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LCP's response to the DWP's Call for Evidence on pension trustee skills, capability and culture

1 September 2023

This document sets out LCP's response to the Call for Evidence on pension trustee skills, capability and culture published by the Department for Work and Pensions on 11 July 2023.

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 160 partners and over 300 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, including investment strategy. The remaining 20% relates to 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 overall thoughts

We have set out in the pages that follow, our answers to the specific questions posed in the Call for Evidence.

In the main, we believe trustees are aware of their requirements; capable of considering the full range of investment opportunities; well supported; and not held back by fiduciary duty nor regulation, in relation to investment in unlisted equities.

That said, we make several recommendations in our response:

- We support mandatory training requirements for trustees. However, we recommend a cautious approach to any requirement for accreditation, potentially starting with the Chair of Trustees for pension schemes of a certain membership size.
- There should be further encouragements or requirements for all employers to provide trustees (member and corporate appointed) sufficient time to fulfil their (broader) duties.
- Improvements are needed from investment managers including on product offerings, transparency / disclosure and on the valuation of illiquid assets (with regulation to support this if necessary).
- More guidance for employers on the selection and oversight of a DC pension in a Master Trust (where the market is currently significantly driven by price, and this doesn't necessarily produce the best overall outcomes).
- Extending existing guidance on investment to set out how trustees should best think about "productive assets" and on how to balance the different time horizons of members and risks.
- As per our response to the Call for Evidence on Options for DB Schemes, we are calling for new regulations that create a different risk/reward environment for DB trustees (full PPF coverage and easier return of surplus) that in turn can be expected to support more widespread, and for longer, DB investment in productive finance.
- A wider review of fiduciary duty should be conducted, to consider in particular the way in which trustee duties interact with stewardship and climate change – we recognise this is not the focus of this Call for Evidence but set out our early thoughts on this and strongly recommend the Department's autumn review of stewardship proceeds and considers these important points.

We are happy for LCP to be named as a respondent to the Call for Evidence and happy for our response to be in the public domain. We are happy for you to reference our comments in any response.

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LCP's response to the questions in the Call for Evidence

Chapter 1: Trustee skills and capability

Question 1: Do trustees know what the knowledge and understanding standards expected of them are?

Yes, in our view trustees generally know what standards are expected of them, as set out in the Code of Practice.

Question 2: Do trustees currently meet the knowledge and understanding requirements expected of them? Are some types of trustee better than others?

In our experience trustees mostly meet the knowledge and understanding requirements expected of them. Some trustee types, such as professional trustees, tend to demonstrate more consistently the knowledge and understanding requirements. This is likely to be reflective of their background (many previously worked in an advisory or legal capacity in the pensions industry) and the greater access they have to opportunities for CPD (such as industry seminars and sessions run by the advisory community).

Other, non-professional trustees (both member and employer nominated) who are given appropriate time or are supported in their training and development by their scheme secretary, pensions manager, advisers and Unions also tend to show strong knowledge and understanding.

In our experience, it is common for most trustee boards to require new trustees to complete TPR's Toolkit within 6 months of their appointment. Training needs for experienced trustees tend to be delivered 'just in time' in line with decisions being made at meetings, but some schemes have detailed training plans aligned with scheme objectives, which we view as best practice.

We recognise that there are a number of different compositions of trustee boards: a full board of MNTs and ENTs, a board with MNTs, ENTs and a professional trustee (chair or co-trustee) and a Professional Corporate Sole Trustee model. Based on every scheme's unique set up and requirements, we are conscious that each of those models have their pros and cons. Rather than focusing on the industry's preference for a model over another, we would like to draw out the importance of acknowledging the different viewpoints and diversity of thought (as covered later in this response) and appreciate that each of those models addresses those points in their own unique way to ensure good governance and trustee effectiveness.

Question 3: What are the barriers to improving trustee capability? What do you think government should do to ensure that all trustees meet the standards expected of them? Does trustee liability put off potential trustees?

In our view, barriers include time/resource constraints, regulatory and legal complexity and the lack of board diversity potentially leading to group think. The first two barriers are particularly acute for those who are not professional trustees and who also have a 'day job' which is outside of the pensions industry.

Having clear and up to date regulatory guidance helps trustees understand what is expected of them. ***Implementing mandatory training requirements for all trustees can help to ensure that all trustees have a baseline level of knowledge and understanding.*** Non-professional trustees should also be given specific time and support to help them to meet the standards and fulfil their duties. For example, this could be by encouraging, or requiring employers to provide employed trustees with a 'bank' of time to spend on training and providing access to support materials. A buddy or mentor system to assist new trustees with their role may also help trustees to feel comfortable and supported, as well as knowing what's expected of them.

A professional trustee secretary supporting the board to identify and organise relevant training can also positively impact overall governance.

One benefit of a Sole trustee arrangement is that training needs can be streamlined through a consistent and regular training arrangement on a Professional Trustee firmwide level removing the need to train individual trustee boards.

Potential member nominated trustees may be put off by concerns relating to their own personal liability and personal risk. In our experience it is still common for MNT nomination communications to focus on the risks rather than the benefits of

the trustee role and this may have the unintended consequence of putting off potential candidates. However, once individuals understand the protections available to a trustee (e.g. corporate trustee structure, protection under scheme rules, protection offered by legislation and reliance on professional advice), in our experience these concerns are reduced.

We note that Trustee Liability Insurance is becoming more expensive. Whilst this doesn't directly impact trustees (insurance is usually paid for by the sponsor), it is possible that sponsors may look to reduce their level of coverage due to increased costs. There is also a question about the extent to which liability insurance covers data / cyber breaches, which may cause a nervousness for trustees.

Question 4: Do trustees (including Master Trust trustees) have the right knowledge and understanding to invest in the full breadth of investment opportunities? If not, what can be done to improve this?

Typically, we have seen that professional trustees have a greater level of knowledge and understanding of more complicated investments, including property, infrastructure, private market debt, unlisted equity and other illiquid assets. We note that, in general, Master Trust boards include professional trustees. However, in our experience, member nominated trustees with appropriate support and training (or relevant background) are open to exploring the full breadth of investment opportunities, including those which may have been less familiar to them at the outset / based on their personal experience.

For most trustees, the challenges to investing in illiquids do not tend to be driven by a lack of understanding of the opportunities (and risks) of investing in these asset classes, but rather external factors. These external factors notably include:

- the need for liquidity, particularly for DB schemes as they get more mature;
- the availability of these investments to DC schemes and smaller DB schemes (this has been addressed in part with the launch of Long Term Asset Funds ("LTAFs") earlier this year); and
- concerns over pricing: for many DC trustees there remain concerns about the fairness of pricing of illiquid asset classes in what is a daily pricing world (this was covered well in the "market values" section of this TPR blog). We hope guidance from the Pensions Regulator will help with this issue.

To address these concerns, we believe asset managers could have a role in developing new investment funds and products (such as the recently launched LTAFs) which meet the specific needs of both DB and DC pension scheme trustees, while investment platforms can definitely do more to offer greater choice in this area for both DC schemes and smaller DB arrangements. Legislative and regulatory (including Solvency II) changes could also better incentivise insurers to take on more illiquid assets from transacting DB schemes, which would in turn reduce unnecessary 'sell-off's' of illiquid assets from DB schemes.

For commercial Master Trusts, the additional cost of accessing the full breadth of investment opportunities remains a concern. We often find that when a company moves their DC pension arrangement to a Master Trust, the company does not want members' fees to increase, but at the same time, also wants to reduce their own costs (typically the admin costs). As a result, Master Trusts are 'forced' to keep costs for investments very low in order to be attractive to new business. In our view this stifles investment innovation and ultimately good outcomes for members in these Master Trusts. But this is not a trustee issue – it is a feature of the competitive nature of this market, driven by the commercial preferences of employers.

We believe that Value for Money (VFM) regulation may help with these Master Trust selection issues. ***But in addition, more guidance for the selection and oversight of a DC Pension in a Master Trust would help to encourage employers to look beyond price***. Better, and required, transparency to members on the breakdown of the fees they pay before and after a move into a Master Trust would also be useful as this would act to highlight how administration and investment management fees have changed under the Master Trust.

Question 5: Is there enough understanding of advice around the consolidation of schemes?

Consolidation has been referenced in the Call for Evidence documentation as a potential route for trustees who are failing to meet the required governance

standards. While this may be a route to consolidation, in our view the key drivers for consolidation in the DC and DB market are for smaller schemes to access economies of scale which ultimately benefit members through greater buying power (accessing a greater range of asset classes and innovative investment and insurance solutions) and reduced charges (fund management and ongoing scheme management costs).

Typically, trustees will consider advice focussed on the above areas when deciding whether to consolidate. In our experience there is a good level of trustee understanding of these issues. In the DC market, consolidation has been progressing at pace for many years through transfer to Master Trusts which has been underpinned by a strong understanding by scheme trustees of the relative merits of consolidation.

The VFM review that DC scheme trustees have been required to conduct for several years has served as a helpful benchmark and context for advice and discussions on whether to consolidate.

New VFM regulation will provide a means to identify the underperforming DC schemes which may lack the scale and buying power to deliver value for scheme members. The new framework will provide arguably a more objective means for trustees to identify where consolidation may be in members' best interests.

Question 6: Do you think that the government should require all trustees to provide information to enable TPR to keep a register of all trustees?

On balance, and in theory, we think a register of all trustees is a good idea. The register could provide enhanced oversight and allow for better communication (e.g. it could make it easier for TPR to convey important updates and track whether communications have been read). It would also make it easier to identify qualified trustees and bring pensions in line with other industries which have such a register, including the legal profession, actuarial profession, and charity sector.

Question 7: If the government were to require this information, would it be best achieved through the scheme return or through a separate trustee return?

Depending on the information being provided to TPR (see below), we think the information could be best captured through the scheme return. This would allow all information to be consolidated in one place (which would be easier for TPR) and would be more efficient (i.e. instead of requiring a separate trustee return). This approach may also mean that trustees are less likely to be late in providing the information, as they are used to meeting the annual scheme return deadline.

However, if the information being provided to TPR were to include sensitive personal data for trustees (e.g. ethnicity, date of birth and home addresses) then it may be more appropriate for this to be segregated from the main scheme return.

Question 8: Do current accreditation frameworks provide a high enough bar to equip trustees who become accredited to properly fulfil their role, including in making investment decisions?

The current accreditation frameworks offered by the APPT and PMI are still relatively new with c500 trustees having achieved accreditation currently. We recognise accreditation as a useful means to ensure a minimum level of competence and accountability of those looking to become trustees, as well as offering the opportunity to achieve a degree of oversight of those acting as accredited trustees.

While the current accreditation frameworks are a good starting point for raising the bar for trustees, they are not a guarantee of effectiveness in trustee decision making. Trustees will continue to need to supplement their accreditation with other forms of training, development, or guidance to enhance their capabilities and confidence in making investment decisions.

In our view it is essential that accreditation does not become a "tick box" exercise, but that the spirit of accreditation is embraced. We therefore argue that any strengthening of the current accreditation schemes would need to be at a pace that could be supported by the trustee community naturally, rather than rushed through. We suggest that accreditation is not set at too high a bar to prevent entry of non-professional / member nominated trustees as this would reduce the diversity of trustee boards. Alongside this, and as suggested by the APPT in their recently published review, professional trustees could be required

to attain a higher level of accreditation than non-professional trustees (for example through completing a higher-level examination).

Question 9: What proportion of your trustee board are accredited trustees?

n/a

Question 10: If we required each scheme to have a certain proportion of accredited trustees, where should this bar be set? Should Master Trusts be required to have a greater proportion of accredited trustees than single-employer schemes?

We understand that c500 trustees have achieved accreditation under the current frameworks: presently there are a far greater number of DB and DC schemes than there are accredited trustees.

Any move to require a certain proportion of accredited trustees for each scheme would need an appropriate lead-in time. Setting a timescale for schemes to achieve a certain proportion of accredited trustees may result in the bar for accreditation being set at a level to achieve this objective in the required timescale, rather than being set at the level determined as appropriate to drive standards. ***As a potential starting point, the requirement could be set for the Chair of Trustees of DB and DC schemes of a certain size (as measured by number of members) to be accredited.***

In our experience, while we see the value of accredited trustees, there is also significant value in a diverse trustee group which includes diversity of professional background and expertise, and hence, requiring a certain proportion to be accredited must be carefully considered. For example, many Master Trust boards have sought trustees from other industries to diversify the board's capabilities and experience – which we see as a positive. Not all of these individuals are currently accredited, but the quality of the trustee board is typically considered a core part of the Master Trust value proposition. As such, we do not believe any higher requirement need to be set for Master Trusts but note that these individuals could seek accreditation if this was a mandatory requirement.

Question 11: Should there be more rigorous requirements for those acting in the capacity of a professional trustee? What sort of requirements/standards should professional trustees be meeting? Should there be mandatory accreditation?

Professional trustees are typically held to a higher standard by scheme sponsors and by other trustees: they are often expected to have a higher level of knowledge and experience and bring specific pension capabilities to a trustee board. As such, there are already inherently higher expectations of professional trustees across the industry.

As referred to above and suggested in the APPT review of the accreditation regime, professional trustees could be required to meet a higher level of accreditation via higher examination requirements.

The introduction of a set of higher standards may also introduce barriers to entry for individuals looking to enter the professional trustee market – and so reduce the supply and/or diversity of professional trustees (notably for younger trustees who may have less industry experience). If standards were to be introduced, we would therefore suggest a phased approach so that new trustees have time to build up their knowledge and expertise prior to being required to meet the standards/requirements in full. This is consistent with the current period of grace exemption in the TKU regulations.

A 'one size fits all' set of requirements for professional trustees may not be appropriate, particularly where the professional trustee fulfils a specific role on the board (e.g. bringing insurance or investment expertise or acting as Chair).

The introduction of greater requirements could also have the knock-on effect of increasing the fees charged by professional trustee firms and so reduce the accessibility of professional trustees to (typically smaller) schemes with budgetary constraints.

Mandatory accreditation is unlikely to be achievable in the short term given the balance of supply (c500 accredited trustees) and demand (c5,000 DB schemes, let alone DC schemes and Master Trusts) and would need to be phased in with appropriate support by TPR, APPT and the PMI.

Question 12: How would you define a professional trustee for the purposes of legislating for all professional trustees to be accredited?

We are supportive of using TPR's definition of a professional trustee as a starting point:

A professional trustee is an individual or a company who acts as a trustee of one or more occupational pension schemes in the course of a business that includes providing trustee services. A professional trustee does not include a trustee who is or has been either:

- *a member of the pension scheme or a related pension scheme*
- *employed by, or a director of, a participating employer in the pension scheme or an employer in the same group unless they have represented themselves to one or more unrelated schemes as having expertise in trustee matters generally.*

We are also aware that the APPT defines a Professional Trustee as an independent trustee who sits on boards of a minimum of two pension schemes.

Chapter 2: The role of advice

Question 13: What are your observations on the external support trustees are given to make investment decisions, particularly in relation to unlisted equities?

As a professional investment consultancy, we provide significant support to our trustee clients in assisting them to make investment decisions. We help them to define their investment objectives, risk appetite (including liquidity risk), asset allocation, manager selection, and manager monitoring. We meet all relevant legal requirements in providing such advice. In our experience trustees want and use far greater levels of support than is strictly required.

We consider unlisted equity in our strategic asset allocation advice. Alongside other private market assets, unlisted equity is a standard asset class in our long-term asset models.

However, unlisted equity also comes with some challenges and drawbacks, which we have a responsibility to highlight to our clients. For different reasons, DB and DC pension schemes have not had a high allocation to unlisted equity for some years:

- DB schemes, generally, are now mature and well-funded. The illiquid, growth-focussed and long-term nature of unlisted equity does not fit with the risk, timeframe or liquidity requirements of many mature DB schemes.
- Access to unlisted equity has been difficult for DC schemes to date, predominantly due to investment platforms struggling to deal with illiquid assets. This is now improving, and since the launch of the LTAFs this year we are now seeing trustees of DC schemes (typically the larger own trust schemes) actively considering our advice to invest in more illiquid assets via these funds. Whilst there is a range of allocations that may be appropriate, on average allocations may be around 10% to 20%. We note there is a natural lead time between agreeing to make an allocation and funding that allocation, so increases to illiquid holdings via LTAFs will be seen in the coming months and years.
- Unlisted equity also poses challenges in DC schemes in relation to valuation, pricing, and reporting, which may affect the transparency and fairness of the scheme – this was set out clearly in this TPR blog. ***We encourage TPR guidance in this area to help with this issue.***
- For both DB and DC schemes, unlisted equity is costly and complex. Returns are, of course, not guaranteed. Unlisted equity typically involves paying high fees to the fund manager, which can erode returns to at or below levels we might expect from more liquid asset classes (even the Mansion House claims of excess unlisted equity returns rely on below average – around half price – fees). To achieve a diversified portfolio of unlisted equity investments, typically, the investor must have a programme of different funds and different vintages.

For the above reasons, unlisted equity is not always included in our final asset allocation advice to pension schemes. That said, we research a broad spectrum of private market investments, including unlisted equity, and support our clients with the selection and implementation of those investments as relevant. We regularly recommend allocations to unlisted equity with other client types –

charities, sovereign wealth funds, endowments, etc – and have some programmes of private market assets with our DB pension clients (typically schemes that are larger, less mature and well supported by stronger employer covenants). A low unlisted equity weight by UK pension schemes is, therefore, not inherent across our advice. We can, and do, incorporate it in clients' portfolios where it is appropriate to our clients' circumstances and objectives.

Question 14: What changes could be made, including to the regulatory environment, to improve trustee support in relation to unlisted equities?

For DB schemes, we do not think that the regulatory environment has had an undue effect on the support given to trustees in relation to understanding how unlisted equities could form part of the scheme's strategic asset allocation. The emphasis on risk management and the increasing maturity of DB schemes will have, to some extent, encouraged DB schemes to take a conservative approach to investing (from a capital risk perspective and/or from a liquidity perspective), which naturally leads to lower strategic allocations to unlisted equity.

In very general terms, we think the level of risk-appetite implied by regulatory guidance for DB schemes has been appropriate (within the current regulatory framework), and unlisted equity allocations have not been unduly suppressed. We therefore believe that significant change to the (investment) regulatory environment for DB schemes is not warranted.

However, we do believe that it is worth exploring wider regulatory change that would support further investment in productive finance including unlisted equities. ***In particular, we have put forward a proposal for regulatory change that would act to extend the relevant investment timeframe for certain DB schemes, so that holding more productive finance and unlisted equity would be more appropriate in future, and for a longer period.*** We are replying separately to the Department's Call for Evidence on Options for DB schemes on these matters.

We note that the latest draft of the proposed DB funding code included the concept of maximum investment risk. We believe this is appropriate, but this could act against the aim of encouraging greater investment in unlisted equities in some cases (in the absence of wider regulatory change).

For DC schemes, the requirement for daily dealing and operational issues at platform providers / administrators have prevented large scale investment in illiquid assets, including unlisted equity. Until recently, accessibility of these asset classes at a lower price point has been extremely limited. Over the last year, however, there has been significant improvement to access due to the new LTAF authorisation and government engagement in this area. There is a long way to go before illiquid assets in DC are commonplace, but we believe they will become more mainstream as more LTAFs are launched and the larger DC schemes pave the way. Several of our clients have already agreed to introduce illiquid allocations via LTAFs (to be implemented in the coming months, with illiquid assets then built up following that implementation), adding to a number of existing illiquid allocations across many of our larger single sponsor arrangements through other investment authorisations.

We do not believe that any significant regulatory changes are required for non-Master Trust DC schemes.

We have some concerns around commercial Master Trusts and the low-cost environment they are forced to operate in. The commercial drive to lower cost solutions for Master Trusts has had a significant impact on the lack of investment in illiquid assets (including unlisted equities) to date. We believe that many Master Trusts which are considering unlisted equity may offer it as an alternative default option, rather than as part of their main default investment strategy, due to cost pressures. Whilst this is a concern to us, we do believe the Mansion House Compact will encourage DC schemes including Master Trusts to consider allocations to illiquid assets.

One area we do believe could be improved is the measurement of the investment performance of unlisted equity funds which is not directly comparable to the way more liquid assets are measured. The lack of transparency and risk of mis-interpretation from unlisted equity performance reporting has also been well documented (e.g. by Ludovic Phalippou here). We would like to see better levels of transparency from unlisted equity managers on their performance track records, including details of cashflows to and from investments, to enable a proper assessment of past performance and potential future financial return. This would help trustees better understand the detail of the opportunity. ***Achieving these enhanced disclosures from investment managers may need a regulatory change.***

Question 15: To trustees: To what extent do trustees use investment consultants to support decisions around allocations to unlisted equities? Did they subsequently increase? Is there a deficiency of knowledge or expertise by investment consultants of these types of investments?

We appreciate this question is directed to trustees but have responded to the elements of the question where we consider we have relevant and helpful observations.

The investment consultancy industry is well resourced with considerable expertise in a wide range of asset classes, including unlisted equity. In our experience, it is not a lack of support or knowledge that has driven low allocations to unlisted equities historically.

Many of our DB pension scheme clients have legacy programmes of investing in unlisted equities and current programmes of investment in other private markets. LCP also has non-pension clients that have significant, ongoing unlisted equity programmes, where we advise them on strategic and manager selection decisions for these investments. We understand this to be common across our investment consultancy peers and so there is an active advisory market (with evolving expertise) in unlisted equities as an asset class.

In our experience, trustees use their investment consultants to support decisions around unlisted equity, just as they do for decisions around other asset allocations over time. We incorporate unlisted equity into our strategic asset allocation models and clients consider portfolios that incorporate unlisted equity when reviewing their strategy.

For most mature DB schemes the idea of new unlisted equity allocations is, however, often dismissed early in the process. This is driven by the scheme's low-risk, low-return requirements and the need for liquidity (requirements which are not met by the risk/return profile of unlisted equity). Rising gilt yields and the resulting (general) improved DB funding levels has accelerated this dynamic, with lower (or nil) contributions from sponsors increasing liquidity pressure on schemes to pay pensions, whilst requirements on return have only reduced.

For DC schemes, the regulations and operational structure are improving to ease access to illiquid assets, including unlisted equities. We are beginning to see illiquid assets being included in portfolios with the launch of LTAF funds. We are supporting DC scheme trustees considering an allocation to illiquid assets. We provide advice to clients on strategic allocations to different illiquid asset classes; efficient construction of the portfolio for rebalancing, operational and cashflow requirements; manager selection; and dealing with fund platforms to ensure smooth integration with other assets held by the members.

Question 16: What changes could be made to investment management to support pension scheme investment decision-making?

Given the emphasis of other questions in this Call for Evidence, we have answered this question in relation to unlisted equities.

In our view the key changes that would better support decision-making relate to transparency, product offerings, DC procedures and cost structures. We have expanded on each point in this answer (and elsewhere in our response).

The key change we would like to see is transparency of disclosure, in particular reporting of past performance, levels of risk, and fees by investment managers. To commit to unlisted equity mandates, trustees need to place a great deal of faith in the manager to source attractive opportunities, increase value and exit effectively. The information they are provided with to encourage such decisions is currently, generally, lacking in detail.

Improvements in the provision and consistency of track record disclosures would help with this. Unlisted equity returns are typically expressed as an Internal Rate of Return (IRR) and the challenges with this approach are well documented (e.g. here). IRR is easier to manipulate and harder to compare to other, listed, options. It is therefore very difficult for trustees to make decisions between different investment opportunities and different investment managers on this basis. Providing the underlying data on the IRR calculation, specifically cashflow information, would allow a better and more consistent comparison to be undertaken by trustees with support of their advisers.

We recognise the significant developments in the DC space to enable investment in illiquid asset classes through the launch of LTAF funds. ***Development of products that package both listed and unlisted investments may further support investment in unlisted investments.*** These mandates would offer diversification in the structure of returns as well as greater liquidity than unlisted mandates alone. It would also avoid being a forced seller of an investment that

moves from unlisted to listed when it may continue to represent a good investment opportunity. We believe that a wider range of investment options and liquidity profiles would better provide for the diverse range of pension scheme needs that we see today.

More robust procedures around the valuations of illiquid assets by investment managers would create greater confidence for trustees to allocate funds towards illiquid assets. When members buy and sell their DC funds, they are trading the illiquid assets between themselves. The price of these trades derives from the valuation of illiquid assets provided by the investment manager. Since the illiquid asset itself is not being traded by the investment manager, the valuation provided by it is often out of date or has, implicitly, a wide error margin around it. This situation creates potential unfairness between members when DC schemes invest in illiquid assets. We would like to see a greater focus on valuation to build confidence that this risk is limited.

In our experience DB and DC trustees already focus on value (e.g. net returns after fees, provision of reporting and other services) rather than absolute fee levels in their investment decisions. However, historic fee bases associated with unlisted equity mandates are difficult to ignore in trustee decision-making given their high level.

Innovative approaches to fee bases that better align investment managers and investors would likely be well-received; and innovation in how and when performance fees are charged to mitigate the risk of unfair transfers between members (as described above) would be welcome.

Question 17: To trustees: How does legal advice impact on your investment decisions? What is an acceptable level of tolerance for investment risk? Is there a culture of ‘risk aversion’?

We appreciate this question is directed to trustees but have responded to the elements of the question where we consider we have relevant and helpful observations.

We do not find that legal advice drives trustees’ investment decisions. Most of our trustee clients take legal advice in ensuring compliance with relevant requirements and on the appointment of new mandates. It would be unusual for legal input on asset allocations to influence or change a trustee’s investment decision: more commonly legal input is sought after the investment decision has been made and at the point of implementing the decision – e.g. to ensure the management agreement signed is robust.

From a legal perspective, the key hurdle DC trustees are often impacted by is the unintended default issue, where a decision has or needs to be taken by the trustees on behalf of members to move member savings from an existing self-select choice and hence, unintentionally creating an additional default investment. This then requires additional governance to meet all of the regulations regarding default investment strategy design. We, and the PLSA, have raised previously with DWP.

We do not consider there should be a universally “acceptable” level of tolerance for investment risk by DB or by DC trustees. Tolerance to investment risk is very scheme specific, notably driven by:

- maturity and covenant strength (DB); and
- member age and members’ individual risk profile (DC) – noting that this changes over time.

Furthermore, we do not consider that there should be a single measure of risk which trustees should use. We advocate considering a DB scheme through different risk lenses, including traditional Value at Risk but also stress testing scenarios. We note this is consistent with the latest draft of the proposed new funding code.

We believe there is a tendency for risk aversion from a trustee perspective, in part due to their fiduciary duties. This is particularly the case with closed, mature DB schemes. We do not believe this as inappropriate, particularly given the defined structure of DB benefits. Under the current regulatory framework, trustees will usually prefer a lower-risk, lower-return investment strategy to progress the scheme against its funding target (with the balance of any funding deficit to be met by cash). On the other hand, sponsors usually have a preference for funding deficits to be met by investment returns rather than by cash contributions (with directors being subject to their primary duties to shareholders / owners of the business, rather than by a fiduciary duty to pension scheme members). In our experience the natural tension between these

positions generally results in an appropriate balance of risk/return in the funding and investment strategy.

This tendency for risk aversion for trustees of DB schemes has been supported (but not exclusively driven) by the regulatory environment and recent guidance. This could be changed through wider regulatory change for DB schemes, as covered in our separate Call of Evidence on Options for DB Schemes.

We do not believe there is a culture of investment risk aversion from DC trustees, as the members they represent will include those far from retirement who will have greater risk tolerances. However, there are concerns amongst trustees with regards to illiquidity risk when it comes to members approaching retirement and, further, concerns with valuation timings and performance-based fees given the difficulty in structuring the fee fairly for members. We address these points in more detail in other parts of this document.

Chapter 3: Barriers to trustee effectiveness

Question 18: Is fiduciary duty a well-understood concept? Do current regulations and guidance support trustees to make investment decisions which seek higher returns for members? If not, what changes would be useful?

At its most basic level we believe "fiduciary duty" is a well understood concept. The core principle that trustees must act in the best interests of members is deeply embedded in trustee thinking. However, there are naturally varying levels of understanding of some of the more legal/technical debates concerning the nature of "best interests" and the timeframe over which this is considered, which means that some trustees may be more cautious about taking certain factors into account. ***We understand that the Department will be reviewing this area in its stewardship review in the autumn. Whilst we recognise that it is not the focus in this Call for Evidence, we believe the concept and legal interpretation of fiduciary duty in relation to stewardship and in particular climate change, should be urgently reviewed.*** We set out some brief thoughts on this below in this response and look forward to being part of the debate later in the year.

Current investment regulations support pension trustees to make investment decisions which strike the right balance, so far as possible, between risk and returns, depending on the needs of the scheme and the risk budget and acting in members' best interests. There are specific references to these points in Regulations 2 and 4 of the Occupational Pension Schemes (Investment) Regulations 2005.

It would be inappropriate in our view for regulations to be amended so that the pursuit of *higher* returns was encouraged, where these higher returns were incommensurate with the trustees' risk budget. In practice, we see trustees using investments at the higher end of the risk / return spectrum, supported by current regulations and guidance, where appropriate.

One particular issue that we see arising is that the phrase *"financially material considerations over the appropriate time horizon of the investments"* can create barriers to taking non-traditional factors into account beyond the (often) short time period to a buyout transfer to an insurer (for DB) or over the working lifetime of members (for DC). However, in practice, super long-term factors (e.g. 50 year long-term future UK economic growth, and climate change risk) will also impact the members of pension schemes (and their families). In our view, this is an area that merits reform and should be addressed in the upcoming stewardship review (as noted above).

Existing guidance could benefit from some discussion about how best trustees should seek out investment opportunities in "productive assets" – e.g. how the risk and reward characteristics of these assets should be assessed and what extra due diligence may be required, to assist trustee decision making.

Question 19: Do trustees currently make investment decisions in the long-term interests of pension savers? If not, what barriers are there to trustees making investment decisions in the long-term interests of savers?

In our experience, trustees do generally make investment allocation decisions in the long-term interests of the members of their schemes (constrained to the "financial interests" of members, in relation to "this scheme only" and only over the expected lifetime of the scheme or investment) and do use illiquid and longer-term assets where appropriate within that context.

However, we see some clarification (and potential regulatory change) would be helpful for trustees where there is a misalignment between the life of the investments/the scheme and the *longer-term and wider interests of members*.

In particular, where DB schemes are targeting insurance and wind up in a short time frame, trustee investment decisions are generally focussed on the short term, to maximise their chance of guaranteeing each member's pension. However, we would like to see a debate about clarifying and/or extending the legal interpretation of fiduciary duty to members so that the wider and longer-term interests of members are also borne in mind. This would acknowledge long term member interests being correlated with long term economic growth (i.e. better supporting investment in productive finance) and correlated with mitigating systemic risks, particularly climate change.

Whilst we recognise it is not the focus of this Call for Evidence, we think a more significant re-interpretation of fiduciary duty could include:

- **Time horizon.** Clarification that fiduciary duty includes consideration of members' best financial interests over the remainder of members' entire lifetimes so that DB trustees can legitimately think beyond the short time frame to buy-out.
- **Macro versus micro.** Clarification that trustees may have regard to the real-world impact of their investment decisions, not just the impact that external ESG factors have on their scheme's investments. This is relevant not only because those real-world impacts will take place over their members' lifetimes, but because they will have an impact on the stability of financial systems – and thereby the security of pensions – long before the worst impacts of e.g. climate change (if left unchecked) may be felt.

In summary, in the current regulatory constraints, we do not believe fiduciary duty is itself a barrier to investment decision making in the area of productive finance, but we believe the interpretation of fiduciary duty should be reviewed for other reasons such as the interaction with systemic risks such as climate change. We understand that the Department will be reviewing this area in its stewardship review in the autumn when these matters can be further considered and addressed. However, we do believe that the current wider regulatory constraints are a barrier to trustee investment in productive finance, and our proposals for wider change (full PPF protection and easier return of surpluses) are covered in our response the Call for Evidence on Options for DB schemes.

Question 20: How do trustees balance investment returns, costs and charges, and services when making decisions in the long-term interests of savers?

We advise our clients that costs and charges are a relevant factor but should rarely drive investment decisions. Services are increasingly a differentiator between different investment managers and commonly taken into account.

Pension boards vary, but in our experience, trustees do balance costs against risk/return and other factors when making investment decisions. In this context, many of our DB clients employ investment managers on relatively high fees, particularly in illiquid asset classes where they can see a benefit from using the service (such as higher returns for the level of risk). For example, a significant number of LCP's DB scheme clients use private credit funds where fees are far higher than for liquid asset classes but are still seen as good value for money, given the characteristics of the investment and realistic return expectations.

In our experience trustees are cost conscious and, in general, will require confidence that any fee premium is likely to earn an excess return.

Question 21: Do trustees' fiduciary duties discourage investment in alternative asset classes? If so, please explain with examples.

No. Trustees' fiduciary duty requires trustees to act in the financial best interest of members. In doing so, the trustees must balance the pursuit of higher returns with the associated risks. Trustees can, and do, invest in alternative asset classes and so it is hard to argue that trustees' fiduciary duty is a barrier to investment in these alternative asset classes. It is likely that other factors come into play such as attitude to risk, governance capability and budget and that these are impacting whether trustees invest in such assets.

Question 22: Is the way in which trustees exercise their fiduciary duties preventing trustees from seeking the best returns for pension savers? If so, what is causing this?

Not directly. Fiduciary duty requires trustees to consider a range of factors, including the balance of risk vs return and liquidity characteristics of the investment. It therefore does not prevent the seeking of high returns, where appropriate.

However, as noted there is a challenge for trustees around time horizons, and therefore whether the investment is delivering the 'best overall long-term return' for individual savers in this context. For example, whilst the impact of climate

change and sustainability are not generally disputed, the timing of those impacts is subject to greater debate. As mentioned above, we expect this to be picked up in the upcoming stewardship review.

Question 23: Do those actors who have most influence on advice to trustees on long-term investment decisions experience any challenges or barriers in provision of their advice on illiquid assets? If so, what would unblock this?

In the main, no, we do not believe so. However, when it comes to DC advice, barriers will include the lack of access to suitable funds on investment platforms and hence, the greater risk in advice of trying to get a fund onto a platform and seeding new investment strategies.

Question 24*:* Would trustees find it helpful if they received more direction from regulators when assessing their investment decision making? In addition to our work on Value for Money we are also interested in whether the advice for trustees provided by regulators via training and guidance supports our objective to shift the focus from cost to value?

The Pension Regulator already provides guidance to trustees on investments and the factors that trustees should consider when deciding on their investment strategy and appointing investment managers. In our view it would be inappropriate for the Regulator to guide or require trustees to invest in specific asset classes. It should be for trustees to assess and set the investment strategy taking account of the profile of the members and the appropriate balance between risk and return.

In the short term some guidance from the Regulator on how trustees might balance the different time horizons of members and risks would be welcome, dealing with the specific challenge, for example, on the relative weight that climate change and sustainability should have in considering shorter and longer term impacts on both risk and return. In the medium term, we believe a more fundamental re-interpretation of fiduciary duty should be considered, as mentioned above.

Whilst the guidance and materials provided by the Regulator are read and understood by professional trustees and trustees of larger pension arrangements, that level of knowledge and understanding may be less prevalent in small and micro schemes with non-professional trustees who may be more time constrained and/or or are less supported by their employer in being given the opportunity to access materials provided by the Regulator. Encouraging or requiring employers to provide sufficient time to trustees to fulfil their duties would help with this.

Question 25: Do lay trustees have enough time and support to perform their duties effectively? Do professional trustees? If not, what changes would support this?

Based on our experience with trustees we observe that in most cases, employed trustees struggle to find sufficient time to carry out the trustee role. Typically, pensioner trustees are more able to find time outside the constraints of regular employment. We receive feedback from some non-professional trustees who state that whilst they are often allowed time off work to attend trustee and committee meetings, there is less allowance for other aspects of the trustee role, such as making decisions between meetings, reading topical updates, or undertaking training outside of meetings.

Professional trustees often have more time to perform their duties effectively as it is their profession. However, there is a risk of a strain as the demand for professional trustees on trustee boards increases.

All employers should be encouraged or required to give trustees, both member and corporate appointed trustees sufficient time to fulfil their duties.