THE SOCIETY OF PENSION PROFESSIONALS
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SPP Flash Poll:

ESG Risk in Covenant: One Year On

The SPP Covenant Committee polled SPP members on how ESG risks in the sponsor covenant are taken into account by DB pension schemes – originally in 2021, and now in a September 2022 update.

We have looked at the two surveys taken just over a year apart, to understand what messages the profession can take from them:

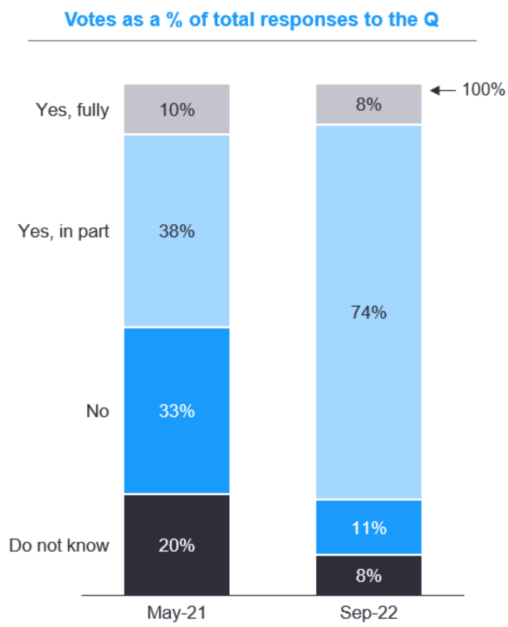
- First, the positives: **Engagement in this topic continues to increase**, with a greater survey response rate, penetration of ESG covenant risk assessment with clients, and significantly increased clarity over how it should be treated
- However, **for some schemes ESG risk in covenant is still not considered** – including for reasons of **lack of budget, data, or understanding**
- In particular, the results potentially indicated **a gap between ESG covenant risks and how these are factored into scheme funding journeys:** we saw a potential gap between the approach a covenant adviser may take to assessing ESG risk to the covenant, and the inputs an actuary needs to incorporate those risks fully into the scheme's funding journey – which the Covenant Committee is following up on.

ESG Risks are increasing in importance but still not fully considered

Results underscored that ESG/Climate change considerations in covenant assessment are increasingly relevant, with >80% of respondents stating it is now taken into account – although the majority declared that these considerations are taken into account *in part* rather than *in full*. Also, on a positive note, compared to the previous year, there was a sharp reduction (-34%pt) in those declaring *no consideration given* or *no knowledge* of ESG/Climate change considerations.

Factors being considered include sustainability and climate change risks, with corporate governance standards now growing significantly as a factor being considered

As in the previous year, *Sustainability* and *Climate Change* risks were the most included factors, with both registering a significant increase year-on-year. *Diversity and Inclusion in staffing* and *Human Rights in the supply chain* have somewhat increased in popularity in the year, but much more significant growth in the inclusion of *Corporate Governance Standards* to 45% of responses, up 20%pt year-on-year



Note: 35% increase in responses between 2021 and 2022.

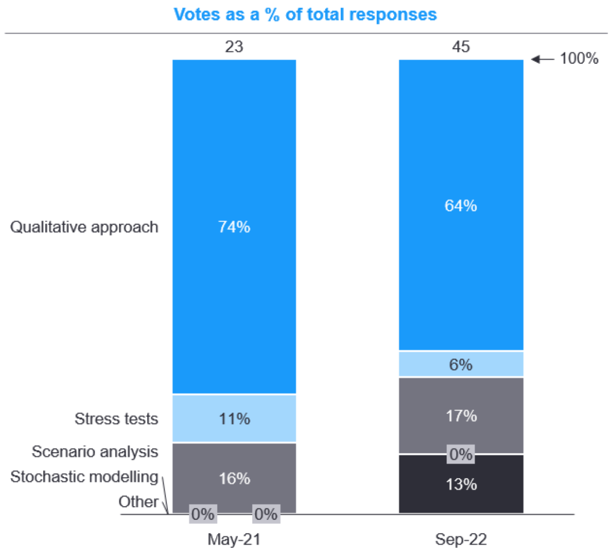
Q: Is ESG/Climate change risk of the sponsor considered when assessing covenant?

Range of approaches to assessing ESG risk in the covenant

For schemes considering ESG risk, we see continued development of approaches beyond the purely qualitative (e.g. Red-amber-green ratings), including stress tests, scenario analysis and blended approaches (using a combination) seen by 36% of respondents, up 9%pt in 2021.

ESG in the Long-Term Funding Target

There has been a pleasing development in the proportion of respondents suggesting that ESG covenant risks are *not factored into* the longer-term funding – reducing by 10%pts but still at nearly 40% of responses. Actuaries responding to the poll took a more sceptical view of the inclusion of ESG covenant risk into funding targets – something that the Covenant Committee, will be looking into further to help improve integration.



Q: How is ESG risk in the covenant assessed?

Note: Other refers to N/A and blend of approaches.

Lack of clarity is still the main challenge

Whilst there has been a significant improvement in schemes failing to consider ESG risk due to “lack of clarity over how to treat it” – reducing by 32%pts – this still remains the number one constraint with more than 1/3rd of respondents citing it. However, in 2022 budgetary constraints have now leapt into view, with more than 20% of respondents citing this as the biggest constraint – up from 3% in 2021.

Insurance transactions and ESG: Important but not a deal breaker

Finally, we asked about the emphasis on ESG and stewardship factors when considering a transfer of scheme liabilities to an insurer. On a positive note, there was a reduction from 55% to 21% in the number of respondents that ESG factors have *limited priority*, with an upswing in the percentage of those that *actively*

interrogate providers when deciding on an insurance deal. However, almost a third declared that poor performance on ESG would *not rule out* a provider and an equal portion uncertain as to whether ESG factors were a consideration.

Notes:

The first poll of SPP members was carried out in May 2021.

The second poll took place, using identical questions, in September 2022.

In both polls, the majority of recipients were covenant advisers, actuaries and professional trustees, with a smaller number of lawyers and investment / other consultants.