Department
for Work &
Pensions

Paul Maynard MP
Minister for Pensions

Sir Stephen Timms
Chair
Work and Pensions Select Committee

17th May 2024

WPSC Reply - Fiduciary Duties and Climate Change

Thank you for your letter dated 17 April 2024.

I welcome the Committee's investigative work in relation to pension scheme trustees' consideration of Environmental Social and Governance (ESG) factors, in their investment approach for the benefit of members. As the Pensions Minister I very much see my job as ensuring that those who have fiduciary responsibilities live up to the demands of their role and that the system in which they operate incentivises the highest standards of behaviour and protects the best interests of those who rely on it.

The summary of the findings from the evidence session your Committee held in February, along with the recently published Financial Markets Law Committee (FMLC) report is therefore incredibly useful and timely. It has helped to provide a stronger foundation for my department in our discussions with industry stakeholders on how the government can continue to clarify fiduciary duty, particularly in relation to climate change, through the series of roundtable discussions we have planned. Our commitment to engaging with the industry on this subject matter was set out in the Government's Green Finance Strategy 2.0.

I am pleased to confirm dates for those roundtables have been set in May and June 2024, respectively, and invitations sent. We expect a good mix of law firms, financial institution networks, advisory bodies, non-profit/charity organisations, investment companies, and pension member organisations and schemes, to participate fully to the debate.

We plan to use the first roundtable event to discuss the current legal interpretation of fiduciary duty, building on insights from the FMLC report, and your evidence session findings, to explore what barriers to investing may be faced by pension scheme trustees and other decision makers. This will be followed by a second roundtable that will attempt to use this insight to determine the most effective and practical option to provide the clarification necessary. The space between the two events will allow my department time to gather additional feedback and information where required and consider options.

As your evidence suggests, we too recognise that some stakeholders within the industry are calling for additional guidance, whilst others are seeking changes to existing legislation. However, it would be wrong of us to prejudice the outcome of any action we may take before we have had a chance to hear from a wide selection of stakeholders, with the aim of building a consensus for what is needed.

However, I also want to be clear that we are starting from a base in which the law has been clarified by the Law Commission previously[1]. They confirmed that pension scheme trustees should take into account financially material ESG factors. What these factors are, and whether or not they are financially material to a particular investment, is a matter for the trustees to judge, based on appropriate advice. Where trustees are looking at non-financially material factors, such as those relating to quality of life, there is still scope to take these into account also.

Following the industry roundtables, my department will ensure a briefing session is held in which interested Parliamentarians will have the opportunity to provide insight and discuss the conclusions drawn from these events. I look forward to writing to you nearer the time with further details.

With respect to trustees of DB schemes it is crucial they recognise the significance of ESG and climate risks, even when nearing buyout. By incorporating these risks into their journey plans and insurer selection, trustees can safeguard the long-term sustainability of their pension scheme liabilities.

To achieve this, trustees should continuously evaluate ESG risks, integrate ESG considerations into investment strategies, ensure their fund managers are incorporating sustainability in security selection, and ensure their chosen insurer can manage long-term ESG risks.

As you can appreciate, the regulatory approach for insurers is different and does not sit with the responsibilities of my department. The Financial Conduct Authority (FCA) is responsible for the conduct regulation of insurance firms. The Prudential Regulation Authority (PRA) is the authority responsible for the prudential regulation and supervision of insurers. The PRA expect firms in scope of Supervisory

[1] Pension Funds and Social Investment - Law Commission

Statement [SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change] to manage the financial risks from climate change.

In practice insurers are expected to embed climate-related financial risks into their governance and risk-management frameworks and to allocate responsibility for climate change to senior management functions. In addition, they need to complete scenario analysis and disclose in line with the Task Force on Climate-related Financial Disclosures (TCFD) requirements.

Turning attention to the question you raised on the work my department is taking forward in partnership with The Pensions Regulator (TPR), on improving trusteeship, the government's response to last year's call for evidence[2] on trustee skills and capabilities, confirmed our view that the majority of trustees are knowledgeable, well-equipped, and committed to their roles. Accreditation is not currently mandatory for professional trustees, but our response strongly encouraged all professional trustees to seek accreditation.

We also concluded that some trustees require more support than others to meet their knowledge and understanding obligations. My department is supporting TPR to develop and implement a trustee register, which will enable better data analysis and targeted support for the trustees who need it most.

TPR's revised general code published in January 2024 contains a module concerning the duties and expectations on trustees in relation to investment governance. The code also has specific modules concerning stewardship and ESG. It makes clear that, unless exempt, those governing pension schemes are required to include their policies in relation to financially material ESG considerations, and how they are taken into account in the selection, retention and realisation of investments, in their statement of investment principles (SIP). They must also include their policies on the extent, if at all, to which they take into account non-financial matters (the views of members and beneficiaries, including their views on ESG matters). Trustees of schemes that are required to produce a SIP, must produce an implementation statement (IS) setting out how and the extent to which, in the opinion of the trustees, the stewardship policies set out in the SIP have been followed.

In terms of investment consultants, it is my understanding that HM Treasury intend to consult on the Competition and Market Authority's recommendation that investment consultants be brought within the FCA's regulatory perimeter.

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[2] Pension trustee skills, capability and culture: a call for evidence - GOV.UK (www.gov.uk)

In relation to climate change reporting, specifically, my department is taking forward in the second half of this year a post-implementation review of the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021; the requirements relating to reporting in line with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations). This will see us work closely with the FCA and TPR. The TCFD requirements were brought in to improve both the quality of governance and the level of action by trustees in identifying, assessing, and managing climate risk. Our review will consider how pension schemes subject to the requirements of the Regulations are currently reporting, what actions they are taking and potentially whether there is scope to lower the current threshold to ensure more schemes are brought into scope of the requirements.

Scenario analysis is one of the components of TCFD reporting and some industry papers published in 2023 by Carbon Tracker and others, including the Institute of Faculty of Actuaries (IFoA), Economics of Energy Innovation and System Transition (EEIST) have highlighted challenges with some of the scenarios used.

Therefore, we continue to work with regulators, and we welcome progress within the industry to ensure that scenario analysis models support effective decision-making and will look to acknowledge the issue in the review. However, we do not believe that the Government should mandate which models should be used by pension schemes. It is important that modelling which considers climate, ESG and wider sustainability factors is allowed to develop and evolve as data availability increases.

Finally, I want to express my thanks again for the Committee's work on this important subject. I hope I have sufficiently covered all the questions raised at this point.

As referred earlier, I look forward to providing an update to Committee members following the conclusion of our roundtables on pension trustee fiduciary duty in relation to ESG.

Yours Sincerely,

Paul Maynard

Paul Maynard MP

Minister for Pensions

Work and Pensions Committee

17 April 2024

Paul Maynard
Minister for Pensions
Department for Work and Pensions
(By e-mail only)

Dear Paul,

Fiduciary duties and climate change
In light of your intention to look, including by holding a series of roundtables, at ways to clarify fiduciary duties in relation to climate change, the Committee received written evidence and held an evidence session on 21 February. This raised issues, particularly in relation to the guidance and advice available to support trustees in their decision-making, that we wanted to draw to your attention.

How fiduciary duties are interpreted
Trustees' fiduciary duties are not from a single source—the applicable body of law has developed from a combination of case law and different statutory provisions (FYD0013). We heard that the definition of fiduciary duties is 'permissive' and broad enough for suitably skilled people with the right information to make the right decisions (Q3, Q39). However, this did not mean that no change was needed. We heard that there was a wide divergence in the way trustees were interpreting their duties in this area (Q4) and that pension funds continued to invest in high emitting sectors despite the financial risks of climate change (FYD0010; FYD0004; and Q3).

There was general agreement that the Financial Market Law Committee (FMLC)'s recent paper Pension Fund Trustees and Fiduciary Duties – Decision making in the context of Sustainability and the subject of Climate Change (6 February 2024) had been helpful in clarifying trustees' fiduciary duties in relation to climate change (Qq3–7 and Qq27–8). In particular, it helped highlight that there was a strong case for trustees considering climate change and other sustainability factors as 'financial factors' in investment decision-making, both in relation to individual investments and the impact on financial markets over the lifetime of the scheme's membership (Q4, Q8 and Qq20–7).

We heard that it would be helpful for The Pensions Regulator (TPR) to put the principles of the FMLC report into guidance for trustees aimed at supporting their decision-making (Q7). As well as providing greater clarity on their duties, it could help increase trustees' confidence in the face of potential legal challenges, provided they had operated with 'the right skills, the right advice and the right process' (Q28).

Some argued that the Government needed to go further and change the law. Client Earth argued there was uncertainty that was leading trustees to construe their fiduciary duties narrowly. It recommended as a minimum: requiring pension funds to identify, assess and manage climate risks to the portfolio as a whole (including systemic risk); and ideally including a positive duty for trustees to identify, assess, manage and manage the impact of their investments on the environment and society (FYD0018). ShareAction called for an expanded definition of beneficiaries' 'best interests', to include the impact of investment decisions on the environment, the financial system and society (FYD0004). However, other witnesses were concerned that attempting to make broad changes to the definition risked confusing rather than clarifying matters and might give rise to unintended consequences and create a tension between the new objective and the fiduciary duty to act in the best financial interests of scheme members (Q3, Q20 and Q40).

1. **What are the plans for your proposed roundtables on fiduciary duties?**
2. **Will these look at how best to mainstream the principles set out by the FMLC?**

Defined Benefit schemes

Any new guidance would need to set out the issues as they apply to pension schemes of different types—Defined Benefit and Defined Contribution—and with different time horizons (Q29). In addition, as discussed in our recent report on Defined Benefit Pension Schemes, improved funding levels mean that more schemes are closer than expected to being able to enter a buy-out arrangement with an insurer (para 59). In our evidence session on fiduciary duties, we were reminded of the importance of understanding the implications of this in relation to managing climate change risks (Q29 and 32).

3. **How do the duties of insurers (in considering the climate change risks and impacts of their investments) differ from those applying to pension scheme trustees.**

Getting good advice

We heard that the economic models on the impact of temperature rises used by some investment consultants advising pension scheme trustees did not reflect the findings of the vast majority of climate scientists (FYD0010; Qq13–4 and Q27).

Carol Young, Group Chief Executive of the USS, told us this was a complex and live issue, requiring appropriate models about the impact of climate change that were kept up to date and trustees needed sufficient skill to work with and, where appropriate, challenge their advisers (Q34). Some years ago, the USS had concluded that models they were being offered did not meet their needs and decided to work with the University of Exeter to develop their own qualitative scenario analysis (Q38). Debbie Webb of the Institute and Faculty of Actuaries told us that, although many trustees delegated investment management and therefore did not need to be able to use sophisticated models themselves, they did need to be able to set the strategy and make sure they have investment managers doing the right job (Q37).

TPR has longstanding concerns about the quality of pension scheme governance. In our report on Defined benefit pension schemes, we made recommendations aimed at driving higher standards of governance across schemes, including TPR using the new trustee register to report annually on the number of trustees who have completed its Trustee toolkit (para 102 to 113). In your letter of February 2024, you said you planned to engage with key stakeholders this spring on improving trusteeship.

4. **As part of your planned work on improving trusteeship, do you plan to look specifically at how to build the capabilities and capacities trustees need to be effective in taking account of climate change risks in investment decision-making?**

A further step is needed for effective supervision of advisers in this area. In our report on Defined benefit pension schemes with Liability Driven Investments, we recommended that the Government should bring forward plans for investment consultants to be brought within the FCA's regulatory perimeter in this Parliamentary session (para 105).

5. **Given that legislation to bring investment consultants into the FCA's regulatory perimeter has not been brought forward, it would be helpful if you could explain how DWP and TPR are working with the FCA to ensure that they use appropriate models of the impact of climate change.**

I would be grateful for your response to these questions by Wednesday 1 May. As is usual practice with the Committee's correspondence, I will be publishing this letter and your response on the Committee's website.

Yours sincerely,

Rt Hon Sir Stephen Timms MP
Chair, Work and Pensions Committee

House of Commons
Palace of Westminster
London
SW1A 0AA

workpencom@parliament.uk
+44 (0)20 219 8976
Social: @CommonsWorkPen
parliament.uk