THE SOCIETY OF PENSION PROFESSIONALS

making pensions work

Environmental Social and Governance (ESG) Guide 2023

Introduction

Whilst it is easy to recognise the importance of ESG, it can be difficult for pension scheme trustees to understand the requirements and the practical steps they can take. This guide aims to give a high-level overview of the subject, including possible approaches for different investment structures, details of the underlying legal obligations and how to engage with investment managers and advisers. We hope it provides the practical support needed to take on this essential topic with confidence.

Steve Hitchiner
SPP President

Section 1. How are the scheme's investments held?

Before considering how ESG might be integrated within a scheme's investment approach, it will be necessary to understand how scheme's investments are currently held. Both the type of and the structure of investments will have a bearing on the way that the trustees set an ESG approach.

Different approaches by investment structure

The following table sets out a comparison of the most typical investment structures and where trustees might best focus on integrating ESG into their approach. It is possible that a scheme may use more than one type of investment structure.

Passive pooled fund	Active pooled fund	Active segregated fund
Trustees will have no scope to influence the manager's approach to investment allocation, which will be according to a prescribed index. However, trustees can choose a passive fund where the underlying index better meets their objectives (e.g. where ESG factors are integrated into the index construction process). Regardless of the index, trustees should ensure they understand and agree with how the manager engages with investee companies, including the use of any voting rights. Robust engagement is important even in passive funds to manage risks and to aim to improve returns.	Within actively managed funds, the manager should have a wide discretion to take ESG factors into account in the selection and realisation of the pooled fund's investments. Trustees should therefore ensure that they have confidence in the manager's integration of ESG in its investment approach, taking care to cut through any 'greenwashing' and understand the approach of any ESG tilts or exclusions. Trustees should ensure that they understand the manager's approach to engagement, voting, and reporting. Active pooled funds can go further and select investments specifically on the basis of sustainable themes such as climate change.	Where managers are appointed directly by trustees to manage a segregated portfolio of investments, trustees will have more control over the manager's approach. Trustees should consider the terms of their investment management agreement and agree any specific approach to ESG integration, voting/ engagement and reporting to deliver on the trustees' own investment beliefs and policy. For example, the trustees may wish to specify their own ESG tilts or exclusions. Trustees will have more scope to directly manage voting in relation to segregated equity funds.

Fiduciary management

Trustees that make use of fiduciary management will need to consider their approach to ESG in the context of the investment services delegated, but in most cases, the trustees will be highly reliant on the manager's discretionary approach. Trustees should therefore look to appoint a fiduciary manager whose approach to ESG is aligned with the trustees' beliefs and policies.

For example, trustees need to understand the fiduciary manager's ESG scoring process and how this influences underlying manager selection and the manager's approach to stewardship and the extent to which the fiduciary manager exercises or delegates engagement activities and voting rights.

Trustees should ensure that they have sufficient information available to be comfortable that the fiduciary manager's processes are in line with the scheme's requirements.

Section 2. What are trustees' legal obligations?

What are trustees required to do on ESG matters by law (in brief)?

1. Fiduciary Duty	2. ESG Policy	3. Stewardship
Invest assets in a prudent manner in the best interests of members and beneficiaries. For DB schemes, understand and manage risks to the scheme arising from ESG impacts on the sponsor covenant.	Set out, as part of a scheme's published statement of investment principles (SIP), the policy in relation to how ESG factors are taken into account when choosing investments and how manager engage with their investments on ESG issues.	Report on how they have implemented certain policies and how votes have been exercised via an implementation statement. Publish their SIP and implementation statement online.

1. Fiduciary duty

Trustees are the legal and beneficial owners of a scheme's assets, and they have a fiduciary duty towards members and beneficiaries. There are four overriding general duties:

(1) Observe the scheme's trust deed and rules.

(2) Act in good faith and for the purposes of the trust, which usually means in the best (financial) interests of members.

(3) Treat all member categories fairly (although this does not mean they must all be treated the same).

(4) Act as a "prudent person".

Trustees have wide powers to invest the assets as though they were their own, but they should check that the choice is not limited by the trust deed and rules and remember that they are required to act prudently (i.e. they should not make speculative investment choices).

Trustees should take account of financially material considerations when choosing investments (and considering the employer covenant). Regulations[1] recognise that financially material considerations now include ESG factors.

ESG factors include climate change. It is good practice for all trustees to implement[2] governance structures to maintain oversight of climate-related risks and opportunities, and a legal requirement to do this for trustees of the largest schemes.

There is no legal requirement to take account of members' views. However, trustees should be aware that such views could represent the views of a significant section of society as a whole and any investment that runs contrary to these could be adversely affected due to reputational damage caused by underlying investee companies.

Choosing an investment simply because it is socially worthy (social impact investing) is not the same as taking account of ESG factors. Even if all members were to ask the trustees to make a particular social impact investment, trustees' duties would mean that they should only do so if it poses no financial detriment to the fund.

2. ESG policy and public disclosure

There is a regulatory requirement for trustees of occupational schemes with 100 or more members (and where there is a default arrangement in a DC section or scheme) to produce, maintain and from time to time a statement of investment principles (SIP).

A trustees' SIP must include: the policies on financially material considerations (including ESG) and stewardship; the extent to which the trustees take account of members' views (if at all) and details of the trustees' arrangements with investment managers. Trustees must produce an implementation statement[3] setting out how they have implemented the policies set out in their SIP. These documents must be made publicly available, free of charge online.

Since 1 October 2021, pensions schemes with assets in excess of £5bn need to produce disclosures in line with the Taskforce for Climate-Related Disclosures (TCFD) framework. Trustees must take steps to identify, assess and manage climate-related risks and opportunities (in a proportionate way) and report on what they have done. For example, this may include establishing a net zero strategy. From October 2022, the threshold was lowered to cover all schemes with assets over £1bn schemes. Schemes should start planning for next year's TCFD disclosures by engaging with their managers and advisors early, and drawing on the learnings from this first wave of reports from 2022.

1 *Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005.*
2 *Practical tips and suggestions here: Pensions Climate Risk Industry Group Guidance.*
See also the SPP report How to unleash the power of social impact investing.
3 *https://www.plsa.co.uk/Policy-and-Research-Document-library-Implementation-Statement-guidance-for-trustees*

3. Stewardship

Trustees should actively monitor and engage with investee companies or provide oversight of those who carry out these activities on their behalf. When investments are made via pooled funds, it will be the investment manager that undertakes this activity. Trustees should therefore understand how ESG can be integrated into relationships with their investment consultants and managers, as discussed in Section 3 of this guide.

The Pensions Regulator encourages trustees to sign up to the UK Stewardship Code[4] and directs trustees to the PLSA's stewardship disclosure framework[5], which allows trustees to see, at a glance, the stewardship policies and activities of any participating asset managers.

The Department of Work and Pensions (DWP) recognises that trustees have been heavily reliant on their investment managers' policies, but is encouraging trustees to take more ownership of stewardship issues in the future. This is reflected in the DWP's latest statutory guidance[6], which applies to implementation statements with scheme years ending after 1 October 2022.

DWP's 2022 guidance on implementation statements and statement of investment principles

One of the key themes of the new statutory guidance is that trustees should consider the links between their scheme's stewardship priorities and the voting behaviour in the practice of the trustees' appointed managers. In order to do this trustees will need to identify their own stewardship priorities and trustee boards should be spending time with their advisers now agreeing on what these are.

Trustees should prepare now to ensure that they have all the additional information they will be required to report (as set out in paragraphs 67-95 of the guidance); in broad terms these cover:

- Details of engagement objectives and practical examples of actions
- Information and statistics on the use of proxy voters including commentary on alignment with trustee views and priorities.
- Detailed reporting of most significant vote including information such as: which trustee stewardship priority the vote was linked to (e.g. climate change, board remuneration, biodiversity); if the vote was against management; whether the intention was communicated to the company ahead of the vote; and whether further action is intended to escalate stewardship efforts.

The last point echoes one of the recommendations from the PLSA's voluntary guidance, which suggests that trustees might usefully add some commentary when reporting significant votes regarding any lessons learned and what likely future steps will be taken in response to the outcome.

Other relevant matters

Fiduciary duty of trustees vs investment decision making

In relation to climate change, some trustees may feel that engagement with investee companies is insufficient and that excluding such entities from the investments that they hold is a more appropriate way to execute their adopted policy. This raises the question of whether excluding potential investments can be squared with trustees' overriding fiduciary duties.

In a charity law case[7], the High Court held that doing so was not inconsistent with trustees' fiduciary duties, but it took care not to endorse either exclusion or engagement as a valid approach. In that case, the relevant charity trustees had, as one of their charitable purposes, environmental protection, so they adopted an investment policy which was aligned with the Paris Agreement's goals of achieving net zero emissions, even if the financial returns may not be maximised as a result. Pension trustees will not have the same purpose enshrined in their trust deeds, but there is no reason to think that the Courts would reach a different analysis of the fiduciary duties of a pension scheme's trustees versus a charity's trustees.

4 *UK Stewardship Code 2020*
5 *PLSA Stewardship Disclosure Framework*
6 *DWP 2022 Stewardship Guidance*
7 *Butler-Sloss v Charity Commission (2022)*

Section 3. A suggested approach / framework for trustees

Step 1 – Setting beliefs and objectives

Trustees may find it helpful to develop and maintain a set of beliefs about how investment markets function and which factors lead to good investment outcomes. These should include a consideration of ESG factors including climate-related risks and opportunities. The scheme's investment strategy should then reflect those beliefs in relation to ESG factors which the trustees consider to be financially material. For most schemes, this policy on ESG issues will be documented in their SIP but more and more schemes are implementing bespoke "Responsible Investment Policies", or dedicated climate policies, which set out more detail on their intended approach.

Once the trustees have established beliefs and objectives, these can be applied to the investment strategy, taking an approach appropriate to the scheme's situation as identified in Section 1. These beliefs and policies will form part of the trustees' policies required under the legal disclosures set out in Section 2.

Step 2 – Engaging with advisers

Advisers are keen to help trustees understand the ESG risks and opportunities of their investment portfolio. Trustees may want to set an ESG-related objective for their investment consultant as part of their CMA objectives. An example of this could be *"The investment consultant will help the trustees to develop and document their investment beliefs and constraints, including ESG beliefs and Climate Change considerations".*

The Climate Competency Framework document, published by the Investment Consultant Sustainability Working Group (ICSWG)[8], helps trustees assess the climate competence of their investment consultants. The framework includes topics to ask your investment consultant about, including:

- The climate specialists/researchers within their organisation.
- Whether they are a signatory to the Principles of Responsible Investments (PRI) and/or UK Stewardship Code 2020.
- How they identify climate risks and opportunities in the market.

As ESG forms part of trustees' investment beliefs and policies, the investment consultant should incorporate ESG into their recommendations to the trustees around manager selection. The trustees should also expect the investment consultant to provide them with regular ESG training.

Step 3 – Engaging with investment managers

In recent years, the UK market has become flooded with managers eager to demonstrate their capabilities in integrating ESG considerations and stewardship capabilities resulting in a large variety of approaches. There are some key questions that trustees should consider asking to test the robustness of these approaches.

- Does the manager have a systematic approach in place that enables it to explain how ESG factors are considered in the investment process? Is this an over-arching approach or does it go into detail depending on the asset class?
- Does the manager provide case studies or examples of where ESG considerations have influenced the construction of their portfolio?
- Can the manager demonstrate where and why they have voted for or against management on any equity holdings within their portfolios?
- What structure does the manager currently have in place for reporting elements of ESG integration and stewardship and what plans are in place to enhance this over time? For example, can the manager demonstrate where and why they have engaged with their investments alongside the outcomes resulting from that engagement - this is relevant for all asset classes.
- Does the manager have dedicated ESG expertise? If yes, how is this structured? If no, what are the responsibilities of the portfolio managers and analysts with regard to considering ESG factors and practising good stewardship?

8 *A collaboration of 17 investment consultants formed in 2020 taking action to support and accelerate sustainable investment initiatives in the UK.*

One area which trustees should be aware of is "greenwashing" – where an ESG-focused policy is not actually integrated within a manager's processes. Warning signs of greenwashing include:

- Reliance on third-party ESG rating providers in portfolio construction.
- Managers not able to point to some examples where their consideration of ESG factors had an impact on which investments to hold in the portfolio.
- Limited evidence of involvement in external bodies related to general or specific ESG issues.
- Managers themselves not aligned with what they are preaching in terms of ESG integration and good stewardship.

Legal framework for asset managers – helpful things for schemes to know

The asset management sector has been heavily impacted by the wave of ESG-related regulation over the last few years. The new and proposed ESG requirements put forward by the Financial Conduct Authority (FCA) impact all aspects of the asset management sector, ranging from product design, classification, ongoing management, disclosure and distribution. These requirements not only have a direct impact on asset managers, but also indirectly impact investment funds and other products offered to pension schemes. Asset managers are also being impacted by commercial considerations such as client-led preferences for ESG products and strategies, and reputational concerns over 'greenwashing and similar ESG claims.

The UK is part-way through its journey towards implementing ESG-related regulatory requirements in relation to its asset management sector. The UK's legislative proposals announced to date may be broken down into three broad components:

- **TCFD-compliant reporting:** The UK has published rules requiring UK-authorised asset managers to publish disclosures in line with the TCFD recommendations. The obligation to publish these disclosures is much higher than for pension schemes – they apply to asset managers with more than £50 billion in assets under management (AuM) for periods starting 1 January 2022, and for other asset managers with more than £5 billion AuM for periods starting 1 January 2023. The scope of the TCFD reporting is limited to climate-related financial material information, and is, therefore, more limited than the ESG-related disclosures required in the EU under their Sustainable Finance Disclosure Regulation (SFDR) or the Taxonomy Regulation.
- **Sustainability disclosure requirements (SDRs):** In November 2020, the FCA published a discussion paper on proposed new sustainability disclosure requirements applicable to UK asset managers (the precise scope is unclear at present). The SDRs intend to provide an industry-wide standard for key sustainability-related information, and it is intended to build on the TCFD reporting obligations which are already in force. Once implemented, the SDRs are expected to be broadly consistent with the EU's SFDR although further details are still awaited.
- **Investment labelling regime:** In November 2022, the FCA published a further consultation paper on the proposed SDR rules. The key aspect of the proposals is a framework for sustainable investment labels. To earn a sustainable label, managers must evidence: sustainable objectives; investment policy; key performance indicators; resources and governance and stewardship. This is expected to reduce the risk of greenwashing by providing UK investors with clarity on the ESG-related features of investment products.

Legal framework for insurers

Insurers, like all other organisations, are increasingly impacted by ESG factors. Much of the impetus for this comes from non-legal sources such as public opinion and shareholder demand. Given the less direct link with pension schemes trustees, we have not set out in detail the legal obligations of insurers, but these include: TCFD disclosures and consideration of climate risk when assessing capital requirements[9] for the Prudential Regulation Authority (PRA). Other items to note include a joint paper issued by the PRA, FCA and Bank of England on how diversity and inclusion might become a more prominent feature in the financial services sector.

9 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021

The Society of Pension Professionals (SPP)

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Harnessing the expertise of its broad membership, the SPP strives to deliver value to its members and improve how pensions work, positively impacting outcomes for pension scheme members, the pensions industry and its stakeholders.

The SPP Vision

A secure retirement for all, supported by a thriving and diverse pensions industry, operating within clear and trusted regulation.

The SPP Mission

To deliver value to our members through education, experience and opportunity to influence. To support the wider pensions industry, government and associated bodies in delivering an effective operating and regulatory environment.

For more information on the SPP, please visit our website or email info@the-spp.co.uk

Credits

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