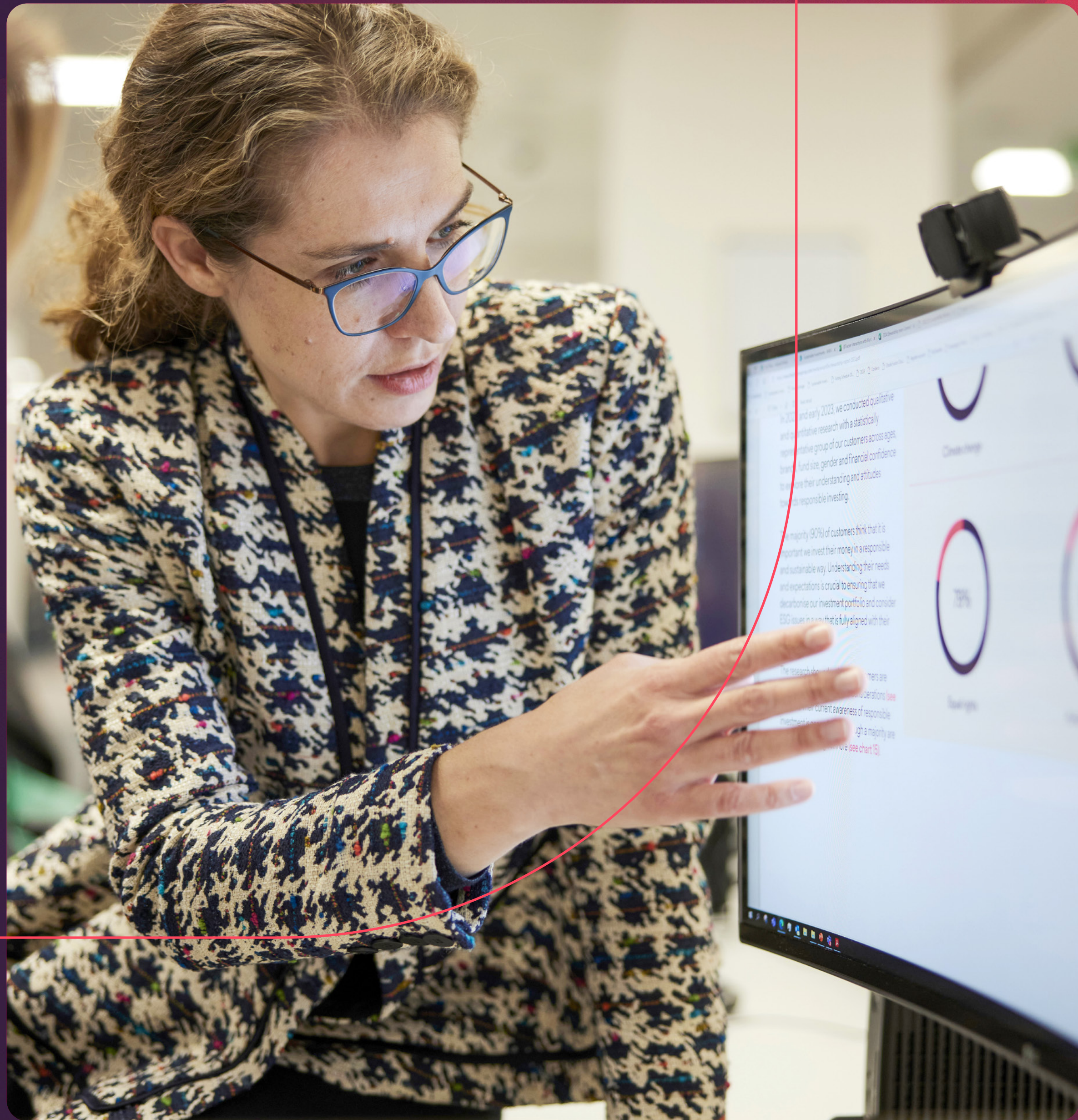
Phoenix

Charting the UK's Net Zero Future:

Policy recommendations to unlock investment



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Executive summary

Delivering net zero by 2050 remains a huge challenge and will require a step-change in collective action and investment

Given the fiscal constraints facing the next government, the private sector will be crucial to providing the majority of investment required to keep net zero on track.

This can only happen where policy is in place that supports investment outcomes. As providers of pension and savings solutions, Phoenix Group's primary focus is to deliver good financial outcomes for our members and customers. We believe that by successfully navigating a transition to a net zero future, we can improve risk-adjusted returns. Unlocking investment is closely tied to the next government addressing the pension savings gap that exists in the UK.

By increasing pensions contributions there could be a greater source of investment in UK assets that in turn supports better outcomes for pension savers.

We have identified four key areas of policy support that the next government should adopt to address both the supply and demand of finance for climate solutions in order to crowd in private sector funding to support delivery of the country's net zero transition.

Policy recommendations

1. **Develop a National Transition Plan**
2. **Focus on unlocking regional investment in net zero**
3. **Evolve climate considerations within fiduciary duty**
4. **Accelerate regulatory and legislative pensions reform**

Executive summary continued

1 Develop a National Transition Plan

See page 6

- Create an economy-wide National Transition Plan with sector-specific roadmaps
- Include details of specific policy levers across pricing, regulation and support
- Embed a capital raising plan within the National Transition Plan
- Expand HM Treasury's mandate to include net zero
- Include tracking the plan's delivery in the Office for Budget Responsibility's mandate
- Ensure that the National Transition Plan positions growth at its core and embeds just transition principles

2 Focus on unlocking regional investment in net zero

See page 8

- Create an investor advisory body to work with the Department for Energy Security and Net Zero ('DESNZ') to build the skills and capacity in local authorities needed to build investment pipelines of climate solutions.
- Endorse Local Area Energy Plan guidance[1] as the national framework for place-based whole energy system decarbonisation planning, to encourage regions to develop consistent local transition plans.
- Simplify funding pots and encourage use of financing mechanisms to crowd in private sector capital.

3 Evolve climate considerations within fiduciary duty

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- Establish a Fiduciary Duty Taskforce to maintain momentum from the Financial Markets Law Committee paper to build industry capacity to manage climate change and wider sustainability factors.
- Evolve the Value for Money framework to consider private markets investments for defined contribution savers in line with initiatives such as the Mansion House Compact.
- Support consolidation of pension schemes in order to improve standards of governance and encourage the scale necessary to facilitate greater investment in private markets net zero solutions.

4 Accelerate regulatory and legislative pensions reform

See page 12

- Increase default contributions in auto-enrolment from 8% to 12%[2].
- Reduce duplication between regulators to simplify the regulatory landscape for the pensions and insurance sectors.
- Support defined contribution savers through consolidation of schemes.
- Support Solvency II reform through introduction of a Matching Adjustment sandbox.

1 The future of Local Area Energy Planning in the UK – Energy Systems Catapult.
2 Falling behind the curve: The costs of delaying an increase in auto-enrolment contributions

Introduction

Phoenix Group is the UK's largest long-term savings and retirement business. As a purpose-led organisation we want to help people live better, longer lives.

By taking the right actions to decarbonise, we believe that we can manage the risks and maximise the opportunities of climate change on behalf of our c.12 million customers. And with over £280 billion assets under administration, our scale means we can make a real difference. We believe that we have a societal responsibility to address the climate emergency and play a leading role in supporting the transition to a net zero economy in a way that ensures good customer outcomes and benefits all our stakeholders.

We were proud to publish one of the first Net Zero Transition Plans in the insurance sector. It sets out the actions we are taking to become net zero by 2050 across our investment portfolio, operations and supply chain. We are on track to achieve our interim 2025 portfolio decarbonisation target under most scenarios as long as we implement the actions we have committed to. However, it is likely we will need to do more in order to achieve our 2030 target, and we will become increasingly dependent on action from others. One of the central pillars of our transition plan is therefore using our scale and voice to drive wider system change to establish the necessary policy, regulatory and market conditions to achieve net zero.

We recognise that the UK has made significant progress in reducing emissions, recently becoming the first major economy to halve its emissions relative to its baseline year. This decarbonisation, largely led by the shift to cleaner energy sources in the power sector, provides a great platform for further emissions reductions. However, a significant challenge remains, especially as the focus now increases on more challenging sectors such as buildings and transport. As noted in the Government's Powering Up Britain strategy, net zero represents a significant opportunity to grow and level up the UK economy, supporting hundreds of thousands of green, highly skilled jobs in the process.

The UK needs to invest £2.4 trillion in climate solutions by 2035 to remain on track for net zero by 2050. This is clearly a significant challenge and requires a system-wide focus[3].

Given the current public finance constraints, attracting private finance will be crucial. The pensions industry is well placed to invest in climate solutions, but its ability to do so in a way that delivers value to customers is currently hindered by barriers affecting both the supply of and demand for finance. As detailed in our *Unlocking Investment in Climate Solutions* report, overcoming these barriers could help enable the UK pensions industry to finance up to £1.2 trillion of capital investment in UK climate solutions between now and 2035, up to 50% of the total requirement.

The link between the UK's under-saving and unlocking investment

The need to increase savings in the UK is critical as the UK is under-saving for retirement. There is now widespread consensus that current minimum auto-enrolment contribution rates are simply not enough to meet the future retirement income needs of today's in-work population. The default contribution rate should be raised from 8% to 12%. As a result, the question for policymakers ought not to be if default contributions should be increased, but when.

Increasing default auto-enrolment contributions sooner would deliver a range of benefits to savers and the economy, and these benefits need to be balanced against the urge to delay any increase because of short-term costs to households and employers. Our analysis estimates that every five-year delay in increasing contributions could cost £11.5 billion in UK listed equities, a further £2.5 billion in investment in unlisted equities, and £2.5 billion in investment in infrastructure and real estate. This amounts to an estimated nearly £16.5 billion cost to investment across these asset classes for every five-year delay in increasing contributions.[4]

Building consensus

Scaling up investment in climate solutions will require close collaboration across local and national government, regulators and investors. Doing so in the right way has the potential to support good customer outcomes, whilst also supporting wider national policy objectives of economic growth and regional investment. The scale of the investment needed coupled with the current economic context means the role of private finance in delivering net zero is more important than ever.

In early 2024, Phoenix Group, in partnership with ABI's Investment Delivery Forum, hosted a series of roundtables to further explore the priority recommendations from our *Unlocking Investment in Climate Solutions* report. Attendees included government, peers, industry bodies and MPs, alongside the pensions industry.

This paper builds on the report by outlining the key net zero policy priorities that a new government should focus on in the early days of a new Parliament.

3 According to "Balanced Pathway" set by the UK Climate Change Committee's Sixth Carbon Budget (2020)
4 Falling behind the curve: The costs of delaying an increase in auto-enrolment contributions" (2024)

Policy recommendations

Develop a National Transition Plan

Focus on unlocking regional investment in net zero

Evolve climate considerations within fiduciary duty

Accelerate regulatory and legislative pensions reform

By moving quickly to identify the right priorities, set the agenda across relevant departments and implement effective delivery programmes, a future government has the potential to make significant early progress towards delivering net zero.

Overview of *Unlocking Investment in Climate Solutions* report

The UK pensions sector could play a significant role in investing in the UK's transition to net zero

Our *Unlocking Investment in Climate Solutions* report found that, with the right reforms and on the right terms for pension savers, UK pension funds could quadruple their investment in UK climate solutions between now and 2035 to up to £1.2 trillion. This would account for half of the overall gross capital investment in climate solutions needed by 2035 for the UK to remain on track with its net zero transition.

However, greater investment is currently limited by a scarcity of scalable opportunities and regulatory constraints. We know there is a genuine appetite across the UK pensions industry to scale up investment in climate solutions – and many companies have set public aspirations to do so. However, many are currently struggling to match their ambition with action due to a range of policy and regulatory barriers which affect both the demand for finance and the supply of finance. These barriers limit our ability to invest in ways that deliver customer value and, crucially, align with fiduciary duty.

Overcoming barriers

Through our research we identified seven strategies for policymakers and regulators that could help unlock greater investment in climate solutions from the UK pensions industry, three relating to the demand for finance and four relating to the supply of finance.

Strategies to address barriers that impede the 'demand for finance' for climate solutions:

1 A National Transition Plan

The UK should develop an economy-wide National Transition Plan, defining a range of sector-specific strategies, roadmaps and policy instruments to support investment in climate solutions.

2 Policy intervention

To make the UK attractive to investors, long-term policy certainty and incentives are key. Policy intervention aimed at reducing volatility of returns of climate solutions or abating costs for early-stage technology providers are central to this.

3 Scaling regional investment opportunities

Initiatives that accelerate the go-to market of new technologies, aggregate fragmented opportunities and provide a consistent planning regime at national level will all help to scale up the supply of climate solutions for investment across the UK.

Strategies to address barriers that limit the 'supply of finance' for climate solutions:

4 Fiduciary duty

Provide clarity on how climate impact should be considered as part of fiduciary duties as it can be inconsistently interpreted across the financial services sector. Providing clarity on how to consider climate risk and its effect on investments in a long-term prudential strategy will help our industry integrate the net zero transition into investment decisions and engage investee companies.

5 Reporting and disclosure requirements

Requirements aimed at improving reporting transparency and standardisation of investment in climate solutions will provide greater clarity for investors and consumers in assessing climate risk.

6 Risk sharing

Risk-sharing mechanisms between investors and government (central and local) can be effective ways of crowding in private finance by altering the risk-return profile of investments to make them more attractive to long-term investors.

7 Regulatory reform

Accelerating ongoing regulatory consultations – with the expectation that the capital freed up for investment would be targeted at productive and sustainable finance, including climate solutions – would make investment in climate solutions more appealing for the insurance industry.

This policy paper focuses on the subset of high priority strategies to focus on in the near term. The strategies have been assessed on potential impact and feasibility to implement. Figure 1 highlights the priority strategies according to impact and feasibility.

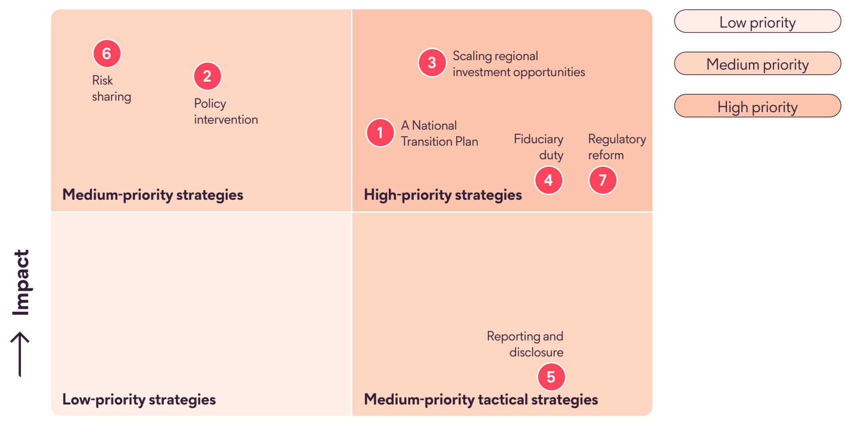


Figure 1

Develop a National Transition Plan

Recommendation 1

Develop a National Transition Plan

Summary of policy recommendations

- Create an economy-wide National Transition Plan with sector-specific roadmaps
- Include details of specific policy levers across pricing, regulation and support
- Embed a capital raising plan within the National Transition Plan
- Expand HM Treasury's mandate to include net zero
- Include tracking the plan's delivery in the Office for Budget Responsibility's mandate
- Ensure that the National Transition Plan positions growth at its core and embeds just transition principles

The need for a National Transition Plan

Institutional investors and businesses across all sectors are consistently calling for greater long-term policy and strategy certainty on the net zero transition. This is crucial for institutional investors such as Phoenix Group, who can only invest where it meets their fiduciary duty to their end policyholder/savers, and are ultimately looking for long-term stable returns. Any investments in climate solutions need to support good customer outcomes as customers save towards retirement.

The UK has shown leadership through the creation of the Transition Plan Taskforce, which is now seen as the gold standard net zero transition plan framework for corporates. The UK should build on this momentum to develop a National Transition Plan.

Internationally we have seen ambitious policy responses to the challenge of net zero, in particular the US Inflation Reduction Act and the EU's Green Deal Industrial Plan, both of which are transforming the international net zero landscape and demonstrating what ambitious climate policy can achieve. The US Inflation Reduction Act has already catalysed around $278 billion in new clean energy investments, creating more than 170,000 jobs.[5]

Whilst the UK has made significant decarbonisation progress, analysis by the Climate Change Committee ('CCC') shows that the UK's 2030 emissions target is currently at risk due to insufficient policy across key sectors.[6] Without greater policy support, we also risk losing international competitiveness in growing markets such as clean energy and electric vehicles.

A National Transition Plan would provide a clear market signal and substantially reduce uncertainty, paving the way for private finance to allocate capital in support of the net zero transition.

5 Clean Energy Boom Anniversary Report" Climate Power (2023) – Climate Power
6 Progress towards reaching Net Zero in the UK - Climate Change Committee (theccc.org.uk)

£2.4 trn

investment needed in climate solutions in the UK by 2035

up to

£1.2 trn

the amount the UK pensions industry could invest if supply and demand barriers are overcome

Develop a National Transition Plan continued

Policy recommendations

Below we have summarised the six recommendations to deliver a comprehensive National Transition Plan:

1. Create an economy-wide National Transition Plan with sector-specific roadmaps

The UK should develop a comprehensive, economy-wide National Transition Plan. It can build on the existing Net Zero Strategy and bring together existing sector roadmaps such as the Civil Nuclear Roadmap to 2050, Hydrogen Roadmap and Carbon Capture, Usage and Storage Net Zero Investment Roadmap into one overarching plan. It should be aligned to the CCC's carbon budgets.

Within the overarching plan, sector-specific strategies should ultimately cover all real economy sectors, with the initial priorities being the most carbon intensive, hardest to abate sectors and where the UK can amplify its international competitiveness, such as energy production & distribution, transport, the built environment and industry. When designing sector-specific strategies, significant private sector consultation should be undertaken and could be formalised on an ongoing basis by establishing sectoral stakeholder councils.[7]

> Institutional investors and businesses across all sectors are consistently calling for greater long term policy and strategy certainty on the net zero transition.

2. Include details of specific policy levers across pricing, regulation and support

The National Transition Plan should address all the levers that the Government has at its disposal to catalyse the net zero transition:

- **Pricing:** Measures such as aligning carbon pricing across high-emitting sectors through tightening the UK Emissions Trading Scheme ('UK ETS') emissions cap, expanding it to new sectors and introducing a Carbon Border Adjustment Mechanism ('CBAM'). Measures to support early-stage revenues for nascent technologies will also be necessary. The impact of Contracts for Difference ('CfD') on scaling the UK's offshore wind industry demonstrates what can be achieved.
- **Regulation:** Standard setting to encourage lower carbon industry and products. The Future Homes Standard's introduction in 2025 is a good example of how regulation can drive energy efficiency in new homes.
- **Support:** Spending focused on increasing commercial maturity of low-carbon sectors, acting as catalytic capital that de-risks less proven technologies in order to crowd in private sector capital. Other support can focus on building regional investment opportunities as outlined in the following section.

These policy levers should address the systemic issues that are currently holding back the transition to net zero, including grid capacity and connection delays; planning delays and the de facto ban on onshore wind in England; supply chain issues for net zero infrastructure; and the green skills gap, with c.200,000 more workers needed in the UK to keep the energy transition on track.[8]

3. Embed a capital raising plan within the National Transition Plan

A capital raising plan should be a central part of the National Transition Plan. It should map out the investment required across sectors and regions by different pools of capital (e.g. from venture capital for emerging technologies, through to pension fund investment for proven technologies) and set out how the Government plans to use initial public investment and commitments to catalyse private sector investment.

The plan should also detail how the UK will reduce its reliance on fossil fuels, which will help investors assess the attractiveness of assets in sectors that rely heavily on them, and allocate capital accordingly.

4. Expand HM Treasury's mandate to include net zero

The net zero transition will require a cross-government effort and should be a central priority for multiple departments. HM Treasury is particularly crucial to delivery and therefore its mandate should include the delivery of net zero and have overall responsibility for developing the plan. An Office for Net Zero Delivery, as recommended in the Independent Review of Net Zero, could be tasked with coordinating departments to ensure delivery against the plan.

5. Include tracking the plan's delivery in the Office for Budget Responsibility's mandate

To ensure credibility, progress against the National Transition Plan should be tracked by an independent organisation. This could include monitoring technology deployment rates and finance flows against the capital raising plan. Given the significance of net zero as a potential catalyst for growth, the Office for Budget Responsibility's remit should be expanded to include this.

6. Ensure that the National Transition Plan positions growth at its core and embeds just transition principles

There are a number of guiding principles that the Government should adopt to ensure the success of a National Transition Plan:

- Position the net zero transition as the growth story of the 21st century.
- Incorporate the just transition to detail how this will be achieved in high-emitting sectors and ensure that skills needs and job-creation opportunities across sectors are considered.
- Develop a systematic approach for skills and green jobs to support transition across the UK.

7 Making markets: The City's role in industrial strategy (greenfinanceinstitute.com).

8 Energy transition will be constrained by green skills gap of c.200,000 workers – PwC Green Jobs Barometer.

Focus on unlocking regional investment in net zero

Recommendation 2

Focus on unlocking regional investment in net zero

Summary of policy recommendations

- Create an investor advisory body to work with DESNZ to build the skills and capacity in local authorities needed to build investment pipelines of climate solutions.
- Endorse the Local Area Energy Plan Guidance, the national framework for place-based whole energy system decarbonisation planning to encourage regions to develop consistent transition plans.
- Simplify funding pots and encourage use of financing mechanisms to crowd in private sector capital.

Background

The huge investment needed to deliver net zero represents a significant opportunity to catalyse regional growth and jobs. Around 80%[9] of the UK's overall greenhouse gas emissions are within scope or influence of local authorities, and much of the investment in the net zero transition is needed in local infrastructure and services such as the built environment and transport. Local councils are increasingly taking action, with over 300 having already declared a climate emergency[10].

Institutional investors have a long track record of supporting regional investment in productive and capacity-enhancing assets such as social housing and regeneration projects across the UK. However, there is currently only a limited deal pipeline for institutional investors to support regional investment in the net zero transition, especially for newer asset classes such as hydrogen and district heating. These investments will need to increase in pace and scale for the UK to remain on track for net zero by 2050.

Barriers to regional investment in net zero include:

- **Lack of sufficient capacity within many local authorities to support the national aim of reaching our net zero goal.** The Local Government Association ('LGA') has explored this issue and found from its survey that 79 out of 90 respondents thought a lack of workforce capacity was a barrier to tackling climate change and 70 respondents identified skills and expertise as a barrier[11].
- **Lack of certainty on regional investment opportunities:** Many local authorities do not have detailed net zero transition plans.
- **Inconsistent access to funding and financing mechanisms to grow the deal pipeline:** The National Audit Office identified 21 funds that local authorities can apply for, and there is often a lack of resource to manage this process[11].

c.80%

of UK's overall greenhouse gas emissions within scope or influence of local authorities

300+

local councils have declared a climate emergency

9 Local government and the path to net zero – Housing, Communities and Local Government Committee – House of Commons (parliament.uk).
10 Councils sound alarm on local climate threats I Local Government Association.
11 The role of local government in reaching net zero - House of Commons Library (parliament.uk).

Focus on unlocking regional investment in net zero continued

Policy recommendations

To address these issues, we recommend the following policy interventions:

1. Create an investor advisory body to work with DESNZ to collectively build the skills and capacity in local authorities needed to build an investible deal pipeline

Having the right skills and sufficient capacity in local authorities will be crucial to crowding in private sector capital. The Government should create an Investor Advisory Body to work with DESNZ to collectively build local authorities' skills and capacity and provide support to build deal pipelines for climate solutions. The Investor Advisory Body's remit could include supporting the identification of potential investment opportunities and helping to ensure they are structured to align with institutional investors' investment criteria and requirements. The Cities Commission for Climate Investment ('3Ci') Net Zero Neighbourhoods model is one example that could be supported by the new advisory body to develop retrofit programmes across the UK. In conjunction with the Investor Advisory Body, the UK Infrastructure Bank's advisory capacity should also be scaled up to further support regional growth.

The Investor Advisory Body will also have an important role to play in collaborating with policymakers and enabling bodies such as the UK Infrastructure Bank to address UK-wide sectoral challenges in areas such as district heating and electric vehicle charging infrastructure, and ultimately make them attractive to institutional investors.

2. Endorse Local Area Energy Plan Guidance[12] as the national framework for place-based whole energy system decarbonisation planning to encourage regions to develop consistent local transition plans

All local authorities need to have clear plans to decarbonise and invest in the new net zero sectors that will provide jobs for local communities. By adopting Local Area Energy Planning ('LAEP'), an integrated planning approach to detailed place-based whole energy systems pathways and delivery plans for net zero, local authorities will be able to identify projects and investment in a consistent way across the country. This could potentially make aggregation of projects within and across regions possible, which would increase investment ticket sizes and attractiveness for institutional investors. The Department for Levelling Up, Housing and Communities should mandate LAEP in the National Planning Policy Framework to ensure uptake across the country to build upon the one in six councils across England and Wales that have adopted this method to date.

There are great examples from across the UK where local and combined authorities have put net zero at the heart of their regional growth. The West Midlands Combined Authority has invested around £707 million in various initiatives supporting the net zero transition. Bristol City Council has invested £7.5 million and over two years of planning to attract up to £1 billion of investment in the city's energy system over the next 20 years. The challenge for policymakers is to support other local authorities to replicate this success at an accelerated pace. To do this the Government should fund further City Leap Replicators that adopt the approach of Bristol City Leap to attract private sector capital across the country.

Regional empowerment will be key to successful delivery and therefore the Government should ensure that any further devolution deals support decarbonisation through specific sector strategy such as funding for housing retrofit, as seen in the West Midlands Combined Authority and Greater Manchester Combined Authority devolution deals.

3. Simplify funding pots and encourage use of financing mechanisms to crowd in private sector capital

Alongside capacity building, funding will be crucial to catalyse private sector investment, in particular through de-risking investment opportunities. Direct funding for projects through the Public Works Loan Board and UK Infrastructure Bank will not be sufficient[13]. Local authorities find the wide range of potential funding pots difficult to access and are dissuaded from bidding due to complex processes. Funding pots should therefore be simplified and allocated at regional levels. The focus of funding should be on de-risking investment and reducing volatility of returns through mechanisms such as loan guarantees, and blended finance schemes that utilise capabilities of the UK Infrastructure Bank. The scale required will be significant: it is estimated that to develop projects to attract £100 billion of capital investment, £5 billion of initial development funding is required[13].

Regional empowerment will be key to successful delivery and therefore the Government should ensure that any further devolution deals support decarbonisation

12 The future of Local Area Energy Planning in the UK – Energy Systems Catapult.
13 Mobilising local net zero investments: challenges and opportunities for local authority financing.

Evolve climate considerations within fiduciary duty

Recommendation 3

Evolve climate considerations within fiduciary duty

Summary of policy recommendations

- Establish a Fiduciary Duty Industry Taskforce, convened by the DWP, to build capacity through issuing a guidance and education programme across the sector.
- Evolve the Value for Money framework to consider private markets investments for defined contribution savers in line with initiatives such as the Mansion House Compact.
- Support consolidation of pension schemes in order to improve standards of governance and encourage the scale necessary to facilitate greater investment in private markets net zero solutions.

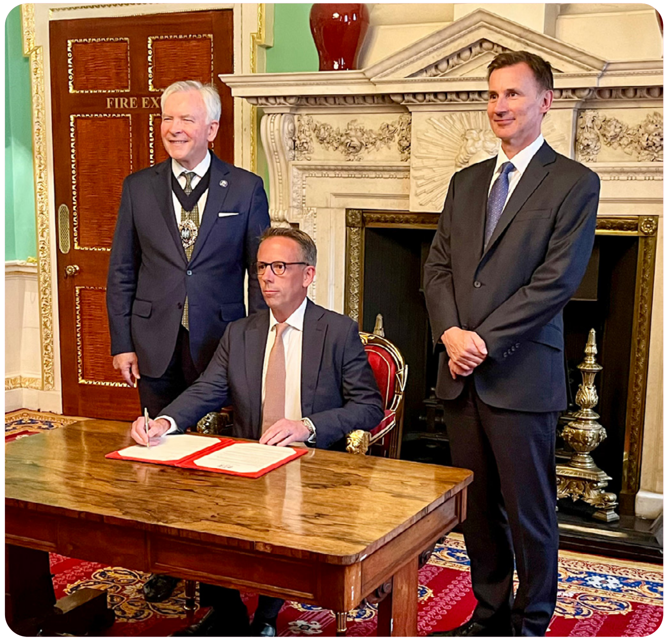
Background

Recognising and managing the material financial risks posed by climate change to the financial sector is critical for the pensions industry to fulfil its fiduciary duty. However, this has been an uncertain area for pension trustees, as well as actors in the wider ecosystem such as advisers. This uncertainty was recognised as a challenge by the Government in its Green Finance Strategy, with the subsequent commissioning of a Financial Markets and Law Committee ('FMLC') report. The FMLC report found that trustees can account for sustainability considerations, such as climate change, without breaching their fiduciary duty, given their financial materiality.

To support the next phase of the pensions industry effectively managing climate risk there are a number of areas to address:

- **Trustee capacity:** Navigating the risks and opportunities presented by climate change is a complex subject and one that has lacked a consistent approach across the industry.
- **Structural issues:** Private market assets are traditionally more costly and therefore unlikely to be investable under the current Value for Money framework, which may mean pension savers are potentially missing out on higher returns.
- **Fragmented industry:** A key challenge to building capacity within the industry is the sheer number of pension schemes, with c.5,300 defined benefit ('DB') schemes and c.27,000 defined contribution schemes ('DC'), of which 25,700 schemes have fewer than 12 members[14].

14 Latest data from The Pensions Regulator – as of 31 December 2022.



5300 DB schemes

25,700 DC schemes

in the UK pensions market

Evolve climate considerations within fiduciary duty continued

Policy recommendations

To address these barriers, we make the following three policy recommendations:

1. Establish a Fiduciary Duty Taskforce to maintain momentum from the FMLC paper to build industry capacity to manage climate change and wider sustainability factors

To maintain momentum from the FMLC paper, the Department of Work and Pensions (DWP) should adopt the recommendation by the Impact Investing Institute to establish a Fiduciary Duty Taskforce. A coalition between government and industry, the Taskforce would bring together participants from the insurance sector, pension funds and industry bodies. It would take forward activity to unblock the structural and behavioural barriers preventing the widespread interpretation of fiduciary duties as explained by the FMLC paper, such as sharing best practice through case studies and a guidance and education programme aimed at key actors within the pensions industry. The Impact Investing Institute, as an independent thought leader in this space, could provide the secretariat.

The DWP is already working to evolve the consideration of climate change within fiduciary duty and identifying solutions to practical barriers that need to be overcome. The DWP should come together with industry participants through the taskforce to deliver change.

2. Evolve the Value for Money framework to enable greater allocation of defined contribution assets to private markets

There are important interlinkages between fiduciary duty and other guidance for pension scheme trustees. The Value for Money framework is a particularly important consideration, because sustainability opportunities are often in private markets which have higher associated costs and are therefore not currently part of most default funds due to their narrow focus on cost as a result of the charge cap. The DWP has proposed a derivation from the charge cap for certain types of performance fees, but a cultural shift is needed to ensure that trustees take advantage of it. Savers therefore may risk missing higher returns on funds invested in private markets, as demonstrated by the superior performance of Australian and Canadian pension funds, which invest ten times more in private markers than comparable UK schemes[15]. The Government needs to build upon the Mansion House Compact to explore how alternative assets can be integrated into current charge cap constraints.

3. Support consolidation to enable greater capacity building within the pensions industry

The Government should accelerate its consolidation agenda in order to improve standards of governance and encourage investment in more private markets net zero solutions. Disclosure requirements and value for money assessments will have some effect, but in order to achieve scale government and regulators may need to take a more directive approach. Schemes that operate at scale have a much greater ability to direct investment on a strategic level that can help support the transition to net zero. It is recognised that climate considerations and how to manage them within fiduciary duties are evolving, but effectiveness varies across the sector. Whilst pension trustees are central to effectively managing climate considerations, to effect change the whole pensions ecosystem requires upskilling on managing climate risks, including advisers who are crucial partners to pension trustees.

Insurance companies and other asset owners have an important role to play through their interactions with trustees and the wider pensions ecosystem. Trustees tend to come from a relatively limited pool that can lead to a degree of group think. Diversifying the trustee pool and ensuring a strong knowledge of climate could help bring climate risk further up the agenda. One example of this is the approach taken by Standard Life in its Trustee Accelerator Programme, which is seeking to support candidates from non-traditional sectors. However, effective guidance that will ensure widest adoption should come from the DWP; trustees generally receive legal advice about their investment and climate policies, and effective guidance is the best way to influence this advice. This guidance should be informed by the Fiduciary Duty Taskforce proposed above.

> Government should accelerate its consolidation agenda in order to improve standards of governance and encourage investment in more private markets net zero solutions

15 Chancellor's Mansion House Reforms to boost typical pension by over £1,000 a year – GOV.UK (www.gov.uk).

Accelerate regulatory and legislative pensions reform

Recommendation 4

Accelerate regulatory and legislative pensions reform

Summary of policy recommendations

- Increase default contributions in auto-enrolment from 8% to 12%, ensuring more people have a decent income in retirement that in turn boosts pensions investment in productive finance.
- Reduce duplication between regulators to simplify the regulatory landscape for the pensions and insurance sectors.
- Support defined contribution savers through consolidation of schemes.
- Support Solvency II reform through introduction of a Matching Adjustment sandbox.

Background

A supportive regulatory regime is crucial to unlocking investment. Unlocking investment is closely tied to the next government addressing the pension savings gap that exists in the UK.

By increasing pensions contributions there could be a greater source of investment in UK assets that in turns supports better outcomes for pension savers. Modelling from Phoenix Insights, our longevity think-tank, shows that 2.4 million people or 40% Defined Contribution savers expect at least the Pensions and Lifetime Saving's Association minimum income but are not on track to achieve it.[16] Therefore, the Government will need to consider when is the right time to increase automatic enrolment contribution to increase financial security of pension savers in retirement.

Out of the seven countries with the largest pension savings (P7), the UK allocates the least to private markets which include the types of social and economic infrastructure that the country needs to grow. Just 14% of UK assets are allocated in this way, whilst the average amongst other P7 countries is 20%[17]. As a result, pension savers are missing out on the value created by these types of investments, which many other countries benefit from due to typically superior returns. Regulatory reform is required to allow the pensions industry to invest more broadly in such assets. In allocating greater investment to private markets, Pension funds must prioritise customer outcomes, and their interests will always come first.

16 Raising the bar – A framework for increasing auto-enrolment contributions - Phoenix Group

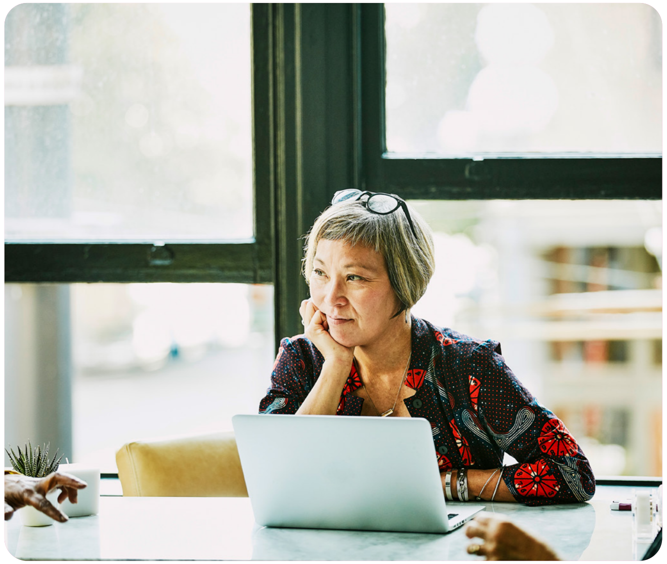
17 Phoenix Group completes two successful bids to invest into UK Government's LIFTS programme | Phoenix Group (thephoenixgroup.com)

40%

Defined Contribution savers not on track to achieve desired income in retirement

14%

UK assets allocated to private markets against the P7 average of 20%



Accelerate regulatory and legislative pensions reform continued

Policy recommendations

We believe the following recommendations will help to further unlock investment:

1. Increase default contributions in auto-enrolment from 8% to 12%, ensuring more people have a decent income in retirement that in turn boosts pensions investment in productive finance

There is now widespread consensus that current minimum auto-enrolment contribution rates are simply not enough to meet the future retirement income needs of today's in work population.

Our report, *Falling behind the curve: the costs of delaying an increase in auto enrolment contributions*, also highlights the need to manage the costs of increasing contributions to businesses and the economy, and sets out a framework to help address this. There are also wider economic benefits to increasing contributions. Pension funds are key institutional investors, and there is an increasing policy focus on driving more pensions investment into private assets such as Venture Capital, private equity, private debt, infrastructure and real estate.

Increasing investment in these asset classes is critical for the long-term growth and productivity of the UK economy by supporting our competitive and high-growth sectors. Key sectors such as Fintech, Life Sciences, and Artificial Intelligence all rely on significant investment to fund growth and R&D.

In addition, investment in these asset classes can help to build the infrastructure that will deliver net zero and environmental goals. Our analysis estimates that every 5-year delay in increasing contributions could cost £11.5bn in UK listed equities, a further £2.5bn in investment in unlisted equities, and £2.5bn in investment in infrastructure and real estate. This amounts to an estimated nearly £16.5bn cost to investment across these asset classes for every 5 year delay in increasing contributions.

2. Reduce duplication between regulators to simplify the regulatory landscape for the pensions and insurance sectors

The Government should carry out a holistic review of the pension and insurance regulatory sector to highlight the frictions across and between the sectors, with specific objectives to further consolidate both DC and DB markets to provide larger asset pools for investment, identify key rule differences between pensions and insurance sectors that frustrate investment deployment and direct the regulators to amend the rules[18] which prevent net zero investment at scale.

The The Financial Conduct Authority ('FCA'), Prudential Regulation Authority ('PRA') and The Pensions Regulator ('TPR') all have responsibility for regulation of different parts of the pensions sector across the DC and DB markets. These multiple regulators all influence rules which affect where pension schemes and insurers can invest. The UK pensions sector is split roughly equally across DB and DC, with DB pensions in decline while DC is fast growing driven by automatic enrolment. Management of both types of pension scheme sit across the pensions and insurance sectors, which means a customer with the same pension can be subject to different rules depending on who is the regulator. The two systems are also not independent of each other. For example, as most DB schemes target insurance buy-out as the most viable exit route for their scheme, providing greater certainty for pensioners and consolidation of schemes into insurance, DB schemes are also impacted by insurance investment rules which affect their ability to buy out. Perversely, we see DB schemes divesting from private market assets into more liquid funds, to transfer to an insurer as a premium, only for the insurer to reinvest these funds into private markets[19].

3. Supporting defined contribution savers through consolidation

Recent government policy to enable Long Term Asset Funds ('LTAF'), that are designed to invest efficiently in long-term, illiquid assets and exempting performance-based fees from the regulatory charge cap are welcome moves to help enable DC schemes to invest in private markets.

However, barriers remain to making these investments a reality, in particular the lack of scale of pension funds in the UK. This is linked to the issue of the ability of thousands of trustees and advisers across the industry managing relatively small schemes to effectively engage with and manage the risks and opportunities that arise from the net zero transition. A smaller number of very large schemes would be better placed to engage with these investments on a strategic level.

18 Using new powers under FSMA.
19 Illiquid assets a key focus for DB pension trustees – FTAdviser.

Accelerate regulatory and legislative pensions reform continued

4. Support Solvency II reform through introduction of a Matching Adjustment sandbox

The Solvency II reforms are critical to unleashing more capital towards the UK's infrastructure needs, including supporting the net zero transition with investments in climate solutions such as offshore wind, solar and energy efficient housing. Solvency II reform largely impacted the areas of the insurance regime that relate to DB pensions and annuities, with minimal impact on DC products such as unit-linked savings.

Last autumn, the PRA published proposals designed to enable broader and quicker investment by insurers in their matching adjustment ('MA') portfolios.[20] The majority of annuity pension liabilities sit within these MA portfolios, and act as the home within the insurance company for transferred DB scheme liabilities. Therefore, investment restrictions on MA portfolios impact not only insurance firms but also DB schemes seeking insurance protection for their member benefits.

The Government has already legislated to partially relax the requirements around which assets qualify for 'MA', allowing investment in assets where "the risks to the quality of matching are not material", instead of the previous rule only allowing assets with "fixed" cash flows. This is a pragmatic move in the right direction, but we have identified assets which qualify under legislation, but not under detailed PRA rules. Crucially, PRA rules effectively restrict insurance investment to debt instruments with a credit rating and prohibit direct investment without complex and inefficient restructuring, which we believe to be unnecessary to manage the risks associated with direct investment. This complex restructuring effectively requires two investors for each project instead of one, which increases the costs of funding and ultimately constrains investment.

More generally, we need the regime to be agile enough to quickly respond to future funding needs; for example, to support the net zero transition where we do not know what new technologies will emerge, or how this funding might be structured.

We have proposed the introduction of a Matching Adjustment sandbox targeted at investing in productive or sustainable assets that do not qualify under the existing rule. Firms like Phoenix Group would voluntarily apply to invest limited amounts in assets which would ordinarily be ineligible in the sandbox for a short period of time. At the end of the sandbox period, once the PRA has examined the asset characteristics, the PRA would either amend its rule to facilitate sector-wide investment or decline to amend its rule, publishing the rationale for its choice.

Importantly, the sandbox would provide a mechanism to allow insurers to actively engage with regulators and help fulfil the PRA's new growth and competitiveness objectives. It would also allow the regime to be more flexible and evolve over time without the necessity for ongoing government intervention. We are encouraged by the PRA's interest in our sandbox proposal as demonstrated through our bilateral engagement and the newly established 'sandbox' working group and we hope to see the idea implemented quickly.

20 CP19/23 – Review of Solvency II: Reform of the Matching Adjustment I Bank of England

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