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Call for evidence on Responsible Investment for a Just Transition – Response from the Pensions Policy Institute

1. Response

1.1 This is the Pensions Policy Institute's submission to the All-Party Parliamentary Group for Local Authority Pensions' call for evidence on Responsible Investment for a Just Transition.

1.2 The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

1.3 This submission does not address all the specific questions in the consultation, neither does it seek to make policy recommendations. Rather, the response points to relevant research that the PPI has conducted over the last year. The Engaging with ESG research series, which can be accessed via the links below, contains evidence pertinent to key aspects of the consultation, specifically around the key challenges faced by schemes and others involved in the investment decision-making process when designing and implementing ESG strategies.

Engaging with ESG: The story so far (December 2020)
https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2020/2020-12-02-briefing-note-number-124-engaging-with-esg-the-story-so-far/

Engaging with ESG: Climate Change (February 2021)
https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2021/2021-04-22-engaging-with-esg-environmental-social-and-governance-factors/

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Engaging with ESG: Environmental, Social and Governance Factors (April 2021)
https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2021/2021-02-18-engaging-with-esg-climate-change/

2. Key points

2.1 The process of designing and implementing an appropriate ESG investment strategy, delegating to asset managers, or selecting an appropriate off-the-shelf solution from a fund manager/platform, is complex and schemes face a number of challenges. These include:

- Information overload and data issues
- Dependence on third parties
- Levels of knowledge and understanding

3. Information overload and data issues

3.1 As the focus on ESG has grown, so too has the quantity of information available about ESG risks and approaches for integrating them into investment strategies. More easily accessible information can help those responsible for making decisions about pensions schemes' investment strategies to improve their knowledge around ESG. Too much information and difficulty determining which information is most salient, however, can impede decision-making. More than a quarter (28%) of respondents to PPI's Engaging with ESG Survey[1] said that too much information had been a challenge when designing their approach to ESG, while 22% said that conflicting information had also been a challenge.

3.2 Schemes also identified availability, cost and consistency of ESG data as a barrier to both design and implementation of an effective ESG strategy. A lack of consistency and clarity in data and reporting is a fundamental barrier to improving ESG risk mitigation. Schemes that do not have a working knowledge of the data available and the way in which it relates to their investment strategy are less likely to be able to design and implement an approach that appropriately protects members against the long-term risks associated with ESG. They will also find it more challenging to hold third parties involved in the design and implementation of their investment strategy to account.

3.3 Schemes report that consistent and clear data on social factors is especially challenging to find. The broader scope, qualitative nature and difficulties associated with evaluating social risks and opportunities mean that developing an understanding of data around social factors, and how this relates to scheme investment decisions, is more challenging than for environmental and governance factors.

4. Dependence on third parties

4.1 Across the broad range of schemes covered by PPI's Engaging with ESG Survey, many expressed the view that reliance on third parties, such as external asset managers, can be a constraint on ESG integration. More than a quarter (28%) of schemes in the survey said that the need for a platform, asset manager or other third party in implementing their strategy proved to be a barrier to constructing it exactly as they would have liked. While acknowledging that the need for a platform, provider or external manager can constrain their ESG investment strategy, schemes in the survey seemed to accept this status quo as a limit within which they would have to work, rather than a catalyst for engagement with third parties to drive forward innovation so that they are better able to implement their preferred ESG investment strategy.

4.2 Stewardship and engagement are increasingly important components of ESG approaches, which can be challenging when schemes predominantly delegate day-to-day investment procedures to providers or asset managers. Schemes do not always have the internal expertise or governance resources to fully understand or assess activity undertaken on their behalf, and are heavily reliant on the detail and accuracy of information provided to them about these activities. DB and larger DC schemes are more likely to have internal policies for direct engagement with companies they invest in, as well as a greater understanding of stewardship and engagement activities being undertaken on their behalf. Other schemes, however, are yet to incorporate these considerations into their decisions about how to delegate investment decisions. For example, a respondent to PPI's Engaging with ESG Survey said that they did not take into account asset managers' engagement and stewardship activities when selecting and retaining managers. On average, expectations about asset managers' engagement behaviour and reporting appear to be increasing. However, several schemes in the survey reported there was still work to be done before asset managers are fully meeting these expectations.

4.3 Schemes may need to engage with and challenge their pension provider and/or external asset managers more directly in order to drive forward innovation to ensure that off-the-shelf and pooled products meet their needs and align with internal policies on ESG investment. Smaller schemes with lower levels of assets under management generally have less power to influence external fund managers. However, if enough larger schemes engage providers and external asset managers, this should drive up standards and availability across the industry, to the benefit of smaller schemes.

5. Levels of knowledge and understanding

5.1 Policy and regulatory change relating to ESG is occurring rapidly, which can be challenging for schemes that do not already have the necessary expertise to catch up at pace. Although knowledge and understanding of ESG issues have grown across the industry, there is still a need to improve some scheme decision-makers' knowledge in this area, especially around the more practical aspects such as the implications of different investment approaches.

5.2 Schemes predominantly outsource their day-to-day investment decisions, which means that most schemes do not have their own detailed voting and engagement policies. However, now that implementation statements are part of the regulatory requirements, there is a need for all trustees and providers, regardless of scheme size or type and the level of direct day-to-day involvement with ESG approaches, to have a sufficient level of knowledge and understanding in order to best fulfil their role to effectively scrutinise external managers used by their scheme.

5.3 Knowledge and understanding of the importance of corporate governance standards tends to be reasonably developed among scheme decision makers, while environmental issues, especially climate change, have been growing in focus for some time. However, the broad scope and qualitative nature of social factors in particular, and the difficulty associated with evaluating social risks and opportunities, can make it harder for schemes to understand how to integrate these risks effectively into their investment strategy. This is an area where a source of comprehensive and neutral guidance could be especially beneficial for scheme decision makers that don't know where to start in assessing the financially material nature of social risk factors. This aim could also be aided by increased integration and cohesion across the industry, as asset managers and consultants who are especially engaged on ESG could share knowledge with schemes and help to improve standards across the industry.

Notes

1. PPI's Engaging with ESG Survey, carried out in November 2020, sought to gather insight into the approaches being used by schemes in order to take into account ESG risks, and the challenges they have faced along the way. The survey was open to responses from both schemes and third parties involved in the process, such as consultants and asset managers. There were 62 responses in total, including 31 pension schemes, 48% of which were Defined Contribution and 52% Defined Benefit.