THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

Environmental Social and Governance (ESG) Guide

Foreword

I applaud the SPP for producing this very short introduction. It shows trustees how to get started and highlights the common pitfalls to look out for. ESG is a journey, and I strongly recommend this guidance for schemes who are still in the early stages.

Guy Opperman
Minister for Pensions and Financial Inclusion

Introduction

Meeting their ESG obligations can seem daunting for pension scheme trustees. This is particularly true for trustees of small to medium sized schemes with smaller budgets and which are predominantly invested in pooled funds, who believe their options for action are limited.

This SPP guide is aimed at the trustees of such schemes. It seeks to give them high level guidance on their legal obligations, what actions they can practically take depending on their investment structure, and how best to engage with advisers and investment managers. We hope that it provides practical support in navigating this ever more complex and regulated area.

James Riley
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 a 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.

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. more appropriate ESG integration). 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.	Within actively managed funds, the manager should have a wide discretion to take ESG factors into account in its 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.	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)?

Fiduciary Duty

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.

ESG Policy

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.

Stewardship

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.

Legal framework surrounding trustees' actions

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 a wide power 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 trustees to implement[2] governance structures to maintain oversight of climate-related risks and opportunities.

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 in 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[3], trustees' duties would mean that they should only do so if it poses no financial detriment to the fund.

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 .
3 See the SPP report How to unleash the power of social impact investing.

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.

Legal framework surrounding trustees' disclosures

ESG policy

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 review 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[6] setting out how they have implemented the policies set out in their SIP. These documents must be made publicly available, free of charge online.

4 UK Stewardship Code 2020 .
5 PLSA Stewardship Disclosure Framework .
6 https://www.plsa.co.uk/Policy-and-Research-Document-library-Implementation-Statement-guidance-for-trustees .

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.

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".*

Recently, the Investment Consultant Sustainability Working Group (ICSWG)[7] published their Climate Competency Framework, which 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.

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

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 details 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?
- 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 regards to considering ESG factors and practising good stewardship?

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 ratings 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[8].
- 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.

Step 4 – Considering upcoming developments

Three significant legal, regulatory and practical developments are expected to come into force later this year:

1. The DWP[9] is finalising regulations and statutory guidance that, starting in October 2021, will impose mandatory governance and disclosure requirements in relation to climate risk on trustees of large schemes (with asset values of £1 billion or more) and DC master trusts. These requirements will be reviewed in 2023 and it is very possible that their scope will be widened to include smaller schemes.
2. The Pensions Regulator is consulting on a new code of practice which will require trustees to assess the risks and opportunities associated with climate change as part of their risk assessment.[10]
3. The prospective PLSA quality mark for responsible investment. This will include metrics to judge RI against and allows schemes of all sizes to evidence their credentials.

8 https://www.unpri.org/reporting-and-assessment/reporting-framework-glossary/6937.article .
9 DWP Consultation on Taking Action on Climate Risk .
10 Climate change TPR code module | The Pensions Regulator .

1.

The Society of Pension Professionals (SPP)

SPP is the representative body for a wide range of pension advisers and service providers. The breadth of our membership profile is a unique strength for the SPP and includes actuaries, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and specialists.

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

Thanks to those who contributed to this guide, in particular: Adam Gillespie, XPS; Stuart O'Brian, Sackers; Jamie Govan, Aberdeen Standard Investments; Clifford Sims, Squire Patton Boggs; John Wilson, Spence & Partners; Neil Davies, Barnett Waddingham; Tony Bacon, LCP and Jane Evans, EY. Thanks also to Spence & Partners for their design work.

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