extremely good job of highlighting how that committee’s expert opinions suggest that there is an extremely strong case for climate change and many other sustainability factors to be considered as financial factors. We now want to see the FMLC report taken on by the Pensions Regulator and codified into guidance for trustees. We think this Committee could do a nice job by writing to the Pensions Regulator to ask it to look at that.

Q5 **Selaine Saxby:** Good morning. In 2021, the Government introduced mandatory climate-related reporting for pension schemes. One of the aims was to encourage trustees to think more thoroughly about the risks and opportunities of a transition to a low-carbon economy. How effective do you think this reporting has been?

James Alexander: It is great that that reporting is there. It is so important that we have this reporting across the landscape. We want to see it move more into the corporate space, so that corporates are reporting, allowing pension fund trustees to get the full range of information and data that they need to make decisions.

I think that reporting is having a positive impact, but as Tony and others have highlighted, there is still quite a way to go before all those factors are taken into account as thoroughly as they should be, and it still does not necessarily change the interpretation of fiduciary duties around what parts of that reporting to include and consider as part of an investment decision.

Charlotte O'Leary: We put out market research on TCFD reporting from last year. It was debated in the House of Lords by Baroness Ros Altmann. We demonstrated that although transparency and disclosures are important, the action as a result of that is minimal. A lot of that is because of a lack of data or improper or incomplete advice. Therefore, while it has raised it on the agenda, it is not leading to sufficient action.

Tony Burdon: I agree. It is vital that we have that data. This is a disclosures framework. We use that data in assessing the performance of schemes, but it is not really leading to trustees driving action to tackle climate risk in a serious way.

Q6 **Selaine Saxby:** That leads to my follow-on question—I will come to you, Tony, and then Lewis. How has it—or has it?—changed trustees' investment decision making or how they invest?

Tony Burdon: I don't think it has. There is still serious risk aversion, lack of understanding and the weighting of short term versus long term, as James described. But it is early years yet. These reports have only been out for a couple of years, so there is more to do. But it is just not enough—it is not driving real change.

Lewis Johnston: I just want to reinforce a point. We have been supportive of disclosure regimes and the implementation of TCFD for a long time, but ultimately we are not going to disclose our way to net zero. Your follow-up question about the real-world outcome of this is really pertinent. Ultimately, we are still not seeing that alignment. As I said, there is this reflection of the wider economy that is not aligned with a net zero transition.

There is also the issue that, in the intervening three years, a lot of the climate models on which certain assumptions are based have been shown

to be deficient. Research by Carbon Tracker and the Institute and Faculty of Actuaries showed some of those deficiencies. That is also important.

Finally, while guidance and clarification and requirements to disclose and so on are all worthwhile, ultimately what it will come down to and what trustees and their advisers are going to look to is what their fiduciary duties require them to do in law. At the moment, that does not integrate impacts. That is why we need to see that legal change. There is a lot to build on in the FMLC report—it is an incredibly nuanced and thoughtful document—but it is important to understand what its remit was. It was not to provide legal advice or guidance. Ultimately, that needs to be enshrined elsewhere.

Q7 **Sir Desmond Swayne:** I am after your principal concerns about the way that fiduciary duties are being interpreted. We have already covered some of this ground. James, you have referred to the timescale not being sufficiently cognisant of the breadth of time over which some investments will have an impact and, Tony, you have given some scenarios in which trustees are not sufficiently cognisant of the impact of their investments. Does anyone have any other concerns or want to add to those? Are the timeframes the issue? Is it that a particular investment is not considered in the breadth in which it should be?

Charlotte O'Leary: One of the other things we need to consider is the DEI component of trustees. Trustees are there to honour the benefits of all of their members—youngest and oldest—and it is within that context that systemic risks and opportunities like climate change need to be viewed. We have found that when you couch it in those terms, that you have the same obligation to your oldest member as to your youngest member, it becomes a very different mindset.

The timeframe point is not just about the timeframe of the investment; it is the timeframe in relation to the cohort you represent. That then becomes about more than just investments. Remember that investment returns are just one dimension. Contributions are a massive factor here. We are focused on climate change, but one of the biggest risks we face for pensions is a lack of contributions.

At the moment, we have staggering gaps, particularly around gender. The Government itself has issued reports showing that the gender pension gap in defined-contribution pension schemes is an eyewatering 60%. In thinking about fiduciary duty, many things are not being addressed here, and I do think that it is worth pointing that out. The FMLC report did not get to the point about contributions.

Tony Burdon: I very much agree. The Committee has looked at this as this as well. We have that double whammy of millions of British people not saving enough and looking forward to a very bleak retirement. When you compound that with the impact of the climate crisis on pensions and returns, and on their wellbeing, it is a pretty appalling prospect for millions of British people.

I think there is a serious risk that many trustees are failing in their fiduciary duty and potentially subject to legal challenge. That is because they are weighting current pensioners more highly than pensioners in the future. As James said, many will look to retirement in 2100. What does that world look like? Currently, we are on track to see 2.5° more warming by 2100. As you said, Sir Desmond, I highlighted some of those impacts. It is an appalling scenario. Yet our trustees might be weighting oil and gas investments as good for their schemes because of current high returns, ignoring the damage that expansion of those industries will cause to our planet, exacerbating the climate crisis for those future pensioners when they retire in 2100. I see that as a serious failure of trustees.

That is why the FMLC paper quite clearly states that trustees should consider rejecting short-term gains because they create long-term risks to the fund. With the risk aversion of trustees compounded by risk-averse investment consultants and pension lawyers, we get a structure where trustees are not stepping up. That is why we need very clear guidance. The FMLC paper should be translated into clearer language, a bit more directive to trustees, so that they have confidence that they are operating legally in making these decisions.

Q8 **Sir Desmond Swayne:** The Association of Pension Lawyers, if I can paraphrase what they have said, say, "Actually, the fiduciary duties are perfectly clear. The complexity arises when we try to shoehorn quite different objectives, like climate change, into them." Are we agreed, at least, that the principal fiduciary duty is the financial welfare of the members of the fund? Where will it be legitimate to compromise that by introducing climate change? For example, would it be possible to set aside concerns about climate change because of the financial interests of the members of the fund?

Lewis Johnston: This is a really important point. One should not misunderstand the argument that we are putting forward. The primary role of a scheme is to serve the interests of its members, and we are not for one moment saying that they should be subordinated to any other agenda, whether a climate agenda or a social agenda or anything like that. The primary purpose of a pension is to deliver an income in retirement. What we are saying is that at the moment the way that fiduciary duty is framed does not allow trustees to properly serve those interests because of the myopic way in which everything has to be considered in terms of the financial impact on the scheme. By integrating the impacts of a scheme on those wider factors, you are empowering trustees to properly understand in a more comprehensive way whether their strategy is in the best interests of those members.

To your second point—when you really come down to it, should there be this trade-off?—I think it is a bit of a false dichotomy, because trustees are already expected to manage and balance lots of different aspects. You would not have a strategy that just went for the highest return

irrespective of any other risks. We are saying that by integrating impacts alongside return and risk, you allow for a much better outcome and you do a service to the beneficiaries now and in the future. It addresses the time-horizon point that Tony made as well.

Charlotte O'Leary: I come back to my initial point, which is that you cannot ask something of pension fund trustees that the rest of the financial system is not required to do. If the Companies Act states that company directors can pursue short-term maximisation of profit, you cannot expect pension funds to be considering something other than that. The system has to be aligned. If you are asking pension fund trustees to consider long-term systemic risks and opportunities, it must be right that asset managers, investment consultants and legal advisers must be doing the same. How on earth can you have a system that is entirely out of line?

James Alexander: Thank you for the question. I think fiduciary duties are well established in the context, as Lewis said, of looking into the financial factors. The difficulty or difference of opinion emerges—and this is where there is a considerable challenge that we are all talking about today: the way that this is interpreted—in how people define what is and is not a financial factor, with specific relation to the timeframe over which an investment is made. Obviously, as we have all said, a pension fund is a very long-term investment proposition. The other factor is the definition of climate, sustainability and other system-wide challenges as financial components in fiduciary duties.

The problem is not necessarily with fiduciary duties per se; it is with how they are being interpreted across the board. That is why we think that the FMLC paper should become guidance to trustees. Let's see how that beds in. We think it will make for a very substantial aligning of the range of understandings and do a strong job of clarifying what fiduciary duty is all about.

Tony Burdon: It is a really pertinent question. Climate change is not the objective; the objective for trustees is their members' best interests. As the FMLC paper says, climate risk is financially material, so it has to be considered. If I can reinforce the issues around temperature rises, they are catastrophically financially material, and that is why it is so important that they are considered.

Q9 **Sir Desmond Swayne:** The Financial Markets Law Committee set out to provide "a general explanation of the legal positions and the uncertainties and difficulties" facing fiduciary duty. Did they succeed? What is left unresolved, aside from what you said, Charlotte, about never having got to contributions?

Lewis Johnston: First, you explained the remit very well. In terms of that remit, they have certainly delivered. It is a really thoughtful and nuanced document. The question is whether it will achieve what we need to achieve in terms of empowering trustees and giving them the

confidence to integrate some of these factors that they currently feel unable to integrate.

We have seen this kind of guidance before, for example in 2014 and 2017 from the Law Commission. I emphasise that the FMLC report was not there to provide guidance or legal advice. It was there to clarify the difficulties and questions that arise, and it did that very well. We are still left in a position where trustees need the confidence given to them, through a redefinition of the best interests of their beneficiaries in the law, to allow them to take this into account.

We have seen over the last 10 years that guidance has not worked; it hasn't been able to do that. You can change the law in a way that preserves that core duty to act in the financial interests of beneficiaries, preserves the discretion and keeps the core principles of prudence and loyalty, but integrates the point about the impact of the scheme and does not treat pension investments as a kind of passive actor, bobbing along in the wider economy but takes account of their role in shaping that world and economy.

Q10 **Sir Desmond Swayne:** Are you suggesting that we should take this output from the committee—this clarity—and putting it on a statutory basis, given the Herculean task that that would involve, given all the case law that is already there, the common law and the statutory provisions that already exist? It would be a non-trivial undertaking, but is that your view?

Lewis Johnston: It is certainly the view of ShareAction that that should be enshrined in legislation. I do not agree that it would be a Herculean undertaking. As I say, the changes that we propose are not a complete, revolutionary overhaul of those fiduciary duties; they preserve those core elements that we have just been describing. We actually have a responsible investment Bill, where we have set out exactly how that would be achieved. I think it could be achieved in a relatively straightforward and really prudent and cautious way. But ultimately, yes, that is certainly what we would advocate.

Q11 **Sir Desmond Swayne:** Is that a general view?

Tony Burdon: Our view is that it is an excellent piece of work but it is a lawyerly piece of work. If you want to do something, you ask a lawyer for advice and they give you six pages of text, and you are not quite sure what you can do. The Pensions Regulator and the DWP need to translate it immediately—this is an urgent issue—into clearer guidance for trustees. That will give them the confidence to make the right kinds of decisions without fear of legal challenge. We have to expedite this. In the longer term, legal change might be necessary, but we need to move to immediate guidance. They have given a fantastic basis for doing so and we should expedite this.

James Alexander: I agree with Tony. This is a great document. It is a really good piece of work. The very first page makes it clear that this is not advice; this is the view of the Financial Markets Law Committee on fiduciary duties right now. So could a trustee rely on it in court if necessary? Could a trustee use it to go back to their advisers and say, "Hang on. We've got this document. How do you work with that?"

Exactly to Tony's point, we want to see this interpreted by the Pensions Regulator and turned into guidance for trustees, and to see how that beds in. At that point, we will have a clearer understanding of whether this is sufficient to provide the guidance necessary or whether there is still a range of various interpretations of fiduciary duties across the pension fund industry, and whether there might after that be a need to consider whether the law is drafted appropriately.

Q12 **Siobhan Baillie:** I was going to ask quite a straight question about whether the legal definition of fiduciary duties needed to be changed, but we have gone around that quite a few times. My understanding is that James, Charlotte and Tony are talking about interpretation, guidance and the Companies Act point—I saw that—but ShareAction is in a different place and would ask for a legal change now. Is that about right?

Charlotte O'Leary: Yes. Can I just add something? The FMLC paper is really important, but I would highlight that the footnotes are almost as important as the main text. I encourage everybody to look at them—particularly footnote 38—because they refer to things like double materiality, impact and universal ownership. That is particularly important because not all investment consultants and advisers provide that advice, so we are making a massive assumption about what is happening in the marketplace.

The other thing is that it does not point out the nuance between defined-benefit schemes and defined-contribution schemes. The reason why we need guidance now is that we have plenty of mature defined-benefit schemes going to buy-out without asking these crucial questions about sustainability. That is very concerning. We need more nuance in guidance that needs to come from TPR on sustainability in relation to different types of schemes and where they are in terms of their maturity.

Lewis Johnston: I certainly would not overstate the difference. It is perhaps a difference of emphasis. You have all alluded to the fact that there may need to be a change in the law. We would also welcome additional guidance to enshrine and provide additional clarity on some of these principles. Again, though, that has been tried before and it ultimately has not worked. That is not to say there is not scope for additional clarification, but, ultimately, the amendment of the definition of best interests in the law on fiduciary duty would empower trustees to take this much wider view and give them the confidence that Tony has already alluded to as being absolutely crucial.

Q13 **Debbie Abrahams:** Good morning, everyone. I want to spend a few

minutes to understand the economic models that investment consultants use to advise trustees. I have experience of economic models but from a health perspective. First, could you explain a little bit more about the types of models that are used and what you believe are the issues within them? Who would like to kick off?

James Alexander: It seems everyone is looking at me. At a basic level—you will have to ask the investment consultants for more details about the models that they use—the industry exists to provide advice to trustees, and there is rightly an awful lot of advice that trustees need to take, because of the weight of responsibility that they have for the financial health in retirement of millions of people. It is an enormous responsibility and it is right that they take guidance.

One of the challenges is when different models are used. We know that some models say that portfolios will have only a minimal impact if the world warms by 4° and other things that are demonstrably untrue. But more in the mainstream, there is a challenge to trustees: they spend a lot of money taking guidance, but if they choose not to follow the guidance from their consultants, where does the liability sit for any problems that arise as a result? If something goes wrong and the pension fund trustees can argue that they took the best possible guidance, they followed that guidance and still something went wrong, well that's life; things don't go to plan. If the pension fund trustees take guidance but choose not to follow that guidance, for whatever reason, and then something goes wrong, you have of course much more serious questions to ask of those trustees.

Given the range of different things that trustees need to consider, the inherent underlying human response is to take the guidance even if you are not fully on board with it or even if you think it does not fully incorporate all the factors and components that you think it should include. You can ask lots of questions, of course, but you still feel somehow compelled to take that guidance.

One challenge here is that a small number of investment consultant firms provide an enormous range of advice and have, therefore, huge power in the industry. Some think of the industry as a pyramid with the pension funds at the top because they hold the assets and then they appoint asset managers to manage them, but one might argue that above the pension fund trustees are the consultants, and that with the power that they hold over decision making, with the interpretation that they take on a range of factors, including fiduciary duties, the long-term nature of pensions and the economic impacts and models of future changes in the environment or other factors, they have huge power in the system.

I think there is a reasonable question to ask, which the Committee might wish to ask the FCA and the Government: given the outsized power that these consulting firms have, how are they regulated and what approach do the FCA and others take to ensure that that advice follows some core regulatory principles?

Tony Burdon: I very much agree with that. Others in the next panel will probably know more detail about the design of those models, but having done a bit of economic modelling in the past myself, economists try to make assumptions that simplify things to allow some sort of calculation and you end up with a number. Clearly, the advice given to trustees has been completely erroneous. Trustees end up in a position where they cannot disagree with it because they are worried about the threat of legal action. That is extremely problematic.

My understanding is that those models do not take into account flooding. Do we think climate change is going to drive flooding across the globe? I think we know that. The impacts on food production across the world are not taken into account. These are economic models. They have not consulted climate scientists with a specialism in understanding these changes. They are really problematic.

I welcome—and you will hear from USS later—the approach to looking at more qualitative descriptions of what may happen that can then guide trustees. The FMLC paper gives permission for trustees to consider that kind of approach in their decision making. But you have—the Competition and Markets Authority looked at these companies in the past—a very closed group of companies, as James said, with a lot of power and a lot of influence, and you have low-capacity trustees who take their advice. I think there is a need to revisit with the FCA regulating them.

Charlotte O'Leary: I will not go into the specifics of the economic models, but there definitely are issues with the scenario analysis that is being used. Some of that is to do with the types of inputs going in, whether they use implied temperature metrics or science-based targets. There is not necessarily consensus around that, which is why USS went to the University of Exeter to look at what should go into those models.

Even where we have got to now is not an end state. This is still ongoing. We still do not have full scope 3 emissions. We are still not covering the full picture and so that will evolve. I have some empathy with the investment consultants in terms of what they are trying to achieve, but the investment consultants themselves set up a sustainability working group that they run and manage, which in and of itself is problematic. Who has independent oversight of that?

That is one reason we decided to look at fiduciary managers and investment consultants—please have a look at the link in our written response. We demonstrated in that that the discrepancy between those who give integrated advice on ESG and impact and those who do not is quite wide. That cannot be the case when pension fund trustees come to rely on it, so I think something needs to be looked at. That is why I have pushed for the Companies Act change—because that applies to the whole chain.

Lewis Johnston: It is a really important question. I mentioned the deficiencies in the climate scenario models earlier. Our written evidence

details a little bit of that and points towards the research, but the fundamental problem often is that it prioritises or privileges a quantitative approach over a qualitative analysis. That boils down to prioritising what can be measured, however imperfectly or uncertainly, over measuring what should be prioritised.

The FMLC report was really positive in this regard, in terms of advocating a numbers-and-narrative approach. There is a lot to be said for that. It is a wider issue, though, than just the climate models, which touches on the role of investment consultants in the system. There is almost a risk aversion-cubed built into how the pension investment system works. It is right that they are prudent—we are talking about people's retirement income here—but it is not in members' interests to be excessively risk averse. The redefinition of the best interests of beneficiaries to take account of the wider impacts would free them up to take a wider, more nuanced and comprehensive view of how their investment strategy is actually serving those beneficiaries.

Debbie Abrahams: That was helpful, thank you. I am staggered that it is a question of either qualitative or quantitative evidence and both are not used, but from what you are saying, there are issues in the design and the oversight of these models and the validation and so on, but also in trustees' capacity to question them and their validity. Thank you very much.

Q14 **Chair:** It seems a strange situation—if it is the case—that schemes work on the basis on economic models that suggest that a 4° increase in global temperature is modest, whereas the scientists tell us it is beyond catastrophic. How has such a divergence of views arisen?

Tony Burdon: I understand—you will perhaps hear from the next panel in more depth—that the economic model is flawed. Its assumptions, looking at the impact on global GDP at 1.5°, 2°, 3° and 4°, is deeply flawed. I might be entirely wrong, but I think one assumption is that the productive economy takes place within buildings, so it does not take into account flooding, droughts or mass migration. One real risk is that millions of people will not be able to live where they live now because the mix of heat and humidity—the wet-bulb temperature—will kill people. It does not take into account the mass migration that will be driven by extreme climate change. It is just so flawed.

This was discovered through freedom of information requests to pension schemes to find out that this advice is being given. It is absolutely stunning. It is an absolute travesty. It is wonderful that it has been spotted and that we have schemes like USS working with a university to look at other approaches. The modelling needs to get a lot better.

It also worries me that we have net zero frameworks that schemes are using, such as the Net Zero Asset Owners Alliance and the IIGCC—we have agreed global frameworks—but are those good enough? Are those

based on some of these erroneous economic modelling scenarios? It is quite shocking that that has happened.

Charlotte O'Leary: One of the things that we need to take into account here is that we are using traditional economic models and traditional modern portfolio theory, and a lot of those things are being reviewed and looked at in a completely different context. You just need to look at Kate Raworth's "Doughnut Economics" or at "Moving Beyond Modern Portfolio Theory". The difficulty is that it is not well socialised. It is held usually at an academic level, but it is not popularised among the investment community. Why is that? I know I keep banging on about it, but it is because if companies—and all of the actors we are talking about are companies—are focused on short-term profit maximisation, what is the incentive to change structural models that they are using? It comes down to who plays the honest broker in this situation.

James Alexander: Building on those things, the other component is the position of a pension fund in the economy. As I said earlier, the pension fund cannot insulate itself from what happens to the economy. It cannot move its investments around in such a way that what happens in the economic does not have a material effect on the pension fund itself. A core part of the pension fund's consideration must be what happens in the wider economy and, therefore, must be the pension fund potentially trying to look at its role in understanding what might happen in the wider economy and potentially trying to influence that, too.

Q15 **Chair:** Lewis, you have been the clearest in calling for a change in the law. I think the change you want is that schemes should take into account the impact of investments. Did you say that you have a draft Bill that would do that?

Lewis Johnston: We do. I am not speaking as a lawyer, but we have consulted with lawyers quite extensively. Our responsible investment Bill in late 2020 set out in detail how the principles that I have spoken about could be enshrined in legislation.

Q16 **Chair:** Is the impact that you envisage that they should be focusing on the financial impact on the scheme or the impact on the world?

Lewis Johnston: It is the impact on the beneficiaries rather than the impact on the world outside in a nebulous, abstract way.

Q17 **Chair:** The financial impact on the beneficiaries?

Lewis Johnston: It is certainly primarily financial, but looking at the wider environmental and social impacts of a scheme's investments and the impacts they may have on the beneficiaries.

We know—our written evidence alludes to this—that members want their money to be invested in a way that aligns with their long-term interests and with their values. An important aspect of our responsible investment Bill was a duty to understand the priorities of beneficiaries so that they

could be integrated into the investment strategy. That is not to say that the discretion would be delegated to the members. We do not advocate that at all. I think that would be a dereliction of fiduciary duty. It is ultimately up to the trustees to make those judgments. But this inside-out approach in addition to the outside-in approach is fundamental—and understanding the impact of the scheme on wider factors.

Charlotte O'Leary: Can I build on that? I am not sure whether the Committee is aware of UK SDR, the sustainable disclosure regime, but that means that, effectively, asset managers can decide to launch funds that are trying to have particular impact goals. That means only some of the funds that they will offer will have that impact baked in.

Our view, building on Lewis's view, is that the impact that you have through an investment on the world is financially material, in the same way that what happens to the world is material to the company, and needs to be factored into every investment. We recognise that that is difficult, but we cannot have a situation where only some funds or some investment opportunities have that built in. We have to get to a situation where that is recognised in the system.

Q18 **Chair:** I can see that looking at the financial impact is doable, but the very wide impact that you describe sounds quite difficult to implement in law or in practice.

Lewis Johnston: I don't think it would be difficult to implement, because you are preserving the discretion of the trustee, and they are already expected to balance different factors in their investment strategy. They are not always immediately quantifiable.

As Charlotte said, ultimately, so many of these factors are financially material, but myopically looking at it only through that lens does not equip trustees with the decision-making capabilities that they need to act in those longer-term best interests. As you said, that needs to be a systemic approach. It cannot be restricted to particular designated funds. It needs to be part of the default fund strategy, preserving the need to act in the financial best interests of beneficiaries and taking into account all of these wider environmental—we have spoken about climate change, which is the focus here today—and social factors. I think that is the proper role of a pension trustee in meeting the interests of a member.

Chair: Thank you all very much for giving us very interesting answers to our questions. We are grateful to you all. We ask you now to please step down and allow our second panel to come forward. Thank you.

Examination of witnesses

Witnesses: Carol Young, Nigel Peaple, Rachel Croft and Debbie Webb.

Q19 **Chair:** Welcome, everybody, to this meeting of the Work and Pensions

Select Committee considering the fiduciary duties of pension fund trustees. We are grateful to the members of the second panel, who have now joined us. Can I ask you each to tell us briefly who you are?

Nigel Peaple: I am Nigel Peaple. I am Director of Policy and Advocacy at the Pensions and Lifetime Savings Association, which represents workplace pensions. The schemes in our membership run about £1.25 trillion in assets and have about 30 million members.

Carol Young: Hi, I am Carol Young. I am the Group Chief Executive of the Universities Superannuation Scheme, one of the largest private pension schemes in the UK and one of the very few remaining open defined-benefit schemes. That means that we are a very long-term investor. We can and have for some time taken a long-term view and, as part of that, viewed climate change as a relevant financial factor.

Debbie Webb: Debbie Webb. I am the Chair of the Pensions Board at the Institute and Faculty of Actuaries, and that is who I am representing today. My day job is as a scheme actuary at WTW, where I do a lot of work with large pension schemes.

Rachel Croft: Hello. I am Rachel Croft. I am a member of the council of the Association of Professional Pension Trustees and I am here today in that capacity. My day job is as a professional trustee at Independent Governance Group.

Q20 **Chair:** Thank you all very much for joining us. You heard the first panel telling us that the way trustees understand their fiduciary duty means they cannot take sufficient account at the moment of the dangers of climate change in their investment decisions. I am interested to hear from each of you how far you agree with that concern.

Nigel Peaple: Talking with our members, we do not have that impression. We feel the fiduciary duty definitely does allow pension schemes to take account of climate change challenges. The FMLC report that has come out rather underlines that point by emphasising how so many of those climate change issues are actually financial factors.

Carol Young: We have not seen fiduciary duty as a barrier to thinking about climate change as a relevant financial factor. It has been drawn out here that trustees and fiduciaries that have the relevant size, scale and skills are able to do that effectively. We have found that we have been able to do that. Indeed, I will go a bit further and say that we harbour a concern that if fiduciary duty were to be changed or amended or a parallel duty introduced, it might confuse more than it would clarify.

Q21 **Chair:** Picking up your point about the scale, is there a problem for funds that do not have the resources that you have at your disposal? I know you have worked with universities on this. You can do your own modelling, research and so on. Others who use investment consultants' models may not be able to do that. Is there a difference?

Carol Young: I think there is a duty on anyone who becomes a trustee and takes on a fiduciary duty to make sure that they are properly resourced and that they are able to challenge their investment consultants. That is at the heart of that duty. I cannot speak for all schemes, but addressing this properly definitely requires a level of resource and skill because it is complicated. If you have those things, you can address it.

Debbie Webb: In talking about fiduciary duty and what schemes do, it is helpful to unpack a little what we are trying to get schemes to do. There are almost three levels. The Freshfields investing for impact report from 2021 was really useful in setting out three different levels of investing for sustainability.

The first level is simply taking account of financial factors, risks and returns on sustainability when you make investment decisions. I think most schemes understand that and most schemes do that. At that very basic level, it happens.

The second level is about what they called instrumental investing, which is investing to have a positive impact on sustainability and climate change going forward, but in pursuit of your financial aims. If it will help your overall financial aims, then you can invest sustainably and for impact. The sort of things USS is doing very much fall within that. What the financial law report very much supported is being able to quite broadly consider that in how you invest.

They called the third level ultimate ends investing. That is where you invest for impact on climate change as a goal in itself. It needs to be a secondary goal because the primary purpose of the trust is still to meet the benefits of the members and that must be the primary purpose, but it has as a secondary motive or secondary purpose the impact on climate change happening as an end in itself. I do not think that bit is currently permitted under fiduciary duty. There is a debate about whether it should be but, if it is felt that it should be, there would need to be regulatory change to effect that.

Rachel Croft: In our experience, nothing within the current definition of fiduciary duty prevents trustees from taking into account climate change considerations and climate risk. It comes back to the core of trustees' duties, which are to protect the financial outcomes of members of the pension schemes and, in doing so, we must inevitably take into account all risks that might prevent us from achieving those objectives. Climate risk, clearly, is one of those risks.

Different schemes will have different sensitivities to climate risk. For example, large, open schemes will have longer time horizons and, therefore, greater sensitivity to climate risk; whereas at the other end of the spectrum, smaller schemes or closed schemes, which may, perhaps in the defined-benefit area, be looking to buy out their benefits within a short time horizon, will have less sensitivity to climate risk.

We welcome the FMLC report and its clarity on achieving a balance between recognising trustees' fiduciary duty and clarifying the difference between financial and non-financial factors that should be taken into account.

Q22 **Selaine Saxby:** Good morning. One aim of the mandatory Task Force on Climate-related Financial Disclosures reporting was to encourage trustees to think more thoroughly about the risks and opportunities of the transition to a low-carbon economy. How effective has this reporting been?

Rachel Croft: The first thing to say—it was mentioned by the first panel—is that it is early days in this regime. The largest schemes will be in the process of carrying out their second round of reporting. The next rung down will have done one. Some schemes—those with assets less than £1 billion that are not DC master trusts—will not be under the regime at all currently.

It is fair to say that it is a complex area and a high degree of learning has been needed among the trustee community and the advisers, but trustees have taken this very seriously. They have taken steps to undertake training to understand the requirements and to be able to test and challenge their advisers.

Where I think the regime does need a bit more work is, as some of the members of the first panel mentioned, in the accuracy and reliability of some of the data and the modelling that underlies some of that reporting. But, as trustees, we recognise that this area is moving and evolving and that it is incumbent on us to stay up to speed, keep abreast of developments and approach it with that in mind.

Q23 **Selaine Saxby:** You are nodding along, Debbie. Does anyone else want to add anything?

Debbie Webb: It really has increased the time the trustees are spending on these issues. It has increased the focus and, in that sense, it has been very successful. Perhaps some of that time has, particularly in the first stage of the first reports, been spent thinking about the process of getting to the report, and the reporting and disclosure side of it, rather than about the inherent climate policy and how to effect change. As we move on and the schemes already have the format of the report and know better what they are doing, that shift to thinking more about the investment side will happen as we go through the next iteration.

Carol Young: I broadly agree and I will not over-labour those points. It has helped move us on. It is very important, though, that it does not become too prescriptive or burdensome. What we really need is action, not further and more detailed reporting.

The thing I would pull out is that one of the things that it encourages is thinking about scenario analysis. As the previous panel mentioned, we have voluntarily disclosed since 2018 and we have made two formal

disclosures, and that led us to work with the University of Exeter to think about how we could develop decision-useful climate scenario analysis. We think that has been a really distinctive contribution. We have made it publicly available because we want to see this change and we think transition is a team sport.

We continue to work on how we can take these shorter-term scenarios that take numbers and narrative and look more broadly than the climate pathway work to help trustees to factor that into their thinking. When we are thinking about how we want to bridge the gap in how people who have a shorter investment horizon think about these things, we are hopeful that that is a helpful contribution. We are now turning our attention to thinking about transitioning physical risks as well and factoring that in.

There is definitely a way that it can be done within current fiduciary duty. To your original question, TCFD has helped, but now we need to focus on action, not more burdensome reporting.

Nigel Peaple: To build on that slightly, we surveyed our members just over a year ago and asked, "Do you think TCFD reporting has helped you focus on climate change issues?" Half said it had helped them. The other half said, "Not really, because we were already focusing on it."

An interesting point here is about the regime that applies. TCFD reporting, as you know, was brought in first for occupational pension schemes and then later for companies. That tends to mean that the data supplied via asset managers and advisers to pension trustees as they are trying to make their decisions about TCFD is not as good as we would all like. There is a data issue.

Finally, on the regulatory side, the local government pension scheme, which is the largest pension scheme in the country, does a great deal in this area. There are many fine examples of them really engaging with dealing with sustainability issues. They do not yet actually have a requirement on them for TCFD reporting. That seems to be a Government regulation issue. It is always being delayed. It is always being promised.

Q24 **Selaine Saxby:** Have schemes experienced any other specific challenges with the TCFD reporting that any of you would like to highlight and put on the record this morning?

Rachel Croft: As I mentioned, it is early days. In the first and second rounds, there have been concerns about the accuracy and reliability of the data in some cases. I think trustees would welcome any move towards standardising that data.

Nigel Peaple: I will emphasise that we are at such an early stage of understanding climate change. Business and society are at such an early stage of understanding their impacts. The data that is coming up and the

models—a fair point was made earlier—are not yet perfected. It is early days still.

Q25 **Selaine Saxby:** Is there a risk that it will become a tick-box exercise?

Carol Young: There is a risk of it taking all of the governance time available to think about this topic if it is not right sized. I think everyone has agreed thus far that trustees have a lot to consider and a lot of things to manage. You want something that facilitates trustees factoring this into their broader decision making. To the extent to which we can be freed up to do that, that would be helpful.

Q26 **Chair:** Nigel, on your point about local government, should the same obligation be imposed on the local government scheme?

Nigel Peaple: Absolutely, and the people who run that scheme feel that as well. It helps to have a harmonised approach across society and in reporting.

Q27 **Sir Desmond Swayne:** Notwithstanding Rachel's forthright statement to the contrary, are trustees' fiduciary duties with respect to climate change unclear in any areas?

Rachel Croft: Unsurprisingly, no, I do not they are not unclear. Lawyers will give you an answer on what constitutes trustee duty that will cover a long period of legislation and case law. For trustees, in a practical sense it is very straightforward: we are there to act in the best interests of the members of a scheme, and that means their financial interests. As I said, the FMLC guidance clarifies further what are financial factors and non-financial factors, and in particular that the climate risks we have been discussing have become financial factors. That makes it very clear for trustees in carrying out their duties to take into account very seriously climate-related risk.

Debbie Webb: I agree with that. As I said, the Financial Markets Law Committee report made it clear that trustees can and should be doing the first two levels of investment I was talking about as part of their fiduciary duties. To be clear, I phrase fiduciary duty as the responsibility of the trustees to fulfil the purpose of the trust. The purpose of the trust is to make sure that members get their benefits as specified and as they fall due. Reinterpreting it as member interest is not quite right, to be clear about that.

Getting back to climate change and fiduciary duty, the Financial Markets Law Committee report is particularly helpful in describing how wide financial factors are. It talks about it at individual investment level, it talks about it at portfolio level, and it also talks about investment in the sense of what it will do to the financial markets you will be investing in over the lifetime of your membership. Particularly that third one makes it quite a broad factor when it comes to looking at financial markets. It also makes it clear that, as Carol said, it is numbers and narrative. It is not just about what you can quantify; you can use qualitative narrative to

make those decisions. That all means that it does become clear what the fiduciary duty is and how much trustees can take it into account.

Q28 **Sir Desmond Swayne:** Do trustees take an insufficiently long-term view when considering investment risks? Do some of them take too narrow a view of the potential risks of a particular investment?

Carol Young: Let me take a bit of the previous question and that question together. Fiduciary duty in the law is pretty clear, and the FMLC's contribution to that debate has been really helpful and would align with our views. Where some clarity might be welcome in terms of broader discourse—it maybe comes into some of this—is that it is open to trustees to take climate change into account as a relevant financial factor. But one of the fundamental things about fiduciary duty, which sometimes gets lost in some of these discussions, is that trustees and fiduciaries are what we describe in law as principals, not agents. It is not their job to harvest in the views of members and to execute that in investment policy. It is their job to invest the assets of the trust in line with the purpose of the trust.

If you can give trustees some confidence that they will not be subject to hindsight or meritless legal claims around individual members' personal preferences, provided they have operated with the right skills, the right advice and the right process, they could have some additional confidence to think more widely and to take action. Currently, we see fiduciaries here and abroad simultaneously facing litigation for doing too much and doing too little on climate change. That shows the bind that fiduciaries face. It is not possible to gather and execute the shared view of half a million people, as is the case in our scheme. Trustees need confidence that they can take this into account. If you were to clarify or give weight to the FMLC's findings, which make it clear that that is how the law stands, you would open the door to trustees to act with greater confidence.

Nigel Peaple: I agree with the value of having further guidance. When the PLSA has put forward case studies from our larger pension schemes of how they do net zero investing, it has always been very popular.

On the point generally about fiduciary duty, there is not much detailed data about problems that might be experienced, but when we talked to our members about this, they said that there was a fairly limited number of specialist lawyers in this space, so there is a call for more climate change lawyers.

Q29 **Sir Desmond Swayne:** Ah, right—more lawyers. While we are on lawyers, the Association of Pension Lawyers, as I said earlier, suggested that everything is absolutely clear but that the complexity arises when you try to push something with a quite different ultimate objective into the mix. Do you agree that, ultimately, trustees must always take decisions in the best financial interests of the scheme beneficiaries? Are there circumstances in which fiduciary duties might legitimately conflict

with mitigating climate change risks? If they do, what do we do about it?

Rachel Croft: That clear view from the Association of Pension Lawyers comes through also in the FMLC report and it is in keeping with how trustees typically understand their duties.

As you say, tension may arise where there might be pressure otherwise for trustees to make a decision that would worsen the security of members' benefits in a defined-benefit scheme in favour of taking action on climate, for example, or to decide not to enter into a buy-out, if that was their preferred end game for the scheme, again, in favour of taking action on climate.

Debbie Webb: We very much agree with the APL position on that. It is about purpose and we are clear that, provided you are taking the financial interests and the long-term view into account, you can do it. If the Government decided they wanted pension schemes to go beyond that and to invest for the specific purpose of impacting climate change as a secondary objective, you would need to change the regulations to permit that.

Carol Young: I absolutely agree that the primary purpose of the fiduciary is to invest in the best financial interests of the beneficiaries. We are a large universal owner, though, with a very long-term time horizon, and so we also accept that we cannot cherry-pick or invest our way around these issues. We see them as relevant financial factors not just in the long term but, as the modelling we have done with Exeter and the other work we have done shows, as things that you can begin to translate into decision-useful scenarios that you can take into account in the shorter term. I don't think you need to change fiduciary duty to allow us to do that. Indeed, where would it end? There is this, there is nature, there is antimicrobial resistance—

Sir Desmond Swayne: Well, quite.

Carol Young: You have to allow fiduciaries, frankly, to do their thing and make sure they are appropriately skilled and resourced to do that effectively.

Nigel Peaple: It is absolutely clearly the case that any pension fund with a reasonably long time horizon will need to take account of climate change issues. It is true that in some circumstances, some closed DB schemes with only a small number of years to buy-out may be thinking that these climate change investment issues are not directly relevant to them. However, TPR produced a blog last summer emphasising that even those schemes with a short time horizon should think hard about the climate change implications of their investment portfolio, which often will be Government bonds, of course, at that point.

It is also important for the Committee to think about what happens after these closed DB schemes go and get buy-out with an insurer. What

investment mix are buy-out companies running? That will be where the assets sit for much longer.

Q30 **Sir Desmond Swayne:** Does the FMLC report disappoint in any way? Does it leave anything unresolved?

Rachel Croft: The FMLC report provides great clarity on the definition of fiduciary duty and that balance between acting in members' best financial interests and taking into account the serious and real risks presented by climate change.

You could consider enshrining all or some of that report into guidance. In the first panel there was more talk about changing the law. I have already expressed some concerns about changing fiduciary duty itself, but enshrining some of that report into guidance with some practical examples would be a very real-life way of helping trustees to encapsulate it without going to the trouble of changing the law.

Q31 **Sir Desmond Swayne:** Are you collectively of the view that taking the output and having the TPR put it into guidance is all we need to do, or is there a question of making this statutory? Are you happy with guidance or should we make it law as well?

Carol Young: I am happy with guidance. I have a strong preference for that over changes to the law. It is a helpful contribution to the debate. It is not all we need to do, though.

The key point is we cannot pin too much on a single report or a single pension scheme, or indeed pension schemes as a whole, to make the real-world change we need to make. Pension schemes can play a part within a broader system but, if Governments and regulators believe that climate change is an important factor, it needs to be addressed at the system level and we need to let pensions be part of that system.

Nigel Peaple: I agree that guidance would do a very good job. It makes sense for TPR to consider the FMLC guidance and make sure that it is accessible and useful for pension schemes, but it is a really good thing and enough. It is better than changing the law, which might have all sorts of unintended consequences.

Picking up Carol's points about the wider picture, which we have not really talked about, the UK does not yet have a transition plan to net zero. If we had one, it would be much easier for pension funds to work out which investments will be climate aware and will help to achieve net zero. We do not yet have a green taxonomy that shows which assets are green. Also, something that comes up a lot, and has been brought up by many others, is the lack of investment opportunities in green things and the lack of Government action. If the Government were working with industry, with a clear idea about how to achieve a green economy, it would be much easier for pension funds to invest in a way that helps to achieve net zero.

Sir Desmond Swayne: I blame Labour.

Q32 **Chair:** Nigel, can I pick up your point about insurers, who in quite a lot of cases will manage these assets in the future as a result of buy-out? Remind us of the regulatory framework for insurers in this area. Are there constraints?

Nigel Peaple: I am not an expert on the regime for insurers, but I believe they are under TCFD requirements and will now be under the FCA SDR requirements, so they have disclosure requirements. Beyond that, I am not an expert. I don't know if anyone else on the panel is.

Chair: That is something for us to look at separately, perhaps. Thank you very much.

Q33 **Debbie Abrahams:** Good morning, everyone. You probably heard my question to the previous panel about the validity of the economic models used by investment consultants, particularly in relation to the incorporation of climate change in investment decisions. Do you agree with their overall comments?

Debbie Webb: The IFoA, in conjunction with the University of Exeter, recently produced a report on this issue, which concluded that there was a bit of a disconnect between climate science and some of the economic models currently being used for TCFD reporting, so in the way that the schemes were reporting.

The first thing to say is that this stuff is hard. It is complex to model. It is a very new science. We are all developing and learning as we go. The initial economic models that were developed to do this had limitations. That was economists trying to make robust models and trying to make sure they carefully justified each assumption. That meant that they put constraints on the models, which has meant that when it comes to running them through, particularly when it comes to looking at the downside scenarios, they have potentially understated the impact.

The models try to model what they call the hothouse effect, which is where we get to 3° or 4° of global warming. The IFoA and the university's findings were that those tended to, sometimes quite materially, understate the financial impacts of those scenarios. So yes, there is an issue there.

The IFoA report suggests three areas where things can improve. One—to me, this is actuarial science 101—is understanding the limitations of the models and making sure when you talk to people about using the models that they understand the limitations and they understand what they do and what they do not do. The second, which Carol has already alluded to, is absolutely about using qualitative analysis and scenario analysis to supplement the quantitative analysis. The third, which clearly we at the IFoA and others are working on hard, is to help make the models better and to expand them, make them more sophisticated and make them a better reflection of what we think the real-world impacts will be.

Q34 **Debbie Abrahams:** Carol, I should say I am a former USS member—I need to declare that. Do you want to comment?

Carol Young: I have not looked at the commentary on broader investment consultants in depth, but I have always found the investment consultants that I have worked with externally to be professional and thoughtful. Some of this may well come about from the fact that this is indeed difficult and emerging work.

In the current scheme at USS, our in-house providers provide the majority of our investment advice, supplemented by working with external experts, including the University of Exeter. We found that the models that were used when we looked to do our climate scenario analysis mapped out long-term climate pathways but tended to look at climate risk in isolation and tended to make smoothing assumptions. We concluded that that was not particularly decision-useful.

The work that we undertook with Exeter and that we made available tried to look at five to 10-year time horizons. It tried to capture some of the knock-on effects like mass migration and instability, and then it generated four scenarios that we think better reflected real-world risks and opportunities. They go from the optimistic, where politics, economics and markets work together, through to the far less optimistic, with toxic political debate and market dysfunction, which frustrates progress. We wanted to do that and to make that available so that people can start to factor that into their decision making. As I said before, we think it is a distinctive contribution.

We are now working through the very difficult work, actually, which is why you need to be skilled and resourced, of trying to embed that into our financial decision making, our expectations and our portfolio management. It can be done. As I alluded to, we are now also beginning to think more about how we allow for physical risk within that.

What you find is a very complex issue, a very live issue, and the modelling and lots of well-motivated people working to keep up. It definitely requires trustees with sufficient skill to interpret that and to work with and, where appropriate, challenge their consultants. I have always been in large, well-resourced schemes where that has not been a problem. I cannot comment about whether it is a problem more broadly.

Q35 **Debbie Abrahams:** I am interested to understand the process. Clearly, you looked at the models and you said, "These aren't good enough."

Carol Young: They didn't give us everything we needed, certainly.

Debbie Abrahams: Absolutely. And you said, "Right, we need to do something about this," and you developed your own model. How did you get to the process to decide that the models you were provided with were not adequate?

Carol Young: I already mentioned that we had been voluntarily looking at TCFD disclosure since 2018. We had been thinking about how to integrate it. It is probably underpinned by the fact that we are a large scheme and a universal owner and so we long ago concluded that we could not go around these issues and, therefore, had to engage with them and understand the impact they would have on the portfolio.

Q36 **Debbie Abrahams:** Was that all trustees and you had a board decision or was it one trustee? How did you actually come to that conclusion? Was it brought to your attention by different consultants who advise you? What decision making made USS specifically come to the view that, "This isn't a good enough model"?

Carol Young: The first thing I should say is that I have been here six months, so I wasn't around for all of that, but I was well briefed when I came in and I have had the opportunity to see the current trustee board in action.

Every trustee board brings a balance of skills and some people have more skills and interest in a particular topic. We have world-class economists on our trustee board, for example. We have people who were heavily embedded in TCFD. More relevant for the Committee is that we have—and I can see we have always had it—cognitive diversity and a culture of challenge, debate and working with our advisers to really understand what we are being told. I cannot give you the history of how it came about, but I can with some confidence say the factors that underpinned it.

Q37 **Debbie Abrahams:** So the previous panel's view about capacity within boards is important. You have said you have a very well-informed board.

Carol Young: Yes. I wholeheartedly support the long-standing regulatory agenda around having schemes of sufficient size and scale with the right skills to tackle the true complexity of what it takes to be an effective fiduciary.

Debbie Webb: I can expand a little about which schemes and when the models matter. When you are USS and you are doing your own investments, it is absolutely critical that you have the right models to make the decisions on the actual investments. Most trustees we work with delegate that day-to-day investment management to a third party. They do not need the sophisticated models that help to determine the right individual investments. They need to understand enough to give policy direction and to give guidance and to agree the key strategic aims with those investment managers. It is those investment managers who need the models and the more sophisticated ways to look at the investments, and they potentially do have the capacity to do that.

I guess what I am saying is that it is not that every scheme, no matter how small, needs to be able to use sophisticated models. That is not decision-useful to them. They need to understand the high level to set

their strategy and to make sure that they have the right investment managers doing the right job.

Q38 **Debbie Abrahams:** The trustees need to be able to ask the right questions to have confidence in those—

Debbie Webb: Yes.

Carol Young: That is why we made our scenario work available. I have said already it is a team sport. More of this work needs to be done and put into the system at large so that not everybody has to undertake what we chose to undertake but can instead build on that.

Debbie Abrahams: Absolutely. I am conscious that two people have not answered.

Rachel Croft: From a professional trustee perspective, we welcome the work done by USS and the collaborative nature in which they have presented and shared it. It will no doubt be very helpful to a lot of schemes, so thank you.

I also echo the comments made by Debbie. Clearly, not every scheme is a USS. A handful of schemes have that size and that in-house investment management capability. But professional trustees bring to schemes a view of the full range of different sizes of schemes and different investment consultants. They bring that skillset to, as you say, critically challenge what is in front of them, whether they are schemes subject to TCFD reporting or schemes not yet subject to any reporting.

Nigel Peaple: I will build on those comments about the capability of trustees, which is clearly important. We think there is a role here for TPR. We have said before that it should have a register of trustees. When you have a register of trustees, you can build out from that and work out people's knowledge and capabilities and skills, which is so important.

Debbie Abrahams: Fantastic. Thank you, everyone.

Q39 **Chair:** Picking up your point there, Nigel, is there a wider role for the Pensions Regulator in this area? Carol, given what you do, should the Pensions Regulator encourage schemes to do what you do or support you in some way?

Nigel Peaple: More guidance from the regulator is good. There is also the issue of the regulation of investment consultants, which was raised before. We have thought for some time that they should come within the FCA remit in order to have those key principles of practice to make sure the standards are high and up to date. I am sure often they are, and we have heard about how everything is developing anew and we are at the frontier of knowledge. Nevertheless, it is really important that high standards are applied.

Carol Young: The TPR has already sought to clarify some of these matters. As we have all said, anything that gives a bit of weight and

support to the findings of the FMLC would be welcome. It is the same tension that we talked about in TCFD and other things, though. One beauty of fiduciary duty is that it is quite elegant, in that it is broad and it allows for suitably skilled people to make the right decisions with the right skills. I think we would want, still, legislative guidance that allows suitably skilled trustees to apply it to their schemes, rather than anything that becomes too terribly prescriptive. I think that is difficult for everyone, the regulator included.

Chair: Thank you. Siobhan Baillie.

Siobhan Baillie: I think my question has been answered. It was about what has had the greatest impact on decision making, which you have been talking through at length.

Q40 **Chair:** Can I ask a question slightly related to this? If the law was changed, or if someone was to propose the law is changed, in the way suggested by ShareAction earlier, what problems might that cause? You have made it clear that you are not seeking such a change, but would such a change be problematic or not?

Nigel Peaple: I think it would be, because the whole industry would have to go through the whole business of trying to work out how to interpret it and how to apply it. We have already seen how knowledge has been deepening, growing and spreading, as we have been describing. If you were to go in left field with a completely different approach, I am sure it would slow down activity—apart from the bigger risk that people will not have their pensions made because there will have been investments made that are not financially suitable.

Carol Young: I already said that any change or addition to the statute book has to earn its place and you need to be reasonably comfortable that it will clarify more than it will confuse. My concern is that it would confuse more than it would clarify. Obviously, I come at that from the stance that I don't think there is a huge problem to be solved with fiduciary duty itself. I fear that it would probably take agenda time and thought from trustees as to whether it changed the nature of what they were able to do. You could empower and give confidence to trustees far more effectively by adopting and giving some additional weight to the FMLC's findings such that they could act with confidence and, in particular, be confident that they would not be subject to swathes of litigation provided they had followed proper purpose, which would be a great risk if we introduced competing priorities.

Debbie Webb: Also, there is a great risk of unintended consequences. The whole fiduciary risk framework is very well understood and, I would argue, has worked very successfully for pension schemes for a long time. As was pointed out by the previous panel, it is complex. It is not in one place in law. It is a combination of law and a lot of case law over time. It is well understood. The concept works and should continue to work. Making broad changes to that risks trustees having to take it into account

in unexpected ways, and it could bring into tension this new duty and their primary function of making sure that people get their pensions, which is what we are really doing. We would not favour any changes to broad fiduciary duty.

If anything was to be considered at all, it should be narrow. It should be about investment decision making. It should be about the current investment regulations for pension schemes. It should be permissive, to make it clear that these climate change or sustainability factors are relevant factors that trustees can take into account. You might be able to encourage this change with something explicit about investment decision making explicitly within the investment regulations for pension schemes, but that is as wide as we would want it to go.

Rachel Croft: Likewise, as I have already said, we think that the fiduciary duty for trustees is very clear and already not just permits them but requires them to take into account seriously all risks that could prevent them from achieving their objectives of providing the best financial outcomes for members, including the risks relating to climate. To attempt to change that would cause some of the difficulties that the other panellists have already mentioned, in particular a tension, maybe, that trustees would be faced with a decision to worsen the security of members' benefits in a defined-benefit scheme, for example, in favour of making a more climate-friendly investment, or to decide not to transact a buy-out for the same reason, which would not be in the best financial interest of the members of the scheme.

Q41 **Chair:** Carol, a couple of times you have talked about addressing this at the system level. Could you tell us a bit about more what you envisage there or what would make that happen?

Carol Young: My point there was that if there is a view, which we would share, that there is more to be done to effect real-world change, Governments and regulators could probably do that in more direct ways than by placing an additional duty on fiduciaries—anything that promotes the ability within the UK, for example, for people to take more personal steps, so improvements in the grid such that we can get better electrification. My point was more that if you want to make this change, pension schemes are a part of the change, but we cannot make the change alone. The world needs to transition. We believe it does, and we would love to see regulators and Governments taking action that makes that happen more broadly rather than thinking that it can be solved through an additional duty on pension schemes.

Q42 **Chair:** There was a suggestion in the first panel that the Companies Act should be changed. Is that the sort of change that you have in mind?

Carol Young: I am not deeply steeped in that, so this will be a bit of a drive-by observation. It potentially would introduce some of the same challenges that you see if you change fiduciary duty. If we believe these things are important, we can require data to be shared on it, we can put

regulations in place that put transition front and centre of the Government's agenda, and we can price externalities properly. I am not sure that a change to the Companies Act would be the right way to do that, but honesty dictates that I say I have not given that specific point an awful lot of thought.

Q43 **Chair:** I have two other things that I would like to raise, on rather different subjects. It was reported last night by Bloomberg that the Chancellor is considering options to increase pension fund investment in UK assets, apparently including setting a threshold for this, and maybe "requiring pension funds to disclose their allocations to different UK asset classes and launching an independent review to determine an appropriate threshold of UK asset allocation for pension pots".

Carol and Nigel and maybe others as well, what would be your reaction if that were indeed in the Chancellor's mind at the moment?

Nigel Peaple: The PLSA has done some work over the last year or so thinking about how to make investment in the UK more attractive to pension funds. We have thought about it in terms of a whole series of things: different things for DB and DC; changes to regulation; ideally changes to fiscal incentives. On the other hand, we have always favoured the continuation of trustees' ability to have freedom of investment, and not interfering with the fiduciary duty and, therefore, not setting quotas.

I have not seen the Bloomberg report. It sounds to me like they are not thinking of setting quotas there, but are thinking about maybe providing greater transparency of how much assets go to UK investments, which is fine. It also sounds to me like they might be thinking of having a target. There is already the Mansion House compact, which, as you know, is a voluntary initiative by some of the largest DC pension funds to aim to invest in unlisted equity and certain other asset classes. Provided it is not a mandatory target and provided it is on disclosure, it is fine, but we think it would be better to change the regime more generally to be attractive.

Briefly on that, we talked about DB funding and having more flexibility in the funding code, which we perhaps will go on to. In the DC area, we have talked about the importance of bringing forward the value-for-money regime so that investments are not always done as cheaply as possible but are more focused on performance. We have asked why the UK could not do like some other countries and have fiscal incentives for investing in UK companies. There are lots of things to do in that space. I have not seen the Bloomberg report.

Carol Young: I have seen the report. If it is disclosure only, we already disclose our UK holdings. We have significant UK infrastructure assets. If the aim is to disclose, it would not be a problem. If the aim is to mandate, I agree that would be very problematic and would cut across fiduciary duty. If the aim is to make the UK attractive to investment, we would support any action that increases the range of attractive

investments. We can tackle that best by making the UK a more attractive place to invest rather than mandate.

Q44 **Chair:** But you would not be keen on a threshold for UK asset allocation for pension pots, whatever that might mean.

Carol Young: It depends where they put it. If it was in line with Mansion House, if it was a minimum level of UK investment, I imagine we probably would meet it right now. But on first principles, I would object to the idea of mandated thresholds, because trustees have significant responsibility and, therefore, they have to have the rights to go with that. One of those rights is the ability to set the investment strategy that they think is appropriate.

Debbie Webb: I would worry if it cut across asset class decisions about the types of assets in which schemes invest, because that would go quite a long way to fettering fiduciaries' duties to invest as they see right. Lots of schemes hold a lot of UK gilts. If the measure was simply whether you hold UK assets, mature pension schemes would have no problem at all given their gilt holdings. It would not have an impact. But to say that they have to hold growth assets would be difficult and would fetter duty in a way that would not be good.

Rachel Croft: I will add simply that trustees would probably welcome the option, with greater funds becoming available, to invest in that way as long as it is in keeping with the overall strategy for the scheme and takes into account the timescales for that scheme, but not its being mandated.

Nigel Peaple: Our members say, "If we have long-term stability regarding the Government's industrial strategy for the UK and we have Government action, say doing shared cost on key transition issues like on the green side of things, that's the kind of thing that will naturally draw this pension fund money into the UK." The Government should think of pension fund money in the way they think about foreign direct investment: "What can we do in the UK to make it the kind of place that everybody wants to put their money into, rather than mandating others to pay into it without it meriting investment?"

Carol Young: Indeed, if they did that, if there was the right regulatory environment and the right incentives for capital to flow, foreign direct investment would probably come quite naturally, but so would institutional investment, and to some extent it might even crowd in some of that foreign direct investment. It is all about the right regime.

Q45 **Chair:** Finally, I want to put a question to Carol in particular. We have heard in the Committee a number of times that open defined-benefit schemes like yours have been worried that the new funding regime heading in our direction might force inappropriate de-risking. How far have those worries been addressed, from your perspective? Are you still worried that this could turn out to be a problem? What specific points do you want to see in the final version of the funding code when it appears?

Carol Young: We welcome that some of the detail has been laid in Parliament, and we also welcome that the unique features of open DB schemes have begun to be acknowledged. Our concerns, however, are not fully addressed, because the devil will be in the detail, specifically in the detail of the covenant guidance.

We have emphasised to you today that our ability to take a long-term view and address issues like ESG is underpinned by the fact that we are an open scheme with a long-term view. We believe that we have a covenant horizon of 30 years because of the backing that we have of not a single employer but a sector. That has been integral to our ability to think long term and to invest for the long term. Our great concern is that if anything in that guidance in any way shortens that covenant horizon, it will have very real-world consequences.

While we did the modelling for another reason—we did it to show that the covenant support that we have put in place had a real financial benefit to the sector—it can be used as a proxy because it looked at a similar impact: "What if we could look for only 20 years rather than 30?" We concluded that the future service contributions from the higher education sector would have needed to be over three percentage points higher. That would have been about £330 million more going into the scheme, basically just to plug the gap arising from the fact that we would not be able to take such a long-term investment horizon. We very much hope that we will be heard, but that covenant horizon piece is integral for us and integral to our ability to be a long-term investor.

Q46 **Chair:** Do you think you are being heard on that?

Carol Young: We have a very positive and constructive relationship. We have certainly been given the opportunity to make our case. We made our case on the need for it to reflect open schemes, and that has come through. I travel in hope that the ability that we have had to make our case means that it can be factored in, but, as I say, it has real-world consequences for us.

Rachel Croft: In relation to the broader range of schemes of all sizes that will be subject to the new code, the regulations are broadly as expected. They continue to require a low reliance on the covenant-type target at the point at which the scheme becomes significantly mature. That definition is awaited. As Carol has said, the concerns that open schemes had expressed seem to be being incorporated.

What we await in the DB code in particular, for the broader range of schemes, whether open or closed, is sufficient flexibility to fund the schemes on a basis that is specific to those circumstances. In addition, given the improvements in funding positions for a large number of schemes over the last couple of years, we await the flexibility for trustees and sponsors to target a range of different outcomes, including running on the scheme as an alternative to buying out.

Debbie Webb: As both have said, the new regulations are a significant improvement on what was there before and have addressed a number of the issues that there identified. The introduction of a new term has caused problems: talking about "reasonable certainty" when looking at covenant longevity. There is a requirement for trustees to take into account reasonable certainty when they decide on the length of that longevity. USS, whether it is 20 years or 30 years, is still very unusual. Most schemes I work with do not have reasonable certainty that lasts beyond five years or even more than that. That includes some open schemes. For those schemes, how that gets interpreted and how covenant advisers interpret that could be quite a significant challenge. That is the one area where I think there are issues.

Carol Young: Even open schemes share your concern on that.

Debbie Webb: Yes, I certainly know of open schemes that are significantly concerned about that.

The second issue is about how much flexibility there really is. The consultation response said that there is flexibility in part because this is all about how you fund, not about how you actually invest. The requirement for funding is that, when you get to low dependency, your assets have to be highly resilient to short-term market changes. That "highly resilient" requirement for the more mature schemes means that we have to assume a pretty low-risk investment strategy and, therefore, a very conservative funding target when we look at the funding target. If schemes are funded to that level, trustees have little incentive to take additional risk as the system currently stands. They are doing their duties. They will be de-risking and making sure they meet the benefits. From a corporate perspective, there is very little incentive, as the regime currently exists, to take any risk if they are already funded to the right target, because they are on the hook if it goes wrong, and potentially on the hook to pay contributions quite quickly if it goes wrong. So there is a practical constraint around that flexibility.

There is also a legal constraint around that flexibility. This is where the regulations and the various changes that have been made to the Pensions Act itself become important. The primary legislation—for anybody who wants to look it up, it is section 221B of part 3—says that the statement of strategy that the trustee produces needs to explain if their actual investments are not in line with their funding investment strategy and, if they are not, they have to say how they will remedy that. I cannot see trustees wanting, for too long or too far, to go away from their funding and investment strategy in their actual investments, given that legal requirement that sits in the primary legislation. So there are some potential constraints there around flexibility.

Nigel Peaple: From talking to our members, there is a sense that the regs are more flexible—that is helpful—but there are still lots of issues to

answer and be sure about, and maybe still concerns, as you have just heard.

Chair: Thank you all. You have given us a very interesting set of answers. We are grateful. That concludes our questions to you and it concludes our meeting. Thank you all very much.