FairPensions™

The campaign for **responsible** investment

Response to DWP Select Committee Call for Evidence: Automatic enrolment in workplace pensions and NEST

Summary

- Responsible stewardship of investments will be vital to the achievement of auto-enrolment's policy goals.
- We applaud NEST's thoughtful and forward-looking approach to responsible investment, as well as its efforts to engage members and understand their needs, including with respect to risk appetite and ethical preferences. We hope its leadership will drive up standards across the market.
- We are concerned at the limited attention that has so far been given to ensuring that standards of governance and consumer protection are consistent and comparable across the pensions market. Trust- and contract-based pension arrangements are subject to separate legal and regulatory regimes. While not suggesting that this separation could or should be abolished, we do think that more concerted government action is needed to ensure that both systems act in savers' best interests. Failure to do this could damage trust in the system and thereby discourage people from saving, as well as damaging outcomes for savers.

1. FairPensions is a registered charity that promotes Responsible Investment (RI) by pension schemes and fund managers, and seeks to ensure that savers are well served by their agents in the City. We concentrate below on the following aspects of this inquiry's terms of reference, which are relevant to our area of expertise:

   - NEST's potential market share and the possible effects on other providers;
   - NEST's investment strategy; and
   - The extent to which auto-enrolment is likely to achieve the desired behavioural change in terms of encouraging people to make provision for retirement.

2. With the decline of defined benefit (DB) schemes, the auto-enrolment landscape will be dominated by defined contribution (DC). This means that the 5-8 million people predicted to begin saving or save more as a result of the reforms[1] will be largely reliant on the capital markets for their wellbeing in retirement. It is vital that these savers' investments are responsibly stewarded. The impact of this on the success of the policy's ultimate goal – providing for an ageing population – will be two-fold. Firstly and most obviously, it will affect the performance of pension investments. Secondly, it may also impact public trust in the system, which will be a key factor in people's willingness to save in the first place.

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[1] The Pensions Regulator, 2011, *'Enabling good member outcomes in work-based pension provision'*, p5. http://www.thepensionsregulator.gov.uk/docs/dc-discussion-paper-2011.pdf

A) NEST – investment strategy & market impact

NEST's investment approach

3. 'Responsible investment' approaches reflect the increasingly accepted view that environmental, social and corporate governance (ESG) issues can affect investment performance, and that appropriate consideration of these issues is part of investors' fiduciary duty to their beneficiaries. Responsible investors seek to incorporate ESG issues into their analysis and decision-making, and to be 'active owners', exercising their shareholder rights (ie. engagement and voting) to improve company performance. In the aftermath of the financial crisis, the need to improve the quality of engagement between investors and companies has been increasingly recognised, most notably with the publication of the UK Stewardship Code for institutional investors.[2]

4. From the outset NEST has taken a thoughtful and forward-looking approach to responsible investment. Its Statement of Investment Principles gives dedicated consideration to responsible investment and confirms that it will become a signatory to both the UK Stewardship Code and the UN Principles for Responsible Investment.[3] Its in-house investment team is well placed to scrutinise their asset managers' responsible investment activity, which will be crucial to ensuring that this commitment is fully implemented.

5. Separately, we also welcome NEST's offering of an ethical fund for members who wish to choose it, following DWP research suggesting that more than a quarter of pension savers were interested in ethical products even if they delivered lower returns.[4] We understand that NEST also conducted detailed research into the particular ethical issues of most concern to their membership demographic. This is particularly laudable, since fiduciary law suggests that any ethical decisions made by a pension fund should be based on the views and priorities of the beneficiaries.[5] However, it also highlights a 'supply-side' problem with consumer choice in this area: NEST's ethical fund is an off-the-shelf product, the F&C Stewardship International Fund, which by its nature imperfectly reflects the priorities identified by this research. It is to be hoped that if, as anticipated, NEST becomes a significant market participant, it will be in a position to negotiate more bespoke products.

6. We are aware that some have criticised NEST for what they regard as an unduly cautious investment approach which will not deliver adequate returns. Whilst it does not fall within our remit to take a position on the investment strategy itself, we would note that NEST's approach has been developed on the basis of robust and careful research into the needs and priorities of prospective members. In

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[2] FRC, UK Stewardship Code 2010, available online at

[3] http://www.NESTpensions.org.uk/schemeweb/NESTWeb/includes/public/docs/statement-of-investment-principles,PDF.pdf

[4] PADA, May 2009, *'Building personal accounts: designing an investment approach'*, p119. See also DWP, 2009, 'Individuals' likely reactions to workplace pension reforms', http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep669.pdf.

[5] See Chapter 4 of our recent report, 'Protecting our Best Interests: Rediscovering Fiduciary Obligation', available online at www.fairpensions.org.uk/fiduciaryduty

particular, evidence that most people's priority is to avoid loss[6] has led to the decision to take a low-risk approach during the 'foundation stage' in order to cultivate the savings habit. We applaud NEST's efforts to discover and act on their members' needs, which can be all too rare in the world of private pensions.

NEST's impact on other providers

7. In a parliamentary debate in December 2010, Pensions Minister Steve Webb expressed the hope that NEST's low charges "will have a downward impact on charges across the market".[7] We hope that NEST's leadership will also drive up standards in relation to responsible investment and member engagement. The publicly available research conducted by NEST, and by PADA before it,[8] should also be a useful resource for funds who wish to accommodate members' preferences and priorities but may not have the resources to survey their own members directly. Greater efforts to ascertain member's preferences in the arena of ethical investment, following NEST's lead, could also help drive the market for more bespoke ethical products reflecting members' priorities.

B) Schemes eligible for auto-enrolment: the 'governance gap'

8. Moving beyond NEST, we note that the DWP recently conducted a consultation exercise on 'regulatory differences between occupational and workplace personal pensions'. Our response to this consultation is available on our website.[9] We believe that the issues it raises have significant implications for the likely success of auto-enrolment in achieving its policy objectives of encouraging saving and delivering adequate pensions. Our comments below may also be relevant to this inquiry's question regarding scheme certification.

9. As the recent report of the Workplace Retirement Income Commission noted, "the UK's workplace pensions landscape is highly fragmented."[10] Different forms of pension provision are subject to different laws and regulations which have developed in a more or less ad hoc way. The most important distinction is that between trust-based and contract-based providers.
   - Trust-based pension schemes are overseen by a board of trustees (both employer- and member-nominated) who have a strict 'fiduciary duty' to act in the best interests of scheme members. Trustees are often not investment experts and most delegate day-to-day decisions to external asset managers. These schemes are regulated by TPR.
   - Contract-based pension providers (firms such as Standard Life and Prudential) are subject to a separate legal regime. There is no equivalent of the board of trustees and these providers do not have the same fiduciary duties as trustees: savers are protected only by their contractual

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[6] See for example 'Building personal accounts: Designing an investment approach, p117-122: http://www.NESTpensions.org.uk/schemeweb/NESTWeb/includes/public/docs/investment-consultation,PDF.pdf

[7] Hansard, 14 Dec 2010: Col 886

[8] See for example 'Building personal accounts: Designing an investment approach': http://www.NESTpensions.org.uk/schemeweb/NESTWeb/includes/public/docs/investment-consultation,PDF.pdf

[9] See www.fairpensions.org.uk/policy

[10] Report of the Workplace Retirement Income Commission, July 2011, p28

relationship with the provider. The employer is not a party to this contract and has no governance responsibilities. However, providers are subject to FSA rules which do not apply to pension fund trustees. They are regulated by both the FSA and TPR, but the FSA is the primary regulator.

10. The body of UK law applying to trust-based schemes is much more developed than that applying to contract-based pension products. In addition, most public policy debates about pensions law and regulation have tended to focus on defined benefit occupational pension schemes. Yet such schemes represent a dwindling proportion of the market: from 1997 to 2010, workplace contract-based pensions rose from 1% to 14% of all private pension saving.[11]

11. Most pension savers will be unaware of the legal differences between different types of pension. Moreover, many will have little or no choice over what type they end up in: under auto-enrolment, the decision is up to the employer. From the consumer point of view, the relationship is the same regardless of the type of pension: they hand over their money to someone whom they entrust to look after it with the goal of providing them a pension in old age. It is therefore logical that the framework in place to ensure consumers' interests are protected should be equally robust for all types of pension provision. This is not to say that the framework should be *identical* – it would clearly be impossible and probably undesirable to efface the distinction between trust-based and contract-based provision. However, urgent government attention is required to ensure that standards of governance and consumer protection are *comparable* across the market, albeit that they may be achieved through different mechanisms.

The 'governance gap'

12. The recent report of the Workplace Retirement Income Commission expressed concern about a 'governance vacuum', saying: *"In a world where individuals lack the time and expertise to drive a good deal with service providers it must be clear who is standing up for their interests and driving the best deal with suppliers. In trust-based schemes the trustees can play this role but the extent to which they do so seems variable. For contract-based schemes it is usually only the employer who could do this and the extent to which they do so is variable."*

13. We agree, except that we believe the implications of the governance gap go beyond the question of agreeing a 'good deal' with providers. Standing up for savers' interests also means holding those providers to account on an ongoing basis - including with respect to their exercise of 'stewardship', or responsible ownership, to ensure that investee companies are well-governed and deliver sustainable long-term returns. This may be jeopardised by weaknesses in the legal framework on both sides of the pensions market:-

14. *Trust-based:* Trustees increasingly delegate their powers but cannot delegate their fiduciary responsibilities. As the Myners Report noted ten years ago, they may not have the expertise to effectively challenge or hold to account those they delegate to. This potentially creates an accountability gap on the part of the asset managers and consultants who make and advise on key decisions affecting members' interests.

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[11] ONS Annual Survey of Hours and Earnings, 2010, cited in WRIC, July 2011

15. *Contract-based:* In contract-based provision there are no trustees at all. In theory, this arguably makes the chain of accountability shorter and therefore more effective. However, many have expressed concern about the absence of anyone charged solely with championing savers' interests. In practice, personal pensions can seem like much more of a 'black box', with nobody entrusted to intermediate between the interests of the individual saver and those of the commercial provider.

<u>*Government response to date*</u>

16. We are disappointed that the government's response to the consultation on regulatory differences appeared to downplay the significance of the governance issue, apparently accepting arguments that "*many providers of workplace personal pensions had arrangements such as governance committees which meant legislative intervention was unnecessary.*" However, according to research by TPR, only around half of all relevant employers have such arrangements in place, and in many cases they are informal with little clarity over their role.[12] There remains a danger that employers will see contract-based provision as the 'easy option' given the lesser responsibilities it places on them – yet it is far from clear that this serves the interests of beneficiaries.

17. The government response also points to its guidance on default funds,[13] yet this guidance is extremely broad-brush and effectively states only that roles and accountabilities must be clear, without any elaboration of what governance structures might be desirable or appropriate to ensure that savers' interests are protected. Governance committees are mentioned as one party to whom the guidance might be relevant, but there is no discussion of the circumstances under which it might be appropriate to establish one or of best practice in their operation.

<u>*Recommendations*</u>

18. *Trust-based:* The Law Commission has stated that asset managers and consultants have the same strict fiduciary duties as trustees under common law.[14] But this is not widely accepted in the industry. We recommend clarification by the regulator to ensure that high standards of protection are applied by those who actually manage savers' money as well as the trustees who appoint them.

19. *Contract-based:* Consideration should be given to the framework governing contract-based providers themselves in two key areas:
    - *Duties:* should FSA rules regarding conflicts of interest and obligations towards savers be strengthened, given that contract-based providers fulfil the same role as trust-based schemes in which the legal framework is strong in this regard?
    - *Structures:* should measures be taken to ensure that savers in contract-based pension products have an independent champion to defend their

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[12] TPR, Jan 2008, *'DC Research: Data on the occupational DC landscape plus results of independent research'*, p27

[13] Available at www.dwp.gov.uk/docs/def-opt-guid.pdf

[14] Law Commission ref; For further details see 'Protecting our Best Interests', 2011, Chapter 2

interests? If so, should this take the form of a 'policyholder committee' within firms themselves (similar to the governance arrangements in jurisdictions which do not have the concept of the trust, such as South Africa), or of employer-led governance committees in individual workplaces, or some combination of the two?

20. If such consideration is delayed until the review of auto-enrolment in 2017, it is possible that the damage will already have been done in the form of suboptimal outcomes for millions of savers and erosion of trust in the system.

About FairPensions

21. FairPensions is a registered charity that promotes Responsible Investment (RI) by pension schemes and fund managers, and seeks to ensure that savers are well served by their agents in the City. RI generally involves shareholder engagement with companies to ensure that environmental, social and corporate governance (ESG) risks with the potential to affect long-term financial returns are monitored and managed.

22. FairPensions publishes research including widely-respected industry benchmarking surveys. Our single-issue campaigns help turn the spotlight onto hitherto neglected areas where there is a strong business case for investor engagement. We also work with policymakers to improve transparency and accountability to savers, and to remove regulatory barriers to RI.

23. We are a member organisation, whose members include representatives of pension savers (such as the National Federation of Occupational Pensioners, UNITE and Unison), a number of leading UK charities (including Oxfam, Amnesty International and WWF), and thousands of individual pension fund members. We are independent of industry and are funded by grants from charitable foundations and trusts.