Pensions Policy Institute

Engaging with ESG: Environmental, Social and Governance Factors

Executive Summary

The Pensions Policy Institute (PPI)

We have been at the forefront of shaping evidence-based pensions policy for 20 years.

The PPI, established in 2001, is a not-for-profit educational research organisation, with no shareholders to satisfy – so our efforts are focussed on quality output rather than profit margins. **We are devoted to improving retirement outcomes.** We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. The PPI gives you the power to influence the cutting edge of policy making. Each research report combines experience with independence to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **Independence** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

Our Vision:

Better informed policies and decisions that improve later life outcomes

We believe that better information and understanding will help lead to a better policy framework and a better provision of retirement income for all.

Our Mission:

To promote informed, evidence-based policies and decisions for financial provision in later life through independent research and analysis

We aim to be the authoritative voice on policy on pensions and the financial and economic provision in later life.

By supporting the PPI, you are aligning yourself with our vision to **drive better-informed policies and decisions that improve later life outcomes** and strengthening your commitment to better outcomes for all.

As we look forward now to the next 20 years, we will continue to be the trusted source of information, analysis, and impartial feedback to those with an interest in later life issues. The scale and scope of policy change creates even more need for objective and evidence-based analysis. There is still much to do, and we look forward to meeting the challenge head on.

For further information on supporting the PPI, please visit our website:

www.pensionspolicyinstitute.org.uk

or contact Danielle Baker, Head of Membership & External Engagement

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The future is ever changing, but the PPI remains a constant "Voice of Reason" in the ongoing debate on the future of retirement in the UK.

Pensions Policy Institute

PPI

EST. 2001

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Executive Summary

This report explores the way in which pension scheme investment strategies take into account Environmental, Social and Governance factors (excluding climate change, which was covered in detail in the previous report in this series), looks at how strategies interact with the current regulatory landscape, and considers future opportunities, challenges, and proposals for effective support to encourage evolution and improved risk mitigation. This summary covers the main points of the report and acts as the conclusion.

Environmental, Social and Governance (ESG) considerations have become an increasingly important component in pension schemes' investment strategies. In recent years, focus on ESG considerations has grown rapidly, with many trustees and providers increasing their understanding and knowledge of this area of investment, particularly driven by changes in regulation.

For some time, much of the focus on ESG has been skewed towards climate change, which was covered in detail in the previous report in this series. However, as ESG investment becomes more important, focus on other areas of ESG is also growing, as a greater number of schemes recognise the need to mitigate the associated risks.

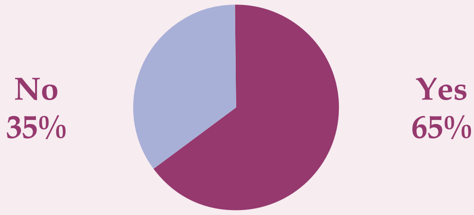
- **Other environmental factors** have often been overshadowed by climate change, but the paths that have led to more effective integration of climate change risks are now serving as a blueprint for other environmental areas, such as biodiversity.
- **Social factors** are growing in importance, a shift that has been accelerated by the events of the last year, particularly COVID-19 and equal rights movements. However, not all investors are monitoring the social issues that can impact the companies in which they are invested.
- **Governance factors** are well-understood in their own right, with corporate governance frameworks an established component of traditional investment strategies. However, failure to recognise the way in which governance practices interact with environmental and social factors may lead to more fragmented ESG approaches.

Activity around ESG considerations has increased substantially and two thirds of schemes in the Engaging with ESG Survey[1] believe they are currently doing enough to account for these risks in their investment strategy, with some Defined Benefit (DB) schemes even reporting that they feel they are doing more than is necessary. Among many schemes, both those that feel they are doing enough and those that do not, there is a recognition that ESG strategies are a work in progress (Figure Ex.1).

1 See Appendix for more details.

Figure Ex.1[2]

Do you feel that your scheme is doing enough in terms of ESG issues?



**'All schemes should have this under continuous review.'
- Defined Benefit**

'Further integration, progressing to TCFD aligned analysis of risks.'
- DC Master Trust

**'More individual choice'
- DC Contract-based**

'Our scheme is on a journey to a more sustainable portfolio over time, in line with our firm's policies.'
- DC Master Trust

**'We're doing the most we can at present, however more resources are needed to achieve the levels required in the new Stewardship Code.'
- Defined Benefit**

'We invest in pooled vehicles and cannot therefore realistically affect the investment strategy on our own.'
- Defined Benefit

'In fact it's doing far too much. ESG has no place in pension scheme investment strategy.'
- Defined Benefit

**'There is a lot of noise and marketing going on about ESG'
– Defined Benefit**

'As we use pooled funds, we are always going to be subject to the pace of our investment managers in implementation.'
- DC Master Trust

**'Major recent change. Can do more.'
- DC Master Trust**

'Yes - ESG is an integral part of the investment process.'
- Defined Benefit

**'We fully understand each manager's approach to ESG and believe we have the right asset mix and fund to achieve the objectives.'
- Defined Benefit**

The previous report in this series highlighted that while some schemes, and those acting on their behalf such as providers or external asset managers, are doing a lot of work to mitigate ESG risks, there is still a lot of work to be done before all schemes have effectively accounted for these risks in their investment strategy. The report identified five areas where further development could help to further progress towards this target:

- **Integrated goals:** Establishing a consensus across all stakeholders (Government, schemes, asset managers and providers) on goals, and the practical steps needed to achieve them, to ensure that climate change considerations are integrated across the investment landscape by a certain date.
- **Engagement and stewardship:** A greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals.
- **Encouraging innovation from third parties:** Pressure from Government, regulators and industry bodies on those involved in schemes' approach to climate change (such as pension

providers, external asset managers and consultants) to provide products and strategies that meet the needs of schemes in integrating these risks, as well as improving the data they provide schemes about their own activities relating to climate change.
- **Increasing knowledge and understanding:** Improving scheme decision makers' knowledge and understanding of climate change across the industry, especially around more practical aspects such as the implications of different investment approaches.
- **Standardised data and definitions:** Producing a centralised data source which provides a starting point for schemes that are unsure where to begin, or are overwhelmed by the quantity of data available - particularly given inconsistencies across different metrics. Feasibly, this would need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

These development areas are perhaps even more salient for the other ESG factors (which are explored in detail in this report). Some of these factors appear to be on the same path towards more effective integration as climate change, but earlier in the process. The progress that has already been made towards more effective integration of climate change risks can be used as a guide for increasing the effectiveness of efforts to integrate these other ESG risks. Consistency in the way in which the various areas of ESG are approached is likely to yield a greater protection for members against these risks.

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 pension provider, is complex. Responses to PPI's Engaging with ESG Survey highlight the barriers schemes face when approaching ESG risk factors, including the following:

- The large quantity and inconsistent quality of information available on ESG risks and approaches. Around a quarter of schemes report that the vast quantity of information available and the inconsistency in the quality of information can make it more difficult to know how to approach ESG risks. Although knowledge and understanding of ESG has grown across the industry, there are still gaps in some areas, particularly when considering social factors. 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.
- ESG data issues - such as availability, cost and divergence between different metrics. Schemes report that consistent and clear data on social factors is especially challenging to find. Many pension schemes will have their research, assessments and engagement carried out on their behalf by their pension provider or external asset managers. This means that scheme decision makers are dependent on the quality of information provided to them. Schemes must ensure that they have sufficient understanding and that they are being provided with appropriate data on both investment allocation and engagement and stewardship activities being undertaken on their behalf by external managers - even if this is done through other parties such as their provider.
- Dependence on third-parties, in terms of how this may limit the ESG strategies available to schemes - and especially engagement and stewardship approaches. Stewardship and engagement are an increasingly important component of ESG approaches, which can be challenging when schemes predominantly delegate day-to-day investment procedures to providers or asset managers, and do not always have the internal expertise or governance resources to fully understand or assess activity undertaken on their behalf. More than a quarter (28%) of schemes that responded to the Engaging with ESG Survey said that the need for a platform, asset manager or other third party to implement their strategy proved to be a barrier to constructing it exactly as they would have liked. However, 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 in order to drive forward innovation so that they are better able to implement their preferred ESG investment strategy. 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.