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Evaluating the impact of Environmental, Social and Governance risks in the Employer Covenant

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Background

The term "ESG" – standing for "Environmental, Social and Governance" considerations – is everywhere in the pensions industry in recent times.

Heightened awareness and action on the climate emergency, social issues and the Covid pandemic have all played their part in accelerating interest in areas of risk that tend to sit outside a company's balance sheet. ESG has become the catch-all term for a wide basket of risks including, but not limited to, climate change.

For trustees of defined benefit pension schemes, knowing that risks may exist that are potentially under-reflected in financials is clearly not only a potential risk to a scheme's investments, but also to its sponsor covenant.

This paper explores how trustees and practitioners should approach understanding the potential impact of ESG risks on covenant, and what to do with the insights gained.

A point of clarity: ESG and climate change

As practitioners, we have observed an unhelpful conflation of the terms 'climate change' and 'ESG'. Often, ESG is said but climate change is meant – leaving trustees feeling like they have addressed wider ESG concerns when in fact they have only considered climate change.

Climate change covers the impact of both global warming and the measures adopted to limit it. It is subject to some additional legislation for schemes, such as the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021[1]. ESG, whilst clearly including climate change risk under the "Environmental" heading, covers a much broader range of considerations.

To assist with bringing some clarity, the SPP has collaborated with the Employer Covenant Practitioners Association (ECPA) to bring separate insight to each topic. The ECPA published a paper in February 2022 exploring specifically the impact of Climate Change on the employer covenant. This paper by the SPP therefore focuses on the wider universe of ESG considerations, and whilst we will touch on climate change, readers are encouraged to seek out the ECPA paper to explore that specific area in more detail.

1 The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (legislation.gov.uk)

Key messages

> The SPP Covenant Committee considers that it is essential that trustees of UK defined benefit pension schemes and their advisers assess and monitor ESG risks in relation to the employer covenant and whether such risks have the potential to disrupt a scheme's funding journey. This is fully aligned to a trustee's fiduciary duty and in our view is supported by the current legal and regulatory framework.

> ESG risks and opportunities can impact both the employer's financial capacity (its ability to underwrite the needs of the pension scheme over time) and its sponsor longevity (the time horizon over which the employer may be required/available to underwrite the pension scheme).

> Whilst it is important to understand climate change and ESG opportunity, from a covenant perspective downside risk is a far more important consideration.

> Trustees and advisers should assess the scope of ESG risk for their scheme's sponsor proportionately. ESG factors should be evaluated within the context of the scheme's current and future need for support. A scheme moving to buy-out within five years will have very different considerations from a scheme that remains open, or one that places reliance on the sponsor long into the future. Tools exist to help refine the range of potential ESG factors to those most likely to be material to covenant, and trustees should also take into account (with appropriate critical scrutiny) any work already done in this area by the sponsor.

> Whilst ESG ratings are available for some (typically larger and/or publicly listed) sponsors, these are a useful input but not a substitute for proper understanding of the relevant risks. ESG ratings are produced for a different purpose and with a different lens to the trustee covenant lens.

What is meant by ESG?

There is no universal agreement on the categorisation of risks within the Environmental, Social and Governance areas – and indeed different sponsors are exposed to a wide range of ESG risks to a substantially varying degree. The strong focus on climate change highlighted by climate risk reporting requirements means that these considerations have arguably had more focus than the other aspects of ESG. However, sponsor longevity and financial capacity can be impacted by a much wider range of ESG risks than just climate change.

Whilst focus on ESG has increased rapidly in recent times, trustee and covenant advisers have long been aware of and focused on certain E, S or G risks for individual sponsor covenants in some circumstances. For example:

> **Environmental:** the implications of climate change and potential for emerging legislation on the value of a sponsor in a carbon intensive sector, such as oil exploration and production

> **Social:** the implications of consumer sentiment for a retail business's prospects

> **Governance:** the impact of fines and conduct penalties on the banking sector

However, it is fair to say that there is an increasing case for trustees to invest greater time and energy in identifying and considering potentially material ESG risks to the covenant, as public and stakeholder scrutiny of ESG risk continues to grow.

In this section we do not seek to define ESG, but to bring to life the types of risks that sponsors may be materially exposed to.

What is meant by ESG: examples

E = Environmental risks

Environmental risk arises from the interaction of the physical environment on the viability of the sponsor and the activities of the sponsor with the physical environment – including climate change and the actions needed to reduce it, as well as other aspects of the physical environment:

> the risk of the environment causing harm to the sponsor - with covenant risk potentially arising from e.g. associated preventative / restorative costs, insurance, disruption etc.

> the risk of the sponsor causing harm to the environment - with covenant risk potentially arising from associated preventative / restorative costs, penalties, reputational damage that may impact demand for the company's products etc

Examples of environmental risks besides climate change include:

> **impact on biodiversity and use of natural capital** – do the company's activities adversely impact on the natural environment or use up natural resources? Will this cause them to face penalties or changes in ability to act in this way in the future?

> **water usage and water scarcity** – will increasing future water stress make the company's operations more expensive or less viable over time?

> **storage, use and disposal of hazardous substances** – how exposed is the company to the risk of failure of its processes to appropriately manage hazardous substances – either in relation to its employees or wider society?

> **waste disposal, environmental pollution (particulates, micro-plastics etc), raw materials, packaging**

Some environmental risks are interconnected with climate change or can be a consequence of actions taken to mitigate carbon emissions – for example rare metal use in batteries for electric vehicles, or the interplay between eliminating plastic packaging and increasing food waste.

S = Social risks

Social risks can be defined as the risk to a company as a result of its interactions with employees, customers, supply chain partners, other stakeholders and society at large.

Social risk covers a broad spectrum which makes it potentially more challenging for trustees to form a view on. Some areas of social risk are linked to societal values, which vary both over time and between geographies.

The DWP provides a useful framework in its call for evidence on social risk[2], grouping it into three areas:

Area	Social factors / themes
Practices within a company and its supply chain	• Health and safety in supply chains • Workforce conditions • Remuneration practices • Modern slavery • Employee engagement; diversity and inclusion
Company products and selling practices	• Product quality and safety, including public health. • Selling practices and product labelling • Customer privacy and data security (Digital rights) • Consumer protection
Companies in the Community	• Management of human rights and treatment of indigenous peoples • Community engagement • Impact on local businesses • Use of local workforces

Examples of social risks:

> **Remuneration practices** – for example, does the company use zero hours contracts, self-employed versus employed labour, or have pay gaps between roles predominantly performed by different populations? These can all potentially drive the risk of future challenge or become subject to new legislation, materially shifting the sponsor's cost base and/or damaging its reputation

> **Product quality and safety** – could damage by the company's products – either to its customers or wider society – lead to penalties, reputational impact etc.?

> **Community impacts** – does the company engage in practices that adversely impact the communities it operates in? Could this lead to future change or challenge?

2 Department for Work & Pensions: Consideration of social risks and opportunities by occupational pension schemes 2021

G = Governance risks

Governance may be defined as the system by which a company is directed and controlled. The governance of UK companies is subject to the Companies Act 2006[3] which sets out the director's duty to promote the success of a company. Other types of sponsor are subject to different legislation and regulatory codes or guidance that seek to set what appropriate control and oversight looks like. For example, charities in England and Wales are principally governed by the Charities Act 2011.

Governance risk is the risk of failure of those systems of direction and control.

Examples of governance risk:

> **Corporate behaviours** – are processes and controls sufficient to ensure the company is acting with integrity / acting ethically, or to prevent practices such as fraud, collusion, bribery etc?

> **Board diversity and decision-making** – is there sufficient challenge within the corporate structure and culture to minimise poor decisions?

> **Compliance with laws and regulations** – are processes and controls sufficient for a company to comply with tax, environmental, employment and other relevant regulations?

An additional governance consideration specific to trustees in considering governance risks in the covenant is around the governance of information provision to the scheme. The Pensions Regulator explicitly links the provision of information to covenant strength[4]:

Trustees should be concerned where information they have reasonably requested is not provided by the employer… If appropriate information is not provided to allow the covenant to be assessed, the trustees should consider reducing their reliance on the covenant when setting their investment and funding strategies.

Therefore it is not unreasonable for trustees to consider this as another relevant example of governance risk to the covenant.

What is the requirement for trustees to consider ESG in the covenant?

As we see above, ESG risks are at the very least capable of crystallising within the performance and longevity of a business, and so in many cases they will be potentially relevant to covenant analysis. As part of both their general legal duties around decision making, and the specific regulatory framework for scheme funding, we consider that Trustees are under a duty to take properly considered decisions in relation to covenant matters: this means identifying and properly considering relevant risks, including ESG risks, alongside all the other all relevant factors that ought reasonably and lawfully to be considered, in order to reach an overall decision that falls within the range of 'reasonableness' in the circumstances. By contrast, choosing to exclude consideration of relevant ESG issues may create a risk of disregarding matters that are, or should be, legally relevant within the decision-making process.

How to evaluate the potential impact of ESG risks on a sponsor

Given the wide range of risks captured under the heading of ESG, knowing where to begin and whether assessment can be meaningful are both real challenges for trustees. We set out below a process to address both of these points, and in Appendix 1 set out some illustrative examples.

Many sponsors, particularly larger companies, may have an ESG rating from one of the many recognised providers in the market. The underlying information underpinning the rating is relevant and interesting to trustees where they are able to access this, but we consider that such a rating should not be a substitute for applying a specific trustee covenant lens to ESG risk. More detail on ESG ratings, their value and the limitations on their applicability to scheme covenant is covered in Appendix 2.

3 In addition, UK listed companies must comply with the UK Corporate Governance Code
4 The Pensions Regulator: Assessing and monitoring the employer covenant (August 2015)

How to evaluate the potential impact of ESG risks on a sponsor

Acute versus chronic risk

It can be useful to think of different ESG risks affecting the employer covenant – both the financial capacity of the sponsor, and its potential longevity – in two ways:

> **Acute** – a crisis that may threaten the viability of a sponsor in the short term

> **Chronic** – reduced income or increased costs reducing financial capacity in the longer term

Examples of acute and chronic risks in each area are as follows:

	Acute	Chronic
Environmental	Large scale oil spill	Increasing cost of raw materials due to climate impact on production
Social	Reputational crisis from a product failure	Increasing recruitment cost and impact of failure to attract and retain talent
Governance	Loss of a key manager	Poor decision making leading to onerous contracts

Process for identifying and evaluating relevant ESG risks:

> **Understand the scheme's covenant context**: Over what period might the scheme continue to need the sponsor to cover cash contributions and/or underwrite risk?

- Understanding and articulating this forms a helpful baseline both for trustees and in communicating with management, particularly where the scheme's endgame may be distant or not yet agreed
- For schemes moving to buy out over time, the sponsor covenant would effectively shift to that of the insurer once bought out. For the purposes of sponsor covenant assessment this terminates the exposure to the employer covenant, but trustees will need to consider the covenant and ESG risk exposure during the time before buy-out (including the risk of delay), as well as the ESG risk and approach of the insurer when moving to buy out.

> **Narrow down which risks to consider**: Assessment should focus on a manageable group of risks that are most likely or most threatening to the sponsor. It can be useful to consider risks relevant to the sector and geographies the company operates in as well as any risks specific to the company itself. Useful sources include:

- Management's view and company's own reporting
- Comparison to competitors' published information on ESG risk exposure
- News items in relation to relevant threats or challenges for the sponsor, its sector and competitors
- Sector analysis and tools such as the Sustainability Accounting Standards Board Materiality Map[5], that show areas of ESG risk most likely to be relevant in different sectors
- Public commentary and risk analysis from rating agencies, sector analysts, investment manager screening tools highlighting known risk areas, and independent data providers such as MSCI, Sustainalytics and IBIS
- Geographic climate and governance risk maps for countries the sponsor operates in, sells to or buys from

5 Exploring Materiality - SASB

- **Evaluate the key risks**: Many ESG risks are hard to quantify (or quantification may have shortcomings), so qualitative evaluation is a very useful starting point for trustees. Having identified areas of ESG risk that are more relevant to the sponsor, approaches to evaluating those risks may include:
  - Comparison to scheme needs: considering which of the risks have the potential to materially impact company profitability or viability over the potential lifespan of the scheme – particularly if the scheme continues to require cash support from the sponsor.
  - Qualitative assessment: having identified potentially relevant risks, a good starting point is to use typical risk approaches such as red-amber-green ratings for likelihood and impact to indicate risks that have the potential to impact the covenant to a sufficient degree to derail the scheme's journey plan.
  - Quantitative 'what if' analysis: some types of risk lend themselves to quantification that can be used in scenario analysis. For example, how would the annual wage bill be impacted if zero hours contracts were banned? What if the company were subject to a fine or penalty in relation to its handling of hazardous waste? What if the cost of the company's carbon emissions were to double? Scenarios can be set using hypothetical examples or historical precedent – for example, risks crystallising on other companies in the same sector.
  - Consider management's assessment of risks: It can be very helpful to trustees if management shares its own assessment of key ESG risk areas, but trustees should apply an appropriate level of critical scrutiny to any analysis provided.
- **Take sponsor input if possible**: It is important to seek to understand what steps the company has taken to identify its own most significant risks and manage these. This would include views on financial resources and, for example, understanding how much cost increases may be passed on to customers to defray the impact of emerging risks. In some cases, current or forthcoming legislation or voluntary commitments may mean that the company is required to assess and monitor its own ESG risk, opportunities and impacts. However, it is important that trustees apply an appropriate degree of critical scrutiny to management's assumptions. It is also important to seek management input into risks highlighted by the trustees' own analysis.
- **Understand how risks or opportunities may crystallise**: It is important to establish how the risk crystallising would impact on the business. Will it create a one-off cost or cash outflow (e.g. a fine or penalty, clean-up costs), a major reduction in revenues (e.g. a reputational event that puts customers off), increase costs over time (e.g. price of raw materials, workforce costs) or some other or combined impact? Will these happen gradually or suddenly?
  - Acute risks can be considered in light of the company's wider financial resources – does it have the access to capital, or ability to flex its cost base, that could help it withstand a one-off event?
  - Chronic risks can be understood through scenario modelling or sensitivities to understand how the company may be affected over time
- **Consider mitigations, protections and opportunities**: Trustees should consider what protections and mitigations may be in place to manage the impact of identified risks, for example, insurance cover, preventative action plans etc. In relation to ESG opportunities, in line with wider TPR guidance, trustees should place more limited covenant reliance on upsides unless they are evidenced and it is clear how they would benefit the scheme.
- **Compare back to scheme needs**: Ensure that potential risks are being considered in the context of the scheme's covenant exposure. Do the potential risks, once mitigating factors are taken into account, cause a misalignment between the scheme's covenant needs, and the potential resources of the sponsor over time?

What to do with the learnings?

The core purpose of understanding ESG risks in the employer covenant is to support trustee decision making. Having considered ESG risks in the context of the sponsor covenant, it is then important to establish what to do with that information. Trustees will need to think about:

> **Triennial valuation and investment strategy**: do the risks identified suggest a change in approach to the scheme funding valuation or investment strategy?
>
> - ESG factors may impact (or impact the uncertainty around) the overall covenant rating given to the sponsor(s) or highlight specific risks for the trustees to be aware of, leading to a change in the level of prudence in the valuation and/or impact the length of any recovery plan.
> - Material uncertainties could highlight the need to seek covenant enhancement, such as security or a guarantee from another group company.
> - Setting an investment strategy which has a different ESG risk composition as the covenant would help diversify and lower the total ESG risk borne by a scheme

> **Long-term funding target (LTFT)**: It will be important to consider whether the LTFT is appropriate to the covenant horizon. For example, if this analysis suggests that there are material risks that limit the potential reliance on the covenant in the longer-term it may be appropriate to shorten the time to reach the LTFT and/or set a more prudent LTFT.

> **Additional monitoring**: Potentially material ESG risks should be incorporated into the trustees' covenant and/or integrated risk management monitoring. Some examples could be:
>
> - Given the importance of financial resilience to manage the impact of acute risk, ensure adequate monitoring and relevant triggers in relation to the sponsor's financial resilience, including access to funding and liquidity sources
> - Monitoring sponsor progress in respect of mitigating steps being developed to manage specific risks (e.g. development of replacement products, reduction in high risk contracts etc) or mitigating factors management is relying upon (insurance cover)
> - Tracking developments in factors that may impact the likelihood of the risk crystallising (emerging legislation, exposure to certain markets or geographies)
> - Monitoring third party ESG assessments of the sponsor (see Appendix 2)

> **Contingency planning**: Some trustees may wish to consider introducing (or strengthening) contingency planning to cover certain risks materialising. This could include:
>
> - Seeking additional covenant support from elsewhere in a group (for example seeking guarantees from areas of a business less exposed to the most material risks to the sponsor – for example, operating in different business areas or with a different customer base)
> - Introducing contingent actions, like contingent contributions, where the trigger is related to ESG risks materialising (or introducing additional triggers on existing contingent actions). For example, failure to meet a specified ESG target relating to a risk material to the scheme covenant, such as progress on net zero milestones.

In all cases trustees will need to be proportionate, considering both the size of the scheme relative to the size of the sponsor, level of reliance on the covenant, and availability of information. This might mean that the focus for some schemes, as mentioned above, is more qualitative with actions focused on holding discussions with management, documenting those discussions, and holding management to account rather than complex and detailed contingency plans.

APPENDIX 1: Illustrative examples

Introduction

In this appendix, we have set out three illustrative examples of ESG factors having an impact on an assessment of Employer Covenant. The examples are fictitious – but designed to illustrate how "real world" issues may have a bearing on a sponsor's ability to support a scheme.

Example 1 – Environmental

A one-off but sizeable Environmental issue – but with the business model remaining intact.

XYZ PLC stores hazardous substances as part of its production. It has been widely reported that a major leak at one of its facilities had resulted in significant environmental damage and negative publicity. Management have assured the markets that this was a "one off" incident caused by a freak event and will not recur. Discussions are ongoing with insurers.

XYZ sponsors a substantial closed DB scheme with a material deficit. The actuarial valuation is ongoing.

Covenant considerations include:

1. What will be the cash flow impact of the clean-up costs?
2. What would be the impact of the incident not being met by insurance?
3. What consequential loss claims might arise from the incident?
4. What other legal sanctions may be imposed upon XYZ PLC and its directors?
5. What bearing might the incident have on debt and equity provider appetite to lend / invest?
6. Could there be a lending covenant breach?
7. How will demand for XYZ's products be influenced by the publicity surrounding the leak?
8. What is the risk of recurrence? (Management says it was a freak event, but what are others saying?)

Example 2 – Social

A Social issue affecting market competitiveness – such as a people-intensive business not being prepared to offer flexible working.

LMN LLP is a well-established partnership providing specialist professional services. Its leadership team has been slow to respond to staff demands for flexible working and has adamantly maintained a culture of "needing to be in the office". Market reports and gossip suggest that the business is losing key professionals – and is struggling to recruit.

LMN sponsors a closed DB scheme for its staff.

Covenant considerations include:

1. What is the impact on LMN's client service levels as a result of losing staff? Are clients leaving?
2. What might the impact on LMN's market positioning and ability to attract new clients and work?
3. How are management looking to address the issue?
4. Will Partners themselves look to move to other firms?
5. Are staff shortages leading to an increase in negligence or other claims?
6. Will LMN need to meet significantly extra pay and other costs to attract new staff? If so, what might the impact on profitability and cash flow be?

Example 3 - Governance

An endemic Governance issue within a sponsor – such as extensive reports of poor corporate governance practices notwithstanding "stellar" financial performance.

ABC Limited was until recently a modestly performing engineering group. Following a purchase by private equity and a pivot of the business, it now operates in a specialist technology area and has experienced remarkable growth under the leadership of its CEO who is known to be driven principally by growth "at almost any cost". Leaked statements to industry press describe a range of governance aspects in the company as "a shambles" – with numerous customer complaints about appalling service and follow-up; and a culture of staff bullying to deliver sales.

The CEO reportedly considers ABC's DB scheme as a "legacy problem" which he sees as "offering no value".

Covenant considerations include:

1. How confident can the covenant adviser be in the accuracy and quality of the information received?
2. How sustainable is the business model? How capable is the technology of replication – and therefore a competitor offering a superior service model and damaging ABC's business?
3. What will happen to ABC's business if it loses key staff?
4. How susceptible to litigation is ABC – from customers and staff? What might the impact be?
5. Will ABC be able to attract further investment and / or borrowing facilities?
6. What would the impact be of the CEO leaving (positive and negative)?
7. Is there likely to be sufficient challenge at board level from other directors?
8. How will all of the above considerations impact forecasts and sensitivities?
9. What might be the impact of the CEO's attitude towards the DB scheme on the approach to funding and covenant support?

APPENDIX 2: Use and value of external ESG ratings

ESG ratings by professional rating agencies have emerged as key indicators in evaluating the financial performance of companies, alongside the risks and opportunities they are faced with and their impact on the external environment.

ESG ratings are predominantly used in the context of investing, in particular in the construction of portfolios and understanding long-term risk-return profiles. Other stakeholders also take them into account, such as lenders assessing their exposures, determining eligibility for borrowing, and launching new sustainability-linked products.

Given they may provide a forward-looking opinion on a company's preparedness for dealing with ESG risks and opportunities, ESG ratings, where available, should be considered as part of any sponsor covenant assessment. However, at present they should be treated cautiously. We summarise here some of the key features and limitations.

There are a number of different ESG rating providers and each have their own objective, emphasis (for example, financial versus ethical) and methodology for determining an ESG rating. Some provide a 'letter-grade' akin to credit ratings, whereas others categorise companies into different risk severity buckets, for example from negligible to severe.

For all providers, data is understandably a key input in the process. Sound data quality is crucial in achieving reliable and comparable ESG scores as it enables investors and other market participants to better assess and model risks and opportunities. Providers typically obtain macro-level data at sector or geographic level and company data from a variety of sources including company financial and sustainability disclosures, specialised government and academic data sets, NGOs and self-reported corporate data. AI is also commonly used to monitor media sources. These data sets are continuously monitored and reviewed to detect any significant changes that may trigger re-rating.

However, the significant disparities in sustainability disclosures between companies due to voluntary reporting and lack of overarching standards creates three major problems on corporate disclosure which distorts data quality: opacity, subjectivity, and inconsistency. This poses a serious risk to the relevance of ESG reporting, and the threat of greenwashing can come into each pillar of ESG. The combination of shareholder and public pressure with major reporting and disclosure initiatives such as the Taskforce of Climate Related Financial Disclosure (TCFD), Global Reporting Initiative (GRI), and Carbon Disclosure Project (CDP) shows increasing efforts to resolve the data quality issue.

The process of achieving an ESG score can vary depending on the rating agency. For example, MSCI's ESG ratings are determined based on industry specific issues and are intended to be used to assess relative performance within a sector, whereas Morningstar's ESG ratings are an absolute risk assessment, meaning the output is intended to be comparable across sectors and non-peer groups. Typically, there are three steps of calculation: scope, measurement, and aggregation through weights. In other words, the rating agencies identify sub-risks and opportunities, and assign a weight depending on the level of contribution to environmental or social impact and the expected time frame for the issue to materialise, to calculate the overall ESG score. Some rating companies do this by having both risk exposure and management metrics for each risk or opportunity to determine the severity of the risks faced by corporates and how they manage the risks. Risk management metrics also include one-off risks, such as controversies. The level of involvement and management of these events can be used to indicate the adequacy of a company's corporate governance, alongside the typical evaluation of a company's leadership, audits, internal controls, executive pay and shareholder rights.

How useful are they?

ESG ratings are directionally helpful. As many trustees and advisors are now aware, the historical view that investing in line with environmental and social values provides no financial benefit and thus comes at a direct cost to profit or future cashflow is being increasingly challenged. There is now empirical research showing positive correlation between ESG performance and superior financial performance[6]. Firms that perform well on 'material' ESG criteria have been shown to outperform companies who performed poorly, and at the very least do not underperform rivals with weaker ESG characteristics. Therefore a summary rating of a sponsor's ESG characteristics can be helpful to frame or support a view of its long-term prospects.

The pandemic has shone a light on ESG practices of firms, in particular how they reacted to significant market shocks and how they have managed their staff and customer relationships with significant legal and operational restrictions on standard practices.

In contrast to credit ratings, which assess the likelihood of a company to repay its debt, ESG ratings are more focussed on long-term resilience factors and sustainability, which arguably aligns better with many pension schemes' time horizons.

6 Responsible investing: New evidence, new energy - Royal London for advisers

Evidence in recent years[7] has suggested that ESG ratings provide additional information relevant to the identification of risk that was not fully captured by credit factors including credit ratings. Studies found ESG ratings had characteristics distinct from credit ratings and delivered additional insights into risk and performance. Whilst some of the divergence in performance may relate to the significant influx of investor capital into ESG-focussed funds, it nonetheless highlights the financial materiality of ESG ratings on sponsors.

Consideration of ESG metrics by sponsors also helps to mitigate downside risk since ESG, above all, is a risk management strategy. Furthermore, stricter regulation is quickly becoming one of the major reasons for ESG considerations, for example, the enforcement of TCFD for pension schemes demonstrates the speed at which successive regulations are being rolled out. Sustained pressure from shareholders and activist organisations pushes ESG matters further into board room discussions. Failing to manage or measure the ESG attributes runs the risk of losing out on a growing market, new customers, and causing reputational damage to the firm. Hence, ESG ratings provide incentives to improve corporate governance and management of environmental and social risks.

An over-reliance by investment managers on taking third-party ESG ratings at face value can be viewed in a negative light, and a similar concept should apply for covenant assessments. The lack of a global ESG reporting standard, due to different assessment approaches and metrics being required for different industries, creates opportunities for corporations to present a distorted reality that does not reflect the relevant picture for trustees of the level of potential ESG risk they may be exposed to. This creates a ripple effect on ESG ratings. If the company-level data is greenwashed, its ESG rating can be inflated overall as additional bias is added by the rating agency. Similarly, if the level/quality of a company's disclosure fails to match its positive ESG credentials it could be rated harshly, albeit disclosure is commonly used a governance quality indicator. As mentioned earlier, data quality should see significant improvement in the coming years. Whilst ratings are available on thousands of companies globally, many sponsors will still not have an ESG rating.

Layered on top of reporting considerations is the fact that certain agencies might give different ratings to the same companies due to different rating methodologies and use of underlying metrics. Unlike credit ratings, which are highly correlated across the different providers, there is very little correlation in ESG ratings (comfortably under 50% across the main providers).

Example: A high profile example of a company being rated differently by different ratings providers is Tesla. MSCI rates Tesla above average when it comes to ESG and refers to it as an ESG leader on corporate governance and behaviour. However, others believe it has various governance and social concerns, with FTSE and S&P rating it poorly compared to the wider automobile industry. Sustainalytics gives it a middling rating, highlighting the range of potential views on a single company.

The key takeaway is that ESG ratings are useful tools but not a replacement for in depth company analysis and understanding applying a covenant-specific lens.

How should ESG ratings be used?

Trustees and practitioners should be aware of the benefits of ESG ratings in providing additional insights into a sponsor's ESG risks and opportunities. Due to the sheer range of areas that are condensed into a single rating grade, and the lack of consistency in ratings across providers, it is vital that practitioners understand the underlying drivers of a sponsor's rating and how it fits in with their own views on a sponsor's strengths and weaknesses. Where possible it is beneficial to consider scores from multiple providers to obtain a range of viewpoints.

There should be an awareness of the individual characteristics of the associated pension scheme, for example the time horizon for reliance on the sponsor, when considering ESG ratings in the context of a covenant review. Clearly some ESG risks may not manifest, some will but over an unknown timeframe, while other risks/opportunities provide understanding of management approaches and the journey a company is on. Having a good awareness of the methodology of the rating providers, and what the underlying drivers of the rating are, will allow better understanding of concerns related to the sector the sponsor is a part of and to what extent individual management decisions are addressing the issues of the sponsor and their sector. ESG ratings are predominantly used by investors as part of the investment decision-making process. Whilst the investor perspective aligns with the covenant view in some respects, there should be an awareness of when trustee and shareholder views may differ.

Having access to and understanding of a sponsor's ESG rating can complement other analysis being carried out by practitioners. They can also be a very useful tool in shaping conversations with the sponsor's management team and for getting access to further data and insights. This can be particularly relevant in large multi-national firms with separate finance, sustainability and pensions teams, where the trustees' typical contacts may not have a deep understanding of the ESG matters related to the firm.

7 https://www.msci.com/www/blog-posts/what-esg-ratings-tell-us-about/02186445118

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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.

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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.

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