

RESPONSE TO WORK AND PENSIONS COMMITTEE INQUIRY ON ‘DEFINED AMBITION’ (COLLECTIVE DEFINED CONTRIBUTION) PENSION PROPOSALS

INTRODUCTION

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 1900 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$70 trillion in assets under management. Over 250 of these signatories are based in the UK¹.

Responsible investment explicitly acknowledges the relevance to the investor – in this case beneficiaries of pension schemes – of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of financial markets. The PRI welcomes the opportunity to contribute evidence for consideration in the government's proposed formulation of Collective Defined Contribution (CDC) pension funds.

The PRI has experience in international ESG regulation and has developed a wealth of practical guidance on incorporating ESG factors into pension fund investment decision-making. The PRI's Managing Director, Fiona Reynolds, participates in the UK Green Finance Taskforce². We would welcome further dialogue on the issues raised in this inquiry.

ABOUT THE INQUIRY

The Commons Select Committee inquiry has been launched to explore merits of introducing a new category of Collective Defined Contribution (CDC) funds to the UK pensions market, that would aim to provide more certainty for individuals than Defined Contribution (DC) pension funds and less cost volatility for employers than Defined Benefit (DB) pension funds. The Committee has invited evidence to help explore the role that CDC schemes could play in the pension landscape, the potential benefits to savers and the wider economy, and the legislative and regulatory framework required to make it work.

SUMMARY OF PRI'S POSITION

We commend the government for exploring options to encourage workers in the UK to contribute to pension schemes that will ensure they are able to retire with the dignity of a sufficient income. This is particularly important given; the move away from many companies offering DB pension

¹See <https://www.unpri.org/signatory-directory/>

² <https://www.gov.uk/guidance/green-finance#green-finance-taskforce>

funds, the introduction of the UK's auto enrolment process into DC pension funds, and in the context of growing and ageing populations which impacts government spending and planning.

We believe that the proposed CDC funds could play a role in addressing the inadequacy of provisions for retirement income that currently exists across the UK.³ The PRI offers the following recommendations to enable and encourage the integration of ESG factors into investment decision-making in the UK capital market, to benefit the UK pensions market and proposal for CDC pension funds.

The PRI recommends for any future plans to introduce CDC funds, the government should:

- 1. Structure CDC pension funds to meet the need for large consolidated – or pooled – pension funds.** CDC pension funds could help to address problems with pension funds' governance and size that currently exist in the UK market.
- 2. Consider how responsible investment can be integrated into the design of CDC pension funds** to build trust and engagement with beneficiaries and to ensure that CDC pension funds have a clear view towards long-term investment and a sustainable financial system.
- 3. Clarify that the consideration of ESG factors is core to how CDC pension funds discharge their fiduciary duties.**

Our more detailed response below focusses on key issues which the Committee has identified in its background comments to the inquiry, which we think are of significant long-term social and economic interest.

THE PRI'S RESPONSE

- 1. The government should structure CDC pension funds to meet the need for large consolidated – or pooled – pension funds.** CDC pension funds could help to address problems with pension funds' governance and size that currently exist in the UK market.

In the Autumn 2017 budget the Chancellor announced plans to "unlock" investment in UK infrastructure through long-term investment in "scale-up" innovative business. CDC pension funds have been identified as a potential source of this type of investment. We welcome the Committee's recognition of the need to link "patient capital" to the real economy and the government's proposal to invest beneficiaries' savings into larger "collective" funds to mobilise capital towards these ends.

We recommend that the introduction of CDC pension funds should be carefully balanced with minimising further fragmentation of the UK pensions market. There is evidence that larger schemes are positively correlated with good governance and stewardship and ESG practices which, as noted above, are integral to responsible investment that benefits savers, the wider economy and long-term stability of financial markets. Whilst recognising that many small schemes can and do integrate responsible investment practices well, we note that within the PRI membership base, larger pension funds (>USD\$ 5bn in AUM) are considerably more likely to have stated their policies in relation to; the governance/implementation of their chosen ESG strategy (49% vs. 26%) and stewardship activities (engagement 74% vs. 47%. Voting: 85% vs.

³ Successful pension fund systems operate in many countries, including the Netherlands, Denmark and Australia. These countries rank the highest in the Annual Mercer Pension Index, which ranks the pension systems in 30 countries according to their adequacy, sustainability and integrity. The afore named countries score 77+ with the UK scoring 61.4 out of a total 100. Here, the UK ranks in the bottom half of all countries assessed and the study provides six recommendations for the UK to consider in any forthcoming design of CDC pension funds. The study recommends that to improve its provision the UK needs to: raise the minimum pension for low-income pensioners; further increase the coverage of employees in occupational pension schemes; raise the level of household saving; and accelerate the intended increases in the state pension age (Melbourne Mercer Global Pension Index, 2017).

56%).⁴ By contrast, the UK has many small pension funds, and further consolidation or pooling of investments will support the ambition of more infrastructure investments being made by UK pension funds.⁵

We welcome the Government's decision to publish a white paper with proposals to encourage consolidation in early 2018.

2. The government should consider how responsible investment can be integrated into the design of CDC pension funds to build trust and engagement with beneficiaries and to ensure that CDC pension funds have a clear view towards long-term investment and a sustainable financial system.

The Committee's ongoing inquiry into pension freedoms has highlighted the general level of mistrust and disengagement with pension plans. Mistrust of pension plans has resulted from a number of mis-selling scandals and poor financial advice. Disengagement has resulted from beneficiaries' lacking a sense of their ultimate ownership over their investments, including which companies are invested in on their behalf, further confounded by difficult to understand fees in the investment chain. Indeed, mistrust of pension plans is part of a broader lack of trust in the financial services sector.

The PRI believes responsible investment can help the UK pension industry address mistrust. By integrating ESG factors into investment decisions, pension funds can better manage risk and generate sustainable, long-term returns. This is increasingly being recognised by pension funds internationally, but with some way to go. For example the UK Financial Conduct Authority refers to an Investment Association (UK) study in its Asset Management Market Study: "In a recent sample of 34 IA members, half reported that they managed at least some proportion of assets according to ESG considerations and, where they did, approximately one fifth of total assets were subject to ESG requirements".

In addition, responsible investment may operate as a lever for greater beneficiary engagement with pension plans. A recent study undertaken by The Wisdom Council found that from a survey of 100 individual/retail investors in the UK:⁶

- 8 out of 10 wanted to find out more about ESG – rising to 9 out of 10 for millennials.
- 2 out of 3 of 25-34 year olds said that if an ESG fund were easily available they could see themselves investing for the first time or investing more in a fund like this in the next 12 months. Among the over 55s, where responsible investing holds less appeal, 1 in 4 reported they would invest new money or increase investments in the sector.
- More millennial investors said they would invest in responsible strategies through their corporate pension or personal pension if they were available (37% vs 29% ethical, 43% vs 32% green, 34% vs 29% impact, relative to the total sample).

The UK has an opportunity to lead other major markets in building trust and reengagement with pension fund beneficiaries by requiring responsible investment and ESG integration into CDC pension funds. Once published, we recommend the Commons Select Committee inquiry

⁴ This report examines the relationship between scale of pension funds (measured by assets under management) and indicators of ESG governance and stewardship. All data is sourced from 2017 responses to the PRI Reporting Framework and PRI's performance assessments of pension funds.

⁵ We note the government's acknowledgement of feedback from stakeholders on pension fund consolidation as 'burdensome and ineffective' and welcome the government's forthcoming white paper with proposals to encourage consolidation in early 2018 (Pension funds and social investment: the government's interim response, December 2017).

⁶ <https://www.thewisdomcouncil.com/twc-insights/>

incorporate the recommendations of the EU High Level Expert Group on Sustainable Finance and the UK Green Finance Taskforce.

3. Clarify that the consideration of ESG factors is core to how CDC pension funds discharge their fiduciary duties.

The PRI has welcomed previous clarification from the Law Commission, The Pensions Regulator, the DWP and DDCMS that fiduciaries should consider ESG issues in investment decision-making:

- In its study of the fiduciary duties of investment intermediaries, the UK Law Commission concluded that “where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should take them into account.”⁷
- In March 2017, The Pensions Regulator clarified that trustees “need to take environmental, social and governance (ESG) factors into account if you believe they’re financially significant.”⁸
- In December 2017 the DWP (and Department for Digital, Culture, Media and Sport) issued the government’s interim response to the Law Commission report: *Pension Funds and Social Investment* (Law Commission No 374, December 2017. Full response due in summer 2018). Some of the changes recommended by the DWP (and DDCMS) will have a direct impact on the ability of pension funds to become involved in responsible investment. New CDC schemes should benefit from these legal changes and consultations.

The PRI continues to recommend revision of the Investment Regulations (applicable to occupational pension schemes)⁹: to reflect the modern interpretation on fiduciary duty which refers to the importance of considering ESG as necessary to properly execute fiduciary duty; to make a clear distinction between ESG and ethical investment, and reflect guidance issued by The Pensions Regulator, and remove the implication that ESG integration is an optional aspect of fiduciary practice. The transposition of the IORP ii Directive provides a good opportunity for the government to revise the Investment Regulations. Such clarification should also apply to the regulatory framework for CDC pension funds.

⁷ <http://content.tfl.gov.uk/law-commission-guidance.pdf>

⁸ <http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx>

⁹ See https://www.unpri.org/download_report/24187.