Principles for Responsible Investment

IN SEARCH OF SUSTAINABILITY

PRIVATE RETIREMENT SYSTEMS AND SUSTAINABILITY:

UNITED KINGDOM

FINANCE UNEP INITIATIVE | United Nations Global Compact

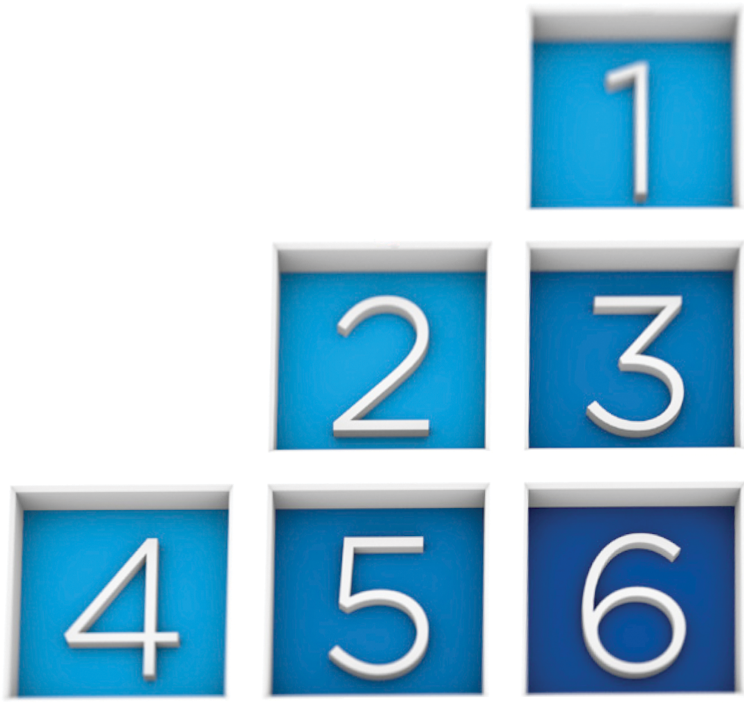
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

CONTENTS

INTRODUCTION

In a dynamic regulatory environment, the UK funded pension market is undergoing significant change, with defined contribution schemes growing much faster (in terms of membership) than their defined benefit counterparts. In terms of assets, defined benefit (DB) schemes still dominate, with private sector occupational schemes holding GBP1,615 billion in assets and public sector schemes holding GBP341 billion in March 2019. Occupational defined contribution (DC) schemes, by contrast, hold assets worth GBP 350 billion as of July 2019 (Table 1). This figure comprises GBP 170 billion managed under a trust structure (December 2019) and GBP180 billion managed under contract arrangements (July 2019).

Since the introduction of mandatory automatic enrolment in 2012, private sector occupational pensions have shifted conclusively from DB to DC in terms of membership.[1] Over 10 million workers were automatically enrolled into a workplace DC scheme between January 2013 and June 2019. DC pensions may be trust-based or contract-based (contract-based schemes have typically offered more investment choice to members), but regulation is converging. It is important to pay attention to the master trust sector, which is likely in future to capture the bulk of growth in DC membership.

The UK has a supportive regulatory environment for responsible investing by pension funds, despite pressure on trustee agendas caused by regulation and market and demographic pressures. There is a coordinated effort by regulators to encourage alignment of pension investments with the goals of the Paris Agreement.

As in the US, the pensions industry appears to be relatively fragmented, but assets and influence are in fact concentrated with a small number of dominant pension plans and service providers.

1 Employers must offer a DC plan, employees may opt out.

Table 1: UK Market Structure. Sources: multiple

	PRIVATE SECTOR OCCUPATIONAL				LOCAL GOVERNMENT OCCUPATIONAL	NON-WORKPLACE PENSIONS
	DB	DC Trust	Of which, Master Trust	DC contract		
Total assets (GBP billion)*	1,615	170 (all schemes) 71 (excluding micro-schemes)	38.5	180	341	470
PRI signatories as % total assets	Circa 18%		5 out of 38 master trusts are signatories, a further 13 are part of a larger organisation that is a signatory	9 of the 12 GPPs with IGCs/auto-enrolment platform are signatories	66%	n/a
Sector concentration	5,500 schemes, top 20 circa 30% of assets	2,000 schemes (excludes micro), top 150 hold 83% of assets	Top 5 circa 65% of assets	2,140 schemes 12 GPPs with IGCs 4 GPPs have circa 40% of assets	England & Wales 8 pools	25 main platforms Share of top 4 firms in individual personal pension market 46%
Service provider concentration	Top 3 asset managers > 70% of institutional pension assets Top 2 investment consultants > 40% of market Top 5 fiduciary managers > 70% of market					
Regulator	TPR	TPR	TPR	FCA	Ministry/Directorate. TPR for governance and administration	FCA
Governance structures	Trustee	Trustee	Trustee	Independent Governance Committee	Local administering authorities/pension boards	
Asset allocation	Equity 24% Bonds 63% Property 5% Hedge funds 7% Other 5% Cash -4%	10 years to retirement Equity 42% DGF 47% Managed/balanced 4% Bonds 6% Other 1%	10 years to retirement Equity 51% DGF 9% Managed/balanced 22% Bonds 14% Other 4%	10 years to retirement Equity 37% DGF 22% Managed/balanced 25% Bonds 12% Other 4%	Equity 62% Fixed income 22% Cash 1% Property 8% Other 7%	
Key barriers to system sustainability	No regulatory barriers Smaller schemes lack capability/resource					Lack of participant engagement, focus on simplicity
	Focus on solvency, de-risking		Focus on cost especially in default Implementation e.g. liquidity, platforms, passive strategies			

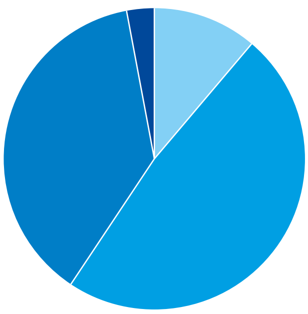
* hybrid assets allocated to DB or DC as appropriate

Sources: DC Trust 2019, 2020, TPR; Effective Competition in non-workplace pensions FS19/5, FCA July 2019; LGPS Funds England & Wales 2018-19, Ministry for Housing, Communities & Local Government October 2019; pensions.gov.scotland; Investment Consultants Market Investigation, CMA 2018; nilgosc.org.uk; IGC reports; IPE 30 August 2019; Investment Association Annual Survey 2018; FTSE 350 DC Pension Survey 2019, Willis Towers Watson; PPF Purple Book 2019

OCCUPATIONAL PENSIONS

Total membership of occupational pension schemes was nearly 46 million people in 2018, of whom just under half were active members (split circa 1 million private sector DB, 6.5 million public sector DB, 13 million DC).[2] Some 76% of UK employees were members of a workplace pension scheme in 2018, up from just 47% in 2012 when automatic enrolment was introduced (Figure 1). Coverage is highest in the public sector, where 90% of employees are enrolled in a workplace pension, overwhelmingly DB. In the private sector, 72% of employees participate in a workplace pension scheme, overwhelmingly DC.

Figure 1: Private sector employees with workplace pensions; % by type of pension, 2018



DB ■ Trust-based DC
■ Contract-based DC ■ Unknown

PUBLIC SECTOR OCCUPATIONAL PENSIONS

Local Government Pension Schemes (LGPS) across the UK have more than 2 million active members, 96% of whom are in DB schemes (Tables 2 and 3).

Table 2: LGPS scheme members. Source: Scheme websites

	LGPS ENGLAND & WALES	LGPS SCOTLAND	NORTHERN IRELAND LGOSC
Active members	2 million	236,000	56,726
AUM GBP billion	287.2	44.255	9.6075

The LGPS is fragmented, with 89 individual funds across England and Wales and 11 in Scotland. In 2018, the funds in England and Wales were grouped into eight more substantial pools, in order to generate scale benefits and enhance their capacity to invest in alternative investment strategies. Most of the larger pools, and Scottish and Irish funds, are PRI signatories, and are beginning to instigate alternative investment strategies, but the pools do not yet determine investment strategy for the full AUM of their constituent funds.

2 Primary source: annual survey of hours and earnings, 2018 provisional results, ONS

Table 3: Public sector schemes. Source: scheme websites

ENGLAND & WALES			SCOTLAND			NORTHERN IRELAND		
Pool	**AUM GBP billion**	**PRI signatory**	**Pension fund**	**AUM GBP billion**	**PRI signatory**	**Name**	**AUM GBP billion**	**PRI signatory**
London CIV	38	Yes	Dumfries & Galloway	0.86		NILGOSC	9.6	Yes
Access	46	Kent (GBP 5 billion)	Falkirk	2.29				
Local Pensions Partnership	21	Yes	Fife	2.42				
Border to Coast	45	Yes	Highland Council	1.88				
LGPS Central	45	Yes	Lothian	6.67	Yes			
Brunel	30	Yes	North East Scotland	4.12	Yes			
Northern Pool	46	Greater Manchester (GBP23.8 bn), Merseyside (GBP8.9 bn)	Orkney Islands	0.37				
Wales	16		Scottish Borders	0.69				
			Shetland Islands	0.46				
			Strathclyde	20.81	Yes			
			Tayside	3.70				
Total assets	**287**			**44.3**			**9.1**	
PRI as %	**64%**			**71%**			**100%**	

LGPS remain open and are subject to a different regulatory framework than private sector occupational schemes. They therefore have a higher allocation to growth investments and a lower allocation to fixed income than private sector DB schemes, with over 60% in equities.

A 2019 report by ShareAction and Unison found that, “With the exception of a small number of leaders in the field… most of the LGPS funds are still developing approaches to how to integrate issues such as climate change or workers’ rights into their public investment policies, some have done nothing to produce policy on Environment, Social and Governance (ESG) polices.”[3] The report highlighted that only 29 funds recognised climate change as a material risk and only 18 funds had a bespoke voting policy, and questioned the degree of ownership of the issue of responsible investment.

The governance structure of the LGPS is complex – made more so in England and Wales by the pools – but the administering authorities of LGPS funds are subject to fiduciary duties to both employers and members, and to public law. In England and Wales, they are required by the government to produce Investment Strategy Statements that correspond to the SIPs produced by private sector plans, and LGPS pension boards are subject to TPR governance standards.

3 Responsible Investment in the LGPS, ShareAction/Unison, April 2019

PRIVATE SECTOR OCCUPATIONAL PENSIONS

Private sector occupational pension schemes may be trust-based (regulated by the DWP/TPR) or contract-based (regulated by the FCA). Private sector DB schemes are trust-based: the employer establishes a person or company to hold the scheme assets on trust for the beneficiaries of the scheme, and manage and govern the scheme separately from the employer. Trust-based DC schemes operate in a similar way, with the trustee responsible for ongoing scheme performance. Contract-based DC schemes are managed and governed by a pension provider, typically an insurance company, according to a contract established between the provider and the member and facilitated by the employer. Contract-based schemes have traditionally offered self-select options to members, although the majority chooses the default option. Since 2012 there have been some efforts to align governance standards more closely with those of trust-based DC schemes, and Independent Governance Committees (IGCs) have been established to represent the interests of policyholders, but IGCs act in an advisory capacity and lack formal powers to mandate changes to the providers' investment strategies.

PRIVATE SECTOR OCCUPATIONAL DB

The UK private sector DB universe is large in terms of number of schemes – nearly 5,500 – and in terms of assets – over GBP 1.6 trillion. By a number of measures, the DB universe is fragmented and schemes lack scale: 74% of schemes have assets of less than GBP 100 million. The bottom third of schemes have only one percent of both assets and members, and the average mandate size for both equities and fixed income is less than half that of pension fund mandates in the Netherlands, at GBP130 million and GBP150 million respectively (Table 4).

Table 4: Scheme size by number of members. Source: PPF Purple Book, 2019

NUMBER OF MEMBERS	2-99	100-999	1,000-4,999	5,000-9,999	10,000+	Total
NUMBER OF SCHEMES	1,964	2,377	727	161	193	5,422
% OF TOTAL	36.2%	43.8%	13.4%	3.0%	3.6%	
TOTAL MEMBERS '000	85	837	1,659	1,122	6,351	10,055
% OF TOTAL MEMBERS	0.8%	8.3%	16.5%	11.2%	63.2%	
ASSETS GBP BILLION	16.8	147.6	259.9	194.6	996.5	1,615.3
% OF TOTAL ASSETS	1.0%	9.1%	16.1%	12.0%	61.7%	

At the same time, there are a number of very large schemes in the UK, such that two-thirds of assets and members are concentrated in under 200 schemes (Table 5). These schemes each have over 10,000 members. The top 20 schemes have 30% of DB system assets and the top 100 schemes over 50%. The potential advantages of scale include stronger governance, internal investment expertise, and greater negotiating power with external providers.

In 2018, the Environmental Audit Committee of the UK Parliament surveyed the 25 largest DB schemes (public and private) on their engagement with climate change risk and attitudes towards reporting in line with the TCFD framework. The responses indicate that the majority of large private sector schemes are engaged.[4] Ten of the 21 biggest private sector occupational DB schemes are PRI signatories.

Table 5: Engagement level of top DB schemes. Source: Environmental Audit Committee website, News, 25 May 2018.

NAME	AUM BILLION	TCFD REPORTING	ENGAGEMENT LEVEL	PRI SIGNATORY
USS	60.55	Committed to reporting	More engaged	Yes
BT Pension Scheme	49.34	Considering	More engaged	Yes
RBS Group Pension Fund	44.10	Considering	More engaged	No
Electricity Pension Trustees Ltd	31.90	No plans to report	Less engaged	No
Barclays Bank UK Retirement Fund	31.82	Committed to reporting	More engaged	Yes
HSBC Bank Pension Trust (UK) Limited	27.32	Committed to reporting	More engaged	No
Railways Pension Scheme	25.48	Committed to reporting	More engaged	Yes
BP Pension Fund	24.45	No plans to report	Less engaged	Yes
Lloyds Bank Pension Scheme	19.83	No plans to report	Engaged	No
National Grid UK Pension Scheme	16.84	Considering	Engaged	Yes
British Airways Pensions	16.06	Considering	Engaged	No
Shell Contributory Pension Fund	15.95	Considering	Engaged	Yes
BBC Pension Trust Ltd	15.84	Committed to reporting	More engaged	Yes
British Steel Pension Scheme	15.05	No plans to report	Engaged	No
HBOS Final Salary Pension Scheme	14.76	No plans to report	Engaged	No
Aviva Staff Pension Scheme	14.40	No plans to report	Less engaged	Yes
Rolls-Royce Pension Scheme	13.35	No plans to report	Engaged	No
Tesco Pension Scheme	13.20	Considering	Engaged	No
BAE Systems Main Scheme	13.01	No plans to report	Engaged	No
Ford Pension Fund	11.96	No plans to report	Less engaged	No
Mineworkers' Pension Scheme	11.40	Considering	Engaged	Yes

4 The Committee made a qualitative assessment of what pension funds self-reported about their engagement with climate change and split the responses into three categories. “More engaged” = taking steps to asses and minimise exposure to climate-related risks, working towards TCFD reporting. “Engaged” = acknowledge climate risk but less evidence of implementation policies. “Less engaged” = not formally considered climate change as a strategic risk

However, the trends towards closing schemes and de-risking means that investments have shifted from growth to hedging strategies. Only 12% of schemes are open to new members and 41% of schemes are closed to new benefit accrual. DB schemes may therefore have less scope to implement responsible investment strategies.

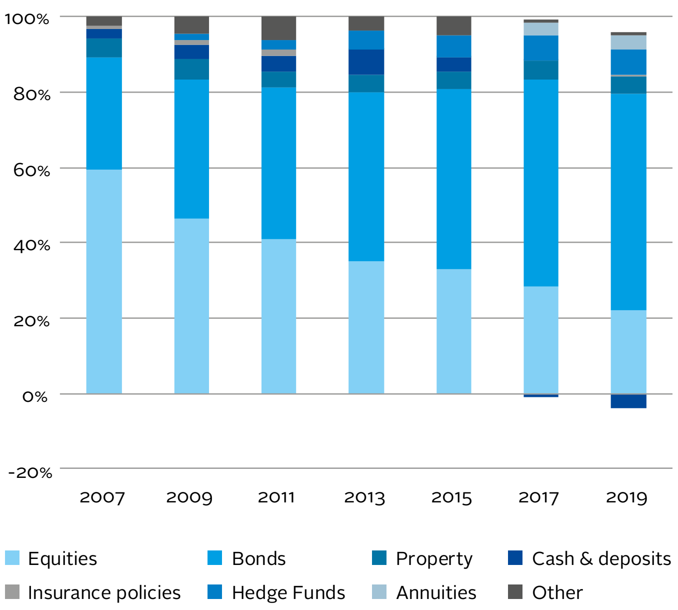
Asset allocation has moved from 60% equities in 2007 to nearly 63% bonds in 2019. Within bond allocations, the proportion invested in corporate bonds declined from a peak of 44.8% (weighted average) in 2012 to 28.4% in 2019, while the share of index-linked bonds rose from 37.5% to 46.2% over the same period (Figure 2). According to the Investment Association, assets managed for all institutional clients in LDI strategies have tripled from GBP400 billion in 2011 to GBP1.2 trillion in 2018.[5] Roughly 12% of DB equity allocation is to unquoted/private equity; this is almost all carried out by schemes with more than GBP 1 billion in assets.

There is also evidence that DB schemes are using more passive strategies – the Investment Association reports that over 30% of assets managed for third-party pension fund clients were invested on a passive basis in 2018, and the majority of the assets are DB.

Larger schemes are more likely to be open to new accrual than smaller schemes (Figure 3). However, they are also more likely to be invested in bonds. Similarly, the best-funded schemes are more likely to have a higher allocation to bonds than to equities.

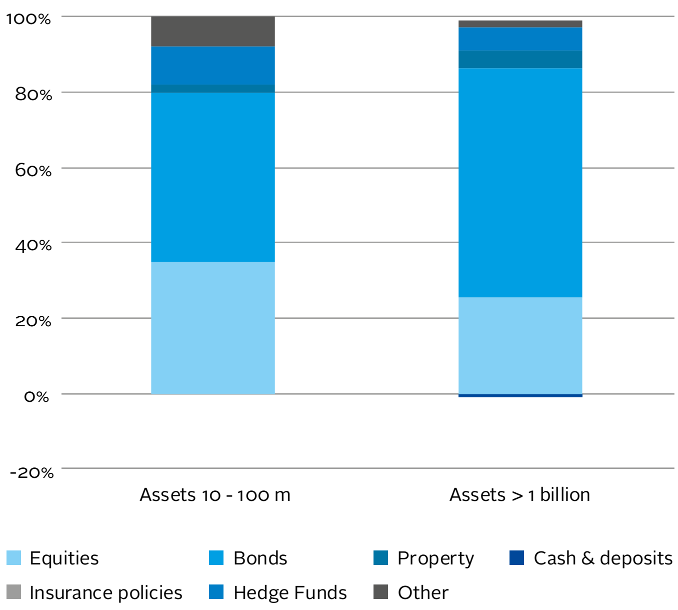
De-risking is in line with TPR's focus on schemes' funding levels as part of its efforts to protect DB members. Until recently, guidelines for DB trustees did not specifically encourage responsible investment, but this is changing, as discussed on the following page.

Figure 2: Weighted average asset allocation in total assets. Source: PPF Purple Book 2019



Negative cash resides with a number of large schemes, likely related to swaps/repos.

Figure 3: Weighted average asset allocation by scheme size. Source: PPF Purple Book December 2018



5 Investment Management in the UK 2018-2019, the Investment Association Annual Survey, September 2019

DB VALUE CHAIN

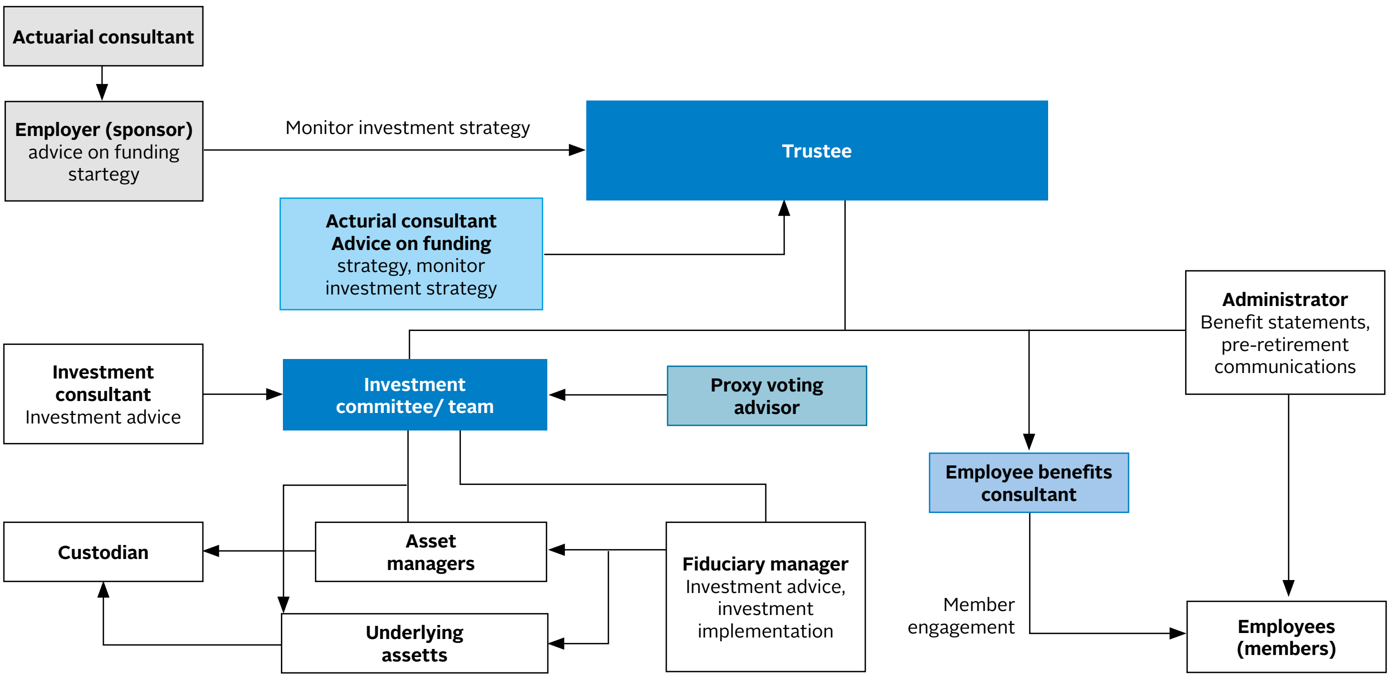
The DB value chain in the UK is relatively straightforward. Sponsors of occupational DB schemes establish a trustee body (or join an existing scheme with a trustee), which takes on full responsibility for managing and administering the scheme. The sponsor remains ultimately responsible for making up any shortfall in the scheme's funding, so has a continuing interest in the investment strategy. However, the trustee has the final say. Members are not directly involved in decision-making, but many schemes have member-nominated trustees. The trustee is the ultimate steward of the assets and of beneficiaries' interests (Figure 4).

Where the value chain gets more complicated is in the use of advisers. The trustee is legally bound to take "proper advice" on investment strategy and almost all DB (and DC) trustees use investment consultants for asset allocation and/or manager selection. Trustees may outsource some or all of their investment function to a fiduciary manager, and they may employ proxy voting advisers to help set their voting policies. Trustees and sponsors may also use employee benefits consultants to help monitor their investment strategies, and both parties need actuarial advice to help establish and monitor the funding strategy.

External advisers may also provide employee engagement services, or this activity may be offered by the administrator.

It is good practice for trustees to set up an investment committee; larger schemes have their own investment teams, which may invest through external managers or directly in underlying assets. The intermediary steps between the trustees and the assets they safeguard may therefore be quite short. However, where DB schemes invest in pooled funds, they may be unable to exercise their ownership rights: the Association of Member Nominated Trustees found that asset managers showed "a near total unwillingness to split votes in pooled fund holdings" and that they did not have voting policies of their own that were sufficiently clear or stringent to replace asset owner policies.[6] This is a potential concern, and not just for private sector DB schemes: according to the Investment Association, 50% of contract-based pension assets and 30% of trust-based pension assets are held in pooled funds; for LGPS specifically the figure is 55%. The Law Commission is currently investigating potential stewardship concerns around intermediated securities.

Figure 4: DB governance and value chain



As there is no straight line from the trustee to the assets, there is a risk that stewardship activity gets "lost" if trustees are not vigilant. Trustees may believe that their consultants, investment team (or investment sub-committee if they have one), asset managers, or custodian is carrying out this activity for them.

6 Mallowstreet 30 October 2019

PRIVATE SECTOR OCCUPATIONAL DC SCHEMES

There are a large number of private sector occupational DC schemes: over 29,000 trust-based schemes and 2,000 contract-based schemes. Stripping out micro schemes (< 12 members), there are 1,740 trust-based schemes.[7]

The number of trust-based DC schemes is falling steadily, and assets are increasingly concentrated in larger schemes. Between 2018 and 2019, assets in trust-based schemes increased by 16% while the number of schemes fell by 12% (Figures 5 and 6).

Figure 5: The number of trust-based schemes is falling. Source: DC Trust scheme return data 2018-19

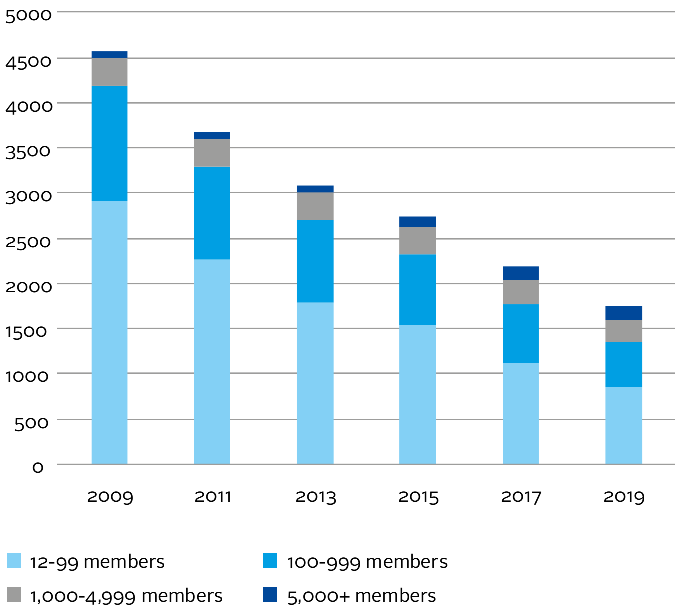
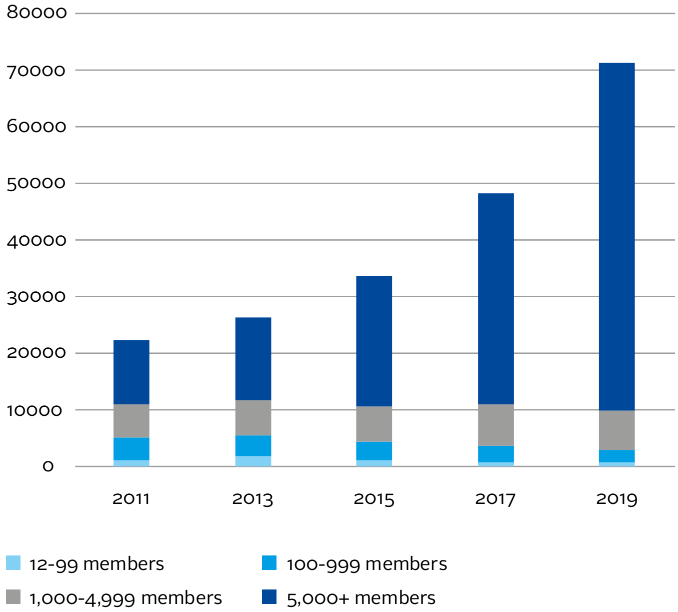


Figure 6: Reported assets in trust-based DC schemes. Source: DC Trust scheme return data 2018-19



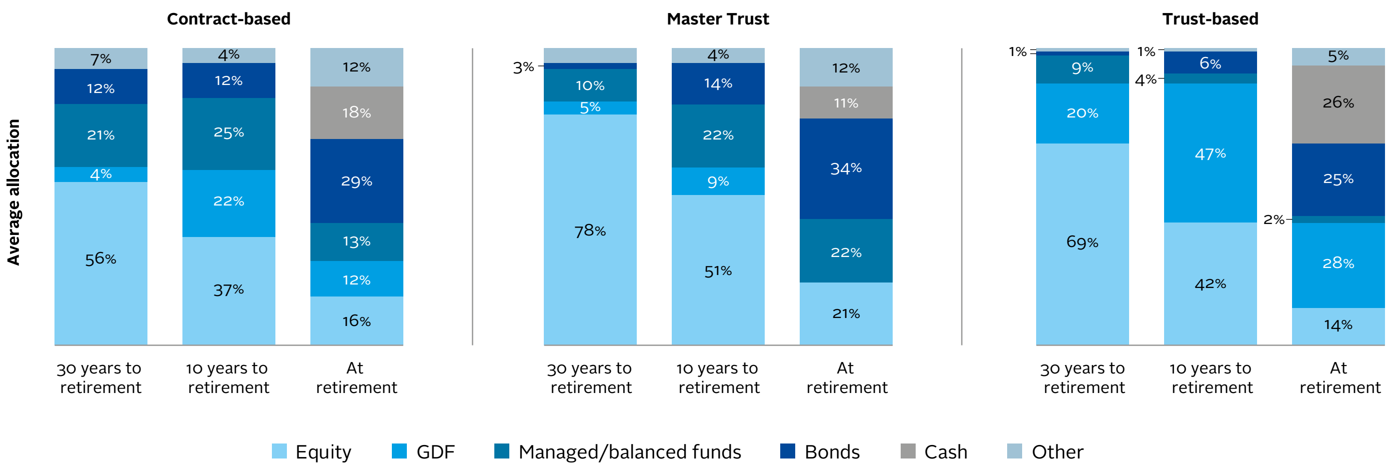
7 Source: DC Trust Scheme return data 2018-19, The Pensions Regulator

The trend towards fewer, larger DC schemes is set to continue as employers turn increasingly to master trusts to enrol new members, or fold their existing schemes into these structures. One in three trust-based and one in five contract-based DC schemes, expect to move to a master trust over the next five years.[8] Some 93% of members who have been automatically enrolled in a pension have been enrolled into a DC scheme; 64% into a trust-based and 29% into a contract-based scheme.[9] According to Defaqto, of the retail workplace propositions open to new business in early 2019, 28% were contract based, 12% trust based, and 60% master trust based.[10]

While this brings advantages in terms of scale and professionalism, master trusts and GPPs pay limited attention to responsible investment. Of the 38 authorised master trusts and 12 GPPs governed by IGCs, only five are PRI signatories in their own right, although 13 others are part of institutions that are signatories. Fewer than half of all master trusts hold any funds that employ an ESG screening or tilting process in their default strategies.[11] However, NEST and People's Pension, which have almost 50% of all automatically-enrolled members between them, are both PRI signatories and integrate ESG into their defaults.

Almost 100% of master trust members and 94% of GPP members are in their provider's default fund.[12] The default strategy is usually set by the provider – with the approval of the trustees in the case of a master trust and advised by the IGC in the case of a GPP – but employers may arrange a bespoke solution. Defaults tend to be lifecycle strategies with a high equity component in the early years, but with a strong reliance on diversified growth funds (DGFs) and other managed or balanced funds, rather than single asset class strategies (Figure 7). This may have the effect of weakening the engagement of governing boards with the underlying assets in the funds. ShareAction found that master trusts were increasingly taking steps to integrate ESG considerations into their equity portfolios but (with the exception of NEST) not into other asset classes, which means that members' portfolios reflect responsible investment considerations less over time.[13]

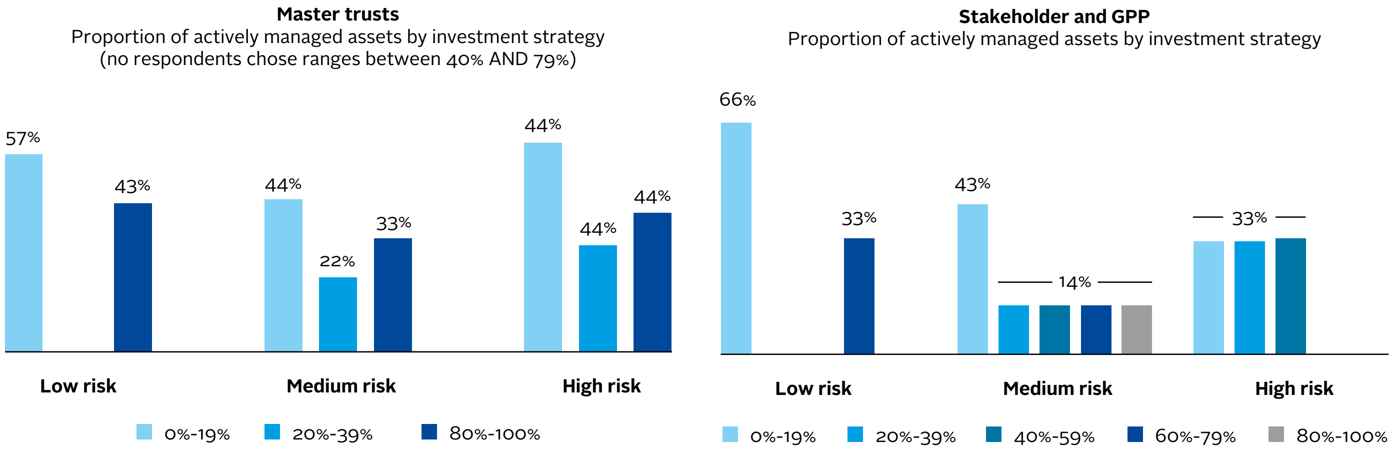
Figure 7: Default fund design: Typical asset allocation. Source: FTSE 350 DC Pension Survey 2019, Willis Towers Watson



8 How do you measure up? Defined Contribution Pension Survey 2020, Aon, 2020
9 Automatic Enrolment Commentary & Analysis, April 2018-March 2019, TPR
10 FT Adviser, 7 May 2019
11 Master Trust and GPP Defaults Report, Corporate Adviser June 2019; PRI data
12 PPI briefing note 108, September 2018
13 Is Regulation Enough? ShareAction December 2019

There has been an increasing focus on the costs of DC provision, and annual member-borne charges for default funds are capped at 75 basis points. This has encouraged the use of passive funds, potentially reducing the opportunities for ESG integration (as ESG-tilted funds may be more expensive than standard index funds) and for stewardship (Figure 8).

Figure 8: Use of actively managed assets and investment strategy risk profile. Source: DC Future Book 2019, PPI



The charge cap is in reality high enough that more complex strategies could be introduced. NEST includes a passive ESG option as part of its default, while the HSBC DC Pension Fund built a bespoke, passive equity fund addressing ESG issues, particularly climate change, for its default. However, the emphasis on cost means that providers are unwilling to charge more than their peers and prefer to compete on administration, communication, and other non-investment features of their schemes.

DC funds in general, and default funds in particular, tend not to invest directly in alternative assets, although the Pensions Policy Institute found that a quarter of contract-based DC schemes held between 20% and 39% of their assets in illiquid investments, primarily accessed via listed vehicles such as multi-asset funds or REITS for property.[14] This is partly to do with the concerns about cost discussed above, but also because of implementation constraints, in particular liquidity requirements and the resources required to properly evaluate alternative investments.

The Pensions Investment Taskforce found that a range of non-regulatory barriers prevented DC schemes from investing in patient capital and other illiquid assets. These included difficulties associated with daily dealing and pricing, high fees for these asset classes, and the need to identify investment options with a suitable risk profile.[15] Most DC schemes currently invest via an insurance platform, so they are restricted to the funds that it makes available.

Platforms were originally designed to serve individual investors trading for their personal pension plans, so operationally they are set up to accommodate daily pricing. DC schemes also usually access underlying asset classes via unit-linked funds, which themselves have liquidity restrictions.

However, there is no regulatory requirement for DC schemes to have daily liquidity and the cash flows of many DC schemes (with more contributions than withdrawals for several years) mean that it should not be necessary for all underlying funds to be very liquid. Still trustees and IGCs should be concerned about fund liquidity in times of stress. Larger DC schemes that either do not use an external platform or have bargaining power with their platform are more likely to be able to access illiquid and alternative asset classes: People's Pension has a 7% exposure to infrastructure and NEST has launched a diversified private credit portfolio.

The opportunities to diversify DC scheme investments should expand in future. The FCA is currently consulting on proposed changes to its "permitted links" rules, with the aim of increasing the availability of long-term investment strategies to DC schemes.[16] In the long term, the largest DC schemes may move off insurance platforms altogether and undertake direct investments. However, the DWP questions whether DC trustees will have the same incentive as DB trustees to consider alternative asset classes if they are satisfied with their schemes' investment performance.[17]

14 DC Future Book, PPI 2019

15 Investment Innovation and Future Consolidation: a Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution Schemes, DWP February 2019

16 Consultation on proposed amendment of COBS 21.3 permitted links rules, CP18/40 December 2018 FCA

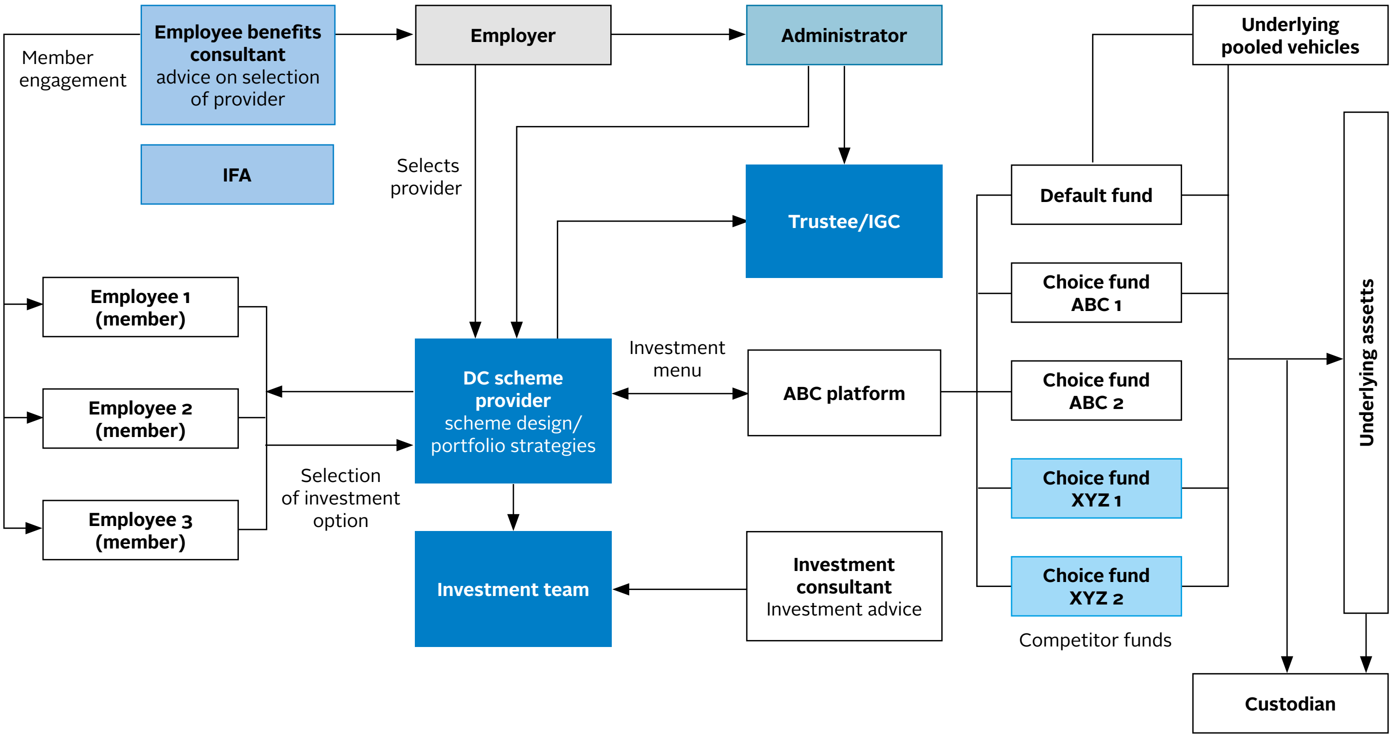
17 Investment Innovation and Future Consolidation: a Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution Schemes, DWP February 2019

DC VALUE CHAIN

Members of occupational DC pension schemes are able to exercise choice in their investment strategies. Outside the default, trust-based DC pension scheme members have a choice of 14 funds and contract-based DC pension scheme members have a choice of 55 funds offered by their providers (median figures)[18]. However, the DC value chain is highly intermediated, distancing DC savers from their underlying investments.

Most DC pension members save into a scheme selected by their employers, governed by trustees or advised by IGCs, as well as operated on a platform and advised by an investment consultant (Figure 9). In 2013, the Office of Fair Trading found that the principal-agent problem was severe in DC workplace pensions: dominant providers sold schemes to less well-informed employers, while the risks of poor scheme performance were borne by employees.[19] Employers might therefore not put in the effort to evaluate a scheme's investment options, or might pay more attention to administration factors than to investments. Most DC investment options are funds, rather than direct investments, usually with some sort of insurance wrapper. The default option is likely to be made up of pooled funds, in a manager-of-manager structure, creating a further layer of intermediation.

Figure 9: DC governance and value chain



Personal pension savers also invest through platforms – they will not have an employer to pre-select their pension provider, but investment advisers can help with the selection of platforms as well as investment portfolios. Platforms offer many advantages to pension savers who want to make investment choices, as they offer a choice of funds and easy switching between them. However, as discussed above, platforms may restrict the choices available and bunded platforms (that belong to a vertically integrated financial services firm) may be unwilling to offer funds managed by their competitors.

The master trust structure simplifies choices for employers and members, but adds another layer of intermediation between DC pension savers and the underlying assets in their portfolios. Member engagement is a challenge acknowledged by master trusts and IGCs across all aspects of their pension participation, although some are beginning to gather information on members' preferences across various criteria, including sustainability.

18 PLSA Annual Survey 2017

19 Defined contribution workplace pension market study, OFT September 2013

Master trust founders include insurance companies (such as Fidelity and Legal & General), employee benefits consultants (such as Mercer) and automatic enrolment solution providers (such as NEST). They appoint a trustee board in the same way that an employer sponsor establishes a trustee for a DB scheme. Unlike the employer, however, the founder also selects the administrator, the platform and the investment strategy. Insurance companies and employee benefits consultants can in-source a large part of the value chain: insurance companies have their own administrators, platforms, and investment funds; EBCs have administration and investment consulting capabilities. The trustee may therefore be one further step removed from the investment process.

In principle, master trust trustee boards and their IGC counterparts can challenge the provider's investment strategy, although it is not clear that this happens in practice. It has not been highlighted in annual reports produced by IGCs. ShareAction found that trustees at master trusts established by insurance companies and consultants were overly reliant on the responsible investment practices of the parent group, rather than having their own policies.

PENSION FUND TRUSTEES

Pension fund trustees are responsible for governance and for protecting beneficiaries' interests; trustees set the investment strategy and are ultimately responsible for investment stewardship. Members of IGCs are responsible for confirming that large contract-based DC schemes offer value for money. From April 2020 their remit has been extended to include reporting on ESG policies, member preferences, and stewardship.[20]

Still, it is not certain that trustees can be relied on to set a responsible investment agenda. A study of DB trustees carried out in 2017 pointed to a trustee population that is predominantly male and aged between 50 and 70 years old, so less likely to have undergone formal training on ESG issues.[21] Furthermore, pensions are complex to govern and trustee positions are not full time. Research conducted for the DWP's Trustee Landscape survey found that boards with only lay trustees spent 10 days per year on trustee duties.[22]

The DWP is keen to improve pension governance by raising standards of trusteeship and encouraging more schemes to use professional trustees. Professional trustees tend to be experienced practitioners – often pensions lawyers or actuaries – who belong to a corporate trustee organisation. There are approximately 350 organisations offering professional trustee services to UK schemes, of which one-third work only with the smallest DC schemes. According to DWP data, 50% of DB, 78% of DC and 64% of SSASs employ a professional trustee.[23] [24]

Primarily, very small schemes and DB schemes with 12 to 999 members (which may lack the resources to implement a responsible investment strategy) use professional trustees. However, a third of professional trustees deal with larger DB or hybrid schemes and professional trustees are also heavily involved with master trusts, IGCs, and the top DB funds. For example, at the two biggest DB schemes by assets, the trustee bodies include corporate professional trustees and individuals who work independently in a similar role; between them, these trustees also work on another 14 pension boards or committees. Professional trustees have a median of seven board positions and these are generally long-term tenures.

Professional trustees are therefore influential in UK pension investments. So far, this influence seems to have been limited in terms of support for responsible investing – only one professional trustee organisation is a PRI signatory. The nature of the trustee's role, the complexity of good pension governance, and the rapid pace of policy and regulatory intervention in recent years may have prevented trustees from paying more attention to responsible investment. The training and background of professional trustees could also mean that "groupthink" in relation to ESG issues is as much of a challenge as in the broader trustee population. In regard to the extended remit of IGCs, the FCA has said; "This may mean upskilling existing IGC members on ESG issues, for example through training sessions, bringing in external expertise to IGC meetings discussing these issues, or recruiting new IGC members with the requisite expertise."

Member-nominated trustees or member panels (as introduced by NEST) may be more inclined to address the responsible investment agenda, to the extent that they are drawn from a wider population than professional trustees.

20 Independent Governance Committees: extension of remit. FCA Policy Statement PS19/30, 19 December 2019

21 Mapping the Trustee Landscape, Aon Hewitt/Leeds University Business School

22 Trustee Landscape Qualitative Research, OMB, 2016

23 Small Self-Administered Scheme

24 DWP Professional Trustee Survey, July 2017. Note: the designation "professional trustee" does not imply a specific trustee qualification. "Lay" trustees can be equally experienced – for example, a trustee board may invite an investment professional to join to bring specific skills, who has a full-time job elsewhere as an investor.

INVESTMENT CONSULTANTS AND EMPLOYEE BENEFIT CONSULTANTS

One of the primary roles of pension trustees is to determine the scheme's investment strategy. Since 1995, trustees have been legally bound to take "proper advice" and this has supported the growth of the consulting market. Consultants and fiduciary managers service a large share of UK pension assets: in 2017, it was GBP 1.6 trillion for consultants and GBP 110 billion for fiduciaries.[25] They are therefore potentially very influential in determining the degree of ESG issues embedded in pension scheme investment strategies.

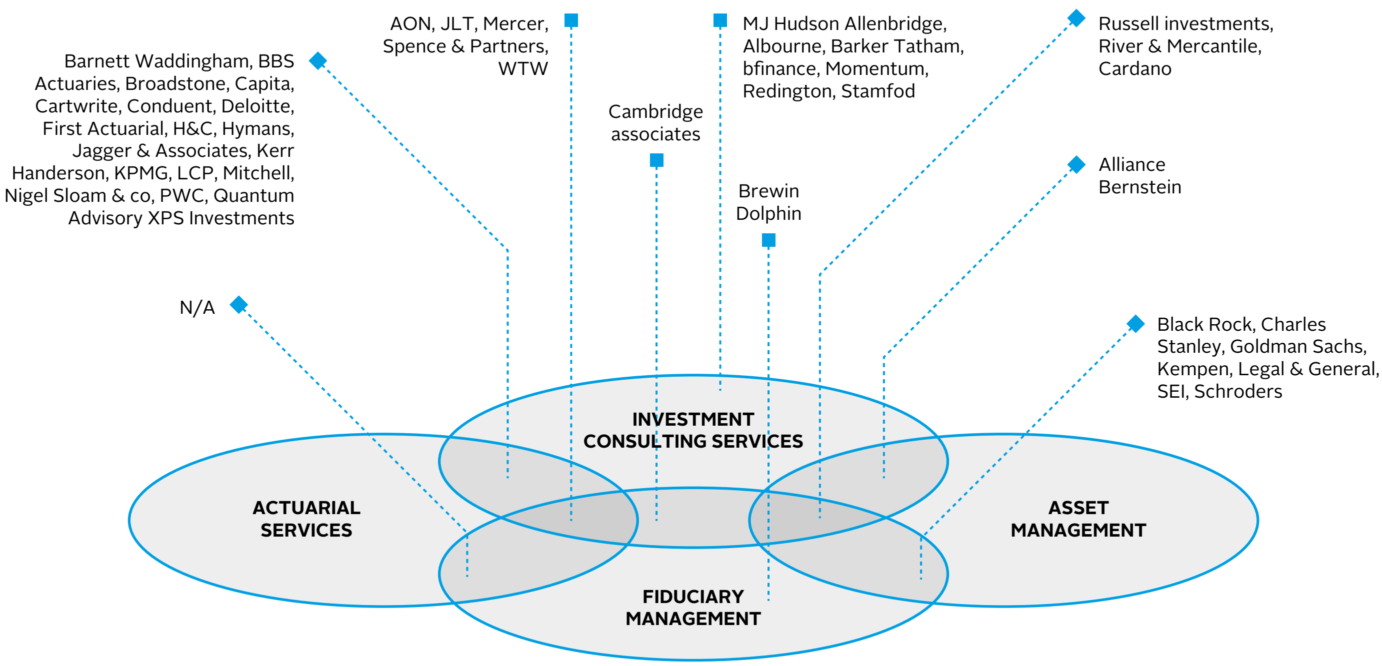
The Competition and Markets Authority (CMA) found that pension schemes accounted for 90% of consultants' revenues and that the consulting market is not very concentrated – implying that trustees should have the bargaining power to be more demanding of their consultants in asking for help with responsible investment strategies. However, the CMA found that trustee engagement with their consultants was limited, although it was better among larger schemes. Following its market study, the CMA has introduced new rules requiring trustees to set strategic objectives before receiving investment consultancy services. The CMA's focus was on investment costs and performance, but this could encourage trustees to establish objectives linked to ESG, especially in light of the other regulatory changes discussed below.

Since the CMA study was published, the consulting market has become more concentrated. Mercer, the second-largest consultant in terms of revenue, acquired top-10 firm JLT Benefit Solutions in 2019. Aon, the largest consultancy firm in the UK, announced plans to buy Willis Towers Watson, the third largest, in March 2020. Following these developments, Mercer and Aon/WTW are likely to have a combined market share of well over 40%.[26] Still, a further 35 investment consulting firms remain active in the UK.

All of the larger firms are PRI signatories.

These firms may offer other services to pension trustees, such as actuarial consultancy or asset management services, making their potential influence even stronger (Figure 10).

Figure 10: Consultant role map. Source: CMA



25 Investment Consultants Market Investigation, CMA 2018

26 See also Professional Pensions online, 19 February 2020

More than half of master trusts use external investment advisers, not necessarily the biggest players (Table 6).

Table 6: Investment trusts and advisers. Source: Master Trust & GPP Defaults Report, Corporate Adviser June 2019 (note KPMG sold its pensions advisory business in an MBO in December 2019)

Barnett Waddingham	Scottish Widows Master Trust, Standard Life Master Trust, The People's Pension
Hymans Robertson	Atlas Master Trust, Autoenrolment.co.uk Master Trust, Ensign Retirement Plan
Dean Wetton Advisory	Carey Workplace Pension Trust, Crystal Trust, Bluesky Pension Scheme
KPMG	Aegon Master Trust Aviva Master Trust, Fidelity Master Trust
River and Mercantile Solutions	Cheviot Trust, Salvus Master Trust
Redington	Now: Pensions, TPT
Marc Bautista	LifeSight
Mercer	Workers Pension Trust

The fiduciary management industry has grown rapidly over the past decade, to reach GBP 172 billion in relevant assets by 2019 (Figure 11).[27]

The market for fiduciary services is more concentrated than that for investment consultancy services, with the top three fiduciary managers controlling 54% of the market in 2017, up from 10% in 2007 (Figure 12).

Figure 11: Growth in assets under fiduciary management. Source: KPMG

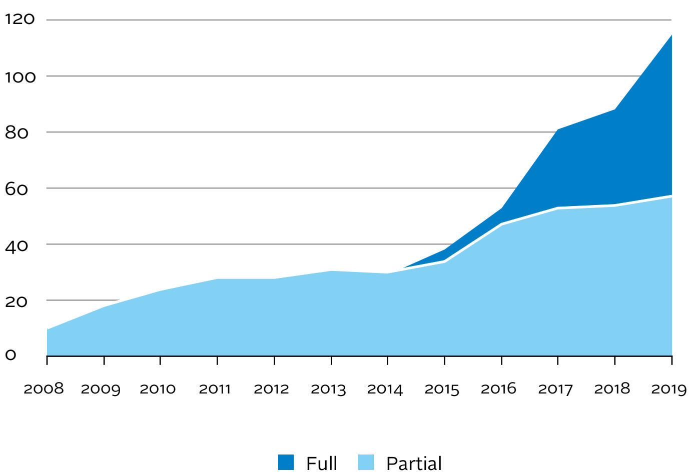
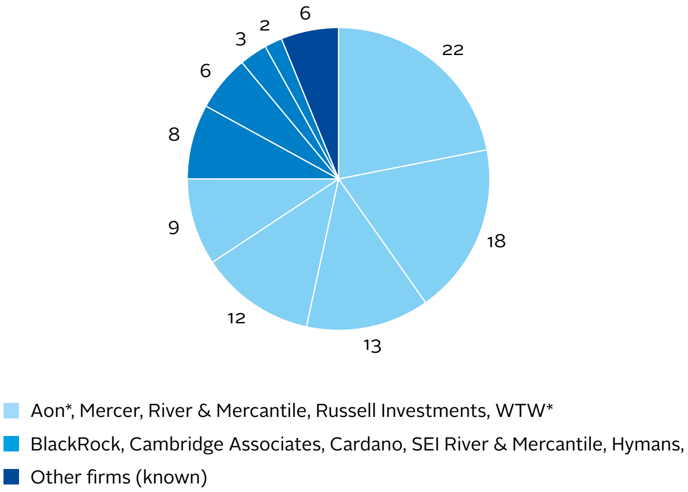


Figure 12: Share by firm of fiduciary management market. Source: CMA



* note: Aon announced plans to buy WTW in March 2020

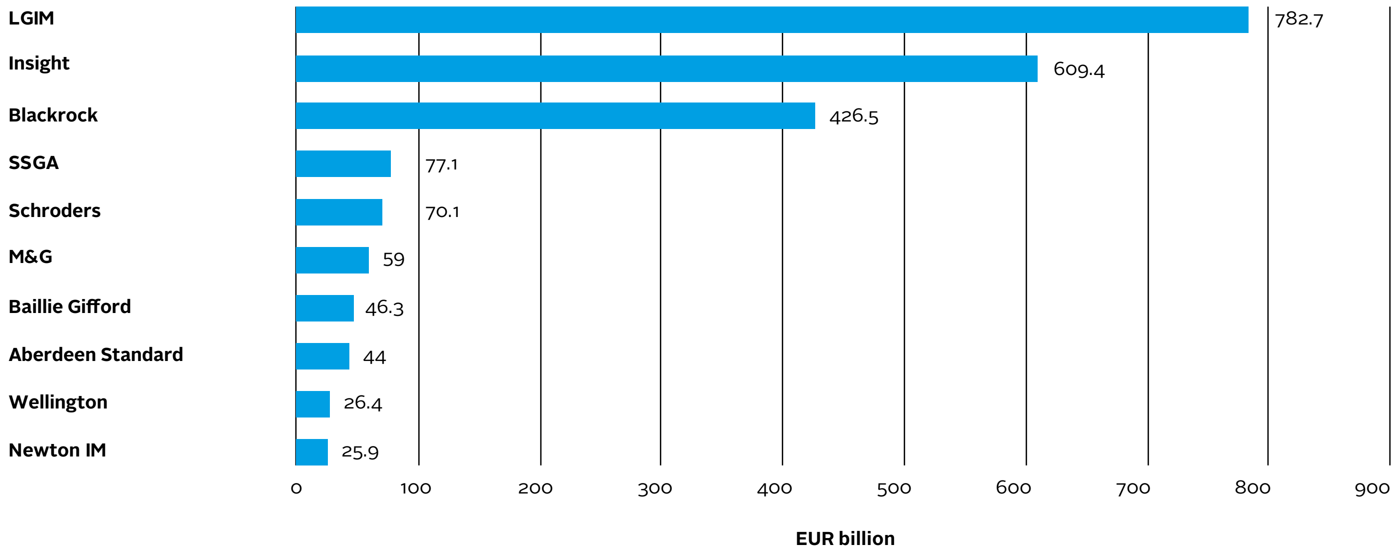
27 2019 KPMG Fiduciary Management Survey

EXTERNAL ASSET MANAGERS

The Investment Association estimates that its members manage GBP 1.8 trillion of external money for UK corporate pension clients and GBP220 billion for the LGPS. LDI strategies represent over a third of institutional mandates. Of the remainder, 76% of mandates are for single-asset strategies. Still, demand for multi-asset strategies is growing among trust-based pension clients, probably due to the growth in default pension assets. IA members also manage contract-based DC assets for insurance companies, at which the proportion of multi-asset mandates is 65%.

The market for UK pension asset management is extremely concentrated, with the top three providers managing over 70% of total AUM (Figure 13).[28] The gap between the top three and the rest of the market is large, and the dominance of the top three is growing. Two of the top three providers overall, LGIM and BlackRock, are also the biggest providers of default funds to the master trust sector.[29]

Figure 13: Top 10 managers of UK pension assets. Source: IPE



* Complex SIPPs invest in a broader range of asset classes and use a broader range of platforms/counterparties

All of the top 10 asset managers in the UK are PRI signatories. However, their record on implementing responsible investment practices is mixed. LGIM scores highly in a ShareAction study of proxy voting, but BlackRock and SSGA are among the worst performers.[30] The Influence Map study on Asset Managers and Climate Change came to similar conclusions.[31] The results for BNY Mellon, the owner of Insight, are inconclusive.

28 IPE 30 August 2019

29 Corporate Adviser op cit.

30 Voting Matters, ShareAction, November 2019

31 Asset Managers and Climate Change, Influence Map, November 2019

PERSONAL PENSIONS

The non-workplace pensions market is worth around GBP 473 billion (Table 7). It shares structural similarities with the contract-based DC market, such as the use of platforms and wrapped investment funds. As in the institutional pensions market (and the asset management market), personal pensions are dominated by a few large firms with a long tail of smaller providers. Providers include life companies, investment managers, platforms, and specialist operators.

Individual Personal Pensions (IPP) have the largest assets under management but are mostly closed to new business. Self-invested Personal Pensions (SIPPs) and Stakeholder Personal Pensions (SHPs) are subject to specific requirements such as on charges and remain open. SIPPs are expected to be the fastest-growing personal pension product going forward. Various other pension plans exist that are fully closed to new business.[32] Using the Top 4 concentration method, the FCA found that concentration was high for SHPs (87%) and complex SIPPs (69%), but lower for IPPs (46%) and streamlined SIPPs (54%).

Table 7: Non-workplace pension market - details. Source: FCA

PRODUCT/WRAPPER TYPE	ASSETS UNDER ADMINISTRATION (AUA) IN GBP BILLION		ACCOUNTS		NUMBER OF PROVIDERS
IPP	254	54%	9.2 million	72%	1,000
SIPP streamlined*	83	18%	0.7 million	6%	1,300
SIPP complex*	67	14%	0.3 million	2%	1,600
SIPP type not specified	11	2%	0.1 million	1%	n/a
SHP	27	6%	1.1 million	9%	2,200
Closed products	31	6%	1.3 million	10%	4,400
Total	**473**	**100%**	**12.7 million**	**100%**	**600**

* Complex SIPPs invest in a broader range of asset classes and use a broader range of platforms/counterparties

Participants are disengaged from the process of choosing their product, provider, and investments –consumers tend to leave them to their adviser, if they have one, stick to a brand they recognise, or choose a standardised product. Levels of engagement stay low during the lifetime of the pension, as evidenced by subdued levels of product switching. This implies that providers have limited commercial incentives to provide innovative products or services. Financial advisers may be able to guide savers to responsible investment options, but the proportion of advised sales is dropping – it is now 50% for streamlined SIPPs and is likely to fall further as platforms offer easier onboarding to participants.

Retail savers more generally, and their advisers, may be encouraged to make more responsible investment choices as more appropriate funds incorporating ESG issues become available (driven in part by institutional demand) and as awareness improves. The Investment Association is proposing the creation of a green label that will make it easier for advisers to understand a fund's green credentials, although similar initiatives in other countries suggest that reaching retail advisers and investors is difficult.

The introduction of the ISR label in France in 2016 has resulted in 337 funds from 63 asset managers receiving accreditation to date, accounting for EUR136 billion in assets, but the primary demand for labelled funds has come from institutional investors and then to a lesser extent from fund selectors. [33]

The FCA is keen to encourage personal pension savers to invest in "patient capital". In addition to its consultation on unit-linked funds, the FCA is consulting on authorised funds for retail investors (such as UCITS, NURS) that are commonly used in personal pensions, but that have liquidity and other protections which potentially prevent them from making this type of investment.[34] This is part of a broad range of recent policy measures designed to encourage pension providers to integrate ESG and climate considerations into their investment decisions and to make green products and services available to savers.

32 Effective competition in non-workplace pensions, FCA, July 2019 of AUA

33 La conquête du grand public, un enjeu pour le label ISR, Les Echos, 25 June 2018

34 Patient Capital and Authorised Funds, Discussion Paper DP18/10, FCA December 2018

POLICY AND REGULATION

Pensions in the UK are regulated by The Pensions Regulator and the Financial Conduct Authority, and may be subject to standard setting and regulation by other bodies.

TPR regulates trustees of occupational pension schemes. It is also responsible for implementing automatic enrolment and for authorising and supervising master trusts. TPR oversees the governance and administration of public schemes.

The FCA regulates providers of non-workplace pensions and of contract-based occupational pensions. It regulates advice in the pensions market and there have been calls for its scope to be extended to cover the activities of investment consultants. The FCA regulates asset managers.

UK pension providers providing EU regulated pension products that include sustainability or green objectives will be required to disclose against the EU's taxonomy for sustainable activities. Financial market participants will have to explain whether and how their products contribute to any environmental objective.

Both UK regulators have for some time been clear that taking ESG factors into account in pension investment decisions is required where these factors are financially material. The FCA has underlined the significant impact that climate change will have on financial services markets and that financial service providers have the potential to help fight climate change. TPR guidance on DC investment governance calls on trustees to consider ESG risks over an appropriate time horizon, to understand the ESG approach of their external asset managers, and to consider the systemic risks of climate change and the potential to engage with portfolio companies on the issue.[35]

TPR has also endorsed the findings of the Law Commission that trustees may take account of non-financial factors (such as members' ethical preferences) in their investment decision-making, if they are confident that members share a particular view and that there is no significant additional financial risk involved.

Despite this encouraging environment, regulators have identified that UK pension assets do not fully reflect the financial risks of climate change and a disorderly transition.[36] This may well be because there has been a large volume of policy initiatives affecting all areas of pension governance, such as pension freedoms, the introduction of automatic enrolment, and investigations into costs and charges, which have left trustees with less time to address responsible investing. There are also ongoing concerns that the investment horizon of pension portfolios is short compared to the long-term nature of pension schemes. Still, they have recently stepped up their actions to align financial flows to the objectives of the Paris Agreement:

- In July 2019, the FCA, TPR, Financial Reporting Council (responsible for accounting standards and actuarial standards and the UK's Stewardship Code) and the Prudential Regulation Authority (supervises banks, building societies, credit unions, insurers and major investment firms) issued a Joint Statement on Climate Change, calling for a collective response.
- Trustees' duties with respect to ESG integration and stewardship have been clarified and significantly strengthened.
- TPR has established an industry group to develop TCFD guidance for pension schemes. Its key requirements will be incorporated into TPR's governance code.
- The 2020 Stewardship Code has been tightened up to require signatories to provide more evidence of the impact of their stewardship activity. Asset managers and asset owners must report on their specific stewardship activities and outcomes across asset classes over a period of 12 months, rather than simply publishing their stewardship policies. For listed equity assets, signatories must provide granular information about their voting history, including the extent of their reliance on proxy voting advisors and whether they enable their clients to exercise their own voting preferences. Proxy advisers have to detail their codes of conduct and their adherence to them. All signatories must take account of material ESG factors when fulfilling their stewardship responsibilities.[37]

35 https://www.thepensionsregulator.gov.uk/en/trustees/managing-dc-benefits/investment-guide-for-dc-pension-schemes-?utm_source=LinkedIn&utm_medium=organicpost&utm_campaign=Investment_Guidance

36 Green Finance Strategy, July 2019

37 The UK Stewardship Code 2020, FRC

The action taken to strengthen and clarify trustees' investment duties includes a progressively tighter reporting standard:[38]

- By October 2019, trust-based occupational schemes (excluding the smallest schemes) were required to update their policies on financially material considerations, stewardship, and non-financial matters
- From October 2019, trustees of DC schemes were required to publish their updated Statements of Investment Principles (SIP). The SIP should outline policy on financially material considerations, including but not limited to those arising from ESG factors, including climate change, over the appropriate time horizon of the investments.
- Trustees of relevant schemes also were required to state their stewardship policies, such as the exercise of voting rights and engagement, for the investments in their default fund.
- Trustees are required to include in the SIP the extent to which members' views on non-financial matters are considered in investment decisions with the option to state that they do not take me account of members' views.
- From October 2020, the SIP should also specify the trustees' policy in relation to asset manager selection, retention, and remuneration, including how this incentivises asset managers to invest sustainably.
- From 2020, DC trustees must publish an implementation statement, setting out how the principles set out in the SIP have been followed in their engagement and voting practices.
- The above requirement applies to DB trustees from October 2021.

ShareAction concluded that the introduction of legislation "seems to have brought responsible investment to the forefront of trustees' minds within the master trust sector". To date, this is more evident in the quality of the trustees' investment polices than in their engagement and stewardship activities, which are still primarily delegated to their asset managers.[39]

A survey of its members by the Society of Pension Professionals found that action by the government and regulator was catalysing ESG activity by pension funds, but that so far most of this activity related to preparing the SIP rather than materially changing the portfolio.[40] The survey also found that none of the main actors in the DC or DB value chains had a material influence on responsible investment activity, which was overwhelmingly a response to policy developments. Trustees, members, and asset managers were not driving change. Indeed, "the public" was cited as a more important factor than all three groups, despite the fact that trustees are not technically beholden to the public.

The FCA is imposing similar duties on IGCs. From 2020, IGCs will be required to consider and report on their firms' policies on ESG issues, member concerns, and stewardship, for the products that the IGCs oversee.[41] These duties also apply to Governance Advisory Arrangements – these are similar to IGCs but are scaled for firms that are less active in workplace pensions, although they may have a significant presence in the personal savings market.

Recent EU regulation may also be implemented in the UK. In June 2019, the European Parliament adopted a number of proposals on sustainable finance. These included a requirement for financial market participants (including asset owners and asset managers) not only to integrate ESG risks into their decision making and disclose how this is being done, but also to take account of and disclose the impact of their investment decisions on sustainability factors. Higher sustainability standards will apply in the retail as well as the institutional space. In January 2019, the European Commission published draft rules on how investment companies should take sustainability issues into account when providing advice to their clients, including introducing questions into the suitability assessment that would help identify ESG preferences. A similar approach will be applied to retail insurance products.

38 The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018 (now the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018) DWP September 2018

39 ShareAction op cit.

40 Putting ESG into Practice, Society of Pension Professionals, January 2020

41 Independent Governance Committees: extension of remit. FCA Policy Statement PS19/30, 19 December 2019

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

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The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

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