CONSULTATION RESPONSE

DWP CONSULTATION PAPER ON INVESTMENT INNOVATION AND FUTURE CONSOLIDATION

April 2019

For more information, contact:

Alyssa Heath
Senior Policy Analyst
alyssa.heath@unpri.org

Emmet McNamee
Policy Analyst
emmet.mcnamee@unpri.org
ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world’s leading initiative on responsible investment. Originally set up by the UN in 2005, the PRI now has over 2,300 signatories (pension funds, insurers, investment managers and service providers) to the PRI’s six principles globally with approximately US $83 trillion in assets under management. 366 of these signatories, representing $9 trillion, are based in the United Kingdom.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that ESG factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on 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.

SUMMARY OF THE PRI’S POSITION

The PRI welcomes this consultation, which targets two important barriers to increasing the uptake of responsible investment in the UK: a lack of investment in patient capital by domestic pension funds¹ and a fragmented pensions market where some schemes lack the resources to effectively engage in responsible investment. The latter was a key finding of the PRI’s Fiduciary Duty in the 21st Century: UK Roadmap, which recommended that pension schemes should be required to reflect on the impact of their scale on governance quality and, where necessary, consider consolidation².

Pension fund investment in illiquid assets in the UK is very low by international standards³. This has the triple effect of overlooking a potential source of investment return for schemes, restricting patient capital projects’ access to capital and missing an opportunity to connect beneficiaries with their pension savings in a more tangible way. Improving investment levels in this area is likely to improve the UK’s economic performance while boosting beneficiary engagement with their pension pots.⁴

As set out in our detailed response below, the fragmented pension fund market in the UK may pose a barrier not only to illiquid investments but also schemes’ capacity to consider environmental, social and governance (ESG) risks and opportunities. Encouraging consolidation could help overcome a key

³ See note 1.
market-based barrier to the development of responsible investment in the UK and improve returns to savers over the long-term.

RECOMMENDATIONS FOR THE DWP

The PRI has two key recommendations:

(1) **Expand the scope of schemes for consolidation.** The scope of the proposed triennial reporting requirements should be expanded to include larger pension schemes, as such schemes can still significantly improve their responsible investment practices, governance and running costs by consolidating.

(2) **Include ESG incorporation as a reporting requirement for smaller schemes.** Evidence from the PRI Reporting Framework shows that larger investors demonstrate better incorporation of ESG issues into their investment strategies. Schemes considering consolidation should report on their ESG incorporation given the likely effects on asset valuation over the time horizons of DC scheme beneficiaries.
RESPONSE TO DETAILED QUESTIONS

The PRI will be responding to questions 1-5.

ILLIQUID INVESTMENTS

Q1. We would welcome comments on the following proposals around reporting pension schemes’ approach to investing in illiquid assets. We would also welcome any other proposals which use reporting to prompt consideration of illiquid assets.

(a) Scope: ‘Relevant schemes’ (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 or 20,000 or more members (or alternatively £250m or £1bn assets to provide for money purchase benefits) would be in scope of the proposed requirement. Would an asset-based or a membership-based threshold be more proportionate and effective?

(b) Reporting their policy: Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles

(c) Reporting their actions: Schemes in scope would be required to report annually on their main default arrangements’ approximate percentage holdings in illiquid assets, and with a breakdown in holdings of the trustees’ choosing.

DC schemes have the potential to be key contributors of financing to patient capital projects; in 2017, almost half of DC pension savers were 25 years or more from retirement age, with nearly 20% below the age of 30⁵. Such beneficiaries are particularly suited to long-term illiquid investments, and restricting their pension investment choices in favour of liquidity which will go unused harms their interests and raises the cost of capital for patient capital projects.

Increasing pension investments in tangible illiquid assets also has the potential to improve beneficiary engagement. The PRI has previously identified greater attention to beneficiary interests as one of nine key conditions that must be addressed to achieve a more sustainable financial system⁶.

Increasing investments in projects which are clearly linked to the “real economy”, such as infrastructure and social impact projects, is likely to boost beneficiaries’ sense of ownership over their

⁶ See: https://www.unpri.org/sustainable-financial-system/how-the-pri-is-contributing-to-a-sustainable-financial-system/199.article
pension pots and improve understanding of how their savings are used in practice. It has been argued that this could lead to savers choosing to increase their contribution, creating a virtuous cycle.

Increasing pension funds’ investments in illiquid assets will require addressing a number of barriers. As identified in the Consultation Paper, pension fund scale is a significant impediment; jurisdictions which have achieved high levels of investment, such as Australia, have average pension fund sizes many multiples that of the UK. The investment platforms through which DC schemes are administered have also been cited as creating an expectation of daily trading, inhibiting illiquid investing.

Regarding scope, an asset-based approach would be more appropriate for scoping purposes, as this will be the most relevant factor to its ability to hold illiquid assets. The PRI supports the lower £250m threshold. A European Commission study seeking to boost venture capital investment found that pension funds and other institutional investors usually require a minimum ticket size of €25 million for it to be viable for them to pursue an investment. While this would mean that smaller pension funds within this proposed scope would generally be precluded from direct investments in patient capital projects, such schemes would still have the option of investing through illiquid funds.

CONSOLIDATION

Q2. Do you think Government should encourage or nudge smaller occupational DC pension schemes to consolidate? If this should only happen at some point in the future what factors should be taken into account in determining that point?

Yes. The PRI recommends that the government should encourage smaller, underperforming DC schemes to consolidate as a matter of priority. Responsible investment outcomes, scheme governance and member charges are on average significantly improved at larger schemes. As the consultation notes, a long tail of smaller schemes is likely to remain without regulatory intervention.

The quality of a scheme’s responsible investment and consideration of ESG factors is as much about priorities and intention as it is about scale; several small schemes incorporate ESG very well. Outsourcing to asset managers or through fiduciary management structures can also help overcome scale-related issues. However, scale conveys multiple advantages and allows more resources to be dedicated to responsible investment for those schemes that prioritise it.

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Evidence from PRI’s Reporting Framework

Global data from the PRI’s Reporting Framework indicates that there is a direct relationship between pension fund scale and engagement in responsible investment activities. In particular, the evidence below shows that strategy, governance, stewardship and scenario planning are significantly improved at larger pension schemes, indicating that on average beneficiaries of larger schemes are better placed to take advantage of ESG-related risks and opportunities over the long-term.

Smaller funds are much less likely to be PRI signatories in the first place. Of the 25 largest pension funds in the UK in 201611, 44% of these schemes are PRI signatories, with 53% of the group’s total assets. By contrast, 0.07% of all12 pension schemes with 21% of all pension assets are PRI signatories. This implies that smaller pension schemes are much less likely to commit to responsible investment principles.

The PRI assesses signatories responses to a number of core and voluntary indicators under the PRI Reporting Framework and assigns a score within each reporting module to assign one of six performance bands (from E to A+). Scores under these modules are on average significantly higher at larger schemes.

The strategy and governance module scores signatories on elements such as responsible investment policy coverage and breadth, objectives and senior level oversight. As shown in Figure 1, the largest pension scheme signatories were over twice as likely to receive an A or A+ as the smallest schemes, and over five times less likely to receive a C or D score.

Figure 1 – Pension Signatory Peering Scores 2017 – Strategy and Governance Module, PRI Reporting Framework13

![Figure 1](https://app.powerbi.com/view?r=eyJrIjoiNGFmNmVmZjAtY2QyMS00Mjc3LWFkYTQiOGExMjY3MzjiN2EyiwiwidCI6ImZiYzI1NzYzfC5iLCJhcGkiOiJodHRwczovL3ppbWcubmV0LmNvbS9vZmZsb3ciLCJlbmRpZ29yZCI6IjIiLCJmcyI6W199)

Pension schemes with less than US$1bn in assets

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13 See: https://app.powerbi.com/view?r=eyJrIjoiNGFmNmVmZjAtY2QyMS00Mjc3LWFkYTQiOGExMjY3MzjiN2EyiwiwidCI6ImZiYzI1NzYzfC5iLCJhcGkiOiJodHRwczovL3ppbWcubmV0LmNvbS9vZmZsb3ciLCJlbmRpZ29yZCI6IjIiLCJmcyI6W199
A similar correlation exists across other PRI reporting modules. For example, no pension funds with less than US$1bn in assets achieved an A+ score in either the listed equity or SSA bonds module – the only AUM grouping for which this was the case.

Performance under individual indicators reflect this overall trend\textsuperscript{14}. Smaller pension funds are less likely to be active owners, despite this being one of the most effective mechanisms to reduce risks, maximise returns and have a positive impact on society and the environment. 64\% of signatory pension funds with less than US$1bn in assets have an engagement policy, compared with 88\% of those with over US$10bn. These smaller pension funds are also four times less likely to track the proportion of shares in their portfolio voted on their behalf than their larger peers, and of those that do track this information, on average they will vote a lower proportion of their portfolio (85\% compared with 94\%).

This pattern is also replicated under a number of social and environmental indicators. This is particularly stark regarding scenario analysis. While 40\% of all pension fund signatories report that they undertake some form of scenario analysis assessing the investment impacts of future environmental, social and/or governance trends, this number drops to 4\% for pension funds with assets less than US$1bn. Such funds may be dangerously exposed to the long-term physical and transition risks associated with climate change\textsuperscript{15}.

\textbf{Figure 2 – Pension signatories undertaking of scenario analysis or modelling of future ESG trends – Indicator SG 13.1, PRI Reporting Framework 2018}

\textsuperscript{14} Data from responses to the 2018 PRI Reporting Framework.

\textsuperscript{15} See: \url{https://www.unpri.org/climate-change/the-inevitable-policy-response-to-climate-change/3578.article}
(ii) Other evidence

There is ample evidence in the UK context that larger pension schemes tend to have more robust governance structures and practices which are likely to mitigate risks and improve returns for beneficiaries. TPR’s 2015 Trustee Survey\(^\text{16}\) demonstrated this quite clearly – trustee boards at smaller schemes met less often and spent fewer days on their duties than the average scheme. Smaller schemes were also less likely to have an investment sub-committee, and their trustees had lower levels of qualification and were less likely to have undertaken recent training.

TPR research\(^\text{17}\) cited in the consultation points out that 80% of larger schemes complied with at least two of four key governance requirements, compared with just 15% of smaller schemes. The recent CMA investigation into investment consultants\(^\text{18}\) found that smaller schemes are less likely to use an investment consultant and demonstrate lower levels of engagement with their consultants, leading to higher fees, lower asset manager discounts negotiated by their consultant and a lower quality of service.

The recent pooling of 89 local pension funds into the 8 Local Government Pensions Scheme (LGPS) pools provides further evidence of the benefits of consolidation, particularly regarding responsible investment. In the short time since pooling was implemented, pools have demonstrated strong commitments to responsible investment practices\(^\text{19}\), with half becoming PRI signatories.

Administrative costs will also be lower for larger schemes as they benefit from economies of scale. For example, TPR research into DB schemes has previously found that schemes with over 5,000

\(^{16}\) See: https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/trustee-landscape-qualitative-research-2016.ashx


\(^{18}\) See: https://www.gov.uk/cma-cases/investment-consultants-market-investigation

\(^{19}\) See: https://www.responsible-investor.com/home/article/vm_lg/
members pay a mean of £182 per member in annual running costs; this number increases significantly to £1,054 for schemes with less than 100 members\(^{20}\).

Q3. We would welcome views on the following proposals around pension schemes reporting their position on the potential benefits of future consolidation, or any other associated proposals.

(a) Scope: ‘Relevant schemes’ with fewer than 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.

(b) What should be reported: Schemes in scope could be required to explain their assessment of whether it would be in members’ interests to be transferred into another scheme with significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?

(c) Reporting vehicle: The requirement could be added to the value for members assessment which forms part of the Chair’s Statement and published annually.

(d) Updating frequency: The explanation of whether it is in members’ interests to consolidate should be updated at least every 3 years, and after any significant change in size or demographic profile.

(a) Scope

The PRI recommends that the DWP take an expansive approach when defining the scope of schemes subject to the proposed reporting requirement, given that even larger than average (by UK standards) schemes can benefit from greater scale.

As demonstrated in the response to Q2, there is a direct correlation between pension fund size and responsible investment practices, governance and running costs, with improved outcomes as pension funds increase in size. Larger schemes do not only outperform the smallest schemes, but also medium-sized schemes. For example, PRI’s snapshot report on *Asset owner practices on manager selection, appointment and monitoring*\(^{21}\) shows significant differences in scores between those pension funds with US$1-5bn AUM and those with over US$10bn. Similarly, even schemes defined as ‘large’ by TPR with between 1,000 and 4,999 members had average running costs which were 54% greater than those with over 5,000 members\(^{22}\).


\(^{21}\) See note 10.

Improved outcomes may not only be generated from the consolidation of the smallest schemes – for example, those with less than £10m in assets – but also for significantly larger schemes. While there may be fewer opportunities for the largest pension schemes in this expanded scope to consolidate, the reporting requirement under these proposals is light. On balance, the benefits of encouraging consolidation among these schemes would appear to outweigh the costs.

(b) What should be reported

The PRI supports the proposed comparison points of charges, investment, governance and administration.

The PRI recommends including the extent to which schemes have incorporated environmental, social and governance (ESG) factors into their investment strategy as an additional reporting element.

The PRI’s Fiduciary Duty in the 21st Century project\(^{23}\) demonstrated that failing to consider material ESG issues in investment practice is a failure of fiduciary duty, and the Investment Regulations now require ESG issues to be addressed in schemes’ Statement of Investment Principles (SIP). The quality of schemes’ compliance with these requirements would be an indication of how well a scheme is poised to take advantage of long-term value drivers in line with the time horizons of its beneficiaries.

Specific indicators might include whether the scheme has executed forward-looking scenario analyses of the investment impacts of ESG trends, and how ESG considerations in the SIP have been managed in practice with scheme assets.

Q5. What do you think about the use of indicators such as trustee knowledge and understanding, open or closed status or member demographics to identify and encourage schemes to consider consolidation? What indicators do you recommend and how could they best be communicated and verified?

The PRI supports the proposed triennial reporting requirement for smaller schemes over the targeted approach set out in this section of the consultation. However, in the event this approach is preferred, the PRI supports the indicators proposed here.

Regarding the use of indicators relating to trustee knowledge and experience, the PRI has previously identified skills gaps on trustee boards as a key barrier to the uptake of responsible investment among asset owners\(^{24}\).

The PRI also agrees that member demographics is also an important indicator which should be used. Schemes with a high proportion of younger people will have longer-term investment horizons and as

\(^{23}\) See: [https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century/244.article](https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century/244.article)

such will be particularly exposed to ESG risks such as climate change. As demonstrated in the response to Q2, larger schemes have generally been better equipped to address such risks in their investment strategies.