Fiduciary duty and climate change

Input to the Work and Pensions Committee's evidence session on 21 February 2024

Issued on 9 February 2024

We understand that the Work and Pensions Committee is holding an evidence session on fiduciary duty and climate change on 21 February and has asked witnesses to submit written responses to several questions beforehand. We commend the Committee on undertaking this initiative, given the significant risks that climate change presents to pension benefits and the role that fiduciary duty plays in determining whether trustees respond appropriately to these risks.

Our CEO wrote to Sir Stephen Timms last September about this topic since it is of vital importance to the advice we give. We would therefore like to share our views and experiences with the Committee.

We set out below our thoughts on the questions the Committee has asked, preceded by some background information on LCP. We restrict our comments to climate change, as this is the focus of the evidence session, but they also apply to other systemic sustainability risks such as biodiversity loss.

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,000 people in the UK, including over 170 partners and over 200 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 80% of our work is advising trustees and employers on all aspects of their pension arrangements. The remaining 20% relates to investment consulting work for other asset owners, insurance consulting, energy, health and business analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Our specialist Investment and Defined Contribution (DC) practices advise on over £330bn in assets, across over 400 clients. The clients we advise range in size from under £10m to tens of billions of pounds.

Unique amongst pensions and investment consultancies, we have an energy analytics arm, LCP Delta, which employs 110 consultants with the specific purpose of delivering a faster, better transition to clean energy. Through this route, we have unusually strong visibility of the gap that needs to be bridged between the requirement for capital investment to change the outlook for climate change, and the suppliers of capital that ought to be a major part of the solution.

With respect to how pension schemes take account of climate change risks in their investments, is there a problem that needs fixing?

Yes. In our view, many UK occupational pension schemes would take more real-world action in relation to climate change if issues relating to fiduciary duty were clarified. We see three barriers in particular:

1. Uncertainty about trustees' fiduciary duty leads to undue caution.

In our experience, trustees – particularly of closed defined benefit (DB) schemes – who would be willing to take greater account of climate change in their investment decisions, often feel inhibited from doing so as they are unclear over the extent to which this is compatible with their fiduciary duty[1]. A range of views exist within the legal profession about the extent to which trustees can take account of climate change. While some lawyers' advice is aligned with the conclusions of the Principles for Responsible Investment's 2022 paper, UK: Integrating sustainability goals across the investment industry, others have a narrower view of what is possible and appropriate. This narrow view is typically based on consideration of short-term impacts on financial returns, without significant consideration of the way that climate-related risks may have financial consequences and the unpredictable timing of those risks. In addition, perceptions that legal advice would not be supportive – based on experiences that predate current understanding of the financial risk – sometimes deter trustees from placing greater emphasis on climate change. In short, legal uncertainty is contributing to inaction.

2. Trustees' time horizons are often too short.

Many mature DB schemes expect to transfer their liabilities to insurance schemes within the next few years, thus discharging the trustees' own duties. LCP estimates that £400bn-£600bn could be transferred in the next decade (out of c£1.5trn DB liabilities in total)[2]. Moreover, some DC schemes expect to consolidate or to transfer their benefits to a master trust over a similar time horizon. As a result, many trustees have a short-term perspective on the relevance of climate risks to their members' benefits and act accordingly. Specifically, they make decisions based on the risks they consider to be relevant over the remaining lifetime of the scheme which is the period over which they are directly responsible for holding the assets. In some cases this is less than three years and in many cases is less than ten years. This means they do not consider it their responsibility to take actions that will ultimately help to mitigate climate-related risks over the 2030s and beyond, even though these could have very material impacts on financial markets and hence members' pension benefits (and quality of life in retirement)[3].

3. Climate change requires collective action which goes beyond the narrow best interests of individual actors.

To obtain the best outcomes for pension scheme members (and society) as a whole, ambitious and urgent coordinated action is required across the global economy to limit global average temperature rises to 1.5°C above pre-industrial levels[4]. If temperatures rise above this level, the physical effects of climate change will become increasingly severe and start to pose risks to the stability of the financial system, with increasing risks to members' pensions[5]. In other words, climate change is a systemic risk which cannot be diversified away. Even if the two points above are addressed, the actions taken by individual pension schemes based on what is deemed to be in their members' best interests will likely fall short of what is needed to limit rises to 1.5°C.

For example, many pension schemes have set emissions reductions targets for their assets consistent with reaching net zero emissions by 2050. These targets are always subject to an override of trustees' fiduciary duty. We think it is likely that situations will emerge in the next few years where actions needed to keep emissions reductions on track are not taken because of concerns that they will harm schemes' risk-adjusted financial returns[6], particularly if it appears that national emissions targets will not be met. Therefore some (many?) pension schemes will miss their targets and overall outcomes – for the climate, the economy and individual members – will be suboptimal, unless trustee duty is clarified to explicitly include real world impact.

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[1] Our experience is consistent with research published by Pensions for Purpose in 2023, One year on – TCFD reporting for pension funds.

[2] See Pensions de-risking: A seismic shift in buy-ins / outs – how is the market adapting? | Lane Clark & Peacock LLP (lcp.com).

[3] See Could climate change cause the buy-in market to collapse? | Lane Clark & Peacock LLP (lcp.com) for information on these risks to DB members' benefits. The risks to DC members' benefits are greater and more direct.

[4] See, for example, Emissions Gap Report 2023 from the UN Environment Programme.

[5] See Climate Emergency – tipping the odds in our favour from the Institute and Faculty of Actuaries and the Climate Crisis Advisory Group.

[6] See, for example, Trouble ahead for GFANZ by Tom Gosling, Executive Fellow at London Business School, which argues that "the optimal trade-off for *financial* risk-adjusted returns is likely to be considerably higher warming than 1.5°C, as this target incorporated many factors that are inevitably ignored by financial markets" (emphasis in original).

Is a legal change to the definition of fiduciary duty needed?

We are not lawyers, so are not qualified to comment on the most appropriate legal mechanisms to address the problems we set out above – including the extent to which the changes we are advocating can be achieved through clarification of existing law or require changes to law. With this in mind, we make the following suggestions (which correspond to the numbering above):

1. Clarification of the current interpretation of fiduciary duty.

The recent paper from the Financial Markets Law Committee (FMLC)[7] provides very helpful clarification of the legal position regarding fiduciary duties. We expect it will help to address many trustees' concerns about what is permitted and ensure greater consistency of legal advice in this area. Endorsement of this paper by the Department for Work and Pensions and The Pensions Regulator could further mitigate the caution that we outline above.

2. Extension of trustees' time horizon.

In our experience, trustees typically do not consider risks beyond the expected lifetime of their scheme. However, the risks a scheme's members face may extend well beyond that time horizon, with those members' benefits being secured through alternative means, such as via another scheme, an insurer or a decumulation vehicle. Therefore, we believe that the remainder of members' lifetimes is a relevant time horizon for trustees' fiduciary duty "to act in members' best interests" and trustees should be able to choose how much weight they wish to place on this time horizon. Footnote 10 of the FMLC's paper suggests this interpretation may already be possible, but we would like to see explicit clarification of this point.

For the avoidance of doubt, we are not advocating that trustees should remain liable for investment decisions beyond scheme wind-up. The FMLC paper is helpful in clarifying that trustees should not fear the hindsight lens, provided they have followed due process[8].

We note that the definition of "appropriate time horizon" in Regulation 2(4) of The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), as amended[9], seems inconsistent with considering a "remainder of members' lifetimes" time horizon.

3. Reframe as a "double materiality" duty.

Current regulations and guidance for UK occupational pension trustees in relation to climate change are framed in terms of managing the climate-related risks and opportunities to the pension scheme, in what is sometimes called a "single materiality" or "outside-in" perspective. To help address the collective action problem we outline above, we believe a "double materiality" approach is needed, whereby trustees also seek to manage the real-world impacts that their actions have on climate change via an "inside-out" perspective. This is because the two perspectives are inherently connected: each pension scheme investment contributes to climate change (due to its role in generating, preventing or absorbing greenhouse gas emissions) which in turn affects the climate risk exposure of the rest of the scheme's investments, both directly and indirectly through its effect on the economy in which the scheme operates.

The real-world climate impact of the scheme's investments should be clarified as a relevant factor for trustees to consider, since this will shape the investment landscape over the coming decades and hence members' ultimate financial outcomes (and quality of life), with trustees choosing how much weight they wish to place on it. Trustees, even of closed DB schemes would, then, explicitly take account of the impacts their investment and engagement decisions have on greenhouse gas emissions in the real world.

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[7] Paper: Pension Fund Trustees and Fiduciary Duties – Decision-making in the context of Sustainability and the subject of Climate Change – FMLC.

[8] See paragraphs 2.8 and 7.2.

[9] "the length of time that the trustees of a trust scheme consider is needed for the funding of future benefits by the investments of the scheme".

Again, we consider the FMLC's paper to be helpful in this regard – particularly the references to systemic risk in section 6 – but do not believe it fully addresses our concerns. We appreciate that the paper's remit is to seek to clarify existing law. We would suggest that, to the extent that existing law cannot achieve these aims, then this is an important enough issue to consider changes to law. We also recognise that this is the most ambitious aspect of our suggestions.

What risks might be involved? How might they be mitigated?

With any investment decision, there is a risk that financial outcomes will be worse than if a different decision had been taken. Our understanding is that, if trustees follow a proper decision-making process and can evidence that they have done so, they have considerable protection under the law from allegations of wrongdoing. A "proper" process includes following applicable guidance. Authoritative clarification of trustees' fiduciary duty, in line with the suggestions above, would therefore give trustees more confidence to take stronger action in relation to climate change.

There is currently a risk that trustees take strong climate action but other parties do not, so the best collective outcome is not achieved and member outcomes are worse than if trustees had acted in accordance with members' narrower financial interests over a shorter time horizon. This risk can be mitigated by relevant parties speaking up about the importance of collective action across the global economy to limit temperature rises to 1.5°C. This could include trustees (and others) encouraging the UK government to take action in line with the recommendations of the independent UK Climate Change Committee and to show global leadership which encourages other countries to fulfil their commitments under the Paris Agreement.

Are there other ways of achieving the same outcomes (such by improving governance, or providing better tools to help trustees ask the right questions and make decisions)?

We believe that clarification of fiduciary duty, as outlined above, is necessary alongside other changes. Based on our extensive experience of advising clients in this area, we do not believe that other changes will be sufficient on their own. While some schemes have taken substantial action to address climate risk, many others have chosen not to do so, despite various existing governance requirements.

We recommend the following changes alongside those outlined above:

1. Education for trustees and their advisers on systemic risks such as climate change.

In our experience, when considering climate change in relation to investment decisions, many people within the pensions industry think narrowly in terms of the risks and opportunities that it may pose to an individual investment, without sufficient appreciation of the way that climate change could threaten the stability of the financial system if temperatures continue to rise. We find that educating trustees on the severity of the likely impacts of a 3°C rise can trigger a paradigm shift that fundamentally alters the way they think about climate change. This shift is needed across the industry in order to achieve the necessary scale of action.

2. Shift trustees' focus from reporting to action.

Current UK pension scheme legislation in this area focuses on reporting, specifically annual climate reports for large schemes[11] and annual implementation statements for all schemes with at least 100 members. Such requirements helped highlight climate change risks, but we find that this reporting consumes a disproportionately high share of the time and advice budgets available for trustees to consider climate change, sustainability and stewardship, and reduces the time that is spent on taking real-world actions in these areas. Moreover, it encourages a tick-box mindset rather than one which prioritises improving member outcomes. We would like the UK government and financial regulators to use the forthcoming reviews of the climate reporting and stewardship regimes as an opportunity to reduce the reporting burden and increase the focus on real-world action.

[11] Broadly, schemes with at least £1bn of non-insured assets and master trusts.

3. Facilitate investments in climate solutions.

The UK government's current focus on encouraging and enabling pension schemes to increase their allocation to productive finance offers an opportunity to facilitate investments in climate solutions such as renewable energy, electrification and energy efficiency. We would like to see an explicit focus in the productive finance reforms on incentivising investments that support the low carbon transition. We refer you to our previous submission to the Committee, in response to your March 2023 call for evidence on Defined Benefit pension schemes, which set out ideas for incentivising long-term investment – an important facilitator for investing in the low carbon transition.

We trust our thoughts are helpful and would welcome the opportunity to discuss them with you.

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