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Environmental, social and governance investing: A guide for trustees

Sustainable Finance and Responsible Investment

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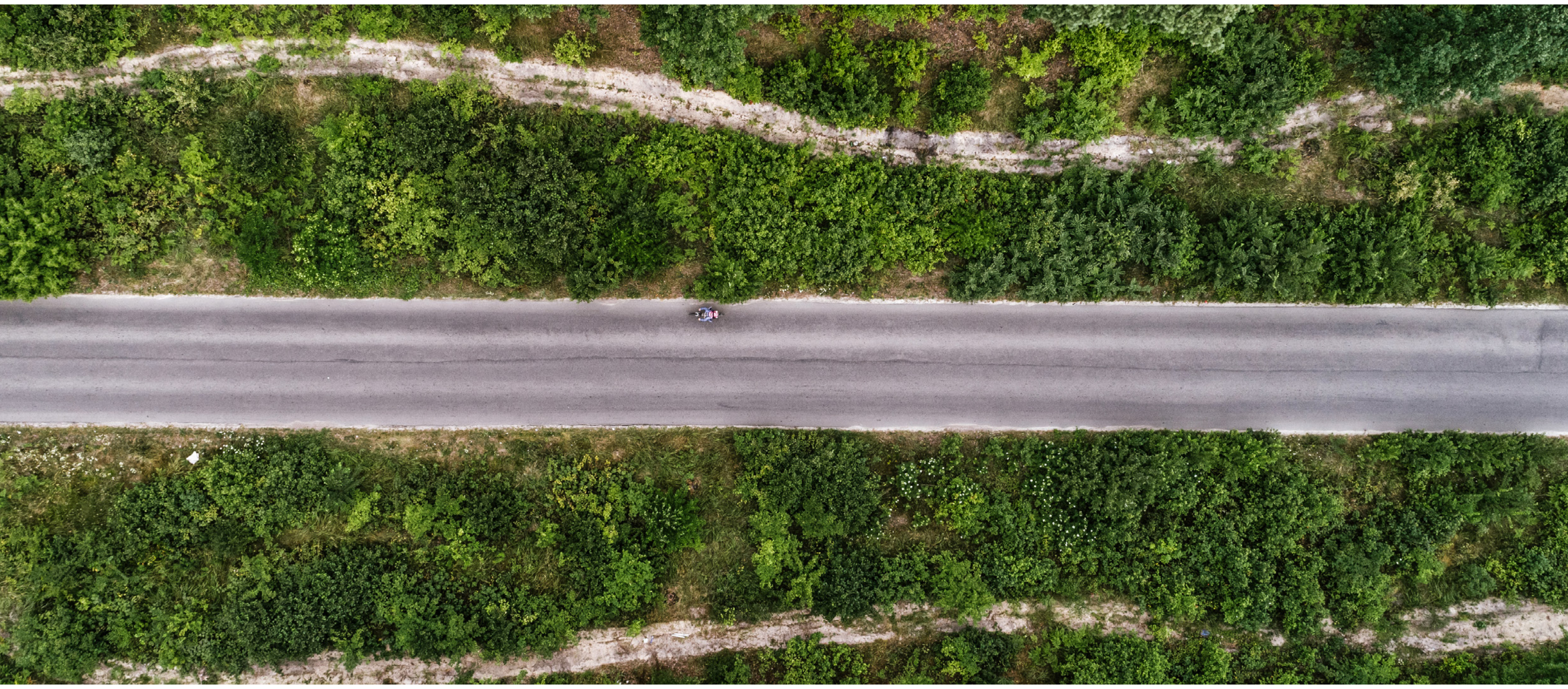
Introduction and history

Welcome to our environmental, social and governance (ESG) investment guide for pension scheme trustees. In recent years, ESG and climate change have become increasingly important issues, both in the UK and globally. With roughly £2.5 trillion in assets, pension schemes are some of the most important players in the investment world. As the prominence of ESG increases, from a cultural, legislative and regulatory perspective, it is important that trustees have regard to the impact ESG has on their legal duties when considering investment issues.

Trustees of pension schemes will be required to consider their investments in the context of ESG factors and set out their policies on stewardship. Trustees of most Defined Contribution (DC) schemes will be subject to further reporting and disclosure obligations.

However, despite this recent interest, ESG is not a new thing. Trustees have since 1 December 2005 been required to record "*the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments*" in their statement of investment principles (SIP). Rather, more recent developments are only a step in a continuing evolution.



The development of ESG in pensions

Cowan v Scargill – 1985
High Court decides that trustees of pension schemes are required to act in the best financial interests of beneficiaries and can only take into account non-financial factors in limited circumstances.

Introduction of SIPs – 1997
The Pensions Act 1995 introduces a requirement for UK occupational pension schemes to have a statement of investment principles.

Investment Regulations – 2005
Trustees required to include a statement in the scheme's SIP regarding the extent to which ESG factors are taken into account.

Kay Review – 2012
Recommended that the Law Commission investigate how the concept of fiduciary duty related to investment.

Law Commission Report on the Fiduciary Duties of Investment Intermediaries – 2014
Discussed how far trustees can take account of non-financial factors such as social and environmental impact when making investment decisions.

Pensions Regulator (TPR) Investment Guidance – March 2017
New guidance for trustees on DB investment, restated the Law Commission's guidance on distinction between financial and non-financial factors.

Law Commission Report – June 2017
Confirmed importance of ESG considerations and recommended greater member engagement where ESG factors are concerned.

DWP Consultation – June 2018
The consultation proposed to "*Clarify and strengthen*" trustees' investment duties and modify the current regulations.

Response to DWP consultation and amended regulations – September 2018
Reflected increasing prominence of ESG factors and included new legal obligations on trustees when making investment decisions and a requirement to report on their policy for how to take into account financially material considerations (including ESG), as well as non-financial matters.

Further amending regulations – June 2019
Revised and extended requirements about including information on voting, shareholder engagement and monitoring in the SIP and, for a DB scheme, the inclusion of its SIP and certain information from the annual report on a publicly available website.

What is ESG investment?

ESG investment means taking account of environmental, social and governance factors when making investment decisions – particularly in relation to the ESG issues that can have an impact on the value of investments held by trustees. This can often be confused with other investment terms such as "*sustainable*" or "*ethical*" investment, and there is certainly some overlap. However, they are not necessarily the same thing. There can also be confusion between the way the term is used in the wider investment world and in the pensions sphere.

ESG considerations can include a wide range of factors, but some examples of these are:

Environmental

— Clean water
— Climate change
— Renewable energy

Social

— Child labour
— Gender equality
— Health and safety

Governance

— Board diversity and accountability
— Executive compensation
— Transparent accounting and disclosure

How do these impact on trustees' investment decisions? For example, the future clean up costs of an oil company's drilling may be financially material, but might be offset by that company's investment in renewable energy.

Trustees should exercise their investment power for a proper purpose – which generally means to provide the benefits promised by the scheme (or, in the case of a DC scheme, provide sufficient capital at retirement to fund the members' retirement). To the extent that a factor (be it ESG related or not) is financially material, trustees should consider that factor when exercising the investment power. This is different to "*impact investing*" or "*socially responsible/ethical investing*", when the ethical impact is more important than the financial returns (i.e. the investor is willing to trade off a significant financial return in favour of the ethical return).

Impact investment is a more difficult area for pension scheme trustees given their investment duties. However, TPR recognises that "*Trustees can choose to actively take account of impact considerations in making an investment decision where they have good reason to think members share their view and there is no risk of significant financial detriment to the fund.*" TPR goes on to make it clear that trustees "*should not choose impact investments where there is a risk of significant financial detriment to the fund.*"

Changing law! Revised SIP requirements

Most pension scheme trustees are already required to include information on the extent (if at all) to which social, environmental or ethical considerations are taken into account in their investment decisions in their SIP. However, reflecting increasing levels of interest in ESG investment, the government has put in place regulations which greatly expand the requirements.

From:

- **1 October 2019**, pension scheme trustees will need to include additional information in their scheme's SIP (including on policies relating to ESG factors and stewardship).
- **1 October 2020**, trustees must further update their SIP to set out how they interact with asset managers and publish it on a publicly available website.
- **1 October 2021**, an implementation statement setting out their engagement and voting behaviour from the annual scheme report must be published on a publicly available website.

Additional requirements will apply to trustees of most DC schemes. A more detailed summary is set out below.

From 1 October 2019:

Trustees' SIPs will need to include their policies on the following:

- **Financially material considerations** over the **appropriate time horizon** of the investments and how they are taken into account in investment decisions. Financially material considerations explicitly include, but are not limited to, ESG issues (including climate change) which the trustees consider to be financially material. In other words, anything that trustees think will have a meaningful financial impact on their investment performance, but given the way the legislation is worded, the trustees' policy on this will need to include ESG factors.

  The appropriate time horizon means the length of time needed to fund future benefits from the scheme. This was included in the regulations to ensure that trustees' policies took into account the long-term nature of pensions investments in making their decisions, which is likely to tie into ESG considerations; for example, how a company's governance or the impact of climate change might affect long-term investment performance. Taking the oil company example given above, a scheme that is likely to buy out and wind up in the next five years may be less concerned with that company's longer term oil field decommissioning costs than a scheme that is still open to accrual.

- The extent to which **non-financial matters** are considered in investment decisions (if at all). The regulations define non-financial matters as the views of the scheme's members and beneficiaries, including their views in relation to social and environmental impact and their future quality of life.

  It can be difficult to establish the views of a scheme's members and there is always the danger that any views expressed to trustees are just those of a noisy minority. Trustees will therefore need to tread carefully when deciding on their policy in this area. They should consider whether and how they can engage with members in this area and be prepared to justify their decision if questioned on it. They should also keep in mind that the legislation does not require them to take members' views into account (and in the government's response to consultation it was made clear that trustees have no obligation to take into account members' views).

— **Engagement** with investment managers or companies they have invested in and other stakeholders on matters such as performance, strategy, risks, corporate governance, social and environmental impact and the investment managers' alignment with the trustees' policies. Trustees are already required to set out their policy on how they exercise voting rights attaching to their investments, but this will require them to have a more in depth policy in place.

Trustees will also need to update subsequent annual reports with the above policies from their SIP.

From 1 October 2020:

Trustees will need to add their policies on the following issues to their SIPs:

— Their **arrangements with asset managers**, setting out information on how the arrangements incentivise the asset managers to align their investment strategies with the trustees' policies and make decisions based on assessment of medium to long-term financial and non-financial performance of investees and to engage with those investees to improve their performance.

— How the **method and time horizon for evaluating** asset managers' performance and remuneration are in line with the trustees' policies.

— How they **monitor portfolio turnover costs** (the costs of buying, selling, lending or borrowing investments) incurred by the asset manager.

— The **duration** of arrangements with asset managers.

— Trustees' policies on engagement will also need to be extended to include matters concerning capital structure and the management of conflicts of interest and engagement with other stakeholders.

Trustees of **DB schemes** will additionally need to publish their SIP on a publicly available website.

Trustees will need to update subsequent annual reports to include the above changes to the policies in their SIP.

From 1 October 2021:

Trustees of **DB schemes** will need to publish an implementation statement on a publicly available website, containing information from their annual report on how the engagement policy in their SIP has been followed and a description of their voting behaviour during the year.

DC Schemes – additional requirements

A lot of focus is put on what trustees of DB schemes must do, but the same requirements will also apply to most DC schemes (including hybrid schemes that have more than just AVCs), along with the following additional obligations:

From 1 October 2019:

— Trustees of DC schemes will be required to publish their updated SIP online, ensuring it is publicly available and accessible free of charge. Members must be made aware of its availability in the scheme's annual benefit statement.

— Trustees of most DC schemes are already required to publish a statement of the investment principles for their scheme's default fund in addition to their scheme-wide SIP. Going forward, they will also need to include their policies on how they exercise voting rights under their investments and on engagement with their investment managers and companies the default fund is invested in.

From 1 October 2020:

— Trustees of DC schemes will be required to confirm in their annual report how the principles set out in the SIP in the previous year have been implemented through an implementation statement. This will need to contain information on how the SIP has been followed, any review of the SIP and any change to the SIP. As with the SIP itself, this implementation statement will need to be made available online.

From 1 October 2021:

— Trustees will need to update their implementation statement to include information on how they have implemented their expanded engagement policies (in relation to capital structure, actual and potential conflicts of interest and other stakeholders) and on their voting behaviour during the year.

The top five questions trustees should ask their investment managers

1. Do you integrate ESG into your investment process?
   ESG integration is not yet required but many investment managers already do it. Often this is not clear on the face of fund documents, so many funds which appear not to have an ESG focus will in fact have ESG risks factored into the investment process. This may or may not be sufficient for the trustees and should be explored. Ask your investment managers if they integrate ESG into their risk monitoring, how they integrate it, and what the limits are. If an ESG risk is flagged for an investment manager, is it acted upon? Or is it simply noted and built into the risk measure? How important is the integration in the actual investment process?

2. What is your ESG policy?
   Although you can expect the biggest investment managers to have well developed ESG policies, it is imperative that you understand the focus of each policy and ensure it aligns with your own in all material respects. Some smaller investment managers are still developing their own policies and here it is important that you can verify that your own ESG requirements can be met.

   How investment managers approach ESG can vary immensely and similar language can be used to mean very different things. Understanding their policy and how it is implemented - across both integration and active ESG investment - is crucial.

3. How do you measure your ESG investments?
   ESG measurements are developing rapidly but still vary in consistency, breadth of coverage and attributes considered for measurement. For example, a fund focussing on governance aspects of ESG may seem to rank fairly low on an ESG index if that index gives more weight to environmental factors. It is crucial to consider how a particular fund is using ESG and whether the measures used accurately reflect what that fund is doing. As the development of ESG indices and other measures remains in relative infancy, obtaining this information from the investment manager is likely to be more focussed and accurate than looking at wider publicly available rankings and measures.

4. Are there any derogations from your ESG policy that we should be aware of?
   If the ESG policy is not explicit about derogations, this should be explored with your investment managers. As ESG continues rapidly to develop, there are many ways in which it can be implemented and, depending on the strategy of the fund, many possible derogations. For example, may a fund invest a particular amount in *"sin stocks"*? May a fund invest in a company if only a small percentage of that company's output would fall foul of their ESG restriction? Can a fund invest in companies that currently don't have a good ESG track record with the intention of impact investing? How much discretion does the investment manager have to move away from the policy? Must current stocks be sold if they no longer meet the criteria?

5. Are you able to integrate our own ESG requirements if these differ from your own?
   As investment managers and trustees (and other institutional investors) develop their own ESG policies and purposes, it will be important to understand whether these are sufficiently aligned to ensure your own requirements will be met. One difficulty faced by investment managers is the myriad ESG needs of different investors. Ensuring that each of these can be catered for, while maintaining their own policies and managing to create a level of consistency across ESG processes, is a challenge for them. It is impossible to be everything to everyone in this area given the wide range of ESG values. Trustees should satisfy themselves that, if there are any areas of inconsistency, these are not material or can be discussed with the investment manager.

What do trustees need to do?

The new legal requirements make clear that ESG factors will play an increasingly important role in trustee decision making and trustees need to prepare for the changes discussed above.

Before **1 October 2019**, trustees should:

— Discuss with their advisers and investment managers to understand how the new requirements will apply to their scheme and the main steps needed to ensure compliance.

— Review their scheme's current SIP and discuss what changes are required with their advisers.

— Obtain investment advice on any proposed changes.

— Consult with their scheme's employers on any proposed changes.

— Update their SIP to set out the trustees' policies on financially material considerations, stewardship and non-financial matters.

— Prepare a policy on engagement activities for inclusion in the SIP (and any SIP relating to a DC default fund).

— Make sure that systems are in place to comply with the additional disclosure obligations, notably including the requirement to make a DC scheme's SIP publicly available, free of charge on a website.

Before **1 October 2020**, trustees should:

— Review the SIP again to include the further information required.

— Review and further update the trustees' policy on engagement activities to ensure that the SIP for a DB scheme is made available free of charge on a public website.

— Have an implementation statement for their DC scheme setting out how the principles contained in the scheme SIP have been implemented in the previous year and make that statement available on a public website free of charge.

From **1 October 2021**, trustees of DB schemes will need to provide an implementation statement on a public website, free of charge. Trustees of DC schemes will need to include additional infornation in their implementation statement.

What's next in ESG?

The Government has updated the legislation on pension scheme investments to reflect the growing importance of ESG issues. However, this is not the end point, but rather part of an ongoing journey and pension scheme trustees will need to be aware of future ESG developments and take them into account in their decision making. There are a few key, upcoming developments that trustees should keep an eye out for:

TPR guidance

TPR has published guidance on how pension scheme trustees can and should take into account ESG investment. This will hopefully provide trustees with some additional clarity on what they should be doing and will need to be carefully considered by them. TPR is likely to publish refinements to this guidance which trustees will need to consider, "and at the time of writing was in the process of consulting on how trustess should set objectives for their investment consultancy providers (which trustees will need to have done before 10 December 2019)."

Increased external scrutiny

Pension scheme trustees with particularly large schemes, or schemes sponsored by prominent employers, are likely to face increased scrutiny of their investment decisions. The requirement to publish the SIP and provide details of voting behaviour will increase this scrutiny. Charity organisations such as Client Earth have written to some schemes challenging them on their investment strategies. Similarly, it is possible that the Work and Pensions Select Committee, as part of its increasing activity in the pensions sphere, may investigate schemes' investment behaviour.

While pension scheme trustees will, of course, need to comply with their legal obligations in relation to ESG, they will also have to be conscious of the potential reputational risk if their answers do not satisfy enquiries from organisations like these.

FRC Stewardship Code

The Financial Reporting Council has a stewardship code, which sets out expectations for how investors should engage with the companies they invest in. The FRC has consulted on a new code, which will reflect the developments in thinking since the last update in 2012, including in relation to ESG. The proposed new code is more onerous than the existing version. When the new code is put in place, pension scheme trustees will need to be aware of it as it will impact on how they are expected to behave when making investment decisions. While the code is voluntary, TPR has indicated that it "*would like*" trustees to adhere to it, "*with a view to improving long-term returns and reducing the risk of poor outcomes due to poor strategic decisions.*"

Investment decisions based on non-financial factors such as the environment or social impact

Trustees need to remember that they are under a duty to use their investment powers for their proper purpose. For example, in a DB scheme, that means exercising them to make sure that benefits are paid in full, or, in the default fund of a DC scheme, making sure that a member has as large a pot of money as possible to retire on. It would be very easy for non-financial factors to interfere with that and so there are limited circumstances in which trustees can make investment decisions based on non-financial factors.

In its 2014 report on pension funds and social investment, the Law Commission set out the circumstances under which it thought the law allowed trustees to take into account non-financial factors, but trustees need to take care when applying this to their own investment decisions because of the risks of an unexpected impact on their investments' performance.

Is there good reason to think scheme members share the trustees' concerns about the non-financial factors?

No

Trustees should not take such non-financial factors into account.

Yes

Does taking into account the non-financial factors pose a risk of significant financial detriment to the scheme?

Yes

Trustees should not take such non-financial factors into account.

No

Trustees may take such non-financial factors into account.

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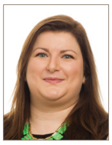

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