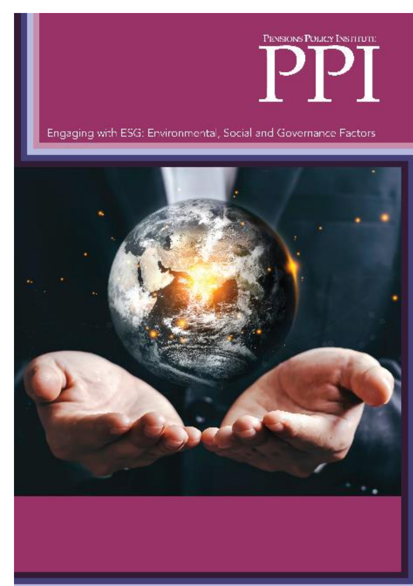
Report kindly sponsored by:

PPI Policy Launch Event

Engaging with ESG: Environmental, Social and Governance Factors

Launch write up:



The Pensions Policy Institute (PPI) held a policy seminar on 22nd April 2021 to launch Engaging With ESG: Environmental, Social and Governance Factors, sponsored by **Newton Investment Management.** This report is the third and final output in the Engaging with ESG series. Following on from the climate change report, it delves deeper into the investment landscape for other environmental, social and governance risks, and aims to highlight practical steps needed to extend their effective integration into investment strategies. It also identifies the way in which lessons learned from the development of climate change integration initiatives can be applied to wider ESG considerations.

The Engaging with ESG series is sponsored by, Newton Investment Management, Phoenix Group, Association of British Insurers, Baker McKenzie, PLSA and Scottish Widows

The event was run as an online seminar with the key findings presented by the author Lauren Wilkinson (PPI), responses from the sponsor Julian Lyne (Newton Investment Management), and responses from the panel members including Brendan Walsh (The Pensions Regulator), and Andrew Parry (Newton Investment Management).

Just under 80 people attended this event, representing a broad range of interests within Government, the investment industry, the pensions industry and the third sector attended the seminar. Chris Curry (PPI) chaired the event.

Report kindly sponsored by:

Presentation of key findings and responses to the report

Chris Curry, Director, PPI, welcomed the attendees to the event and thanked the report sponsor, Newton Investment Management, as well as other series sponsors, Phoenix Group, ABI, Baker McKenzie, PLSA and Scottish Widows for their support. He introduced the report as the third in a series of ESG work underway within the PPI and discussed its importance in the context of developments in legislation, policies and trustee or provider engagement with risks associated with ESG.

Lee Massey, Fundraising and Events Assistant, PPI introduced the panel and participants to the online format of the event.

Julian Lyne, Chief Commercial Officer, Newton Investment Management welcomed participants to the virtual launch, and emphasised the importance of high-quality independent research in decision making, as well as the key role that research plays in improving pension outcomes.

The pensions and retirement landscape are evolving rapidly, particularly in terms of the regulatory environment, and ESG is especially relevant to this process. This report should help us both to understand ESG better and catalyse advances in the way we go about addressing ESG factors successfully. However, the focus on ESG should not just be for the purpose of meeting regulatory requirements, but more importantly for setting investment strategies as responsible investment can provide more resilient long-term returns. It is no longer an option to omit ESG factors from investment strategies, since doing so would present an incomplete picture of portfolio risk and diminish the opportunities and outcomes that can be achieved. Newton seeks to drive positive change through active engagement, but also stress the need to continue to adapt and develop best practice and standards in order to help meet investment goals and regulatory responsibilities. In order to achieve strong outcomes, there needs to be purposeful engagement and strong collaboration across all stakeholders. Julian concluded by extending his congratulations to the PPI for 20 years of adding value to future of retirement.

Lauren Wilkinson, Senior Policy Researcher, PPI, introduced the report as the final output of the PPI ESG series. The time to ignore ESG has passed, since factors are becoming increasingly important and pressing in investment decision making, and more widely recognised as material risks from a regulatory perspective. To date, ESG has predominantly focused on climate change where excellent progress has been made, but a broader view and integrated goals are needed to make sure members are protected against all ESG factors and more work needs to be done in this area. This has been highlighted by the pandemic which has prompted a shift in focus to wider environmental, social and governance factors.

A review of the five key findings from the previous report demonstrated that the development areas identified are even more salient to ESG factors beyond climate change, many of which are earlier in process but on the same trajectory. Although the focus has largely been on shifts to a carbon neutral economy, there is a need to mitigate broader ESG risks and consistency in

how factors are approached will lead to better outcomes and protection for members. Other risks include:

- **Broader environmental risk factors** resource depletion, water waste, energy and waste management and biodiversity loss. The recent focus on climate change risk is easily translated to other environmental considerations where change is already starting to happen, enabling development on frameworks to assess dependencies and impact.
- **Governance factors**: Governance principles are well established but further work is required to ensure risks are accounted for. At present, good quality data tends to be concentrated in larger publicly listed companies, but stakeholder and public trust has been shaken by large scale insolvencies. Many governance factors are more established than other areas of ESG, this allows the opportunity to build on existing frameworks.
- **Social factors**: Although investment decisions are principally based upon financial risk, social factors are becoming increasingly important and their focus is often more on creating benefit than reducing harm. As a result, they can often be harder to integrate and their positive impacts harder to measure. The shift towards recognizing social factors has been accelerated by COVID, the Black Lives Matter movement and workers rights issues. Despite regional and cultural differences, and the risk that social and ethical aspects may be conflated, together these changes emphasise how rapidly health, societal and labour market priorities can evolve.

Engaging with ESG brings with it both **challenges and opportunities**. Key challenges include managing large quantities of information and data of varying degrees of quality, knowledge gaps and inconsistency which can make it hard for schemes to know how to assess and integrate risks, particularly with social factors. A **neutral source of guidance** would be beneficial, particularly as consistent and clear analytical tools and data on social factors are difficult to find. Dependency on third parties for expertise, stewardship and engagement are also challenging for schemes since outsourcing can limit strategies available and the expertise to review or analyse strategies may not be available. Greater engagement with asset managers, driven by increased knowledge and understanding, may be necessary to increase the offerings and ensure that needs and preferences are better met.

There is **significant variation** in views on and readiness for ESG across the industry, with some remaining confusion around financially material nature of ESG risks. Development is dependent upon pace of managers for implementation, and the path towards engaging with ESG is one of constant reassessment.

Lauren concluded that the focus on ESG is extending beyond climate change and other factors are beginning to follow in the success of its implementation initiatives. Although social considerations are growing, there is much more work to be done before schemes can incorporate them into investment strategy. A **broader approach** that takes into account all ESG risks, not just climate change, is needed to ensure members are appropriately protected.

Report kindly sponsored by:

Brendan Walshe FIA, Principal – Investment Regulatory Policy, Analysis and Advice, The Pensions Regulator thanked the PPI and Lauren for her work.

Today's position on the ESG journey can be characterised by a period of rapid change and recent proliferation of new regulations. To date, many schemes have complied with requirements, whilst upcoming implementation statements are expected to make clear that words should be translated into actions, and trustees should be implementing ESG initiatives in a transparent way. By 2023, 90% of DC and 75% of DB assets under management will be covered by reporting requirements which is excellent progress, but there is still further to go. The upcoming roadmap will ensure that financial information starts to flow through by 2025. There is also a need for greater engagement between managers and schemes who have historically said that ESG is the responsibility of the investment manager. Today's report highlights that climate change has been high on the agenda and this focus is expected to continue for the foreseeable future, yet other social, governance and environmental factors are gaining ground. These changes are partly due to the way in which risks exacerbated by inequalities could translate into social considerations in the future.

Although there is no clear view on what best practice might look like for stewardship and engagement, we are likely to see much more transparency in the near future. This will begin with the collection and publication of URLs as well as an index which will give people access to sources of information. Results of an implementation statement review is likely to be produced around 2022 for schemes in scope for current disclosures, and are expected to generate themes for good practice and resilience to climate risk. To ensure that policy intent will translate into actions, trustees should be mindful of emerging risk and adapt as they emerge. Climate change is expected to dominate these risks for some time, but security could become another key area of focus as a consequence of unjust transition.

Real change should be driven first and foremost by engagement, rather than guillotine decisions, and it will be the responsibility of trustees to address this. This change is being supported by the importance that ministers and DWP are placing on improving stewardship, transparency, good practices (such as climate disclosures) and raising awareness of factors beyond the environment.

Andrew Parry, Head of Sustainable Investment, Newton Investment Management echoed thanks to PPI and Lauren, and noted the good timing of the event as today is Earth Day.

Social dislocation and threat to economic models from social and environmental change are key considerations, not just for investment portfolios, but for strategic thinking at national security level. ESG should be understood in terms of real world change, and must be integrated with overall approaches to investing. Schemes also have obligations to ensure that default strategies are appropriately positioned to address issues, recognizing that societal norms and stakeholder thinking are likely to reshape the economy and the way we work. Schemes and

asset managers should support each other on this journey, but there is no simple route map to solving complex issues.

Change will be heavily driven by younger generations, who rank ESG considerations and investment outcomes equally when considering their choices. Despite the pandemic, ESG and sustainable funds saw record inflows in 2020 as capital was mobilised into these areas. Awareness of ESG factors will also shift from products to business models, a shift which will be important to remaining resilient and relevant in a changing world. ESG considerations also relate directly to improved pension outcomes and therefore to the financial imperative at the heart of most schemes. The focus should therefore be not just on reporting methodology and what a company is disclosing, but on their underlying purpose, principles and actions. Investment managers and other stakeholders also have a responsibility to hold themselves to account and live by their standards as a company, particularly in respect of diversity and inclusion.

Active engagement is a valuable tool to ensure portfolios are positioned appropriately. It affords the opportunity to identify how client outcomes can be improved and how investment outcomes can be enhanced in the long term. Although the most effective form of engagement is voting, human interaction is essential to maintaining meaningful and sometimes forceful dialogue. This applies to credit holders as well as equity holders. However, when issues cannot be resolved through engagement, the voice of investors as activists becomes increasingly important as evidenced by the recent growth in active management and in active or proxy voting. Government and civil interactions will also be key to securing long term change, and linking activism to underlying fundamentals will be crucial. Caution should be exercised as we seek to standardise data provision, since standardization (particularly where third-party ratings are used) should not be at the expense of bespoke insights. Many of these ratings are summary indicators of complex nuances across a range of industries, and relay in internal interpretations of data. It will be essential for clients to understand what data is being captured and what their role in decision making could be.

Social considerations are now emerging from the shadow of climate change. Together, they are prompting the widespread reallocation of capital and start of significant social and economic recalibration. It is likely that difficulty engaging with social issues will be addressed in a similar way to climate change, but in all cases a pragmatic and optimistic approach is needed as innovation cannot solve everything. Solutions should not be narrow, but should instead build brand value and make business relevant. We cannot achieve sustainability without addressing business models.

Panel discussion and Q&A

The following points were raised in the discussion, chaired by Chris Curry with a panel consisting of Lauren Wilkinson, Julian Lyne, Brendan Walshe, Andrew Parry, Chantal Thompson, Ian Burger, Joe Dabrowski, Sakshi Bahl, Sindhu Krishna. This session was held

under the Chatham House Rule and the views expressed do not necessarily reflect the views of the Pensions Policy Institute or panellists.

The following themes of discussion emerged during the panel discussion and Q&A with the audience:

Integrating ESG risk factors

- Although the scope and pace of change around ESG can be daunting, strong building blocks are in place from which guidance and strategies can be developed. They are supported by collective conversations and significant progress taking place across industries. Although there is still significant work to be done, the many threads of ESG are beginning to merge into one commonality and in time will become fully integrated in strategies and practices.
- A significant role for government to facilitate this integration is emerging. Reporting requirements are beginning to significantly impact data and decisions, highlighting that pension schemes alone cannot solve the risks presented by ESG and government intervention will be essential. Although information may be incomplete today, data will improve going forwards and an appropriate balance should be struck when making ESG transitions between engaging and forcing change. Potential asset depreciation is something that trustees are expected to incorporate into their risk assessments in the event of challenges towards transition, but they are also expected to be proportionate to the size and the complexity of the scheme.

ESG risk factors beyond climate change

- At present, social factors are ranking above environmental issues in some surveys, in part accelerated by the pandemic, and often blend with issues which are ethical in nature. These factors may include community relations, employee relations, human rights, and workforce diversity. However, they are markedly more difficult to quantify due to their qualitative nature, meaning that their risks are also more difficult to define.
- To accelerate the integration of non-climate ESG factors, it will be important to recognise that risks are not mutually exclusive. To achieve this, we require:
    - Greater understanding of the materiality of social factors. These are likely at a similarly nascent stage to climate change before the development of regulation, cost of carbon metrics etc. Issues such as diversity may have less obvious but equally high materiality, for example implications for supply chains, human rights and labour relations. Social issues are expected to escalate in near future.
    - Less focus on other conflating factors. Social factors should be considered as drivers of financials rather than independent issues, where investors look through to underlying factors that support the notion that well run companies are known to perform better over the longer term. More education is required to act on this content.

- Greater alignment with health and wellbeing supply chain in some sectors, for example tobacco, particularly where there is significant exposure in mainstream indices and no alternative business model is viable. Funds are increasingly building pledges and exclusions into their investment strategies and financial decisions, the drivers of which are often social themes.

Trustee roles

- ESG raises questions around the way in which trustees can balance the principles of their duty to comply with legislation, with their duty to act in the interest of beneficiaries. It highlights gaps both in trustee knowledge and understanding, and in data, both of which are typically filled by reliance on third party providers.
- Reliance on investment managers and third-party providers often both stems from and widens gaps in ESG knowledge and understanding between schemes and trustees. Although legal requirements for trustees are relatively limited, it will be important for them in the future to be able to assess the risks relating to ESG without relying heavily on intermediaries. This could enable them to better select the right investment manager for their needs, challenge advice, set clear and strong objectives including to consultants, and oversee implementation strategies or long-term outcomes.

Engagement with clients and members

- Understanding client expectations is crucial to engagement strategies among investment managers and understanding member expectations should equally important. Risk mitigation is most effective when decision makers recognise interdependent considerations and the strong ties that exist between issues such as corporate governance structures, reputations and supply chains.
- There is a danger of assuming that savers are not committed to ESG because scheme engagement and pensions literacy are generally low. Most managers are moving to incorporate ESG strategies into their funds by default, which seems to be addressing the demand from investors and mitigating the likelihood that they will move funds to an alternative product.
- Trustee focus on ESG will differ between DB and DC schemes. In the case of DB, investment decisions should be primarily based on investment policies as agreed by advisors, unless all members support a particular strategy and the strategy is not detrimental to investment outcomes. However, good practice suggests that DC trustees should be asking members what they want and giving greater prominence to their concerns. They should also recognise that members don’t always have the confidence to make investment decisions, and it is therefore incumbent upon trustees to reflect what members want and need in the design of default strategies.

Engagement with companies

- A strong engagement strategy to address the ESG investment risks in should include:
  - Effective research at the outset
  - Setting out clear expectations to companies, including red lines that might prompt the investor to vote against the company or sell its investments
  - Establish what commitments and timeframes are required from the company
  - Clear escalation pathway outlining when concerns should be raised with other stakeholders eg board members, other owners, policy makers and regulators.
- Sustainability should be an objective across the whole business. It will be important that managers can differentiate between companies taking ESG responsibilities seriously and those who are green-washing since ESG ratings can be misleading. Although there is no single answer, this highlights the need for strong, continuous, integrated and monitored engagement strategies which feed back into voting processes. In respect of social issues, this will likely require a combination of strategies which includes identifying nuances or changes in direction from high level data over time. It will also require tougher questions to companies on behalf of investors, which can encourage introspection.
- Reporting requirements will be central to ESG strategies. Trustees and providers should also take extra care to ensure that managers to whom they have delegated investment responsibility have robust processes in place, and seek evidence that have infrastructure, skills and commitment to the subject of ESG.
- Where large companies are performing well despite social issues, the incentive to hold companies to account on ESG becomes more difficult. However, inaction on social issues presents a significant regulatory risk to the sustainability of these organisations since regulations tend to catch up with working practices eventually. It will be important to consider the trade-offs between short-term profitability based on unsustainable working practices, with long-term company sustainability.
- Collective and collaborative engagement will be critical to increasing accountability in these circumstances. Combining the skills of ESG experts and PMs as capital allocators when engaging with companies can also present a very powerful proposition.

Closing Remarks

- The importance of wider ESG factors beyond climate change is growing, particularly in the context of recovery from the pandemic. Complexity is also increasing, but there are strong building blocks in place and good progress is being made in terms of direction, metrics and reporting.
- There are strong calls for integrated frameworks and a joined-up direction of travel for ESG strategies as social factors gain momentum in investment decisions. Although ESG has historically been framed as a risk factor, it should also be assessed in context of generating ideas and opportunities for future returns as companies re-shape the world.
- Many schemes and managers still have a lot to learn, and it will be important for trustees to find the right balance between meeting regulatory obligations and meeting

fiduciary obligations, since financial returns are crucial. ESG considerations alone are not a sufficient condition for financial success, should be seen in the context of external influences from governments, legislators and civil society.

- Collaborative engagement and integration will be key to the success of ESG strategies and ability of schemes and managers to implement robust policies that can influence long-term financial shifts and outcomes. This should include:
  - Helping trustees to understand financially material risks related to social factors and consider not just the way their managers, invest but also how they govern themselves as a corporate entity.
  - Emphasizing board level responsibility for ESG decisions and outcomes
  - Looking beyond high-level data to indirect exposure when considering corporate conduct from a risk management perspective
  - Increasing member awareness of ESG initiatives, even if distance to retirement makes it more difficult to incentivise meaningful engagement among some groups
  - Investing in education, training, stewardship and reporting
- This research underscores the need for us all to collaborate to ensure that the pensions landscape gets the balance right between meeting the needs of its members and working towards the right outcomes for society.

We would like to thank our major sponsors of the Engaging with ESG series:

And our thanks also go to our series sponsors: