

ESG for DC Master Trusts

How ESG practices are
evolving in the UK defined
contribution Master Trust
market

October 2023



Introduction

The UK Master Trust market is growing rapidly, in terms of both members and assets, with providers from a range of backgrounds, including insurers, asset managers and benefit consultancies. Providers of Master Trusts would need to be distinctive to succeed in a competitive market. Environmental, Social and Governance (ESG) is one area where we see Master Trusts seeking to differentiate themselves.

ESG is an area where Master Trusts are well-placed to take the lead.

The scale of their investment portfolios and the stability of their membership profile and contribution flow enable them to have a meaningful influence on the projects and companies they finance. This helps to accelerate change in ESG areas to support the delivery of positive retirement outcomes for their members. Their trust-based structures also make it possible to demonstrate a high standard of governance that embraces diversity, equity and inclusion (DEI) throughout the scheme's governance and management.

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All trustees should consider material risks and opportunities when making decisions and managing savers' money.

The Pensions Regulator

In particular, over the last year Master Trusts have had to consider climate risks and opportunities to comply with Task Force for Climate-related Financial Disclosures (TCFD) reporting. Mark Hill, Climate and Sustainability Lead for TPR, said: "TPR recently stated that all pension schemes are exposed to environmental and social governance and climate change risks and opportunities, which are becoming increasingly important in determining a scheme's long-term performance".

Purpose of EY report

Given the pace of change in ESG, it is often difficult to navigate this area and be confident that your provider is adopting current leading practices. To support sponsors and trustees who are considering a Master Trust solution or are already using a Master Trust, we have launched EY first industry-wide survey looking at how Master Trusts are incorporating ESG considerations in the UK Defined Contribution (DC) market. With a 20+ year legacy in sustainability and ESG services and our capacity as an independent oversight provider, EY teams are well-placed to build a picture of the entire industry and assess the different stages of ESG maturity exhibited by different UK Master Trusts.

We have assessed the participating Master Trusts across five key areas:

1 Governance

2 Investment integration

3 Stewardship

4 Climate change

5 Reporting

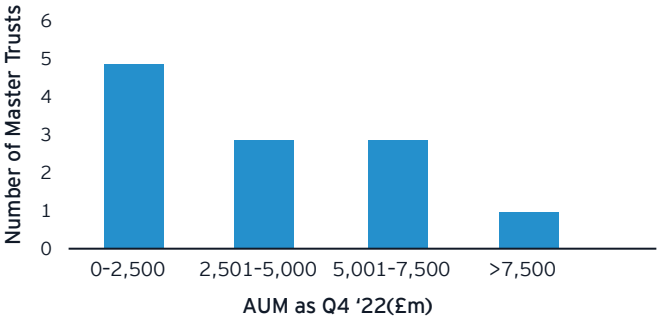
While this survey focused on DC Master Trusts, the key conclusions also provide insights into how major asset managers, insurers and benefit consultancies approach ESG as they will take a consistent approach across their Master Trust and other services.

We hope this survey provides insights to help you navigate the market and help your member outcomes are protected. This is how we help create a better, more sustainable working world.

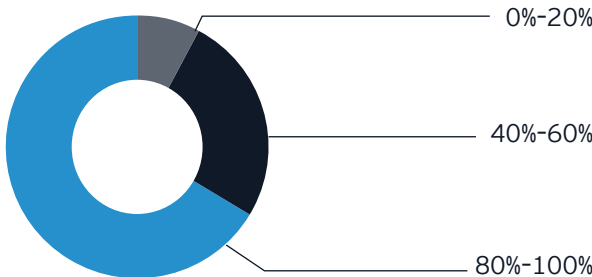
Participants

The survey covers 12 Master Trusts that collectively manage around £50 billion of Master Trust assets and focuses on their ESG activities over the last twelve months to March 2023. The Master Trusts vary in size and profile.

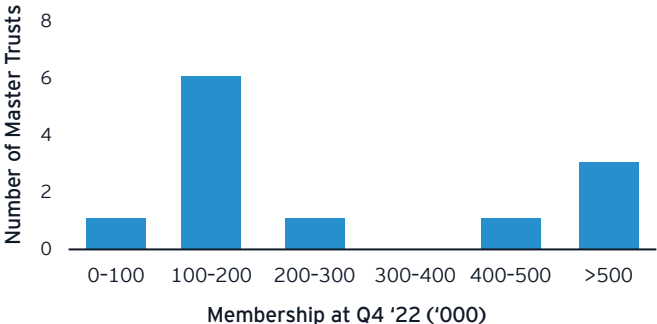
Assets under management (AUM)



Proportion of assets in the default strategy



Membership numbers



We want to thank all participants who took part in this survey:

- ▶ Aegon Master Trust
- ▶ The Aon Master Trust
- ▶ Aviva Master Trust
- ▶ Fidelity Master Trust
- ▶ Legal & General WorkSave Mastertrust
- ▶ LifeSight
- ▶ Mercer Master Trust
- ▶ NOW: Pensions Trust
- ▶ Scottish Widows Master Trust
- ▶ The SEI Master Trust
- ▶ Smart Pension Master Trust
- ▶ Universities Superannuation Scheme

Survey highlights

What questions should stakeholders be asking?

Master Trusts are starting to integrate ESG and climate into their wider investment and reporting frameworks for trustees, but the quality and content vary.

Have you carried out independent assurance on reporting?

Decarbonisation strategies for default options are now common among Master Trusts, and all must comply with TCFD regulation.

Are you considering decarbonisation strategies for you self-select fund ranges?

There is an increasing number of default and self-select investment options available with an explicit ESG. However, it is unclear what proportion will meet the UK's upcoming investment labelling requirements for sustainable investment products once these have been extended to pensions products.

How will updates to investment labelling requirements impact your sustainable investment products?

Diversity on trustee boards, as encouraged by TPR, has been given attention in the last year, with varying levels of how this has been achieved. Seventy-five per cent of the surveyed Master Trusts consider DEI of their board.

Are you keeping up with DEI best practice?

Master Trusts are increasingly engaging members and canvassing their views on ESG. Leading practice is to be a signatory to the FRC's UK Stewardship Code.

Is your member engagement strategy regarding ESG in line with best practice?

Governance



How ESG is considered at the decision-making level is an important indicator of strong ESG governance, along with the approach to diversity of the Trustee Board.

Key themes over the year

- ▶ Diversity on trustee boards, as encouraged by TPR, has been given attention in the last year, with varying approaches to how this has been achieved.
- ▶ There is a broad range of ESG priorities across the Master Trusts; however, climate change is the most common amongst participants.

Trustee board diversity

According to all participants, DEI is considered at the board level; however, there is divergence in the manner and degree to which this is achieved. Diversity is defined differently among the participating Master Trusts, with some focusing only on gender diversity, whilst others also consider ethnic, age and educational background diversity.

Seventy-five per cent of the surveyed Master Trusts consider DEI as a factor in recruiting new board members, and select trustees based on the diversity needs of the board.

Some Master Trusts do not have formal DEI policies in place, while other Master Trusts set gender and ethnicity targets or goals for their trustee board and in-house asset management boards. Some Master Trusts collect diversity data on their directors and then use their Scheme Report and Accounts to report on their board's gender and ethnicity targets (and how they perform against them).

For many Master Trusts, TPR's statement titled 'Governing bodies: EDI guidance', released in March 2023, has resulted in the diversity of the board being considered more closely. This has included conducting annual diversity assessments and training sessions and considering diversity as part of the nomination or application process of new board members.

EY teams have identified that there is more work to be done on DEI beyond gender and ethnicity, with one of the challenges being poor data availability for areas where individuals need to

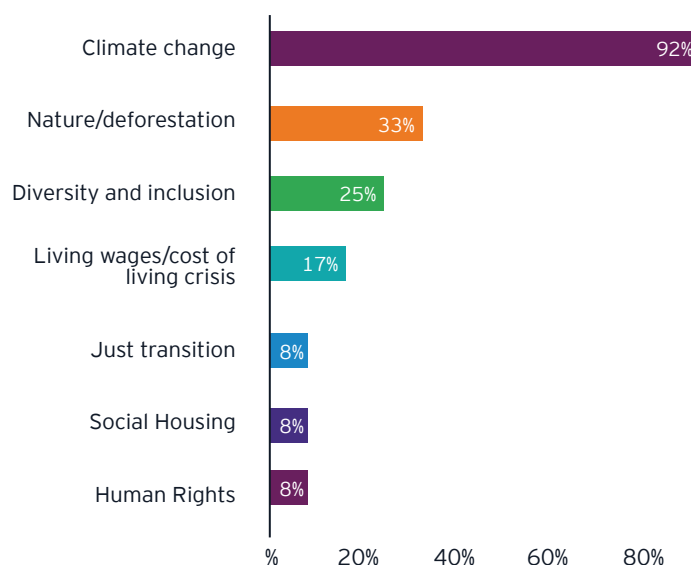
self-identify. Setting a clearly defined DEI policy and strategy (potentially as part of a Master Trust's wider ESG policy and strategy) should be a key area of focus for those who have not done so yet.

ESG priorities

ESG priorities are in place for most of the Master Trusts. EY teams found that among participants there was a wide range of ESG priorities for 2023. These range from more thematic and strategic to practical priorities focusing on implementing ESG into the wider investment process. Climate change is the most common priority across participants, with 11 out of 12 Master Trusts prioritising climate change and reducing emissions. Actions include investing in climate transition funds, engaging with investments to reduce emissions and aligning portfolios with net-zero-goals.

Thematic priorities are shown in the chart below.

Thematic ESG priorities



Implementation priorities include improving the integration of ESG factors across investment options, enhancing stewardship programmes, reporting ESG and carbon ratings, aligning funds with sustainability regulations such as the EU's Sustainable Finance Disclosures Regulation (SFDR) and improving member engagement on ESG.

Investment integration

A woman with curly hair is smiling and looking at a tablet computer. She is sitting at a desk with a laptop and some papers. Another person's hand is pointing at the tablet. The background shows a modern office with large windows and a city view.

Investment processes cover the investment strategy setting approach, portfolio construction, manager or security selection and ongoing monitoring. Master Trusts may provide their members with explicit ESG or impact funds as part of the default strategy and self-select fund range or incorporate their approach to ESG in their process and not explicitly in their fund range.

Key themes over the year

- ▶ An increasing number of default and self-select investment options are available with an explicit ESG link. However, it is unclear what proportion will meet the UK's upcoming investment labelling requirements for sustainable investment products once these have been extended to pensions products.
- ▶ Most Master Trusts (10 out of 12 participants) apply net-zero commitments to their default strategies, with many also planning to extend this to self-select funds.

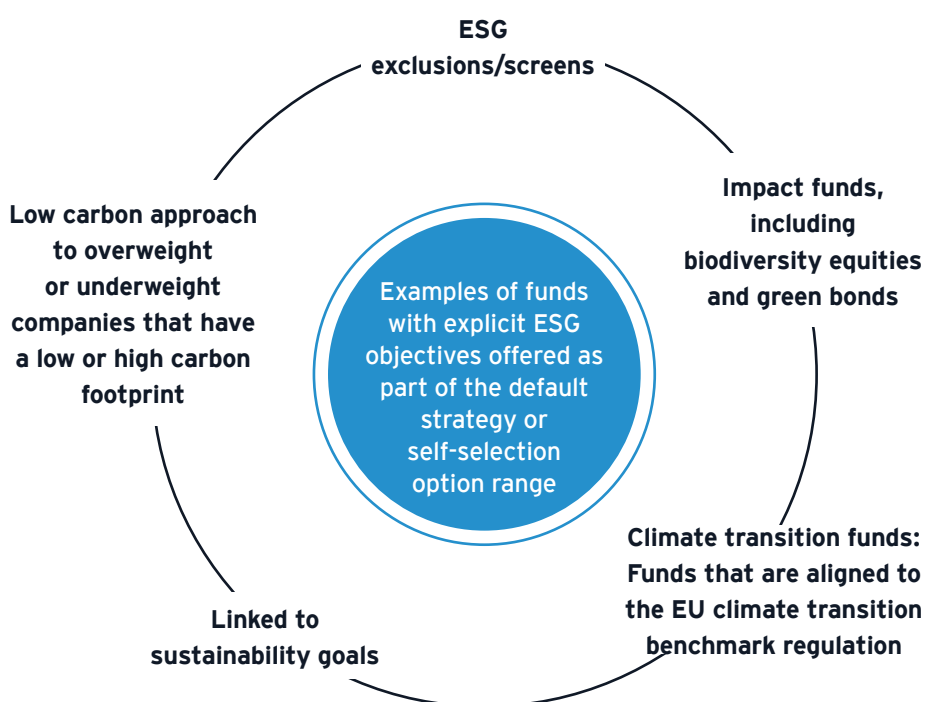
Investment options with an ESG link

Eleven out of 12 participants have included funds with an explicit ESG link in their default strategy. Only one participant did not offer funds with an explicit ESG link as a self-select option.

Several Master Trusts are increasing the number of sustainable investment options available to their members and increasing the allocation to ESG-focused investments within their default strategy.

Allocations to low carbon equity and climate transition strategies across default strategies are considered a priority for several Master Trusts over the next year to support them in meeting their net-zero ambitions. On the more advanced side, we see Master Trusts researching opportunities in private markets with a sustainability focus, including carbon trading.

Examples of funds with explicit ESG objectives offered as part of the default strategy or self-selection option range include:





The UK is due to introduce stronger criteria for labelling investment products as sustainable (expected to be implemented in 2024 for retail investment products, with pension products to follow in due course). In the meantime, some Master Trusts indicated where their ESG-linked funds meet the criteria under the EU's Sustainable Finance Disclosure Regulations, which are expected to be similar to the UK rules. For some of the other fund options currently labelled as sustainable, it remains to be seen which will meet the new UK requirements.

Case study

A fund aims to take advantage of alpha return opportunities and mitigate biodiversity loss by investing in best-in-class companies offering innovative solutions to address issues such as pollution on land and water, land degradation, sustainable materials and recycling.

Another equity fund has a climate transition objective and is aligned with the EU climate transition benchmark regulation.

There are currently over 90 self-select funds available that claim to integrate ESG to some extent. Those offering a small number of ESG options were able to clearly demonstrate the sustainability credentials of these products. However, for those with a large number of options it is unclear how many of these would meet the upcoming sustainability product labelling criteria.

Integration of ESG into the investment process

There are four stages of the investment process where Master Trusts can integrate ESG: strategic asset allocation, portfolio construction, manager selection and securities selection.

Stewardship and engagement were also highlighted as important tools to integrate ESG into the investment process, which is discussed further in the next section.

Strategic asset allocation:

Over 90% of Master Trusts considered ESG during strategic asset allocation, typically across all asset classes.

In practice, this varied from including ESG-aware strategies, considering progress against net-zero targets and climate scenario analysis, employing ESG tilts and screening, and considering ESG factors in capital market assumptions.

Portfolio construction:

ESG is integrated into default portfolios and the majority of self-select funds. Some Master Trusts are applying exclusions to their equity funds (such as thermal coal, and UNGC violators).

EY teams have also seen allocations to sustainable bonds, moving from oil and gas to commodities used in the low carbon transition, and investing in environmentally aware cash and equities.

External manager selection:

ESG is now often a principal criterion in selecting and monitoring external managers. One approach is to set minimum ESG expectations for the selection, appointment and monitoring of asset managers.

For example, some Master Trusts set a minimum ESG rating for managers to achieve and put engagement plans in place.

Securities selection:

Most Master Trusts use external asset managers to carry out securities selection, then the Master Trust assesses how each manager integrates ESG considerations into securities selection via formal ESG ratings.

Where Master Trusts perform securities selection themselves, EY teams have seen various approaches used, including exclusions policies and optimising overall funds to have a higher ESG score or lower carbon intensity than their benchmarks.



A man wearing a straw hat and a grey t-shirt is shown in profile, holding a large, round, green melon with a netted rind. He is standing in a greenhouse filled with lush green plants and vines. The background is filled with large, vibrant green leaves and climbing vines, creating a dense and healthy agricultural environment. The lighting is bright and natural, highlighting the textures of the melon and the foliage.

Stewardship

Stewardship represents the use of influence by investors to maximise the long-term value of the assets they invest in and ultimately create value for pension scheme members. Stewardship, including engagement and voting on ESG issues that pose a risk to investments, forms one of the most important tools by which Master Trusts can bring about positive change within the industry.

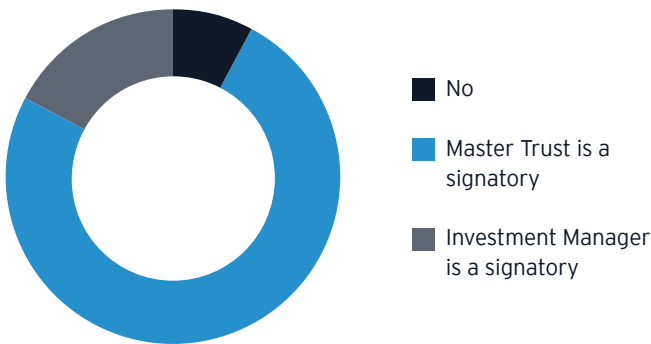
Key themes over the year

- ▶ Leading practice is to be a signatory to the FRC's UK Stewardship Code.
- ▶ Master Trusts are increasingly engaging members and canvassing their views on ESG.

The FRC's UK Stewardship Code

Most scheme funders of the Master Trust participants are signatories to the FRC's UK Stewardship Code. In some cases, the investment manager rather than the scheme funder has signatory status. Only one respondent is not yet a signatory; however, they have applied and are awaiting a response on the outcome.

Are Master Trusts signatories to the UK Stewardship Code?



Stewardship objectives

Stewardship and engagement are important tools to integrate ESG into the investment process. All participants had some form of stewardship objectives, with six participants having standalone stewardship and engagement policies (instead of, for example, building them into their wider responsible investment policy). Most Master Trusts have set their own objectives; however, a few participants relied solely upon their investment advisors' stewardship objectives but had plans to adopt their own stewardship policy in the coming months.

Most participants detailed their approach to stewardship and engagement in either a standalone policy or as part of their other ESG and responsible investing policies.

A typical stewardship policy outlines the Master Trust's stewardship framework, including priority themes, engagement expectations and escalation processes. The policy will also typically define the trustees' expectations of their key service providers and asset managers.

Leading practice is to set concrete stewardship priorities for the year based on the beliefs set out in the trustees' Statement of Investment Principles. Furthermore, leading Master Trusts have regular contact with all their investment managers on at least an annual basis to assess their stewardship, including each investment manager's voting activity (for the listed equity managers) in the priority areas for the scheme.



Engaging members on ESG

ESG considerations, particularly climate and sustainability, are becoming increasingly important to members. As a result, all participants indicated that they engage with members on ESG and dedicate more time and resources to this.

Surveys conducted by Master Trusts on their members have found that over three-quarters of pension scheme members believe that it is important that pension savings are invested in a way that specifically benefits people and the planet, with some members even going further to say that it should be the main goal over financial returns.

Master Trusts include ESG topics in many member communications, including the member website. Some provide regular updates to improve member and client understanding of ESG, including sharing blogs, videos, webinars and dedicated webpages.

All participants engage with their members on ESG. It is popular to use web resources such as Make My Money Matter and Pensions Geeks TV.

EY teams found several ways Master Trusts are canvassing member views:

Member surveys help to build a picture of members' views and expectations on the Master Trust's investments, which can be taken into account when setting the broader responsible investment and stewardship strategy. A few participants also developed tools for members to see where their pension is invested and their personal impact across various sustainability themes.

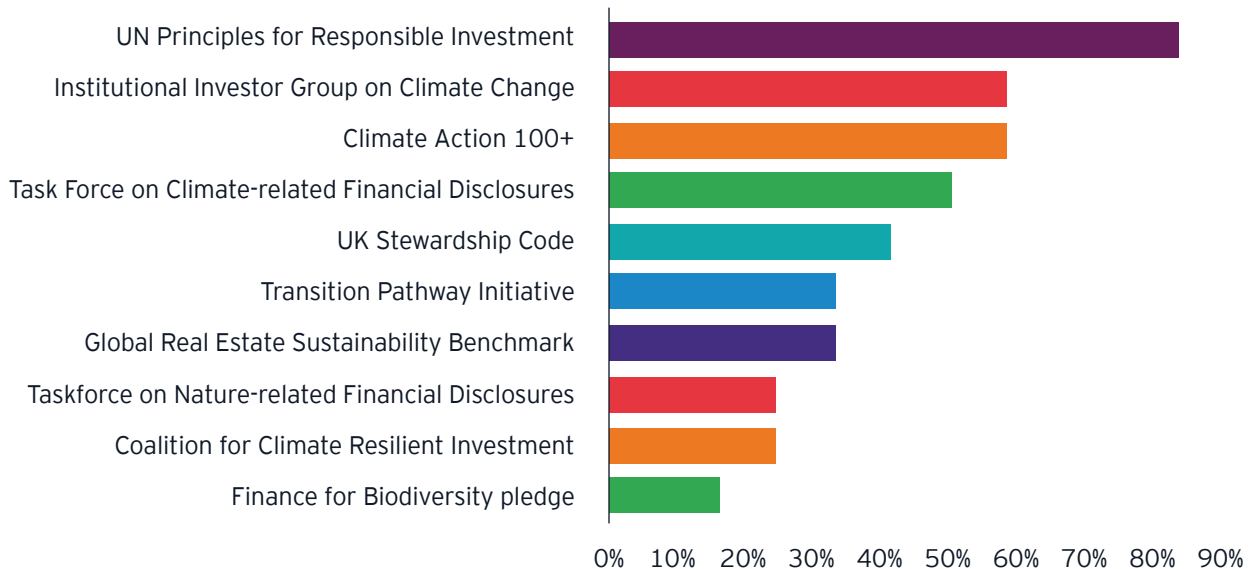
The **Tumelo dashboard** is a popular platform for collecting member views on ESG (four participants reported using it). The Tumelo dashboard allows for the capturing of voting preferences of a large proportion of members and the sharing of their views on AGM issues of the companies their funds invest in. This data can be fed into engagements with underlying managers. Some Master Trusts initially reported relatively low member engagement with the platform, but they expect this to increase.

Monitoring member behaviour to gain insight into member preferences on ESG. This includes self-select choices, online reviews by members and monitoring website statistics, such as feedback on help article pages and the popularity of certain webpages.

Industry initiatives

EY teams found that Master Trusts are involved in many industry bodies and initiatives (over 50 in total). All participants were involved in several initiatives but focused on different areas.

Most popular industry bodies and initiatives



Climate change



Climate change is a fast-evolving area within the wider pensions industry. The potential future impacts of climate change are difficult to estimate, relying on complex scenario modelling and climate metrics for which there may be little data.

Key themes over the year

- ▶ It is now common for Master Trusts to set decarbonisation strategies for their default option, but participants are only just starting to consider doing this for their self-select fund ranges.
- ▶ All authorised Master Trusts must comply with TCFD regulations. There is variation in the scenario analysis and metrics used, but participants typically use three scenarios: Orderly, Disorderly and Failed Transition (or Hothouse).

Decarbonisation strategies

Most Master Trusts (10 out of 12 participants) apply net-zero commitments to their default strategies, with many also planning to extend this to self-select funds.

Some participants set more ambitious net-zero targets for their growth strategies.

Carbon commitments

The most common carbon commitments are net-zero by 2050, with interim targets set at 2030 for a 50% reduction (using either 2019 or 2020 as a base year). However, some set less ambitious interim targets.

The most ambitious targets we have seen are net-zero by 2040, with interim targets of a 50% carbon intensity reduction of investments by 2025 and 65% by 2030.

Currently, most targets only cover the invested companies' Scope 1 (direct) and Scope 2 (indirect) emissions. A few are also starting to include Scope 3 (value chain) emissions as more data becomes available.

Although four participants excluded some assets from their decarbonisation targets, most participants aimed to include all asset classes in their decarbonisation targets.

Those with less ambitious net-zero targets acknowledged the need to constantly review targets to keep up with the pace of change.

One respondent also noted that although they had no specific net-zero targets in place, they aimed for a proportion of companies in their equities portfolio to have Science Based Target initiative (SBTi) targets. Science-based targets are considered to be in line with what the latest climate science deems necessary to limit global warming to 1.5°C above pre-industrial levels.



Climate metrics and modelling

Authorised DC Master Trusts are now required to comply with TCFD regulations, and the industry recognises that climate change is a material risk to pension schemes.

As a result, Master Trusts are now calculating climate risk metrics and carrying out scenario analysis (either in-house or with the help of a third-party provider) to understand their exposure to climate risk.

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TPR recently stated that all pension schemes are exposed to environmental and social governance and climate change risks and opportunities, which are becoming increasingly important in determining a scheme’s long-term performance.

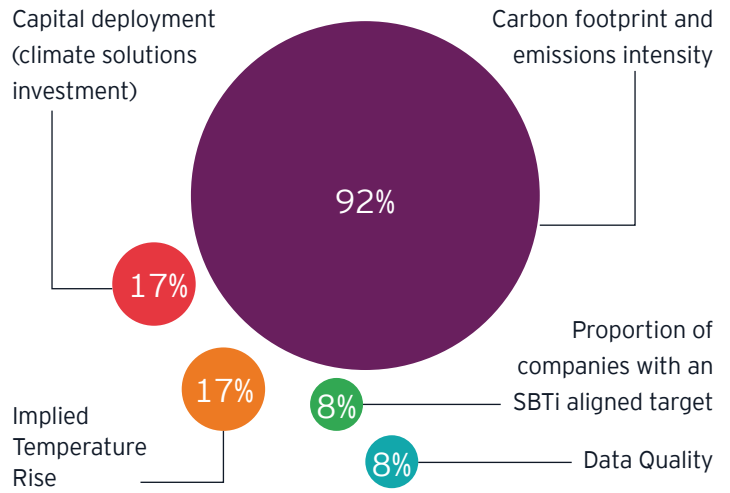
All trustees should consider material risks and opportunities when making decisions and managing savers’ money.

Mark Hill, Climate and Sustainability Lead for The Pensions Regulator (TPR)

Participants generally used two to five scenarios in their TCFD reporting, with three being the most popular. These typically tend to be Orderly, Disorderly and Failed Transition (or Hothouse) scenarios. We also saw the inclusion of an ‘inevitable policy response’ scenario by some participants.

More advanced practice is to monitor climate metrics regularly (rather than just annually) to understand the impact on member portfolios.

Common climate metrics



How scheme funders are addressing climate change

The vast majority of scheme funders have made carbon commitments, with only one respondent having no commitments and one finalising theirs.

Some have set SBTi-verified targets or have committed to increase their investment in climate solutions by specific amounts by specific dates.

Leaders have calculated their Scope 1 and 2 carbon footprint and are now starting to measure their Scope 3 emissions.

Some companies are also turning climate change into a commercial opportunity by developing climate solutions for clients.

Reporting



In conjunction with the regular reporting provided to both trustees and members, there should also be the inclusion of high-quality, digestible, and meaningful reporting that both informs and, if necessary, promotes actions around ESG considerations, risks, and outlooks within the default strategy and self-select fund options.

Key themes over the year

- ▶ Master Trusts are starting to integrate ESG and climate into their wider investment and reporting frameworks for trustees, but the quality and content vary.
- ▶ All Master Trusts provide their members with some form of ESG reporting.
- ▶ There is increasingly some form of independent assurance carried out on reporting.

ESG reporting for trustees

There is a spread in the maturity of the ESG reporting provided to clients and members, particularly concerning the breadth, frequency and depth of areas included.

Regular reporting to the trustees typically includes proprietary ESG scores for fund managers, stewardship reporting that details voting and engagement activity, and climate reporting.

While completing this survey, not all Master Trusts had released their first TCFD report, but they are expected to do this over the coming months.

EY teams have also seen examples of a couple of Master Trusts producing impact analysis against UN Sustainable Development Goals and DEI metrics for the trustees.



Independent assurance

Eight of the eleven Master Trust participants are currently performing assurance on their ESG documents, policies, reporting, and processes, with only one of the remaining participants not planning on doing so in the future.

ESG reporting for members

Although all participants provide their members with some form of ESG reporting, its depth and breadth vary considerably. Some have also been reporting considerably longer than others.

EY teams have seen examples of ESG reporting to members, including sustainability scorecards for funds. These typically include information such as carbon emissions, data coverage, comparisons with benchmarks and exposure to controversial sectors.

Leading Master Trusts are publishing member-friendly content online, such as:

Dedicated sustainable investing pages

▶ to help educate members about the ESG characteristics of their funds and wider sustainability topics.

Access to voting outcomes

▶ and the ability to express views on key votes, e.g. the Tumelo dashboard – see the stewardship section.

Reporting on ESG metrics of their investments

▶ including how members' investments have reduced their personal carbon footprint on an annual basis compared with investing in the global stock market. This can be shown using, for example, equivalent car or plane travel.

In closing

ESG, including climate, is key in the investment industry, and it is positive to see that the majority of UK Master Trusts that participated in this survey have in place various initiatives to achieve net-zero and other sustainability targets. We have seen a large increase in the ESG options offered to members as part of the default and self-select fund ranges.

The world is asking for change. ESG best practices, solutions and allocations continue to move at pace. We firmly expect topics such as biodiversity and increased integration of members' views to be increasingly important, with many Master Trusts already starting to look at these areas.

With higher expectations from the FRC and increasing ESG regulation, as well as a growing proportion of members who view ESG as an important priority, it is more important than ever to consider an independent review of what your Master Trust is doing.


With a 20+ year legacy in sustainability and ESG services, EY teams combines deep technical skills across a breadth of business issues to help businesses create value for sustainability as well as help sustainability create value for business.

How EY teams can help

- ▶ We support trustees and corporates navigate ESG and climate change, and help EY clients confidently meet their ESG objectives by ensuring their approach is aligned with emerging and best practices.
- ▶ We support numerous stakeholders to select and monitor Master Trusts, and help trustees and corporates assess how their ESG processes and reporting compare with the wider industry. This also includes reviewing and monitoring DEI practices.
- ▶ We can also help DC schemes (whether a Master Trust, contract-based, or other) to set ESG and climate objectives and strategies.

If you are also interested in ESG in the UK-defined benefits market, we have conducted a similar review of fiduciary managers. Please visit our page on sustainable finance at www.ey.com/en_uk/financial-services/sustainable-finance to read more or get in touch with the pensions team (contact details on the next page) for information on how we can help you.





Key sustainability questions that we help pension scheme clients and their sponsors to address

Stewardship, reporting and disclosures

Benchmarking

How is our stewardship and governance approach versus market practice?

Are we ahead or behind?

Gap completion

As an FRC Stewardship Code Signatory, what gaps do I need to fill?

How do I fill those gaps?

Disclosure compliance

How do I meet ESG climate and TCFD (Task Force on Climate-Related Financial Disclosures) reporting hurdles?

How do I fulfil corporate carbon accounting demands?

Net zero and strategy

Net zero strategy

What is the plan and timeline for my scheme to reach net-zero?

How do I 'justly' design and execute this transition?

Management actions

What is my joint company-trustee plan for net-zero?

How do I best measure, monitor and manage this plan?

Financed emissions

As the primary enterprise-wide source of financed emissions, how do I measure the scheme's contribution to this key metric?

Risk-led transformation

Risk appetite

How do I set controls and risk appetite for ESG considerations?

How do I measure and manage climate risk?

Integrated frameworks

How do I design an integrated ESG and climate risk framework?

How do I implement this in a practical manner?

Modelling and understanding

How do I raise stakeholders' familiarity with climate risk exposure?

How can modelling or stress testing help?

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About EY-Parthenon

EY-Parthenon teams work with clients to navigate complexity by helping them to reimagine their eco-systems, reshape their portfolios and reinvent themselves for a better future. With global connectivity and scale, EY-Parthenon teams focus on Strategy Realized – helping CEOs design and deliver strategies to better manage challenges while maximizing opportunities as they look to transform their businesses. From idea to implementation, EY-Parthenon teams help organizations to build a better working world by fostering long-term value. EY-Parthenon is a brand under which a number of EY member firms across the globe provide strategy consulting services. For more information, please visit ey.com/parthenon.

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