

It is now just over a year since the Minister and I last stood here to discuss the issue of responsible investment by pension funds – with that debate focussing particularly on transparency to fund members. His response was thoughtful and constructive.

To begin with, it is worth briefly taking stock of some key developments since our last exchange.

First, in recent weeks, 'responsible capitalism' has risen to the top of the political agenda. A cross-party consensus has emerged that shareholders must do more to tackle irresponsible corporate behaviour such as excessive top pay.

Second, we have entered 2012, the year of auto-enrolment. A process that will ultimately see millions of workers begin saving for a pension through the capital markets.

And thirdly, casting our minds back to the Autumn Statement, we have seen the government turning to pension funds as a source of capital to fuel the economic recovery through infrastructure investment.

Put all that together, and it is clear that the way pension funds invest is no longer, as the Minister put it in our last debate, “a minority sport”, but a matter of acute national concern.

Although much has been made recently of the rise of foreign investors and high-frequency traders, UK pension funds still make up around 13% of the UK stock market – with insurance companies who provide pension products making up another 12%. It's vital that this huge pool of capital is invested responsibly in the long-term interests of pension savers.

Unfortunately, as a report published last year by responsible investment charity FairPensions showed, current interpretations of the law may hinder this objective.

Fiduciary duties – our main legal mechanism for protecting those who entrust their money to someone else – do not apply consistently across the pensions market. Worse, they are **generally interpreted** as forbidding pension funds from raising their sights beyond quarterly returns. A view which, far from protecting savers' long term interests, may in fact

be damaging to them.

Clarification of this seemingly obscure and technical area of the law could unlock positive change in a whole range of areas – supporting jobs and growth, ensuring decent pensions, and underpinning the shift to a more responsible, resilient capitalism.

The Prime Minister has indicated that the government wants to give shareholders more powers to block excessive pay deals. This is welcome, but more searching questions need to be asked about how shareholders are using the rights they already have. Figures released by PIRC last week showed that, since the introduction of the advisory vote on pay ten years ago, just eighteen remuneration packages have been voted down – despite the fact that pay has risen out of all proportion to shareholder returns. Why this reluctance?

Most pension funds do not exercise voting rights themselves, but delegate to fund managers whose own duties are unclear. FairPensions' report argues that fund managers do have fiduciary duties **under common law** – a

view shared by the Law Commission – but this is not generally accepted by the industry.

This means that the strict duty to avoid conflicts of interest is not being applied by the people actually making the decisions. This has real implications for how votes are cast by City fund managers who have business relationships with the companies they invest in.

A recent article in the Butterworths Journal of International Banking and Financial Law cited anecdotal evidence of “corporate or investment banking staff overtly or subtly pressuring their asset management colleagues to avoid antagonising their clients by voting against the CEO’s pay arrangements.”

Meanwhile, pension funds themselves are often labouring under the misapprehension that their fiduciary duty prohibits them from taking an interest in Bob Diamond's bonus – when of course, properly understood, this is very much part of that duty.

The pervasive myth that fiduciary duty begins and ends with

maximising returns leads many funds to neglect intangible factors – be they excessive pay or poor environmental performance – even though they may well affect the long-term returns which matter most to pension savers.

This misconception seems to put some trustees off the whole idea of being active owners of the companies in which they invest – notwithstanding efforts through the UK Stewardship Code to encourage them to do so. Still less do funds believe that they can take account of the moral outrage felt by their members over excessive top pay.

These interpretations continue to hold back pension funds' potential to play their part in a more responsible capitalism. Put simply, we cannot have responsible capitalism if the capitalists think that the law prohibits them from acting responsibly.

Here I would like to briefly touch on the subject of our last debate – transparency. Making companies more accountable to shareholders will not be enough to tackle 'crony capitalism': shareholders themselves must also become more accountable to the ordinary savers whose

capital they invest. Among other things, this means much greater transparency about what is being done with our money. At the moment, if I want to find out how my pension fund voted on Barclays' remuneration report, they are not obliged to tell me. In his response last year, the Minister promised to raise this issue with the Chair of The Pensions Regulator. I would be grateful if he could update the House on the results of that conversation and on any further developments.

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Narrow interpretations of fiduciary duty risk holding back not just the responsible capitalism agenda, but also the economic recovery.

Pension savers have a clear interest in the health of the UK economy. It affects not only the growth of their investments, but also their economic wellbeing more generally as UK citizens, jobholders and taxpayers.

The Treasury has observed this obvious common interest when encouraging pension fund investment in UK infrastructure. The Financial Secretary to the Treasury said in a recent speech to the National Association of Pension

Funds: “Your investment in the UK economy can drive economic change and that change should generate more stable and sustainable returns, benefitting Britain’s pensioners.” The same logic can be applied to investment in the small and medium-sized businesses which are the engine of job creation in our economy.

But this is not the logic that underpins pension fund decision-making in practice. We are back to the mantra of the 'fiduciary duty to maximise return', which dictates that return must be sought wherever it is to be found. Given a direct choice between two competing investments, there is no reason for pension funds to invest in the UK rather than, say, China. Indeed, most funds would say that the law legally obliges them to choose the latter if the risk-return profile is even marginally more attractive.

This reduces fiduciary duty to a mathematical calculation which obliges trustees to chase the best return and ignore all other considerations, rather than enabling them to take a common-sense approach, using their discretion to determine how their capital can best be put to work for the benefit of pension savers.

Given the choice, many pension savers might well want to see their savings invested in British industry or green infrastructure. But under conventional interpretations of the law, their views are irrelevant. Fiduciary duty, which exists to protect savers, risks becoming a missing link when it comes to translating our savings into productive investment.

This is emphatically not about hijacking pension funds' capital to serve government ends: that is a dangerous road to go down. It is about allowing them the discretion to take a broad and enlightened view of what is in their beneficiaries' interests, rather than prescribing an approach which may ill serve savers in the long run.

Let us not forget that it was today's interpretation of the law which saw pension funds pile into triple-A rated shares in banks whose risky activities ultimately decimated pension fund value. If funds had been encouraged to think about the sustainability of those returns, rather than just the share price, their beneficiaries might have been better served in the long-run.

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This brings me to the third and final area in which policymakers ignore debates about fiduciary duty at their peril: auto-enrolment. The Pensions Regulator estimates that 5-8 million people will be newly saving or saving more as a result of the 2012 reforms. Many of these will be low-paid workers. There is a huge responsibility on government to ensure that these people's savings are responsibly stewarded and deliver a decent retirement income. This means ensuring that fiduciary standards of care are applied across the pensions market.

During the Committee stage of the Pensions Bill, the Minister rightly noted the importance of taking a “holistic approach” and not creating an “unevenness” by putting “conditions that are not imposed on other investment vehicles on pension schemes”. However, the fact is that there is already unevenness between trust-based pension schemes and contract-based pension arrangements, since the latter are not subject to fiduciary duties and the governance requirements that go with them.

The average saver may struggle to see the difference between these two types of arrangements, in both cases

they are handing over their money to a third party and trusting them to turn it into a retirement income. Yet the legal niceties mean that savers are subject to completely different legal protections depending on the type of scheme their employer chooses.

Last year the Minister's Department consulted on 'regulatory differences' between trust- and contract-based pension arrangements. I hope that he will look at this issue of governance, because it is the single biggest regulatory difference and carries the biggest danger of regulatory arbitrage.

A struggling employer could be forgiven for wondering why they would want to set up a trust-based scheme, with all the governance obligations that entails, when they could simply choose an off-the-shelf product from an insurance firm and think no more about it.

Yet there are obvious reasons to think that such a decision might not serve the best interests of their employees. This is not merely a theoretical objection – I understand that FairPensions are due shortly to publish research which

shows that the absence of clear obligations does indeed create a 'governance gap'. Can the Minister give some indication of whether his Department is looking into this issue, and if so, what might be done to ensure a level playing field for all pension savers?

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So, overall, the misapplication of fiduciary duty is clearly a significant challenge to the government's vision for a strong, responsible economy and a savings culture.

Conversely, a renewed understanding of fiduciary duty offers an exciting opportunity to reshape our economy for the better. FairPensions' report recommends statutory clarification of fiduciary duties, along the lines of directors' duties under the Companies Act, to make clear that pension funds can consider a range of factors beyond quarterly returns. For example, the impact of their investments on the wider economy; environmental and social issues; and their members' ethical views. It also recommends that DWP produce guidance for pension fund trustees on the interpretation of their fiduciary duties.

When these recommendations were debated through a

probing amendment to the Pensions Bill, the Minister helpfully put on record his view that “it is not the duty of trustees simply to maximise short-term returns”. In other words, the measures proposed by FairPensions would amount to clarification rather than a radical departure from existing legal principles.

To some this might beg the question: if the underlying legal principles are sound, is statutory clarification really needed?

It is true that some pension funds already take an enlightened approach to their fiduciary responsibilities. NEST is emerging as a beacon of best practice when it comes to responsible investment, viewing it as part of their responsibility to undertake shareholder engagement and to integrate environmental and social issues into their investment analysis.

Strathclyde Pension Fund offer an excellent example of how pension funds can make investments that add genuine, sustainable economic value for their members. It recently announced a £100 million 'New Opportunities Fund' to invest in job creation in Glasgow, with the proviso that it will

only invest in businesses which pay the Living Wage.

But these examples are very much the exception rather than the rule. The conventional interpretation of the law is highly conservative, and this is reflected in the legal advice received by the vast majority of pension funds.

It is difficult in practice to see how this problem with interpretation of the law can be overcome other than by explicit clarification of the law.

It is also worth noting that even pension funds which take an enlightened view of their fiduciary duties still appear to believe that the law restricts their room for manoeuvre. For instance, one investment officer recalls asking for legal advice as to whether, when voting on a hostile takeover bid, they could consider the fact that some of their beneficiaries might lose their jobs. The answer was no: they could only consider the price they would be paid for selling their shares.

In other words, far from being a counterweight to predatory activities, even the most enlightened pension funds may feel

legally obliged to be complicit in them. For all these reasons, express clarification does seem to be necessary.

To be clear, this is not a question of diluting the fiduciary duty to seek the best outcome for beneficiaries. Nothing in these proposals would change the fundamental principle that fiduciaries must act wholly in the best interests of their beneficiaries.

Rather, it is about making fiduciary duty work better in today's complex financial markets. Indeed, we must seriously ask whether fiduciary duty as currently understood is doing its job properly.

I have already alluded to the lessons of the financial crisis. Moreover, from 2002-2007, pension funds' payments to intermediaries rose by 50%, while returns collapsed to an average 1.1% per year. If the main purpose of fiduciary duties is to make sure that savers come first and that their agents do not profit at their expense, these figures suggest that something is badly wrong.

Neither is this a question of imposing new regulatory

burdens on pension funds, but rather the opposite: clearing away perceived legal barriers and restoring common sense to the law. FairPensions' proposals are aimed at creating an enabling environment, freeing trustees from the fear that they may face legal liability if they depart from received wisdom about how they must invest. This is true of both the recommendation for statutory clarification, and the recommendation for DWP guidance.

In relation to guidance, I would tentatively suggest that the Charity Commission's recent update of its investment guidance for charitable trustees might provide a useful model. It has helped to clarify that fiduciary duty is not a set of handcuffs which prevents trustees from considering anything but financial return. In particular, it has sought to give comfort that "if trustees have considered the relevant issues, taken advice where appropriate and reached a reasonable decision, they are unlikely to be criticised for their decisions or adopting a particular investment policy.

I understand that the Minister's officials have been engaging with FairPensions since the publication of their report about the possibility of guidance, and wonder if the Minister might

update the House on any progress his Department has made on this recommendation.

Of course, I appreciate that government will wish to wait for the results of the Kay Review of UK equity markets before making firm commitments. I understand that fiduciary duty forms part of Professor Kay's remit, and that it has been discussed extensively during his first phase of consultation.

If Professor Kay does make recommendations on this issue, then clearly government will need to consider those alongside the recommendations already made in FairPensions' report.

Overall, therefore, it would be helpful if the Minister could give some general indication of whether there is enthusiasm within government for reform of fiduciary duty, and whether, if it proves to be consistent with the findings of Professor Kay's enquiry, he will work with colleagues in the Department for Business to take this agenda forward.