ASSOCIATION OF PENSION LAWYERS
c/o John Gordon, Ashurst LLP, London Fruit and Wool Exchange, 1 Duval Street, London E1 6PW

EUSurvey
European Commission

15 July 2020

Dear Sir/Madam

European Commission Consultation on the renewed sustainable finance strategy – responses to Questions 92, 93 and 94

I write on behalf of the Association of Pension Lawyers, a body representing members of the legal profession in the UK who specialise in pensions, and pensions-related, law. The Association of Pension Lawyers is a non-political, non-lobbying, not-for-profit organisation representing over one thousand members.

The purpose of this letter is to set out our responses to questions 92, 93 and 94 of the Consultation Paper. We have not commented on other questions or requests for views, as the experience of the Association of Pension Lawyers does not enable us to do so, and we do not comment on issues of policy.

Scope of our comments made in response to Questions 92, 93 and 94

Our comments below are limited to consideration of the integration of members' and beneficiaries' ESG preferences in the investment strategies adopted by IORPs, and, other than where management and government of IORPs relates to investment issues, do not expressly consider the management and governance of IORPs. However, it may be that the points set out below in relation to investment issues also apply, to a certain extent, to the management and governance of IORPs.

While the improvement of the integration of members' and beneficiaries' ESG preferences in the investment strategies of IORPs is a matter for public policy, and outside our remit, we have set out below our view of the legal and practical issues relevant to this question. Our comments relate to IORPs in England and Wales.

Question 92: Should the EU explore options to improve ESG integration and reporting beyond what is currently required by the regulatory framework for pension providers?

- ***Yes/No/Do not know.***
- ***If yes, please specify what actions would be relevant in your view. [BOX max. 2000 characters]***

IORPs in England and Wales are already subject to a number of disclosure and reporting requirements, including generally that they must publicly disclose their policies on the integration of environmental, social and governance factors (including climate change) in their investment decision making and, from October 2020, a requirement on relevant schemes (broadly those providing defined contribution benefits) to provide an annual statement on the implementation of these policies.

The UK Government is also intending to take powers in the current Pension Schemes Bill which would enable it to mandate effective governance and disclosures by IORPs in England and Wales of a prescribed description in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), including disclosure in relation to their alignment with the Paris Agreement goal. We understand that such powers are likely to take effect by 2022.

Whilst we are supportive of disclosures in relation to sustainability issues, we would observe that further developments should be developed in a way that does not duplicate existing disclosure requirements and that instead it would be preferable for them to build on those referred to above. Further, we have observed that the multiple sources of disclosure requirements and their application in relation to different reporting periods for different IORPs has the potential to cause confusion. We would encourage any initiatives to improve ESG integration and reporting to be developed as a single source of disclosure requirements applying uniformly rather than pursuant to multiple sources of overlapping regulatory requirements.

We would also observe that disclosure may be more effective as a compliance mechanism for driving widespread and faster change across the sector if there were clearer industry-wide benchmarks and metrics. TCFD, PRI and the UK Stewardship Code are all initiatives which have strong support by IORPs in England and Wales, but there is currently a wide 'margin of appreciation' as to how an IORP may choose to adhere as signatories. We consider that a consistent and high standard of industry compliance may be more likely to emerge where clearer objective standards are provided.

Question 93: More generally, how can pension providers contribute to the achievement of the EU's climate and environmental goals in a more proactive way, also in the interest of their own sustained long-term performance? How can the EU facilitate the participation of pension providers to such transition?

Pension providers are constrained, just as pension schemes are, to ensure the long-term profitability and sustainability of their pension provision. For pension providers to become more proactive in achieving the EU's goals, investing in the applicable investments would need to meet the requirements of profitability and sustainability over the long term. To have a real impact these investments would need to be at the core of the investment strategy. We would observe that this may be unlikely to occur until all companies are required to consider – and actively address - their impact on the environment as part of their standard operating practice. The EU (and member states) may also consider whether IORPs could be assisted by the creation and development of new markets and investment opportunities (through appropriate law and policy interventions) which have greater sustainability credentials but which also meet the sustainability and profitability characteristics IORPs are duty-bound to seek.

Question 94: In view of the planned review of the IORP II Directive in 2023, should the EU further improve the integration of members' and beneficiaries' ESG preferences in the investment strategies and the management and governance of IORPs?

- ***Yes/No/Do not know.***
- ***If yes, how could this be achieved, taking into account that IORPs are collective schemes whose members may have different views on ESG integration? [BOX max. 2000 characters]***

Executive summary

In our view, it may be possible to improve the integration of and members' and beneficiaries' ESG preferences in the investment strategies of IORPs which are run on a ***defined contribution*** (i.e money purchase) basis, subject to certain provisos.

However, we can foresee significant legal and practical issues with any attempt to improve the integration of and members' and beneficiaries' ESG preferences in the investment strategies of IORPs which are run on a ***defined benefit*** (i.e final salary) basis.

We have set out further detail in relation to these points, below.

Integration of members' and beneficiaries' ESG preferences in the investment strategies of defined contribution IORPs

It may be possible to improve the integration of member views in defined contribution IORPs, for the purpose of ensuring that members are given a suitable range of funds appropriate to their needs. This may include offering member "self-select" funds with particular ethical or social impact attributes, and, indeed, it may be that offering an appropriately wide range of such funds is, itself – at least to a certain extent - a means of improving the integration of members' and beneficiaries' ESG preferences in the investment strategies of this type of IORP.

Clearly, a defined contribution self-select fund, if properly communicated to members, has more flexibility in this regard. However, we note that it is incumbent on the trustees or managers of defined contribution schemes to ensure that the fund options made available to members are appropriate, and have been chosen by the trustees or managers in accordance with the trustees' or managers' legal duties with regard to the exercise of their selection power (which is considered, in the context of defined benefit IORPs, below).

Integration of members' and beneficiaries' ESG preferences in the investment strategies of defined benefit pension schemes

In relation to defined benefit IOPRs, while we are supportive of the need for trustees to engage appropriately with scheme beneficiaries and to be clear in their policies on ESG issues, we can foresee significant legal and practical issues with any attempt to do this. These are as follows:

1. **Interaction with existing legal duties**

It may be difficult for trustees of defined benefit IORPs to integrate the views of members and beneficiaries (on ESG issues, and indeed on other issues) in a way which is legitimate and in line with their fiduciary duties.

In short, if the relevant ESG issues are considered to be financially material, trustees will have a duty to take them into account when making decisions on investment strategy, irrespective of member preference. If, on the other hand, the ESG issues are not considered to be financially material, the legal ability of trustees to take into account the views of members and beneficiaries is likely to be extremely limited.

This follows from the legal framework governing investment in defined benefit IORPs. In this type of pension scheme, where the purpose of a scheme's investment power will be to invest for the provision of a defined level of benefits, with risks generally underwritten by the scheme's sponsoring employer, trustees must exercise their powers for the proper purpose of the trust. This usually means acting in the beneficiaries' best financial interests. The meaning of 'best financial interests' is open to some interpretation (and when forming a judgment on whether it meets that criteria, the impact of a decision can be looked at over a different time frames). Trustees also need to consider their fiduciary duty of prudence when investing. In essence, for a defined benefit IORP, that means looking to fulfil the promise to provide the appropriate level of benefits. Trustees also need to follow a legally 'proper' decision-making process, and to put personal views to one side, when investing.

In this context, ESG factors, if financially material, must be considered by trustees. 'Financially material' does not mean that it has to generate a financial return. For example, it is clear that risk reduction can be financially material (e.g. hedging can generate a loss, and often does so if the portfolio as a whole is doing well, and is still to our mind an investment). Eliminating some other downside risk may still be financially material. Similarly, it is clear that financial materiality is measured on a scheme specific basis, and is not linked to, say, a short term return. On that basis, a long term reduction of risk could also be acceptable.

If a particular factor is financially material, trustees will have a duty to take it into account. (On this point, we note that many factors identified as 'non-financial' do, when analysed properly, have a financial impact (notably through a reduction in risk) and therefore might still be characterised as a financially-material factor.) If the factor is not financially material, then, in our view, trustees should be very cautious about taking the factor into account. The extent to which they can take this type of factor into account is considered further below.

2. Limited legal and practical relevance of non-financial factors

In England and Wales, caselaw has set out the circumstances in which it is appropriate for trustees to take non-financial factors, including the ethical views of members, into account. These circumstances are very limited.

Based on current caselaw, broadly speaking, trustees can take non-financial factors into account only if:

- there is no risk of a significant financial detriment (or there is no significant risk of any financial detriment); or
- they have good reason to believe that the members of the IORP would support the approach.

The second limb set out above indicates that member preferences may be relevant. However, in our view, reliance on this limb would effectively require **all** scheme members (and perhaps beneficiaries) to share the relevant preference. We do not think that the requirement would be satisfied if even a small minority did not share the preference. This is a significant, and most probably insurmountable, hurdle to jump for most IORPs (other than, perhaps, the smallest schemes).

Furthermore, as trustees must exercise their powers for the proper purpose of a trust, it is unlikely that those powers and duties could be discharged by seeking lay member support for a decision (if indeed that could be obtained) that would otherwise fall short of meeting the core obligations placed on fiduciaries particularly when, for defined benefit IORPs, it is not members that underwrite the risk of underfunding.

This means that, in practice, it is likely that factors which are not financially material will only be able to be taken into account if they incur no risk of a significant financial detriment (or, perhaps, if there is no significant risk of any financial detriment). This means that their relevance may be limited to (perhaps very rare) situations where an IORP is exercising a choice between two otherwise (on a financial basis) equal investments. In this context, the circumstances in which trustees will be able to take member preferences into account (at least in a defined benefit context) appear to be very limited.

3. Practical issues in relation to integration of member views

We anticipate a number of practical problems if there is an attempt to improve the integration of members' and beneficiaries' ESG preferences in the investment strategies of defined benefit IORPs.

It may be difficult to formulate and implement a clear and effective way to determine these preferences. Any attempt to use, and rely on the results of, member surveys or questionnaires presents obvious problems (including, for example, the following issues: How would preferences be surveyed? How would the communications/questions be drafted? How often would members be canvassed? Would all members and beneficiaries (including contingent beneficiaries) be contacted? What supplementary information (if any) would be provided? Would members be asked – or requested – to take advice on the subject? How would a response rate of less than 100% be addressed? How would the trustees act if the survey revealed – as it is likely to do – a diversity of preferences amongst members and beneficiaries? etc).

Trustee governance time is also limited for most schemes. We consider that experience may run contrary to any policy objectives if trustees divert time and attention on member ethical views at the expense of considering financially material ESG factors as part of their fiduciary duties.

If you would like to discuss, please do not hesitate to contact John Gordon, at john.gordon@ashurst.com, Stuart O'Brien at Stuart.OBrien@sackers.com, Helen Quarrell at Helen.Quarrell@fil.com, or Dominic Harris, at Dominic.Harris@cms-cmno.com, or by post at the address set out above.

Yours sincerely

John Gordon

For and on behalf of the Association of Pension Lawyers