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A Research Report by Daniela Silcock

Published by the Pensions Policy Institute
© October 2018
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Foreword

Environmental. Social. Governance. Three words brought together to describe an approach to investing that is meant to be more responsible. But responsible to whom or to what? What are pension schemes’ duties and how should they react, if at all, to a growing body of evidence that ESG factors are financially material to asset class performance?

It can sometimes feel that there are more questions than answers when it comes to ESG, which is why Redington sponsored the Pensions Policy Institute to produce this report. What we found was that although further debate will be needed within individual governance bodies around what ESG means to them – in the same way that broader investment strategy needs to reflect the context and beliefs of a particular pension scheme – it can no longer be ignored.

This is in part due to the government clarifying and strengthening the requirements on trustees to consider ESG factors. These new regulations, which were laid whilst PPI were conducting their research, impose a number of new responsibilities on trustees, including:

- From 2019, to articulate in the statement of investment principles (SIP) how they take account of financial considerations that arise from ESG factors, including climate change; and,
- From 2020, for DC schemes to publicly report how they acted on the principles in their SIP.

But that is not the whole story.

In Europe, legislation is moving quickly and further regulations may be brought out that would require explicit disclosure to investors on how climate risk, in particular, is managed. A lack of ESG consideration within the UK could put pension schemes (and other investors) at a disadvantage if it results in UK investors being exposed to greater risk than our European counterparts.

Within chapter 3 of the report, we profile a number of pioneering pension schemes - including the Pooled Local Government Pension Schemes, HSBC, Heineken and People’s Pension – who are already acting and
paving the way for others to follow. Climate change is not the only focus. We have seen a move towards considering wider social and governance factors too. This is a significant step forward and the case studies show the possibilities open to pension schemes.

Whilst there remain barriers to ESG integration, more and more pension schemes are rising to the challenge and either have, or are in the process of, implementing strategies that structure their investment portfolio to take advantage of the opportunities as we move towards a carbon-neutral environment.

This surge in interest is encouraging asset managers to start to develop products that are accessible to all sizes of pension scheme and to broaden the range of asset classes that can be structured to take account of the ESG factors.

The changes in attitude and action over the last year towards ESG is exciting and evolving at pace. We look forward to seeing further innovation to encourage and create more sustainable investments for pension scheme members, now and in the future.

Redington is delighted to have partnered with the Pensions Policy Institute in sponsoring this important piece of research. We hope that you find the content and conclusions in this report valuable and informative.

Lydia Fearn
Head of DC and Financial Well-being, Redington
ESG: past, present and future

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Executive Summary

The world is changing, and approaches to investment are changing alongside it. The potential future economic consequences of global trends such as climate change, social movements, and increased regulation are becoming clearer to many investors. However, there is a lack of consensus regarding the financial implications of these factors for investors.

The Government has laid regulations which strengthen the obligation on pension scheme trustees to consider ESG factors in investment decisions. The FCA currently plan to consult on corresponding requirements for workplace personal pensions in the first quarter of 2019. Pension schemes who do not start to integrate ESG consideration into their investment strategy could face legal difficulties as a result of not complying with regulations, higher admin and legal costs, and potentially reduced returns in the future as a result of not taking financially material risks into account.

Pension schemes who do not integrate ESG consideration into their investment strategy could face legal difficulties, higher compliance costs and potentially reduced returns in the future.

However, there are barriers to ESG integration. There is a lack of consensus regarding how to define and implement ESG considerations. Smaller schemes in particular may not have the resources to bring control of their detailed investment strategy in-house and are generally dependent on third party investment managers who may not believe that ESG factors are important to consider. Some investment managers have developed, or are developing, off the shelf products which could be used by small schemes.
Not all asset managers offer investment funds which integrate consideration of ESG factors. If consideration of ESG factors was built into asset manager benchmarking, there may be more motivation to consider these. If more products that involve ESG consideration were available to small schemes, they would find it easier to invest in companies with better ESG credentials. However, funds which involve engagement with companies about ESG may cost more than funds which passively track indices without engagement.

There is confusion among Trustees and IGCs as to the definition of ESG, and the assessment and integration of ESG factors in investing is not straightforward. Trustees and IGCs would benefit from more concrete guidance and support. Smaller schemes may also need more support around consolidation of assets and/or investment administration, in order to make consideration of ESG factors easier.

Trustees and IGCs would benefit from more concrete guidance and support. Smaller schemes may also need more support around consolidation of assets and/or administration, in order to make consideration of ESG factors easier.
Introduction

Recent years have seen a greater focus on Environmental, Social and Governance (ESG) factors when investing pension funds. This report explores:

• the definition of ESG and how it is interpreted by others;
• why organisations decide to invest, or not to invest, using ESG principles;
• the barriers to ESG investing;
• the current legal position of schemes in relation to ESG; and,
• Trustees’ and IGCs’ perceived legal responsibilities.

Chapter one explores the definition of ESG and discusses how ESG factors can affect investment risks and sustainability.

Chapter two considers current, historical and future regulation, legislation, guidance and best practice relating to ESG.

Chapter three explores current trends in use of ESG and barriers to consideration of ESG factors.
Chapter one: what is ESG?

This chapter explores the definition of Environmental, Social and Governance (ESG) and discusses how ESG factors can affect investment risks and sustainability.

There is lack of agreement regarding the definition of ESG

“ESG” is an acronym for Environmental, Social, and Governance factors.

The Department for Work and Pensions (DWP) defines ESG as: considerations (opportunities and risks) which affect returns on investing in [...] companies, or other entities, whether positively or negatively. There are many other considerations which may materially affect investment returns, and ESG factors are not always themselves financially material.¹

There is some confusion among trustees and Independent Governance Committees (IGCs),² advisers and investment managers, as to the purpose and definition of ESG. While some trustees and IGCs view ESG as a shorthand for assessing potential risks to investment sustainability, others view ESG as a distraction at best or, at worst, detrimental to scheme goals.³ The Law Commission has pointed out that there is widespread lack of understanding about ESG and that confusion arises because of:

- The conflation of ESG with “ethics” and,
- A lack of clarity among trustees and IGCs as to whether they are required to take factors into account which will not impact their scheme financially.⁴

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1. DWP (2018b) p. 8
2. Governance committees responsible for assessing value for money on behalf on members of Defined Contribution, contract based schemes.
3. DWP (2018b) p. 8
4. Law Commission (2017); Law Commission (2014)
Pension schemes who believe there is merit to considering ESG factors as part of their investment strategies agree that ESG is about assessing risks. For example, ESG is:

- ...a handy acronym to capture a wide range of potential sources of risk to return or reputation (DB Scheme Investment Manager)
- ...as a set of filters that are applied to our investments so that we can assess financial risk (DB Trustee).
- ...about recognising that companies cannot get away with doing the wrong thing forever and that eventually there will be financial implications (Asset Manager).

However, other trustees and IGCs, particularly some trustees of DB schemes view ESG as:

- ...a distraction from the goal of delivering long term returns (some reported views of DB scheme trustees)
- ...all about ethics ...just for hippies ...lunch is for wimps (some reported views of DB and DC providers)
- ...a wishy-washy, altruistic approach (some reported views of DB scheme trustees)

ESG is generally considered to be a subset of responsible investing

Proponents generally agree that ESG is a confusing shorthand and does not necessarily reflect the philosophy behind the practice. There is added confusion as many other terms such as Responsible Investment, Socially Responsible Investment, Sustainable Investment, Ethical Investment, Investing for Social Impact and Green Investment are often conflated with ESG.

Responsible Investment is defined by the United Nations Principles for Responsible Investment (PRI) as:

...an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.

5. https://www.unpri.org/pri/what-is-responsible-investment
Subsets of Responsible Investment can be grouped beneath it (Figure 1).

Figure 1: ESG is a subset of Responsible Investment

<table>
<thead>
<tr>
<th>Responsible Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ethical investing:</strong> using ethical principles as the primary filter for choosing where to invest</td>
</tr>
<tr>
<td><strong>ESG:</strong> investing which takes into account financial risks posed by environmental, social and governance factors</td>
</tr>
<tr>
<td><strong>Green investing:</strong> investing in companies focused on conserving natural resources or working on clean air and water initiatives, alternative energy sources and other environmental projects</td>
</tr>
<tr>
<td><strong>Sustainable investment:</strong> a broad term, often considered synonymous with ESG, meaning investing in assets which are judged to be able to deliver long-term competitive returns and positive social impact.</td>
</tr>
<tr>
<td><strong>Social impact investment:</strong> investments made with the intention of generating a positive social impact alongside a financial return</td>
</tr>
</tbody>
</table>

ESG factors can affect risk and returns

ESG factors comprise the following attributes and can affect potential risks and returns in some of the following ways (Figure 2):6

Figure 2: Examples of ESG factors and risks

<table>
<thead>
<tr>
<th>Environmental factors:</th>
<th>Social Factors:</th>
<th>Governance factors:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Resource depletion, including water waste and pollution;</td>
<td>• Working conditions, including slavery and child labour;</td>
<td>• Executive pay;</td>
</tr>
<tr>
<td>• Air pollution; and</td>
<td>• Health and safety;</td>
<td>• Bribery and corruption;</td>
</tr>
<tr>
<td>• Deforestation.</td>
<td>• Employee relations;</td>
<td>• Board diversity, structure and culture.</td>
</tr>
<tr>
<td><strong>Risks include:</strong></td>
<td>• Diversity;</td>
<td><strong>Risks include:</strong></td>
</tr>
<tr>
<td>• Poor environmental practices leading to depletion of resources, and/or hindering production and development; and</td>
<td>• Social unrest; and</td>
<td>• Some stakeholders being prioritised over others and/or disaffected;</td>
</tr>
<tr>
<td>• Reputational risk.</td>
<td>• Income inequality.</td>
<td>• Poor strategic and operational decision-making; and</td>
</tr>
<tr>
<td><strong>Risks include:</strong></td>
<td><strong>Risks include:</strong></td>
<td>• Legal and regulatory risks.</td>
</tr>
<tr>
<td>• Reputational risk;</td>
<td>• Poor productivity; and</td>
<td></td>
</tr>
<tr>
<td>• Potential for legal difficulties (fines, sanctions, being forced to close or change).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6. DWP (2018b)
Providing the highest possible return for the lowest cost is our aim but there will be no pensions beneficiaries on a dead planet (Master Trust Provider).

Some trustees and IGCs, advisers and investment managers struggle to see the connection between ESG factors and investment returns

Some trustees and IGCs struggle to see the connection between ESG factors and investment returns. Especially as some factors, such as depletion of natural resources, may not have an effect until a relatively distant point in the future. The examples below illustrate how ESG factors might affect returns:

- **Environmental risks:** Company A manufactures cars. During the manufacturing process it produces high levels of carbon emissions. The cars which it makes are also relatively carbon inefficient.
  - As carbon emissions are becoming more regulated, Company A runs the risks of paying fines in the future and/or needing to invest a significant amount into the business to comply with new regulations. If Company A were to work towards reducing its carbon emissions prior to regulatory changes, it runs less risk of significant financial loss through non-compliance in the future.

- **Social factors:** Company B produces widgets. It has poor health and safety practices on its factory floor and during its packing and delivery process.
  - Employees at Company B experience frequent accidents which lead to time off work, and legal and medical costs. These factors in turn lead to lower productivity per employee and reduced profits. If Company B improves its health and safety processes, there should be fewer employee accidents, reduced costs, and higher profits for shareholders.

- **Governance factors:** Company C produces and sells clothing internationally. Some of Company C’s board members also have financial interest in companies that do contracted-out work for Company C.
  - If board members are choosing contractors because they have a financial interest in them, then Company C may not be using contractors who deliver the best work for the least cost. Company C may therefore not produce the best goods that it could and may pay out more to contractors than it needs to, thereby diminishing profits. Company C is also open to legal difficulties if shareholders decide to bring action on the basis of an unfair tendering process.

There is some evidence that companies with stronger ESG practices deliver better long-term returns

Much of the controversy around ESG regards whether companies with good ESG practices deliver better returns. Proponents of ESG argue that a strong case has been made that good ESG practices are associated with better returns and sustainability. There are many studies available on the financial impact of taking ESG factors into account. The majority of results indicate a positive financial impact on return, though some show no verifiable financial impact. There are a few estimations of the actual increase in return, though most studies report higher returns without referencing a particular figure as purely ESG related effects can be difficult to disaggregate from other factors which influence return.

Many studies indicate that consideration of ESG factors has a positive effect on returns over time.

Many studies indicate that consideration of ESG factors has a positive effect on returns over time. Some of the expected benefits are unlikely to be apparent until some point in the future when, for example, companies who are reducing their use of finite resources are likely to perform better than companies who do not. Pension funds who do not consider ESG factors as part of their investment strategies may see reduced returns in the future.

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7. OECD (2017)
ESG is about mitigating reputational, operational and regulatory risk, all of which are increasingly material both for capital preservation and sustainability of long-run returns (DB Trustee).

Reputational risk has become more serious. We don’t want to be exposed to companies who may be in the press tomorrow for doing something that is unacceptable to the general public (Asset Manager).

There are several ways of assessing ESG factors

The most straightforward way of assessing ESG factors is through use of publicly provided information by companies on their sustainability and ESG practices and policies. However, not all companies provide sufficient information. There are a variety of ways to research companies beyond the information they choose to make available:

- Asking companies to provide information which is not publicly available,
- Using social media and other public sources to see how companies are perceived and whether there are groups speaking out against company practices,
- Reviewing the outcome of shareholder and company resolutions at AGMs, in order to assess other investors’ views and whether ESG factors are prioritised,
- Assessing the company’s tax policy, for example whether it practices aggressive tax avoidance,
- Engaging with advisers and other investors to share information on companies and their practices,
- Benchmarking company practices, risks and returns against those of other similar companies.
- Accessing ESG risk ratings.12

The ability to assess ESG factors, as well as the potential impact of ESG factors on returns, varies between asset classes

Equities, particularly shares of large, publicly traded companies, are generally the easiest to assess. Other asset classes can prove more difficult and until recently have been under-represented in academic literature and industry debate. The materiality of different ESG factors

Pension funds who do not consider ESG factors as part of their investment strategies may see reduced returns in the future.

Pension schemes are likely to receive more pressure from members to consider ESG factors in the future

Member interest in ESG factors is increasing. 82% of pension scheme members “strongly agree” that their pension contributions should be responsibly invested and 74% “strongly agree” that schemes should engage with companies they invest in.10 Particularly younger members, who are the main consumers of social media, are more aware of the potential impact of ESG issues, for example, poor workplace practices such as zero-hours contracts or ‘bogus’ self-employment arrangements. Younger members are more likely to expect their employer and pension provider to be aware of ESG issues and to take action on these. There is a general sense that members are more likely to find out about poor practices by companies, employers and investors and challenge them.11

Therefore, a potential future risk of not taking ESG into account is dissatisfaction and potential action by scheme members.

10. DWP (2018c) pp. 40, 42
will vary between different asset classes. The below list discusses the ability to assess ESG risks and opportunities in the major asset classes:

- **Large, developed market equities**: ESG information is readily available. Most of the ways to assess ESG factors mentioned in this report are available to investors.

- **Smaller cap companies / emerging market equities**: it can be more difficult to find information, for example in the Asia-Pacific region. More research, engagement, and/or information sharing may be required and it may be difficult to obtain complete information about companies.

- **Fixed income product**: assessment of bonds is a newer area than equity albeit an asset class which is starting to put an increased emphasis on ESG. In particular assessing the ESG risks of sovereign bonds can be complex and challenging. Credit rating agencies do not generally consider the ESG credentials of bonds in detail. In addition, as credit securities have a range of durations this implies multiple investment risk profiles (and so multiple ESG risk profiles). In comparison stocks tend to have a single investment risk profile. This means that assessment of the entire fixed income investment universe is a materially larger undertaking than the mapping of liquid equities.

- **Real estate (environmental risks and community impact are particularly relevant)**: developers are generally required to make disclosures regarding environmental practices and community impact. There are also registers available to investors which provide scoring on the ESG credentials of real estate developers.

- **Infrastructure**: environment, health and safety, labour relations and community impact are particularly relevant to the success of an investment in this asset class. However it can be difficult to assess ESG factors as there is a lack of consistency in disclosure and regulations between different types of infrastructure projects. However, organisations do exist which provide assessment, scoring and benchmarking information for real estate and infrastructure (The Global ESG Benchmark for Real Assets (GRESB) covers both asset classes).

- **Private equity**: as the assets are not publicly traded, and companies are subject to less standardised disclosure rules, it can be difficult to find information. More engagement with these companies is likely to be necessary in order to assess their ESG credentials.

- **Hedge funds and other complex multi-asset funds**: can be very difficult to assess. In particular if the strategy is a multi-manager structure, reporting on underlying assets is often very opaque. Investors will need to engage directly with their fund managers in order to understand the type of ESG assessments that are conducted, if any.

There are four main approaches to putting ESG assessments into practice within an investment strategy: screening, thematic investing, integration and engagement

There are several ways in which ESG factors can be taken into account when making investment decisions. Many trustees leave this to their appointed fund managers, and ask about the approach taken by different fund managers when making appointments. Some appoint other agents to exercise voting rights on their behalf and to carry out other engagement activities:

1. **Screening**: a simple way of avoiding investments in assets associated with poor ESG performance from a portfolio is by excluding particular companies or investment in particular areas. Screening can also be used to choose investments in companies who exhibit particular positive aspects. This method can be problematic for the following reasons:
   - Excluding too many particular companies or areas can negatively affect financial returns by limiting a portfolio’s spread.
   - If poor ESG credentials have adversely affected the value of a company’s securities, there might be an opportunity for investors to enhance that value through active engagement.
   - The information on which company exclusions and inclusions are made may be false.
   - Exclusions may lead to unintended market consequences (Box 1).
Box 1: example of unintended market consequences

Company X was the main producer of an element fundamental to the functioning of ships and lifeboats and provided these elements to almost all ship manufacturers. One of Company X’s clients manufactured armaments alongside ships. Lobbyists discovered this connection and called for a boycott of Company X, claiming it was involved in arms manufacturing. The campaign was unsuccessful. However, had there been a mass boycott of Company X, the company may have been unable to produce the ship elements required for ship building, thereby causing operational problems within the whole industry.

2. Thematic investing: Thematic investing involves focusing investments in assets which target long-term growth in sustainable areas, for example clean air and water initiatives or clean energy projects.
   • While thematic investing can be helpful for ensuring investments are subject to less risk arising from, for example, environmental factors, companies may still need to be assessed for other issues, including social and governance considerations.
   • Those investing thematically may wish to divert some funds to other areas to minimise the potential impact of industry-wide shocks.

3. Integration: Integration involves considering ESG factors as part of all investment activities, generally through rating or assessing potential areas of investment in terms of their ESG credentials and investing only in assets which meet a minimum threshold, or can demonstrate that they are attempting to improve in areas where they fall below par. Integration can be relatively resource heavy as it requires investors to:
   • Undertake primary research on companies or use available ratings,
   • Engage with investment managers and advisers to set investment beliefs and construct a strategy to carry these out

4. Engagement: engagement is an element of Stewardship as it involves exercising shareholder power on behalf of members to work with companies on improving their ESG practices. Engagement can take the form of voting at shareholder meetings or discussing and working with companies on areas which need to be improved. Engagement is a time and resource heavy option but there is qualitative evidence that engagement effects behavioural change. Proponents of engagement believe that working with companies on improving can have a better long-term effect on the market than excluding companies who may then continue poor ESG practices.

It’s not realistic to invest only in perfect companies. If there are concerns about a company we request that they make a plan of action to minimise their risk. This generally has a positive impact on behaviour and is rewarding for the company, investor and the wider market (Internal DB Scheme Investment Manager).

Do you feel comfortable about the company you are about to invest in? If not, address it! (Asset Manager).

13. Incident occurring several years ago, related during qualitative interviews
14. Qualitative interviews
Chapter two: key ESG developments

This chapter considers current, historical and future regulation, legislation, guidance and best practice relating to ESG. The main events and publications which have had an effect on ESG are shown in the timeline below (figure 3).

Figure 3

[Timeline showing key ESG developments from 1991 to 2018]
Trust-based schemes are currently required to state their policy on social, environmental or ethical considerations, if they have one, while contract-based schemes are not.

Trustees are currently required to ensure that scheme assets are invested in the best interests of members and beneficiaries and calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. In the Statement of Investment Principles (SIP), which must be updated at least every 3 years and given to members on request, trustees must state the extent to which they take “social, environmental and ethical” factors into account “if at all” when making investment decisions and their policy if any in relation to the exercise of voting rights attached to investments.

Trustees may take non-financial factors, such as quality of life or members’ ethics, into account subject to a two-stage test:

- A: if they have good reason to think that members share the concern, and
- B: there is no risk of significant financial detriment to the fund.

Providers of contract-based schemes must set an investment mandate and investment strategy objectives with the best interest of the members in mind. Since April 2015, providers of contract-based, workplace schemes have been required to appoint Independent Governance Committees (IGCs), whose role it is to oversee scheme activities and assess value for money for members. IGCs are required to assess whether default investment strategies are designed in the best interests of members and whether performance is regularly reviewed to ensure alignment with member interest. ESG is not explicitly mentioned in these requirements.

The following section provides a brief history of developments and regulatory moves that affect trustees and IGCs’ approaches to ESG.

ESG investing has recently become more of a priority for the Government

Private pensions have existed within the UK since 1590 when the first employer-run pension scheme, “The Chatham Chest”, was established to provide pensions to injured seamen. Following on through the centuries, governments began extending pension coverage to other government employees, and the private sector followed suit in the 19th and 20th century. As a result of the relatively organic development of private pensions, employers ran their schemes without a consistent overlay of regulation and guidance until recently. What this meant in practice, was that there was no universally accepted process by which trustees should approach the investment management of their members’ contributions.

As a result of the relatively organic development of private pensions, employers ran their schemes without a consistent overlay of regulation and guidance until recently.

In 1984, it was ruled that schemes must prioritise the best financial interests of the scheme members over trustees’ views

A legal case took place in 1984, which has had a long-term effect on ESG: the case of Cowan vs. Scargill (both trustees of the National Coal Board (NCB) pension scheme. The National Union of Mineworkers (NUM) sought to gradually disinvest the National Coal Board’s pension fund from businesses that competed with the U.K. coal industry, in line with Union policy (and based in turn on views about the long-term interests of members). Judgement was handed down against the NUM; investment in line with Union policy was not considered a legitimate basis to discharge the fiduciary duty to act in members’ best interests. Although the case led to fiduciaries subsequently favouring a narrower definition of members’ interests, that often excluded consideration of ESG, there was arguably nothing in the judgement that required an exclusive focus on members’ short term financial interests. Cowan vs. Scargill caused confusion among trustees, who believed...
that it conflated ESG with ethical investment and led some to believe that ESG referred only to non-financial factors.19

The Cowan vs. Scargill case caused confusion among trustees, conflating ESG with ethical investment and leading some to believe that ESG referred only to non-financial factors.

In 1991, the ISC published *The Responsibilities of Institutional Shareholders in the UK* which encouraged engagement with companies

In the 1980s/90s the need for a more consistent investment approach became apparent as schemes were investing in a variety of ways, not all of which prioritised the long-term sustainability of scheme returns or accounted for all of the potential risks. In order to properly evaluate the potential risks and returns associated with investing, it is often necessary to study, monitor or engage with companies. In 1991, therefore, the Institutional Shareholders Committee (ISC), published a statement on *The Responsibilities of Institutional Shareholders in the UK*, subsequently updating it in 2002. The Statement,20 set out guidelines for best practice of pension funds:

- Setting out their policy on how they will discharge their responsibilities,
- Monitoring the performance of, and establishing, where necessary, a regular dialogue with investee companies,
- Intervening where necessary,
- Evaluating the impact of their activism,
- Reporting back to clients/beneficial owners.

In 2006, the UN launched its Six Principles for Responsible Investment, prioritising ESG

In 2006, the United Nations launched its Principles for Responsible Investment (UN PRI): The Six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice:

- **Principle 1:** We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3:** We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4:** We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5:** We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6:** We will each report on our activities and progress towards implementing the Principles.21

In 2007, the UN published a report showing that ESG consideration was associated with positive returns in 10 out of 20 studies

In 2007, the Asset Management Working Group of the United Nations Environment Programme Finance Initiative, and Mercers, released a review of research on using ESG factors in investment. In ten of the 20 studies covered, there was a positive correlation between using ESG factors and portfolio performance, in seven cases there was a neutral effect and in three there was a negative effect.22

In 2008, the UK passed the Climate Change Act, which seeks to enable the UK to become a low-carbon economy

The Climate Change Act introduced a target for UK greenhouse gas emissions to remain below 80% of baseline emissions in 1990 by the year 2050. The Act led to an increase in research into

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21. www.unpri.org/about-the-pri
low-carbon alternatives, widening the pool for potential investors who want to invest in more environmentally friendly options.23

In 2010, the FRC published The Stewardship Code obliging signatories to engage with companies that pension schemes invest in

In 2009, the ISC’s Statement of Principles was converted into a voluntary code and was followed, in 2010, by the Financial Reporting Council’s publication of the UK Stewardship Code, which defined stewardship to include engagement with companies and intervention, potentially through using voting rights24 where appropriate. The intended result of institutional investors exercising their stewardship responsibilities on matters such as strategy, performance, risk, capital structure and corporate governance is more accountability for, involvement with, and better long-term performance of, companies in which they are invested.

Stewardship includes engagement with companies and intervention, potentially through using voting rights where appropriate. The intended result of institutional investors exercising their stewardship responsibilities is more accountability for, involvement with, and better long-term performance of, companies in which they are invested.

In 2012 the Kay Review recommended addressing barriers to investor engagement with companies

In 2012, the (government commissioned) Kay Review, published its final report23 recommending that the government do more to address disincentives and perceived regulatory barriers for trustees and providers of contract-based schemes to engage with companies by establishing an investors’ forum and making it easier for schemes to engage collectively and share information. The Kay Review also highlighted that scheme trustees were generally focussing too heavily on short-term asset performance and neglecting consideration of long-term risks, including environmental risks.

In 2014, the Law Commission highlighted the lack of regulatory clarity around ESG

In 2014, the Law Commission published a report26 which highlighted the lack of regulatory clarification on financial and non-financial investment factors (Box 2). The lack of clarity arose from discussion in the regulations conflating “ethical” considerations with ESG factors. The Law Commission highlighted that ethics refer to moral issues, while ESG is related to risks, returns and sustainability. The 2014 report discussed the need to consider ESG factors when devising investment strategies as these are financial factors and may affect the long-term sustainability of companies in which pension funds are invested. The 2014 report recommended that trustees be required to state their stewardship policy, if they have one.

24. As shareholders
25. BIS, Kay, J. (2012)
Financial and non-financial factors refer to the factors which trustees and providers of contract-based schemes might wish to consider when designing an investment strategy. Providers must consider financial factors in implementation but may only take non-financial factors into account in certain circumstances.

- Financial factors could affect returns and/or risks associated with an investment when assessed from the perspective of members’ best financial interest.
- Non-financial factors are factors that do not affect an assessment of financial risks or returns but would be relevant to political, ethical or other non-financial objectives.

In 2015 the Paris Agreement was adopted

The Paris Agreement was adopted on 12 December 2015 by Parties to the United Nations Framework Convention on Climate Change. Signatories pledge to determine, plan, and regularly report on their activities for mitigating global warming. The overall aim is to limit the average global temperature rise to 1.5%. As of 9 September 2018, there were 195 signatories (countries signed up) and 180 parties (countries who consent to be legally bound) to the agreement. The Paris Agreement has led to a greater focus on mitigation of climate change and moves to low-carbon resilient economies and has increased the focus of institutional investors on the issues highlighted in the agreement.

In 2015, Government responded to the consultation

In response to the Law Commission’s 2014 report, the DWP published a 2015 consultation response announcing that instead of amending regulations, The Pensions Regulator (TPR) would issue guidance which clarified the differences between financial and non-financial factors and how ESG issues were relevant to these:

- TPR subsequently advised trustees to state in their Statement of Investment Principles (SIPs), whether they consider ESG factors in their investment strategy.

- The Financial Conduct Authority (FCA) issued a statement emphasising the importance of Independent Governance Committees (IGCs) assessing member views on ESG factors, on use in the default of ethical and long-term social investments, while at the same time considering the risks and potential impact on pension outcomes.

In 2017, the Law Commission called for more clarity and transparency

In 2017, the Law Commission published a report recommending that more needs to be done in law to clarify requirements around ESG and more guidance needs to be provided for contract-based schemes in order to help schemes who are struggling to understand their obligations around ESG. The report called for schemes to provide more transparency about their stewardship policy and how ESG factors are considered in relation to investment decisions. The Committee also published responses it received from some of the UK’s largest pension funds to questions about their policies in relation to climate change risk and green finance.

ESG: past, present and future
In 2018, the House of Commons Environmental Audit Committee published two reports, calling for greater focus on sustainability in investing

In May and June 2018, the Environmental Audit Committee published two reports as part of their Green Finance Inquiry. The Committee called for greater regulation on company, investor and asset manager reporting on sustainability and climate-related risks. The Committee recommended that the Government should explore how a Sovereign Green Bond could be directly tied to achieving its Clean Growth Strategy.

In 2018, the European Commission published proposed Europe wide regulations which aim to integrate ESG considerations into the investment and advisory process in a consistent manner across sectors

In May 2018, the European Commission proposed regulations on disclosures relating to sustainable investments and sustainability risks and amending IORP II. The proposals lay the foundation for an EU framework which puts environmental, social and governance (ESG) considerations at the heart of the financial system to help transform Europe’s economy into a greener, more resilient and circular system. ESG factors should be considered when taking decisions on investments in order to make investments more sustainable. The proposals will come into force in January 2019 and so will be implemented in the UK prior to its timetabled departure from the EU in March 2019.

In 2018, the DWP published and responded to a consultation on strengthening trustee duties around ESG

In June 2018, the Government laid regulations which will strengthen the obligation of occupational pension scheme trustees to consider ESG factors in investment decisions:

- Regulations for trustees, to be implemented by 1st October 2019:
  - Where they are required to produce a Statement of Investment Principles (SIP), update or prepare it to set out:
    - how they take account of financially material considerations, including (but not limited to) Environmental, Social and Governance considerations, including climate change;
    - their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with investments;
    - the extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments.
  - For trust-based schemes providing DC benefits:
    - to publish their Statement of Investment Principles on a website so that it can be found and read by both scheme members and interested members of the public, and inform scheme members of its availability via the annual benefit statement;
    - in relation to the default arrangement, to prepare or update their default strategy to set out: how they take account of financially material considerations, including (but not limited to) Environmental, Social and Governance considerations, including climate change; and (for DC trust-based schemes with 100 or more members) their policy on stewardship.

- Regulations for trustees of DC schemes with 100 or more members, to be implemented by 1st October 2020:
  - Publish an implementation report, online, setting out how they acted on the principles in their SIP.
   The FCA currently plans to consult on corresponding requirements for workplace personal pensions in the first quarter of 2019.

33. HoC Environmental Audit Committee (2018a), (2018b)
34. HoC Environmental Audit Committee (2018b)
In 2018, the EU published recommendations to make ESG investing easier across Europe

2018 also saw the publication of the EU High-Level Expert Group on Sustainable Finance’s final report on Financing a Sustainable European Economy. The report recommended:

- Establishment and maintenance of a common sustainability taxonomy (register) which would identify the conditions under which investments would contribute to the EU’s sustainability objectives.
- Linking the duties of investors to the sustainability needs and preferences of individuals and institutions.
- Reforming disclosure rules so that companies’ sustainability risks are fully transparent.
- Requiring investment managers to engage with investors and provide them with the required information to make active investment choices which reflect their sustainability and ethical preferences.
- Development of sustainability standards and labels which will apply to qualifying assets, starting with green bonds.
- Development of an organisation, called ‘Sustainable Infrastructure Europe’ to support the development of sustainable infrastructure projects across all EU member states.
- Updating ‘fit and proper’ tests for members of governing bodies in financial institutions to include assessment of their ability to address sustainability risks and understand the needs and relevance of customers and stakeholders.
- Strengthening regulation and supervisory guidance so that private capital flows are pushed towards sustainable investments, including extending the role of European Supervisory Agencies.
Chapter three: what does current practice look like?

This chapter explores current trends in use of ESG and barriers to consideration of ESG factors.

**Few schemes have implemented an investment approach which specifically takes ESG factors into account**

The explicit consideration of ESG factors in scheme investment decisions is currently low, however there are a growing number of pension schemes who are integrating ESG factors into their investment decisions or planning to do so in the near future (for example, HSBC, Brunel LGPS, NEST, The People’s Pension).

**Pension schemes who consider ESG use a combination of approaches**

Schemes who consider ESG factors tend to do so by engaging with investment managers to ensure their views are taken into account. Some larger schemes use an internal investment manager and may also undertake their own research, in order to inform the design of their strategy before communicating it to investment managers.

Investment managers who consider ESG generally use a combination of approaches. For example use of internal and external company rating, engagement with companies who don’t meet standards, and thematic investing. Most asset managers also use market benchmarking as a key element of assessing ESG, as peer performance is helpful for determining the degree to which a company should be considered to be performing well or badly.

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37. Qualitative interview, asset manager
Case Study 1: Pooled Local Government Pension Schemes

Local Government Pension Schemes (LGPS) have been pooling assets and investment administration in order to reduce costs and make investment in a variety of assets easier. One of these pools is called The Brunel Pension Partnership (Brunel), consisting of the LGPS for Avon, Buckinghamshire, Cornwall, Devon, Dorset, the Environment Agency, Gloucestershire, Oxfordshire, Somerset, and Wiltshire.

Brunel aims to have ESG risk consideration integrated into every aspect of their manager selection, oversight and monitoring process. Faith Ward, Brunel’s Chief Responsible Investment Officer spoke to us about their ESG strategy:

“We have our eyes wide open to anything that might cause long-term risk. We will invest in a company with concerns or issues if they can make a plan of action to minimise risk. ESG is all about risk and reward and it’s not realistic to only invest in perfect companies; we believe a core part of ESG is about engagement.”

Why is ESG important to Brunel?

“We believe ESG issues have the potential to create risks, as well as opportunities, for investors and as such we should have mechanisms in place to assist in identifying those and evaluating the potential impact. This can include everything about a company from corporate structure, behaviour and culture to product design and treatment of waste.”

How is ESG integrated into Brunel’s investment strategy?

“We select investment managers based on their capabilities and how they assess risk and we also work with managers who want to improve. We expect managers to engage with companies, look at appropriate metrics and even look at the social media on companies. Within Brunel we do our own research. We use data sources to identify active risk, we talk to companies and our advisers, and we use available benchmarks on companies covering a range of ESG factors for example: cyber risk, human rights, animal welfare, Transition Pathways Initiative. There are lots of ways to compare market performance against others.”

“With listed equities our tender questionnaires aim to identify key issues from culture, people, and processes to procedures and reporting. We take different approaches with different asset types.”

What results has considering ESG yielded?

“We have not recently undertaken our own specific analysis, but are aware of numerous, credible studies which have identified clear links with corporate and fund performance. That said, I can say, anecdotally, from my own experience that the investment returns from those managers who we would rate as strong on these matters, but also rate as strong investment managers more broadly, tended to produce more consistent, strong returns over the longer term. There is one specific example where the manager’s performance increased significantly (and has remained strong and highly rated) following on from their investment in building up ESG capabilities.”
What are the barriers to considering ESG factors in investing?

“Within listed equities there are few barriers, particularly with rapid developments in data sets that have reduced the dependency on corporate disclosures to identify risks. With other assets the assessment tools, approaches and processes need improvement. Though within assets that are bought and sold quickly, there is less point in making ESG assessments. Improved transparency from companies and funds would also help to see how they are managing risks and opportunities.”

“There are also systemic challenges around advisers and other parts of the investment process. Often advisers and managers are not fully informed about ESG and they misadvise clients. Trustees and advisers need to be fully equipped to understand the relevance of potential ESG issues.”

Low levels of governance over investment decision-making and a lack of choice for smaller schemes are barriers to ESG consideration

Large DB and DC trust-based schemes are the most likely types of schemes to be exploring the use of ESG factors because they are more likely to have the two main characteristics which enable easier integration: governance and more choice.

One of the main barriers to ESG consideration is the level of involvement that providers of pension schemes have with investment decisions. Almost all schemes invest in pooled funds or use third-party investment managers to make day-to-day investment decisions. The extent to which ESG factors are taken into account varies between fund managers and it is difficult for trustees to distinguish between fund managers using this criterion. Many fund managers offer an “ethical fund”, however these will be active choice strategies that individual members can choose, generally at a higher cost.38

There are a few reasons why asset managers may not consider ESG factors:

- Many pension schemes share the services of investment managers and therefore, investment managers will attempt to represent the interests of all schemes, rather than prioritising the views of any single one.
- A lot of schemes use index-tracking/passive funds for investment in listed equities. ESG factors can then be addressed only by engagement by the fund manager. A passive fund manager spending time and resources on engagement may be more costly and some trustees and contract-based providers may not want to pay more for these funds.
- Asset manager funds are generally assessed on short-term performance in relation to their peers. Managers may worry that consideration of ESG factors will inhibit short-term performance. If consideration of ESG factors was built into asset manager benchmarking, there may be more motivation to consider these.

ESG factors are often ignored or paid lip service. If consideration of ESG factors was built into asset manager benchmarking, there may be more motivation to consider these.

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38. Qualitative interviews
Increased scale can increase choice, strengthen provider governance and reduce costs for members

Providers with more resources (generally gained through higher membership and a corresponding higher value of funds under management) can afford tailored services from investment managers and therefore have more opportunity to influence the overall investment strategy (Box 3). Larger schemes are also able to enrol more members into any particular investment strategy, thereby providing investment managers with more incentive and ability to reduce per-member management costs.

Box 3: a large DC scheme can commission its own investment strategy

Legal & General Investment Management (LGIM) were commissioned by HSBC, advised by Redington, to design a default strategy for its trust-based DC scheme. LGIM created the Future World Fund which uses factor-based investing, which takes into account underlying factors that affect risk and return. The Future World Fund:

- Rates companies by ESG-related metrics. LGIM engages with companies who do not meet the expected ESG standards in order to help them to improve their practices, excluding those who do not raise their standards after a certain engagement period.
- Recognises the potential future impact of climate change and the anticipated transition towards a low carbon economy. The Fund tilts investment away from firms with higher carbon emissions, and towards those generating revenue from the green transition.

While the Future World Fund was constructed for HSBC’s default strategy, it is available for use to other trust and contract-based DC schemes.

Providers with more resources can afford tailored services from investment managers and therefore have more opportunity to influence the overall investment strategy

If more products that involve ESG consideration were available to small schemes, they would find it easier to invest in companies with better ESG credentials.

Some investment managers have developed, or are developing, off the shelf products which could be used by small schemes. If more products that involve ESG consideration were available to small schemes, they would find it easier to invest in companies with better ESG credentials.
Case Study 2: Master Trust

The People’s Pension is a Master Trust scheme, run by not-for-profit organisation, B&CE. The People’s Pension was set up in 2011 and now has over 4 million members. Nico Aspinall, The People’s Pension’s Chief Investment Officer spoke to PPI about their ESG strategy:

“ESG is about long-term risks, and there is enough consensus to support integrating them into your investment process. This means you can’t just look at past returns and volatility to decide where to invest, as they are not indicative of the future. You have to think about your exposure to ESG risks and what that might mean for returns. If the impacts from ESG risks haven’t materialised yet then they are coming and could increasingly become a major market differentiator.”

Why is ESG important to The People’s Pension (TPP)?

“B&CE is a not for profit organisation and a large part of our values come from that. Members of TPP are in general younger so more interested in these issues; and at the same time more financially vulnerable so more affected by the way companies operate. Taken together this means it is more important to us than it might be to others, and we hope to offer an increasingly differentiated approach here.”

How is ESG integrated into The People’s Pension’s investment strategy?

“The process is undergoing transition as we take more in-house control of how we approach ESG. That’s a function of our increasing scale and our values as a not-for-profit investor. Our current approach involves talking with our investment managers and going through how they vote on our behalf, how they engage with companies and how they plan to engage in the future. But we’re not in direct control of that which means we compromise with other investors on issues and what actions to take. We want to do more here.”

“The process we are implementing now involves doing more of the ESG work ourselves. We will assess where there is data on a specific ESG risk that provides insight into future returns so that we can integrate this into our portfolio. The main example here will be Climate Change but no doubt many others over time. Where we think data can be used to improve risk and return characteristics we have to do it. This is not ethical investing, this is about risk and return.”

“Further, we’ll give all the companies an aggregate rating on a range of ESG risks and use this to exclude the worst performing companies. We will also identify particular ESG issues we do not want to have any exposure to in our portfolios, for example weapons banned by the UN Global Compact, and exclude those companies too. These exclusions are broadly made for ethical reasons so we can’t exclude too much without damaging returns. We are looking at the concept of an exclusion budget here, the amount of companies we can ignore without damaging returns, but we’re not sure how this will look in practice at present.”

“This will still leave us with exposure to some ESG risks so finally, we will engage with companies on a prioritised basis to discuss ESG.”
What are the barriers to considering ESG factors in investing?

“The two main barriers are scale and misunderstanding of what ESG means. We increasingly have the scale to do this in-house, which means a better understanding of what is going on and more ability to shape this to our requirements. Smaller schemes should of course consider ESG, but in practice this means selecting between managers who do this on their behalf. This can lead to a mixed approach with less control than seems appropriate to us.”

“There is a lot of jargon out there and that confuses people. We take the PRI definitions here and I would encourage everyone to and certainly not to invent their own! At the same time a lot of people discussing ESG are still talking about ethics not investment. There are two worlds between institutional investment and a green lobby and they risk speaking different languages. This is getting better, but there needs to be more bridge builders who can bring both groups together. We hope our approach will start to show how this can be done over time.”

The DWP has excluded DC trust based schemes with fewer than 100 members from many requirements

In an effort to ensure that small schemes are not being expected to conduct ESG exercises that they have neither the resources nor the time for, the Government excluded DB schemes from all requirements. They have also excluded DC trust-based schemes with fewer than 100 members from reporting on how they take stewardship into account, and their duty to report on how they take financially material factors, including ESG and climate change, into account is limited to the default arrangement. Some advisers and investment managers are sceptical about whether this concession goes far enough, as there may be many schemes with more than 100 members who are still too small to undertake the necessary steps to integrate consideration of ESG into their investment strategy.39

Smaller schemes may need more support around consolidation of assets and/or administration, in order to make consideration of ESG factors easier.

Some trustees are sceptical regarding the benefits of ESG

Proponents of ESG report that they face resistance, particularly from long-established trustees, to considering new ways of evaluating long-term risks. Many trustees see consideration of ESG factors as being about ethical judgements and do not see a connection between these judgements and risks and returns.41

39. Qualitative interviews
41. Qualitative interviews
This entrenchment is generally strengthened by the pressure many trustees face to:
- Ensure long-term liabilities will be met,
- Minimise the amount that the employer needs to pay into the scheme,
- Ensure value for money.

Pressurised trustees are often, unsurprisingly, resistant to adding an extra priority to their agenda, especially when they are sceptical regarding the potential benefits of considering ESG factors. However, some trustees are open to changing their views once the benefits of considering ESG factors are explained to them.42

The majority of DB schemes are run by lay people and putting another layer of governance on them is not fair. If the government wishes to do this it needs to make a massive investment in training up trustees or change regulations around who can be a trustee.42

Some trustees may struggle to comply with the new regulations

Trustees are required by law to secure an appropriate return over the long-term which also account for risks.43 This includes a requirement to take into account factors that are financially material to investment performance.44 The belief that ESG factors are financially material to the long-term performance and sustainability of investments is growing and has been adopted by the Government and the regulators. The Government is hoping to strengthen the requirements on trustees to consider ESG factors with their regulations requiring schemes:
- From 2019, to state in their SIP how they take account of financial considerations such as ESG, including climate change, and
- From 2020, for DC schemes, to report how they acted on the principles in their SIP.

The FCA has made clear its view that ESG factors are relevant to the best financial interests of contract-based scheme members.

The FCA is also considering placing a requirement on IGCs to report on how they take account of ESG and climate factors.

42. Qualitative interviews
43. Law Commission (2017) p. 37 para 5.8
Case Study 3: Contract-based scheme

Heineken moved from offering a DB scheme to offering a DC contract-based scheme, around nine years ago. It set up an in-house governance committee at the same time, in order to ensure that the scheme would continue to meet trust-based scheme governance standards and be operated in the best interests of scheme members. **Julius Pursaill, Independent Chair of the Defined Contribution Governance Committee**, spoke to PPI about their ESG strategy:

**Why is ESG important to Heineken?**

“ESG issues were already important to Heineken, who, as a company, values respect for human rights and diversity in the workplace. Environmental protection and sustainability were also already major priorities for Heineken because of its role as a large scale manufacturer and exporter. So, considering ESG as part of the investment process was not a difficult step.”

“We believe that ESG means taking account of long-term financial risks and opportunities in a way that the short-term market fails to do and is not about morality or meeting member requests for ethical strategies. Obviously ESG is also about other risks, such as the risk of reputational damage, but these are less important than the financial opportunity.”

“We believe ESG factors are becoming more important to our members though they often fail to make active investment choices. It is important that the investment strategy aims to maximise long term risk adjusted return. We believe that the ESG tilts we are implementing will both achieve this and should get a positive response from members.”

**How is ESG integrated into Heineken’s investment strategy?**

“As is typical with many DC schemes, most of our members’ equity exposure is via passive investment strategies. While we think engagement is important and have taken steps to understand our managers’ approaches to engagement, we felt we could go further in the context of our passive (and smart beta) equity exposure. We are currently in the process of setting up new strategies that will be launching in 2019. We needed to think carefully about how to integrate ESG across our lifestyle funds because our members have non-standard investment behaviour. A large proportion of older members, who were part of the DB scheme, are invested in higher-risk strategies, while newer members are mostly invested in the medium-risk default strategy.”

“With the help of our asset managers and our advisers KPMG, we plan to introduce a broad ESG factor tilt on a proportion of global equity assets in both the default and higher risk lifestyle strategies. The ESG overlay is likely to be added to both a multi factor smart beta strategy and passive equity exposures as appropriate. In both cases, companies are rated on their ESG credentials and those companies with good ESG scores are over-weighted while those with poor scores are underweighted.”

“Tracking error will be limited via controls at both the portfolio and sector level.”

“It is likely the strategies will involve some exclusions, for example, pure play coal companies and manufacturers of controversial weapons systems. We will monitor the impact of the ESG tilts on both risk and return. If we are satisfied the tilts are achieving their objectives, we may consider increasing the proportion of assets we tilt.”
What are the barriers to considering ESG factors in investing?

“It is not yet universally accepted that consideration of ESG factors is justified on financial grounds. Some providers and trustees often feel that ESG is a distraction, that members are not interested, that there are other issues that are more important to focus on, and that fully integrating ESG will cost more while there is still only inconclusive evidence that it adds value. Many schemes appear to have a “wait and see” attitude; they are happy to see what other schemes do and once it becomes the norm, and/or easier, then they may start more fully integrating ESG.”

“I don’t think legal uncertainty is a barrier. Trustees understand the difference between financially relevant and irrelevant factors, but unless Trustees are convinced ESG factors are financially relevant, they are highly unlikely to take the fiduciary risk of implementation. Here I am sympathetic - I think fiduciaries should be cautious about justifying any investment interventions principally on the basis of member views or values. It seems highly unlikely there would ever be a unanimity of view among members about what is and isn’t important to them. The role of the fiduciary is clear - to act in members’ best interests.”

There is a risk of becoming out-of-step with the rest of Europe, if more trustees and IGCs do not start to consider ESG factors

European legislation is moving quickly to provide the legal support for ESG consideration. IORP II provides regulations for risk management and the EU might bring out further legislation to require schemes to provide “pre-contract” disclosures on how climate change risk is managed, potentially to members. In 2018, the European Commission published proposed Europe wide regulations which aim to integrate ESG considerations into the investment and advisory process in a consistent manner across sectors. A lack of ESG consideration within the UK could put pension schemes (and other investors) at a disadvantage if it results in UK funds being exposed to more risks than European funds.

There is lack of clarity around what it means to consider ESG factors in investment decisions

There is no single, “right” way to consider ESG factors due to the inherent uncertainty regarding the financial significance of any given factor. For example, a trustee who does not believe that there are financially material risks associated with climate change will not expect a reduction in returns from a manufacturer who is not preparing for, or seeking to minimise the effects of, climate change. Even if boards agree that there is potential for financial loss through a particular practice, they may disagree on the significance of the loss or the level of behavioural change required by a company to mitigate that loss.

When you go down the rights and wrongs things get complicated because it’s all so subjective, for example, gun control is seen as a social necessity by some and a limitation on freedom by others (Asset Manager).

There is disagreement regarding the potential long-term effects on the market of investing or not investing in particular industries. For example, avoiding investment in particular areas could deprive certain industries of resources they need in order to function.

45. www.linkedin.com/pulse/member-views-how-pension-trustees-invest-relevant-stuart-o-brien/
The attitude towards carbon is esoteric and aspirational. You need it for cars and planes etc. You can't switch investment from carbon till technology advances. The whole issue is silly – where do people think electricity comes from? (DB trustee)

This subjectivity carries through into ratings. Each organisation providing ratings on the ESG factors of companies will use their own definitions, methodologies, metrics, and weightings. There are incidences of companies being rated as performing above their peers in relation to ESG factors by one organisation and as performing below their peers by another.47

Key areas which affect difficulties in rating are:

- A lack of consistency in reporting may make comparisons within jurisdictions difficult:
  
  Box 4: companies in the same sector will have different risk profiles

  • Company X (oil extraction) and Y (geological mapping) both work in high carbon producing sectors.
  • Company X has a complex governance structure and a high number of employees undertaking physical work.
  • Company Y has few employees, who do mostly desk work, and a simple governance structure.
  • Company X and Y have a similar environmental risk profiles but very different social and governance risk profiles.

Information provided by companies is not always reliable

Even in cases where companies provide reports on their own sustainability and risk profiles, these reports are not always consistent or reliable.

The challenge is the information provided in sustainability reports, which are unaudited, is often more about building corporate reputation than disciplined ESG reporting. The current rating system is over-dependent on disclosure and as a result those companies who are performing similarly may report this performance in different ways. For example, within the UK, disclosure between companies is not consistent as there is little regulation on how and where they publicise their ESG credentials.

- Company size: larger companies tend to attract higher ESG ratings, when other factors are controlled, because information is easier to gather on large companies.
- Lack of standardisation in disclosure rules may make comparison between jurisdictions difficult: differences in the required information between countries make companies difficult to compare, and mean assumptions may need to be made regarding gaps in data. For example, companies in the same sector and with similar ESG performance in the USA receive consistently lower ESG ratings than those with headquarters in Europe.
- Sector: risk assessments tend to be done on a sector-wide basis and don't always allow for differences in risk profiles between companies within a sector. For example (Box 4),

that have the resources to produce the best disclosure reports correspondingly have better ratings.49

The lack of consistency between ratings approaches may lead investors to wish to conduct their own assessments of companies’ ESG credentials. However, many investors, particularly small pension funds, will not have the time and resources to conduct their own assessments and will be dependent on other organisations to rate ESG risk factors.

48. AACF (2018)
Some projects, such as infrastructure, may be socially beneficial but fail in other areas

Investors have reported confusion regarding how to judge companies which provide a social or environmental good. For example, an investor may wish to use thematic investing as a way of accounting for ESG factors by putting some of their funds into social infrastructure. This type of thematic investing may therefore, exclude consideration of the environmental or governance factors in these infrastructure projects.

There is also a subjectivity regarding the social “good” of some infrastructure projects. For example, a third runway at Heathrow would create employment and support economic growth. On the other hand a third runway could create air and noise pollution for local residents. This dichotomy may be present in many infrastructure projects and can lead to subjective decisions on the perceived social good of a project, based on the particular weighting the investor gives factors such as employment and air pollution.

The above discussion has highlighted the main ways in which assessing ESG factors can be problematic and confusing. Lack of clarity and guidance in navigating this confusion has led to some trustees giving little or no consideration to ESG factors. Trustees and IGCs would benefit from more concrete guidance regarding how to assess and implement ESG factors.

Regulation in Europe is moving more quickly to ensure that members’ views are taken into account in investment decisions

European draft legislation is currently being considered that could require pension providers to consult with members when deciding what investment strategy is in their best interest. If European providers are required to involve members to this degree, UK schemes might start to seem poorly operated in comparison, unless they follow suit.

The reporting chain makes regulatory compliance more difficult

From 2020, trust-based DC schemes will be required to publish how they take account of financially material considerations, including (but not limited to) those arising from Environmental, Social and Governance considerations, including climate change. However, the vast majority of pension schemes will have their research, assessments and engagement carried out on their behalf by their asset managers. This means that Trustees and IGCs are often partly dependent on the quality of their asset manager’s report, when publishing their own report. Some Trustees and IGCs report that the quality of asset manager reporting is variable and that some Trustees and IGCs may not be furnished with sufficient evidence of an asset manager’s ESG process to comply with future regulation. Greater standardisation of reporting from investment managers to Trustees and IGCs would help schemes comply with regulation in future.

Trustees and IGCs would benefit from more concrete guidance regarding how to assess and implement ESG factors.

50. Law Commission (2017) p. 109, para 8.201
52. Qualitative interviews
Acknowledgements and Contact Details

The Pensions Policy Institute is grateful for input from many people in support of this paper, including:

Peter Askins  David Farrar  Stuart O’Brien
Nico Aspinall  Mark Fawcett  Jonathan Parker
Danielle Baker  Lydia Fearn  Julius Pursaill
Lorna Blyth  Honor Fell  Paul Stannard
Alistair Byrne  Madeline Forrester  Chris Wagstaff
Richard Butcher  Sarika Goel  Faith Ward
Chris Curry  Sarah Luheshi  Lauren Wilkinson

Editing decisions remained with the author who takes responsibility for any remaining errors or omissions.

The Pensions Policy Institute is an educational charity promoting the study of retirement income provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects. To learn more about the PPI, see www.pensionspolicyinstitute.org.uk

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A full list of supporting members is on the PPI’s website.
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