PENSIONS AND LIFETIME SAVINGS ASSOCIATION

JUNE 2019

ESG AND STEWARDSHIP:
A PRACTICAL GUIDE TO TRUSTEE DUTIES

ABOUT THE PLSA

We're the Pensions and Lifetime Savings Association; we bring together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with 20 million members and £1 trillion in assets, across master trusts and defined benefit, defined contribution, and local government schemes. Our members also include some 400 businesses including asset managers, investment consultants and other service providers.

Our mission is to help everyone to achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings, and to build the confidence and understanding of savers.

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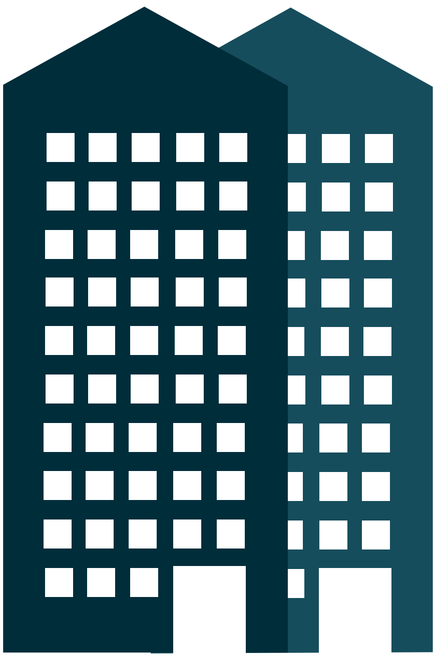


MINISTERIAL FOREWORD

I'm delighted to write the introduction to this best practice guidance.

When I realised the extent of continuing trustee confusion about their responsibility to consider financially material risks and opportunities – whatever their source – I recognised that it was necessary to act. My belief, and that of many others in the industry, is that firms who disregard the impact of their business on the environment, neglect their recruitment and workforce management practices, and undermine the independence and diversity of their boards all incur a significant financial risk, whether it is visible on today's balance sheet or not.

Looming over all of us too is the threat of climate change. Like others, this Government must act, and it will. This will necessarily have an impact on the valuations of firms who are not adapting – and that will have significant repercussions for employers' contributions to fund defined benefit pension schemes, and savers' defined contribution pension pots.

Those are my beliefs – trustees will have their own. This guide is particularly helpful in setting out how trustees can explore, articulate and reach a consensus on their views of the extent to which these factors are priced into the market. It would take a brave trustee, though, to conclude that absolutely none of these issues are material, or that they are all solely matters of personal ethics.

In the regulations, the consultation documents and in my public comments, I've been keen to bring out that all trustees in scope of the regulations can do something and have a responsibility to act.

Most trustees are not FCA-authorised investment managers, and many trustees invest via pooled funds or unit-linked contracts. Those trustees still make buying decisions when they appoint and when they retain managers. Bound up in those decisions are decisions about investment objectives, asset allocation – both across and within asset classes – voting on company and shareholder resolutions, engagement with firms and many other matters.

In fact, when trustees appoint investment managers with no instructions other than "Do ESG and stewardship for us" they are adopting the investment manager's investment beliefs. No pension schemes can recuse themselves in this way and express surprise or claim immunity when those investment beliefs turn out to be very different from their own. So another thing that is excellent about this guidance is that it not only sets an expectation that all schemes have a responsibility here. It also highlights actions that all schemes, whatever their resources or capacity, can do.

Finally, I wanted to emphasise that this is only the start of the journey. These regulations are set to come into force on 1 October, so if you are reading this in June and just beginning to think about your new legal duties to report, I encourage you to move swiftly.

But this is not a 'once and done' exercise. Pension schemes will be expected to monitor, update and develop their statements on ESG and stewardship over time – not only as their membership profile and objectives evolve, but also as our understanding of the materiality of different aspects of ESG and our data improves. It will also evolve as we publicly face up to the challenges of our times - not only addressing climate change, but also doing so in a way which is just - both encouraging responsible capitalism and bringing irresponsible capitalism to heel.

Pension investment strategies are continuing to grow in sophistication, especially in DC. I recently consulted on how we can nudge pension schemes towards broadening the range of asset classes schemes consider, and this will bring fresh approaches to ESG through direct investment in 'real' assets.

In conclusion I applaud the PLSA and the participants of the Taskforce who have given freely their time and energy in developing this invaluable guide – and I urge all trustees to read it.

Guy Opperman MP

PARLIAMENTARY UNDER - SECRETARY OF STATE FOR PENSIONS AND FINANCIAL INCLUSION
DEPARTMENT FOR WORK AND PENSIONS
JUNE 2019

CHAIR FOREWORD

UK pension schemes are long-term investors. They want the companies they invest in to flourish on an ongoing and sustainable basis, so that the value of individuals' savings can be protected and enhanced over the next 10, 20 or even 50 years.

This requires schemes to make the best possible investment decisions with their £1.8tn of assets under management, taking into account all the most relevant risks and opportunities. Traditional investment approaches have focused on issues such as inflation or liquidity, but there is growing recognition that integrating environmental, social and governance (ESG) factors into investment decisions can affect schemes' long-term risk-adjusted-returns.

The government's 2018 changes to the *Occupational Pension Schemes (Investment) Regulations 2005* – changes aimed at supporting schemes both to take account of financially material ESG factors and act as good stewards of their assets – places new requirements on scheme trustees. Taken together with growing public interest in issues such as climate change, gender diversity and modern slavery, ESG is firmly near the top of schemes' agendas both for this year and, I hope, beyond.

The PLSA has been at the forefront of industry efforts to encourage a sustainable and long-term investment culture in the UK and strongly supported the government's work to support trustees in considering financially material ESG issues and stewardship. I was therefore delighted to be invited to chair the PLSA's cross-industry Taskforce to produce this practical and timely guide which takes Defined Benefit (DB) and Defined Contribution (DC) schemes step-by-step through the process they need not only to comply with new regulations, but also to achieve good practice.

Pulling together expertise and tips from leading schemes, investment advisers, lawyers and managers, the main sections of this guide have been structured to reflect the typical journey that trustees take; to help trustees ensure that the most relevant ESG factors and stewardship practices are properly understood, formalised in a relevant policy and, where appropriate, reflected in broader decision-making. The emphasis is not on one-time-only compliance with the first set of regulatory deadlines but also aims to help schemes consider how to develop their approaches in the future.

Through the use of myth-busters, case studies and questions that trustees can instantly use with their advisers and managers, this guide is relevant for all trustees: from those schemes that are at an early stage of considering ESG to those well-advanced on implementing agreed policies and investment beliefs but thinking about how to go even further.

We recognise that trustees and schemes will have their own unique perspectives and situations; the material we offer here is not intended as a template policy or implementation approach but should instead be used as a tool to facilitate engagement with the issue and aid discussions with advisers and managers.

I have been hugely encouraged by the positive reception to this initiative from across the industry, not only from the enthusiastic Taskforce participants who have kindly offered their time and knowledge, but also from the many interested organisations which have supported the process. It has been a truly collaborative venture. I would also like to make special mention to Caroline Escott and Jonathan Cross for their work organising the workshops and in drafting this guidance.

We are all on an important journey in learning how schemes can best act as good stewards and meaningfully integrate relevant ESG considerations in their investments. I hope that this guide will support trustees to use their new duties as the catalyst for better investment decisions in the best long-term interests of savers.

Brian Henderson
CHAIR OF THE TASKFORCE

MEMBER OF THE PLSA POLICY BOARD

INTRODUCTION

Incorporating environmental, social and governance (ESG) factors into investment decision-making has been growing in popularity for several decades, with many UK pension schemes leading the way in doing so. However, the 2018 changes to the *Occupational Pension Schemes (Investment) Regulations 2005 (*henceforth *Investment Regulations)* mean it is now vital that trustees of all schemes understand and include ESG factors and stewardship approaches in their investment decision-making. A failure to do this puts trustees at significant risk of breaching their legal and regulatory duties.

This guide helps trustees understand what they need to do in order to meet those duties and how they can achieve good practice. Although the starting point for this guide is the new *Investment Regulations* for trust-based schemes, many of the considerations we highlight here will also be useful for decision-makers of contract-based arrangements, given the ongoing policy and regulatory interest in this space.

INVESTING RESPONSIBLY: WHAT IS ESG AND STEWARDSHIP?

THE DIFFERENCE BETWEEN RI, ESG AND SRI:

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. Responsible Investment (RI) should not be confused with Socially Responsible Investment (SRI). SRI combines investment returns with ethical investing (investing in line with a set of moral or ethical principles). In this guidance, we view RI as driven by financial rather than ethical or moral implications and its main purpose to improve risk-adjusted returns. ESG is a term that is used to describe a group of risks – environmental, social and governance – that are explicitly acknowledged and integrated into the investment research and decision-making process.

ESG

Anyone making an investment decision does so only after careful analysis of all the issues affecting the investment and which will have a material impact on the performance of the investment. At its most fundamental, 'ESG investment' – a term often used interchangeably with 'responsible' or 'sustainable' investment – adds an extra dimension to traditional financial analysis of equities (private and listed), bonds and other instruments by including evaluation of the most pertinent (or *financially material*) environmental, social and governance issues; this is done with an eye to protecting and enhancing the value of assets held and informing future investment and allocation decisions1[1].

1 Further information on definition of ESG and the different approaches can be found in the PLSA *ESG Made Simple Guide* (July 2019)

Examples of ESG factors are numerous and ever-shifting (see Graphic [1] for a non-exhaustive list 2).

Environmental	Social	Governance
Climate risk	Community Relations	Board Structure
Carbon emissions	Employee Relations	Executive Remuneration
Energy Usage	Health and Safety	Bribery and Corruption
Raw Material Sourcing	Human Rights	CEO/Chair Duality
Supply Chain Management	Product Responsibility	Shareholder Rights
Waste and Recycling	Workforce Diversity	Vision and Business Strategy
Water Management		Voting Procedures

ESG investment is often confused with impact investment. However, there are important differences. ESG investment analyses E, S and G factors to understand the effect on risk-adjusted-returns while impact investing goes a step further by investing in companies, organisations and funds with the express purpose of creating a positive social or environmental impact, alongside achieving a financial return3[2].

STEWARDSHIP

Individuals entrust their savings to schemes, to be invested on their behalf and in their best interests. Schemes therefore have a responsibility to act as good stewards and protect and grow the long-term value of members' capital in a sustainable way.

Being a good steward requires schemes to work with their advisers and managers to undertake a number of activities including monitoring assets and service providers, engaging with issuers and holding companies to account on issues – including ESG issues, though not exclusively – which have a material impact on the long-term value of a scheme's investments.

The 2012 UK Stewardship Code[3] says that "stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole." The Financial Reporting Council, which runs the Code, also notes that scheme stewardship should start from first principles i.e. the allocation of capital and the awarding of mandates as well as the activities at the asset class level (this includes issues such as proxy voting across equity investments).

2 Further details on impact investment can be found in the PLSA's *Impact Investment Made Simple Guide* (March 2018).

3 The Financial Reporting Council (FRC)'s UK Stewardship Code aims to enhance the quality of engagement between institutional investors and investee companies. Both asset owners and asset managers can sign up to the Code.

FIDUCIARY DUTIES FOR TRUSTEES OF OCCUPATIONAL PENSION SCHEMES

Consideration of both ESG and stewardship factors is an important element of the fiduciary duty of UK DB and DC pension scheme trustees. Trustees should take advice on their legal duties, but may wish to think in terms of three core duties when making investment decisions:

- **1. Exercise investment power for its proper purpose**
  In a DB scheme, the purpose of a trustee's investment power is to invest in such a way as to provide the promised benefits.

  In a DC scheme, the purpose of the investment power is to provide a "pot" of money to be used by the member to and through his or her retirement. This means both having a suitable default fund for members who do not make a choice and a range of funds appropriate to the membership. Trustees should invest for these purposes and take care not to let their own personal beliefs influence their decisions.

- **2. Take account of relevant financial factors**
  In July 2014, the Law Commission published a report[4] drawing a clear distinction between "financially material factors" (which trustees should take into account) and "non-financial factors"[5]. This guidance explains how trustees should consider ESG issues as financially material factors in both DB and DC schemes. Trustees should also bear in mind that when considering what is financially material to an investment, risk matters as much as returns.

  Some trustees might want to take account of non-financial factors, such as members' views on ethical questions, impact considerations or religious beliefs which are non-financial in nature. This is a specialist area involving different considerations[6] and it is advisable to seek specialist legal advice before doing so.

- **3. Act in accordance with the "prudent person principle"**
  By its very nature, data on many ESG issues, particularly climate risks (and related financial opportunities), will not be easily found from historical records. Trustees must consider likely future scenarios, how these may impact their investments and what a prudent course of action might be as part of their scheme's risk management framework.

THE 2018 INVESTMENT REGULATIONS

There are new regulatory requirements[7] that directly affect trustees of UK DB and DC pension schemes[8] (a summary of the wider regulatory landscape is set out in Appendix [2]).

Trustees must now ensure that their scheme's statement of investment principles ("SIP") includes trustees' policy on:

- How financially material factors (including, but not limited to, ESG considerations including climate change), over the time horizon of the scheme, are taken into account in the selection, retention and realisation of investments;
- the extent (if at all) that non-financial matters (e.g. member ethical views) are taken into account. For the avoidance of doubt, a statement must be included even if non-financial matters are not considered (e.g. if the trustees have decided not to proactively seek members' views[9]).
- engagement and voting activities in respect of investments (e.g. stewardship). This includes engagement with managers employed by the trustees.

These obligations apply to all pension schemes with 100 or more members. DC schemes with fewer than 100 members are required to have a default SIP covering only the first two. Trustees should seek advice on the precise application of the *Investment Regulations* to their scheme[10]. The deadlines for updating and preparing the SIPs are set out below:

4 *Fiduciary Duties of Investment Intermediaries* (Law Commission, 2014)
5 Which the Law Commission *(ibid)* states "may only be taken into account if two tests are met: 1) trustees should have good reason to think that scheme members would share the concern; and 2) the decision should not involve a risk of significant financial detriment to the fund.
6 For instance, the Law Commission's "two-stage test" mentioned above.
7 Regulation 2 of the *Occupational Schemes (Investment) Regulations 2005*.
8 LGPS funds are out of scope of these regulatory requirements and have their own duties on responsible investment as outlined in the *2016 LGPS Investment Regulations Guidance*.
9 Detailed advice on implementation of this "optional policy" is beyond the scope of this guidance. However, we do highlight some case studies and issues for consideration throughout.
10 Regulations 2, 2A and 6 of the *Occupational Schemes (Investment) Regulations 2005*.

KEY REGULATORY DEADLINES

- **DB and DC trustees** will have to update or prepare their SIP in line with the points above before 1 October 2019.
- Trustees of **DC schemes**[11] will be required to publish their SIP on a publicly available website from 1 October 2019.
- Trustees of **DC schemes** will be required to produce and publish an implementation report setting out how they acted on the principles set out in the SIP from 1 October 2020.

2019 CHANGES TO INVESTMENT REGULATIONS

Trustees should note that further changes were made to the Investment Regulations on 6 June 2019 in order to implement the European Union's Shareholder Rights Directive II (SRD II). These will require further detail on trustee stewardship policies to be added to pension scheme SIPs by 1 October 2020. Trustees may wish to seek advice on these additional requirements in due course.

Trustees should note the following points under the new legislation:

- Trustees will be required to explain their arrangements with asset managers in their SIPs, including how they incentivise their appointed investment managers to align investment strategy with the trustees' policies and to make investment decisions based on long-term performance.
- Also from 1 October 2020 DB trustees will be required to produce a form of implementation statement on their engagement and voting practices. DC trustees will also have to add this disclosure to their implementation statements from that date.
- DB schemes will have to publish their SIPS and, later, their implementation statements on a publicly available website. This mirrors the public reporting requirements for DC schemes that apply from October 2019 as noted above.

CLIMATE CHANGE: IN FOCUS

Climate change is singled out as a key issue for consideration as part of the 2018 SIP requirements. Pension schemes' multi-decade time horizons and portfolio exposures across the local and global economy make them particularly exposed to climate-related risks and able to gain from climate-related opportunities. Given its prominence, trustees will need to develop an understanding of climate-specific issues and how they apply to their portfolio, and take steps so that they are appropriately documented in the policy and included in decision making[12].

11 Excludes DB schemes with Additional Voluntary Contributions (AVCs) only.

12 A step-by-step approach for scheme consideration of climate risk can be found in the PLSA/ClientEarth guide *More Light, Less Heat: A framework for pension fund action on climate change* (December 2017). Specific climate scenarios are explored in Aon's report "*Climate Change Challenges; Some case studies*".

HOW TO NAVIGATE THIS GUIDE

The main sections of this guide have been structured to reflect the typical journey trustees might take to ensure they fulfil their fiduciary duty through incorporating financially material ESG (including climate change) factors and being effective stewards of their assets. This requires trustees to ensure that such issues are properly understood, formalised in a relevant policy and reflected in broader decision-making and implementation.

Each chapter of this guide reflects a stage in the process:

1) Assessment of current approach and requirements
2) Training and education
3) Ascertaining and agreeing investment beliefs
4) Setting the policy
5) Methods of implementation
6) Monitoring and reporting

It is possible either to read through each stage in sequence – likely to be of most relevance to trustees who are new to considering ESG and stewardship – dip into the chapters separately and as the need arises.

This guide has a practical focus, with a number of recurring elements in each section:

- **Myth-busters**
    - These are designed to address some of the most common areas of misunderstanding on these topics
- **Top questions**
    - Sample questions that trustees should consider asking of themselves, their advisers and their asset managers
- **Case studies**
    - Real-life examples of the steps taken by schemes in this area, ranging from minimum requirements up to good practice.

The guidance is not intended to be exhaustive, but instead is aimed at highlighting the most important considerations for schemes of all sizes and types. Further resources are available at the end of the guide or online at: **www.plsa.co.uk**.

1. ASSESSMENT OF CURRENT APPROACH AND REQUIREMENTS

It is vital that the very first step taken by trustee boards in getting to grips with the 2018 *Investment Regulations*, and with ESG and stewardship more generally, is an assessment of their present situation. Only by digging down into the nature of the current approaches taken by managers and advisers as well as the level of understanding, knowledge and experience across the whole trustee board, can a scheme start to take a considered and meaningful ESG and stewardship approach.

CHECKLIST ✓

Have I/we:

✔ Assessed the level of trustee understanding and familiarity regarding ESG, stewardship and the new requirements?

✔ Decided which are the most relevant stakeholders to gain input from e.g. employer, member nominated trustees, third party organisations – and made arrangements for a discussion of these issues?

✔ Understood the ESG and stewardship activities our investment advisers and managers are currently undertaking on our behalf?

✔ Asked our current asset managers for their Responsible Investment or Sustainability policies and implementation reports Stewardship Code statements and Principles for Responsible Investment (PRI) statements?

✔ Read The Pension Regulator (TPR)'s guidance on consideration of climate risk and guidance on the *2018 Investment Regulations?*

Trustees must familiarise themselves with key ESG and stewardship concepts and current market practice. This can be achieved in a variety of ways; for example, discussions as a trustee board, discussions with other trustees and by reading some of the reference materials that have been produced by TPR[13], advisers and asset managers (see Appendix [1] for some suggestions for further reading). This process will help to identify any gaps in understanding or questions to be covered as part of subsequent training.

Trustees should also consider seeking input from the views of other relevant parties (e.g. employer representatives, legal and investment advisers) at an early stage in the process. Although often overlooked, representatives from the sponsoring employer that work in integrated risk management and sustainability functions can often frame ESG issues in ways that resonate with the pension scheme trustees and provide a helpful perspective.

The appropriate forum and necessary time commitment for these discussions can vary significantly (from a one-to-one conversation in an informal setting through to a multi-party workshop). This will largely be driven by the need for future education as well as the availability of time and governance budget. This process of familiarisation is an ongoing one and will evolve as the underlying ESG factors and market practice changes over time.

13 This includes TPR's specific investment guidance on climate risk as well as on the 2018 *Investment Regulations*.

MEMBER INTEREST

There is growing interest amongst pension scheme members in investing in line with their values and views on issues such as climate change, corporate board diversity and single-use plastics. With measures designed to boost the transparency of investment information to savers, such as the new SIP requirement for some trustees to publish an implementation report[14] from 1 October 2020, trustees should be prepared to receive views, questions and challenges from across the membership as well as from civil society and campaign groups. Trustees should work with their advisers to ensure they understand the precise interaction for their scheme between member views, financially material factors and their fiduciary duty.

MYTH-BUSTERS

"MY FIDUCIARY DUTY MEANS I CANNOT UNDERTAKE ESG INVESTMENT"

- The opposite is true. Trustee fiduciary duties require trustees to look at why they are making the investment and take into account all material financial factors. There is a growing body of evidence to demonstrate that issues such as climate risk or good corporate governance have a financially material impact on risk-adjusted-returns.

"THE NEW LEGAL REQUIREMENTS ARE JUST A BOX TICKING EXERCISE"

- The *2018 Investment Regulations* require greater disclosure from trustees about their investment decision-making process. However, the requirement to take into account financial factors in that process is not new and must be carried out on a scheme – specific basis. This means that the trustees themselves need to take a view on the financial materiality of specific factors in respect of their scheme's portfolio. They also need to consider the stewardship approach and practices which best aligns with their objectives and fits with their resources and appetite.
- Any resulting policies must be scheme-specific and will need to be documented and, in some circumstances, made publicly available. Therefore, trustees will need to be able to demonstrate that these areas have been carefully considered. So simply adding generic 'tick the box' statements in your statement of investment principles will not be enough.

"ESG AND STEWARDSHIP IS THE RESPONSIBILITY OF OUR ASSET MANAGERS AND COMPANIES"

- Whilst asset managers and companies are closest to the flows of capital, the legal responsibility to ensure that ESG and stewardship form a meaningful part of the scheme's investment principles, and how those principles are being implemented, rests with trustees. Beyond the regulatory requirements, even if trustees feel their advisers and asset managers are doing a satisfactory job considering ESG factors, trustees have a duty to relay their expectations and challenge asset managers and advisers to improve processes where appropriate.

ACCESS MORE QUESTIONS FOR ADVISERS AND MANAGERS

14 This will be a published statement which sets out how the trustees have acted upon the principles they had previously set out in the SIP. Trustees should also consider the implications of the 2019 changes to the *Investment Regulations* (to implement SRD II) for the issue of implementation statements. Please also see the overview on p.10 of this guide.

QUESTIONS TO ASK

OF YOURSELVES

How can we develop our understanding in this area up to a level that means I can meet my fiduciary duties?

Do we have a good feel for the extent to which ESG is already integrated in our investment decision-making?

Are we satisfied with our current approach to stewardship? Do we currently set the right level of expectations for our managers regarding any outsourced stewardship activities?

Are we comfortable with the ESG profile of the assets we are invested in (e.g. what activities certain companies do and how they do them)?

TO ADVISERS

What are our legal obligations?

What support can you provide us with? What support do you think is appropriate given the resources available to our scheme?

How do you distinguish between financially material and non-financially material matters?

What do you think are the most financially material ESG issues for our portfolio and why?

What is your approach to manager research? Do you have explicit ESG ratings?

TO ASSET MANAGERS

How are ESG matters considered as part of the investment process?

Which sustainability industry groups are you a member of and what does this mean for me as an investor in your fund? To what extent do you undertake collective or collaborative engagement with other investors or organisations?

How are you incorporating and reporting against our investment beliefs?

How is your approach to ESG and stewardship evolving in response to the surge of interest in this issue? What might this mean for our current investments?

2. TRAINING AND EDUCATION

Once trustees feel they have a good understanding of the current approach taken by their managers and advisers, any gaps in their understanding; and the new regulatory requirements, they can work with their advisers to create and implement a training and education programme that is tailored to their needs, objectives and resources.

CHECKLIST

✓

Have I/we:

✔ Cross-referenced the planned content of any training session(s) with those gaps in understanding which were highlighted in the familiarisation exercise?

✔ Spoken with our advisers to understand if there are any recent developments and trends in regulations and market practice that we should be aware of?

✔ Created and agreed a plan for continued education and learning? Has this got buy-in from across the trustee board, and from our advisers?

Training sessions are typically required from both a legal and investment perspective, so that trustees' legal duties are clearly understood before exploring the investment implications of ESG factors, climate change and stewardship activities. Such training should be tailored to trustees' circumstances and address any gaps in knowledge or key questions that were raised as part of the familiarisation exercise. Schemes should ask their advisers and managers for training which fits in with the time horizon and characteristics of their schemes' current and likely future investment approach.

The current UK market for ESG and stewardship encompasses a plethora of different approaches, definitions and 'house views'. Trustees should seek to fully understand how their advisers are ensuring that any training is delivered in an objective, yet focused, way which avoids unnecessarily influencing trustee views. This is particularly relevant if a survey of trustee investment beliefs (carried out as part of wider session to understand beliefs and strategy) is being completed in parallel.

Climate change is singled out as a key issue for consideration as part of the 2018 *Investment Regulations*. Specific training in this area should focus on the need to consider both climate-related mitigation and adaptation in an active way (i.e. mitigating action in light of the low carbon transition and adaptation to improve resilience to physical damage risks).

This process of familiarisation is an ongoing one and will evolve as the underlying ESG factors and stewardship market practice changes over time. Trustees should set up and regularly review a plan for continued training and education.

MYTH-BUSTERS

"IT'S A WASTE TO SPEND MONEY ON INCORPORATING ESG"

- Most participants in the industry now accept the view that ESG factors can have a material impact on long-term risk and return outcomes. Even a relatively small positive performance differential (both in risk and return terms) could, over a typical investment horizon, more than compensate for any up-front costs (e.g. those associated with understanding, documenting and implementing any changes to the investment portfolio). At worst, therefore, the up-front costs should be considered a necessary expenditure.

"OUR SCHEME HOLDS PREDOMINANTLY POOLED INVESTMENTS, SO THERE IS VERY LITTLE WE CAN DO, PARTICULARLY REGARDING STEWARDSHIP."

- With pooled funds, the trustees do not hold a direct interest in the underlying assets and so the extent to which the manager of a pooled fund incorporates ESG issues or undertakes stewardship will depend on its own priorities. However, the choice to invest in a pooled fund is still a long-term strategic investment decision that is made by trustees - and product selection is an optimal time for trustees to exercise their preferences regarding ESG and stewardship approaches.

  ESG and stewardship considerations should be taken into account as part of future manager reviews, including whether it is appropriate to invest or disinvest from a particular fund.

  It is also possible for schemes to collaborate or work collectively with other investors in pooled vehicles, throug industry forums or initiatives such as the AMNT's Red Line Voting. There are also a number of investor or campaign group initiatives on specific issues and on specific funds with which schemes can get involved.

"WE'RE MOSTLY INVESTED PASSIVELY, MAKING IT MUCH HARDER TO INCORPORATE ESG AND ACT AS GOOD STEWARDS OF OUR ASSETS."

- As the market evolves, there are a growing number of ESG-tilted indices and, as with pooled funds, it is open to trustees to review and change the index that a given passive fund tracks. Although investing passively means there is no manager freedom in stock selection, it is possible for managers to exert influence on the companies they invest in through voting and engagement.

QUESTIONS TO ASK

YOURSELVES

How much time do we need to set aside to build the necessary level of understanding in this area?

Who should we invite to provide and receive training?

Are there any particular ESG factors that we consider essential for our investment managers to take into consideration?

Do we want our managers to just manage risks or actively seek out opportunities?

TO ADVISERS

What are the legal requirements?

What evidence is there to support the view that ESG issues, climate change and stewardship are financially material?

To what extent can we, and should we delegate decision making in this area?

How can I consider climate change? Should we treat it separately from ESG and stewardship?

TO ASSET MANAGERS

What do you think are the most financially material ESG risks to our portfolio and why?

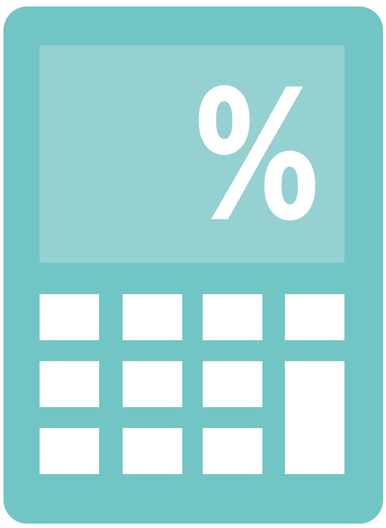
How are you managing climate change risk and opportunities on our behalf?

In what ways are you influencing companies on our behalf?

What is your approach to voting in pooled funds?

Can we direct how our votes are used in pooled funds?

Describe a situation where you engaged with a company, the process you followed and the end outcome?



CASE STUDY 2 – TRAINING

Redington recently guided a new medium sized pension scheme client through the process of identifying their ESG 'persona', developing their responsible investment beliefs, integrating these into the scheme's objectives, and, most importantly, implementing the necessary changes in asset allocation to reflect those beliefs.

The process that was worked though with the client had the following steps:

As a standard part of "getting to know you" with new clients, their views on ESG issues are asked. This identified that the trustees believed that ESG risks are financially material, and that there was a strong desire to go beyond minimum regulatory requirements in this area.

Training was then carried out with the trustees around the broad range of ESG issues to better understand in which category the trustees sat on the scale below:

Given the nature of trustee responses, it was agreed that the trustees sat in the "measure and manage" category. The trustees were helped to articulate their beliefs, and Redington worked with them to draft a statement on responsible investment which reflected these beliefs at a high level. Input was sought from multiple stakeholders including the scheme's sponsor, lawyers, and incumbent asset managers.

A strategic asset allocation review was carried out, which took account of the trustees' risk, return, timescale and ESG objectives. As part of the review, asset classes were identified where the trustee could appoint investment managers which were most aligned to their ESG "persona".

In line with this persona, the trustees made the decision to transition the passive market cap weighted equity strategy to a passive equity strategy with ESG tilts and enhanced stewardship activities.

As part of Redington's quarterly monitoring, there will be a demonstration of how this new investment meets the scheme's objectives. There was also a decision taken to add a standing ESG agenda item to ensure that any developments within the ESG area are highlighted to the trustees. A plan to regularly review the scheme's ESG persona was also agreed.

3. ASCERTAINING AND AGREEING INVESTMENT BELIEFS

Once the trustees have undergone a tailored training and familiarisation programme and have the necessary framework and understanding to make informed decisions, trustees may want to explore (or re-visit) and agree a set of investment beliefs around ESG considerations and stewardship practices.

It should be noted that there are a range of opinions as to which stage in the process trustees' investment beliefs are surveyed. Although here it constitutes a separate, third step in the ESG and stewardship journey, there are advisers who survey trustees on their beliefs at the same time as training and familiarisation. Ultimately, schemes will need to work with advisers to decide the appropriate approach for their circumstances and resources.

CHECKLIST

Have I/we:

✔ Undertaken a survey of trustee beliefs on E, S and G issues and used this to inform and shape the training? Was the survey designed in such a way to encourage trustees to consider their ESG beliefs from an investment perspective, as opposed to a personal one?

✔ Reached an agreed view (as a board of trustees) regarding our key investment beliefs related to ESG, climate change and stewardship? Has this been appropriately documented?

✔ Reached an agreed view on the extent (if at all) that non-financial matters (e.g. member views Investment) are to be taken into account?

Many trustees decide to start the process of documenting their approach to ESG and stewardship considerations through producing a statement of their investment beliefs. Trustees' investment beliefs should not be confused with their personal (i.e. ethical or moral) beliefs, which are not relevant when they are acting as a trustee. The beliefs agreed by the trustee board (constituting its view on fundamental investment positions including issues regarding ESG integration and stewardship) then inform the actions that the trustees might want to take and, most importantly for the purpose of this guidance, form the basis of the principles set out in the scheme's SIP (see chapter [4] below).

One approach to ascertaining trustees' investment beliefs in relation to ESG (including climate change) and stewardship is to make use of a survey of the individual trustees. Depending on the nature of the survey, the results can be consolidated into a board-wide view.

Successful surveys of trustee beliefs are typically characterised by:

- A clear purpose and scope;
- Clarity that the survey is not seeking the personal beliefs of individual trustees, but rather their beliefs in relation to how the scheme should be investing (this can be done through an explicit reminder that respondents should be responding in their capacity as a trustee (with a fiduciary duty) rather than in a personal capacity;

- Questions that are pitched at an appropriate level so that respondents are able to understand the questions and provide informed responses; and
- Questions that are carefully framed to avoid binary outcomes, which may give the impression that a board has significantly different (and possibly irreconcilable) views.

It is unrealistic to expect a group of trustees to agree completely on every belief. In these situations, it important to settle upon beliefs at a level which ensures everyone is comfortable but which are also useful for informing a meaningful approach to stewardship and ESG investment.

Beliefs should be considered statements of *intent*. Therefore, it should be possible for the resultant beliefs to be linked to implementation steps that can be carried out over the short- to medium-term. The resulting beliefs should be used on an ongoing basis and be subject to regular review to maintain relevance. They should also form a key part of any new trustee inductions.

MYTH-BUSTERS

"WE NEED TO HAVE EVERYTHING DONE FOR OCTOBER 2019"

- ESG and stewardship are evolving areas and it will be acceptable for trustees to have started the process, having identified their Investment beliefs and documented these in the statement of principles by 1 October 2019. However, it should be recognised that it will be the journey and the implementation of those principles that may take time. Things are expected to change with time, reflecting changes to market practice and regulation. Trustees should not feel obliged to agree or implement all areas in detail before the 2019 regulatory deadline.

"WE CAN'T SET OUT OUR BELIEFS BECAUSE WE DON'T KNOW WHAT MEMBERS THINK"

- Members' views on non-financial matters should not drive trustees' consideration of ESG and climate change issues as financial factors. Trustees must form their own view on financial matters. Secondary to that, trustees must declare whether or not they take non-financial factors into account in their decision-making (and, if so, how they will ascertain these[15]) but they do not have to ask questions of their members if they do not believe this is appropriate for the scheme at this time. If trustees are minded to pursue this course of action, they should take specialist advice.

15 TPR provides specific guidance on the range of activities which schemes can undertake to survey members' views on these issues.

QUESTIONS TO ASK

OF YOURSELVES

What are our strategic aims and investment objectives? How should these frame our approach to incorporation of ESG, climate change and stewardship?

TO ADVISERS

How can we overcome any behavioural biases?

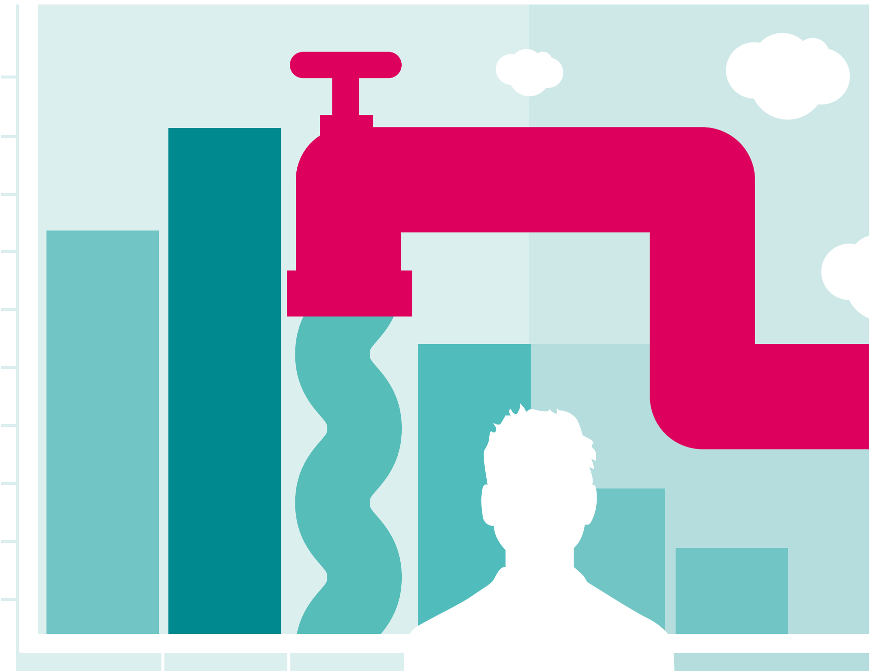
Are our proposed beliefs actionable and implementable? What are the foreseeable impacts and consequences?

What are our options if we want to take into account member views?

TO ASSET MANAGERS

What are your beliefs in this area and why?

Are our proposed beliefs actionable and implementable?



CASE STUDY 3A – TRAINING

Smart Pension's trustee board identified that the ESG landscape was evolving rapidly and that having an understanding beyond simple compliance with the new regulatory requirements would benefit Smart's younger demographic and technology-based approach. Research conducted with YouGov by the provider in June 2018 revealed millennials in particular had a heightened interest in ESG investment with 50% of the under 35s willing to direct their provider to invest their savings sustainably. It also found that 28% said technology to increase the ease with which savers could invest in ESG would make it more likely they would do so.

The trustees agreed that detailed ESG training for the board would be valuable to ensure a broad, unbiased discussion and understand industry best practice. They engaged a specialist third-party provider, to deliver the training. The training covered:

- Interpretations and definitions of ESG, sustainable investment and impact investing and what these mean in the portfolio and scheme context
- Different ways of incorporating ESG investments, for example through passive investing, using exclusion screens and investing along particular sustainability themes
- Recent and forward-looking trends in the market such as specific fund approaches, reporting tools and performance presentation
- What the new regulations require and whether any changes are needed to the scheme's current SIP
- The risks and opportunities available to the scheme from a member engagement and investment management perspective (for example asset allocation)

During the training, trustees discussed issues such as:

- Impact to the investment budget and associated options available to the trustees
- The pace of change in the ESG space
- How to capture opportunities and mitigate risks along themes such as climate change.

The training facilitated informed discussion by the trustees on what their collective ESG beliefs are as a board, what this meant for the investment portfolio and how ESG could shape member engagement.

The training also supported the discussion of how ESG is considered within the investment strategy, default reviews and how the strategic asset allocation needs to change. The views and approaches were discussed and supported by scheme's investment advisers and lawyers who were both present throughout the training.

CASE STUDY 3B – MEMBER FEEDBACK

The People's Pension (TPP) operates a responsible investment research process that makes use of a variety of sources including the resources provided by several industry groups and research organisations to gain a better understand of ESG topics.

As part of this research process TPP also seeks to gauge member feedback to help us understand what is important to the membership.

TPP invites member feedback through email and post and hosts an annual member webinar where members are invited to share their views. TPP is also developing an online feedback mechanism to survey members to understand their priorities.

When TPP identifies a responsible investment issue through this framework, it uses its responsible investment process to determine the most effective method of addressing it. This involves the following:

- Where members raise ESG considerations, TPP considers whether such factors would or might be financially material and whether to take account of them within the context of the Trustee's existing responsible investment approach to improve member outcomes.
- For any priority ESG issue that TPP's portfolios remain exposed to, TPP will also include the issue when engaging with investee companies and decide upon its prioritisation alongside other issues.

4. SETTING THE POLICY

After the beliefs have been decided, they should be used to inform the policies as documented within the SIP or any relevant documents such as the DC Chair's Statement.

CHECKLIST

Have I/we:

✔ Got a policy that we are comfortable captures our investment beliefs?

✔ Reached agreement on how we will action any investment beliefs in terms of implementing any investment strategy changes?

✔ Got a policy that is fully compliant with the new regulations and TPR's future regulatory approach?

✔ Reached a position where we are able to share our policy online (where required)? If we are not required to share our policy online, have we taken a decision as to whether we would like to do so anyway?

It should be noted that the purpose of the SIP has not changed as a result of the 2018 requirements – it continues to act as a written statement governing decisions about investments, but the changes have clarified how trustees should disclose their consideration of financially material ESG issues and stewardship (engagement and voting).

It is vital that the communications are thoughtfully drafted and that there is consistency of language between the SIP and the DC Chair's Statement, should trustee investment principles feature in the latter document. Statements in the SIP should aim to be high-level and cover core policies, with the opportunity for further detail to be revealed in implementation statements or elsewhere.

For instance, although there is no requirement to do so, some schemes have elected to create separate ESG and stewardship policies that are addendums or in addition to the SIP. These policies may be updated on a more regular basis, reflecting the greater scope for changes to impact these policies.

The SIP and any other related policies must be periodically reviewed to ensure they reflect trustees' investment beliefs and intentions as well as current market practice.

MYTH-BUSTERS

"I CAN GET AWAY WITH INCLUDING SOME TEMPLATE WORDING IN MY SIP TO BE COMPLIANT WITH MY NEW LEGAL DUTIES".

- Trustees will need to be able to demonstrate that they have carefully considered their approaches to ESG (including climate change) and stewardship in accordance with the legal and regulatory requirements for their scheme. **It is very unlikely that template wording will fit the specific circumstances of your decision-making and scheme**. It is important that trustees set out their policy, not that of their advisers. Advisers may be able to suggest wording but it must reflect the trustees' decision-making. This is even more important where the SIP is to be published and reported against.

"YOU NEED TO BE BIG TO HAVE A SEPARATE AND DETAILED ESG AND STEWARDSHIP POLICY".

- Schemes and their advisers will already have considered their approach to ESG and stewardship in some detail, to comply with the 2018 Investment Regulations, so producing or publishing further details on the approaches undertaken should be possible in a proportionate manner. Depending upon the importance the trustees place upon ESG and stewardship, this could be a logical governance step for schemes, depending on resources available.

QUESTIONS TO ASK

OF YOURSELVES

Are we comfortable with our current SIP? Does it accurately represent our approach to considering financially material ESG factors as well as our engagement and voting activities?

What additional information, if any, are we comfortable setting out in a document that may become publicly available?

Should we consider producing a separate document which is aimed at scheme members?

TO ADVISERS

How much detail should we go into?

What belongs in a SIP and what belongs in a separate policy?

How are you going to help us deliver our policies?

TO ASSET MANAGERS

We are looking to include certain wording in our SIP, could you please confirm that where applicable, you are able to support us to deliver our objectives?

Are your policies on ESG (including climate change) and stewardship publicly available?

CASE STUDY 4 – LINKING INVESTMENT BELIEFS TO POLICY TO IMPLEMENTATION

RPMI Railpen (Railpen) is the in-house investment manager for the UK railways' pension schemes. Sustainable Ownership is Railpen's approach to incorporating sustainability considerations into the investments it manages on behalf of its members. The team's work is enabled by the Trustee's related investment belief: "Environmental, social and governance (ESG) factors materially impact long-term investment returns and must be taken into account."

The Railpen investment process considers ESG factors through four lenses:

- Improving investment returns
- Reducing investment risk
- Impacting Railpen's reputation as a responsible investor
- Impacting the future world our beneficiaries retire into

Railpen believes that incorporating these lenses into their investment process increases the likelihood of achieving its mission to pay members' pensions securely, affordably and sustainably. The lenses are then used to inform the three workstreams within Sustainable Ownership:

- ESG integration – Railpen incorporates ESG considerations into the portfolios managed on behalf of beneficiaries
- Active Ownership - Thoughtful voting alongside constructive engagement with portfolio companies supports the objective of enhancing long-term investment returns for beneficiaries
- Longer-term risks and opportunities - As a long-term investor, Railpen monitors risks and opportunities over the timeframe it will be paying members' pensions.

Schemes looking to implement a similar framework should ensure that their approach to consideration of ESG integration reflects:

- The balance of internal and external management
- The extent to which specialist ESG resources are available (whether in-house or through service providers)
- The asset class mix

5. METHODS OF IMPLEMENTATION

How a set of trustee beliefs and principles are then put into practice is one of the most important and technically complex parts of the process. A number of different factors and considerations come into play in ensuring consistent and meaningful application of trustee policy on ESG issues and stewardship approaches.

CHECKLIST

Have I/we:

✔ Implemented changes in line with our investment beliefs and policy or have a plan to do so?

✔ Achieved a consistent approach to ESG integration and stewardship across each asset class (where applicable)?

✔ Challenged ourselves that ESG and stewardship approaches have been meaningfully considered as part of our investment strategy and investment manager selection?

✔ Challenged managers and advisers (where applicable) how they will incorporate and report on activity against our investment beliefs?

Implementation should build upon the agreed investment beliefs and policy set out by the trustees; it is helpful for trustees to regularly check and look back upon their beliefs and policy as they go through the implementation decision-making process, to ensure that they remain aligned with their investment beliefs and policy. There are many different aspects to implementation including:

- Strategic allocation to asset classes;
- Selection of a manager;
- Setting mandate-specific parameters (e.g. active/passive and segregated/pooled) and how best to reflect ESG factors in the investment allocation process; and
- Arranging a plan for the ongoing stewardship, either directly or through a manager or third party provider, of the portfolio.

The ways in which ESG issues can be incorporated into investment decisions and implementations will vary by asset class. Although different managers will have different approaches, the following table highlights some indicative considerations for trustees.

	Mandate choice	Implementation	Stewardship
Passive/Index tracking	Trustees should consider the index benchmark and any ESG tilts	No/limited manager freedom in stock selection	Managers can exert influence on companies through voting and engagement. There is also potential for manager to have market influence
Active Equity	Trustees could invest in ESG-oriented mandates such as sustainable equity	Managers should consider financially material ESG factors and their impact on future profitability in company evaluation. Traditionally, data has limited the ability to do this in quantitative approaches (though this is changing)	Managers can exert influence on companies through voting and engagement
Active Fixed Income	Some assets such as green bonds could be considered trustees but likely as part of a broader mandate. This may change in future	Managers should consider potential for ESG risks to impact credit rating and the future ability for borrower to make repayments	It is possible for managers to have some engagement with borrowers on material ESG risks
Real Estate	Some real estate strategies could have social or environmental objectives and appropriate assets may be targeted to achieve these	Managers can consider potential environmental and social risks during acquisition and development and manage resource use during occupation	Managers can engage with tenants and the local community to address potential issues and drive change
Infrastructure	Trustees can consider portfolios biased towards infrastructure that supports a sustainable future	Managers should assess and manage the physical and societal risks arising from infrastructure assets. Longevity of investment means that systemic risks should be considered	Managers can exert influence on underlying companies or asset managers through governance arrangements, e.g. board seats
Private Debt	Trustees could consider mandates which target lending at certain activities	Managers should identify and seek mitigation of potential ESG risks during due diligence on loans.	Managers should have ongoing dialogue with borrowers to ensure that emerging and identified ESG risks are managed
Private Equity	Trustees can assess which companies the manager may target and the potential for unwanted or desired ESG exposures to arise	The longevity of the investment means that systemic risks should be considered. Managers should assess potential ESG risks during due diligence and ongoing ownership	Managers would be expected to have a high level of influence over company management and ensure that governance structures are effective

The main considerations are likely to differ for trustees of DB and DC pension schemes.

KEY CONSIDERATIONS

DB SCHEMES

Trustees of DB schemes, with established asset portfolios, should firstly prioritise their efforts, likely by breaking down their portfolio by mandate type and size. The extent to which ESG and stewardship can be incorporated into an individual strategy will depend on the asset class (so, for instance, there will be a difference between an active equity manager which is selecting company stocks to buy and sell and a liability driven investment (LDI) manager which is hedging risks using derivatives). ESG and stewardship extends beyond equities and will be applied to the range of asset classes in different ways (see above). It is also likely that different approaches will be warranted depending on whether a scheme is dealing with incumbent managers or new appointments.

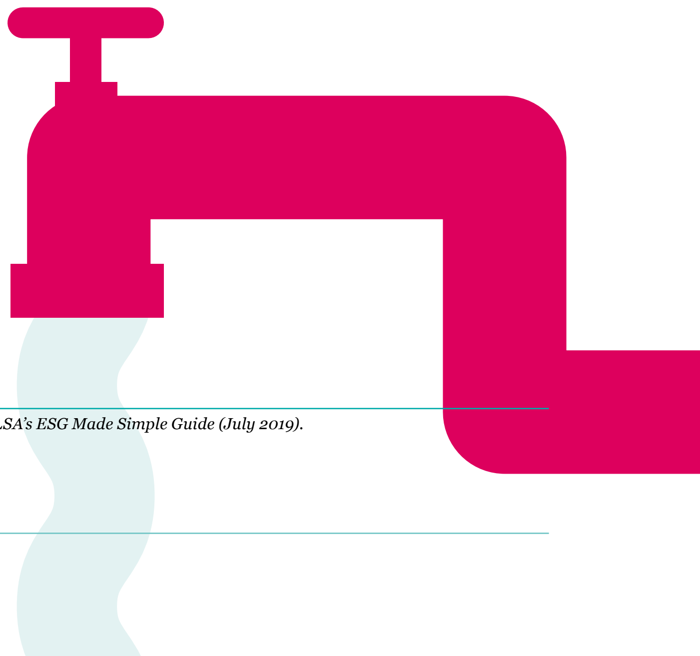
DC SCHEMES

With anywhere from 80 to 100% of scheme members remaining within the default fund, trustees of DC schemes are likely to want to devote a significant proportion of their time to considering ESG factors and stewardship approaches of their default. Many DC default funds will comprise a mix of pooled (and frequently passive) funds but this does not mean that ESG integration, or being a good steward, is not possible. Trustees should consider the default fund's asset mix and the indices they are tracking in passive mandates. Stewardship activities should also be considered. **Merely making an "ethical" fund available in a self-select fund range is not enough to comply with trustee fiduciary duties or the new regulatory requirements** (see myth busters below).

Making changes to a default fund can be a sensitive issue with far-reaching consequences. Where trustees decide to make changes to the default fund in line with the new SIP requirements, they should take specialist advice – as with any other proposed changes to the default.

At the point of selecting a manager, a helpful tool for both DB and DC trustees will be the ratings assigned by investment advisers. Different managers will have different ESG and stewardship approaches. Trustees should ensure that they fully understand the methodology of the rating criteria – including how ESG, climate change and stewardship approaches are considered as part of this, and their respective weightings –before a making a decision.

There are a number of possible ESG approaches and philosophies including integration and screening (negative, norms-based, positive or best-in-class). Different markets and product providers use different terms. It is beyond the scope of this guide to explore the different approaches at a granular level, but trustees may want to take a look at the list of further reading[16] at the back of this guide. Trustees must work with their advisers to ensure they are fully apprised of the implications of each approach for their portfolio, scheme and members.



16 Of particular relevance on the subject of definitions is the *Eurosif SRI 2018 Study* as well as the *PLSA's ESG Made Simple Guide (July 2019).*

MYTH-BUSTERS

"OFFERING AN ETHICAL FUND AS A DC SELF-SELECT OPTION MEANS THAT WE DO NOT NEED TO THINK ABOUT ESG WITHIN OUR DEFAULT FUND".

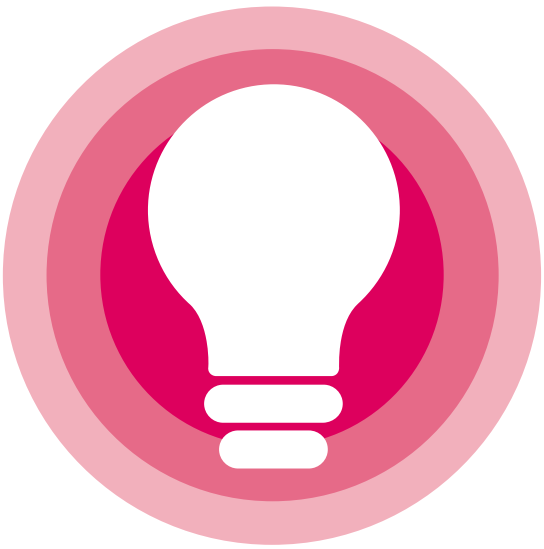
- Financial materially factors, including ESG, must be considered in respect of all DC investment options – importantly this includes the default (where most members' money is probably held) The view stated above also mixes up non-financial factors (ethical concerns) and financially material ESG issues.

"DIVESTMENT FROM CERTAIN COMPANIES OR SECTORS IS THE ONLY REAL WAY TO INVEST IN AN ESG-AWARE WAY".

- Divestment may be undertaken for either financial or non-financial reasons (referred to as negative screening) and is one possible approach for schemes to take. There are other options available including integration (including ESG factors in investment decisions), theme-based investment (allocating new investments towards sustainability themes such as renewable energy) and positive screening (deliberately including an asset on the basis of a positive ESG trait). Whatever the approach taken, it is important to understand how it fits in with the trustees' investment beliefs, objectives and time horizons.

"THE MANAGERS' GLOBAL POLICY SHOWS THAT THEY TAKE ESG, CLIMATE CHANGE AND STEWARDSHIP SERIOUSLY, SO I DON'T NEED TO MAKE ANY FURTHER QUERIES".

- Regulatory requirements are typically imposed at a *manager-wide* level, which, for global managers, means that headline policies in a global ESG, stewardship or responsible investment report may not be region-specific. Trustees should check whether the mandate being considered has a specific ESG and stewardship policy, how this is being implemented and how it aligns with their beliefs.



QUESTIONS TO ASK

OF YOURSELVES

Do we feel comfortable with our proposed plans for implementing the policy?

If we have a DC scheme, have we considered ESG and stewardship approaches for both the default and self-select options?

Have we got the correct fund range to cater for our DC members' needs?

Do our investment managers (and the mandates we have employed them for) align with our investment beliefs and operate in a manner consistent with our SIP?

Should we consider changing one or more of our managers to better align our investments with our beliefs and SIP?

TO ADVISERS

Are our investments aligned with our investment beliefs?

Are we tracking the correct indices across our passive funds?

How do you think about ESG, climate change and stewardship as part of asset allocation, manager selection and implementation?

Can you explain how your manager ratings work, and how they take account of ESG, climate change and stewardship?

What asset class and/or manager should we be focusing our attention on first?

Should our approach be different for current and future mandates? And should this approach vary by asset class?

At what point should we engage with managers around ESG issues (i.e. at the on-boarding or the ongoing management stage) and how does this vary by asset class? What happens if thFe manager does not act upon our mandate?

TO ASSET MANAGERS

What are your credentials in the ESG and stewardship area for the assets we have invested in, or may invest, with you?

What data and research do you use on ESG, climate change and stewardship? Can you give me an example of how the data and research was undertaken and how it influenced your decision making?

How do you take climate change opportunities and risks into account within your investment process? Can you give me a concrete example of when you have done so and what the outcome has been so far?

CASE STUDY 5A – IMPLEMENTATION

The ABC Pension Scheme is a £160m DB fund with assets invested through pooled funds with five different managers.

The trustees' first action was to set out their investment beliefs, including three specific beliefs around ESG issues and explicit recognition of the risks of climate change. Beliefs were used as the impetus for change and, in addition to training, the trustees have taken three steps to change their investment strategy and governance:

1) They enhanced the oversight of their investment managers with additional reporting on ESG factors and an explicit focus on greater challenge of managers as a standard part of review meetings

2) The trustees reviewed their passive equity benchmarks and elected to migrate a proportion of their equity assets into a new climate-aware pooled equity fund that is consistent with their investment beliefs – they intend to review this allocation further

3) The trustees ensured that the management of ESG risks was a core consideration in a real asset manager selection exercise.

All the actions taken fall within the day-to-day activities of the scheme and the trustees increasingly regard this as a matter of normal practice.

CASE STUDY 5B – ENGAGING WITH ASSET MANAGERS

XYZ pension fund is a large DB scheme. XYZ challenged one of its managers on their approach to voting on climate change issues. The firm had made high-profile public comments on the need to address the issue, comments which were positively received by policy makers, asset owners and other investors globally.

However, the XYZ trustees were concerned that there was a disconnect between the publicly stated position and the manager's engagement with investee companies on climate change. This was evident in how the manager implemented its policy through its voting activities, particularly in the US market. This created a reputational risk for the manager, and therefore the scheme, were XYZ to have been identified as a client.

The reason for these concerns included a perceived reluctance by the manager to vote against corporate management with regards to shareholder resolutions with a preference to engage behind closed doors. It was not clear to the XYZ trustees at what point an engagement would be deemed to have failed.

As a result, the trustees raised the issue with the manager at a face-to-face meeting. Whilst the trustees said that the asset manager's position was respected and XYZ supported an engagement approach, they argued that the signals sent by shareholders in their voting was an essential part of good stewardship.

Many other clients raised similar issues with the manager, and the following proxy season, the manager significantly increased its voting on climate-related shareholder resolutions.

CASE STUDY 5C – MANAGING CLIMATE CHANGE RISKS AND OPPORTUNITIES

The trustees of a Mercer client, a mid-sized UK DB pension scheme, wanted to consider the impact of climate change on the scheme. The trustees were aware of the increasing risks posed by climate change, increasing regulatory focus and had received multiple queries from scheme members on its approach to managing climate change risks.

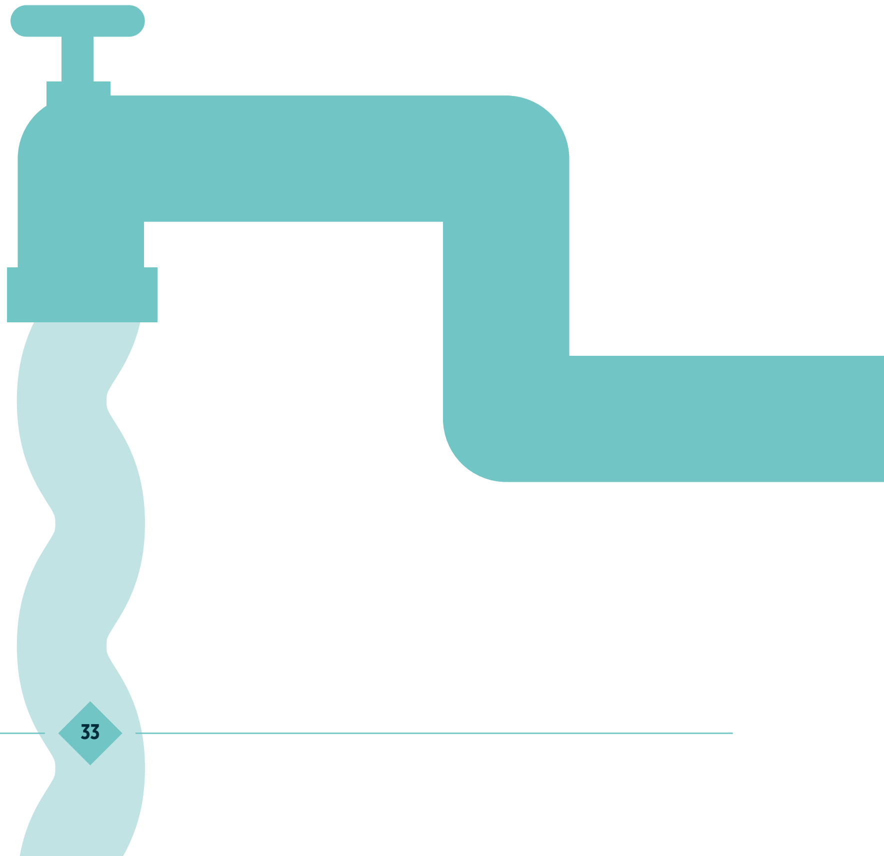
The trustees undertook an education workshop to ensure the board was briefed on the latest developments, including what climate change and the Paris Agreement mean for investors, the asset owner recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosure (TCFD) as well as information on lower carbon investment solutions and opportunities. The trustees also took time to understand what its investment managers were currently doing on the scheme's behalf to manage climate change risks.

The trustees used Mercer's scenario modelling to consider the impact of climate change at the investment strategy level and also at a more granular sector level for the scheme's equity exposure. The analysis considered several climate change scenarios, including a 2°C warming scenario, in line with the recommendations of the TCFD.

Mercer's analysis indicated that the scheme could improve its approach to managing climate change risks and better protect the outcomes for members by reducing its exposure to developed market equities and increasing its exposure to infrastructure, with a focus on sustainable infrastructure. The trustees agreed a revised investment strategy.

The trustees also took the decision to allocate a proportion of the scheme's actively managed equities to sustainable global equities and use a low carbon index for its index-tracking equities.

The trustees updated the scheme's risk register and SIP and adopted a new Responsible Investment Policy, detailing the scheme's approach to climate change. The trustees agreed to regularly monitor climate change risks as part of regular investment strategy and manager monitoring processes.



6. MONITORING AND REPORTING

Once trustees have put in place a specific portfolio decision regarding their beliefs and implementation of their ESG and stewardship approaches, that is far from the end of the process. As with any other service that the scheme receives, it is important to regularly review the performance of advisers and managers and other service providers (such as proxy advisers or custodians).

CHECKLIST ✓

Have I/we:

✔ Got a good understanding of the reporting that we currently receive, and where it can be improved?

✔ Achieved a clear view of our key ESG, including climate change, risks and opportunities across our portfolio?

✔ Fully understood the stewardship approaches taken by our asset managers (or our in-house team, where relevant)?

✔ Mapped out which of our service providers are relevant (and to what extent) to our ESG and stewardship activities?

✔ Agreed a plan and processes for reviewing and monitoring our advisers and managers on their implementation of ESG and stewardship in line with our beliefs and principles?

For every relevant portfolio decision (be it a change in manager or a more fundamental shift in allocation), trustees must have a plan in place to monitor the performance and the effectiveness of decision making of a scheme's advisers and managers. Not only is this good investment governance practice, but the *2018 Investment Regulations* also introduce new requirements for DC schemes which must publish an "implementation report" from October 2020 setting out how they have acted on the principles set out in the SIP over the year[17] .

At the time of writing, an industry-wide standard for ESG and stewardship-related manager and company reporting does not exist, although a number of initiatives are emerging such as the Task Force on Climate-related Financial Disclosures (TCFD) focus on improving the quality and consistency reporting on how climate risks are managed. In this environment, there is no substitute for getting access to the investment managers to understand how a manager's ESG policy and stewardship activities are implemented on an ongoing (and forward looking) basis. Meetings with the investment managers should be supplemented with regular reporting of the portfolio. If this is not practical or proportionate, you might ask your investment adviser how they can help you understand the manager's approach.

Trustees may wish to consider completing a decision monitoring report to verify that actions being taken are consistent with their stated policy (and investment beliefs) and to check to what extent any decisions (driven by ESG and stewardship factors, or indeed otherwise) have impacted returns.

17 The 2019 changes to the *Investment Regulations* (which implement SRD II) also bring new disclosure requirements in this space which trustees should be considering. Please also see our overview on p.10 of this guide.

MYTH-BUSTERS

"THERE IS NO CLIMATE REPORTING DATA AVAILABLE".

- Data does exist and it is improving over time. Initiatives such as the Task Force on Climate-related Financial Disclosures are focussed on improving the quality and consistency of information provided by companies.

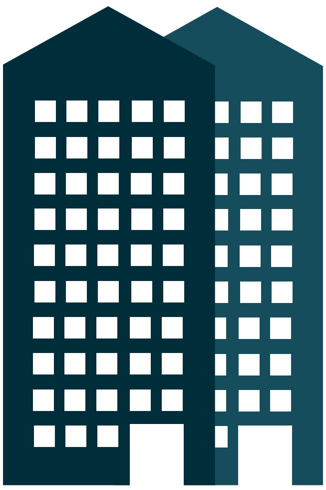
"IT IS IMPOSSIBLE TO PROVE THAT ESG AND STEWARDSHIP ADDS VALUE".

- ESG and stewardship are focused on adding value over time and a proper assessment, therefore, requires a suitably long window to assess an ESG strategy compared to a benchmark unconstrained strategy. Data to complete such analyses is becoming more prevalent, which will allow a critical evaluation of this issue. Whilst not directly applicable at the portfolio level under all scenarios, there are numerous examples in academic literature that find links between strong ESG practices and corporate financial performance[18].

  Furthermore, in line with the "prudent person principle", trustees should consider how ESG factors may impact their investments in likely future scenarios and what a prudent course of action might be as part of the scheme's risk management framework[19].

"IT WILL BE TOO COMPLICATED TO EXPLAIN WHAT WE ARE DOING TO SCHEME MEMBERS".

- Providing information on ESG and stewardship can make investment seem more "real" to scheme members. There is also a growing body of evidence to show that members, particularly younger generations, are increasingly concerned about these issues. Case Study [6] argues that talking about how members' pensions investments are used to tackle real world problems can that can be financially material to members' savings can help engender trust in pensions, improve engagement and provide members with a greater sense of ownership of and appreciation for their pension savings.



18 See, for instance: the PLSA/Sustainalytics report *ESG Risk in Default Funds* (2016); *Total Societal Impact: A New Lens for Strategy* (Boston Consulting Group, 2017); *ESG and Financial Performance* (Deutsche Asset Management/The University of Hamburg, 2016); *The Impact of Corporate Sustainability on Organizational Processes and Performance* (Eccles, Ioannou, Serafeim, 2016).

19 The World Economic Forum's Global Risks Report 2019 provides a useful exploration of the likelihood and impact of key risks including environmental risks.

QUESTIONS TO ASK

OF YOURSELVES

Have our actions been consistent with the policies agreed and documented in our SIP (or related policies)?

What are we telling our members and should we be telling them more?

Have we sufficient oversight on, and reporting from, advisers and managers?

Do we properly understand the reports we are receiving, and the work that any advisers do in order to produce them for us?

TO ADVISERS

Where across my portfolio are my biggest ESG risks and what is your strategy for how we should mitigate these in line with our investment beliefs and principles?

On what proportion of my portfolio am I receiving ESG and stewardship related reporting?

How frequently should we review our ESG and stewardship beliefs?

TO ASSET MANAGERS

Relevant to the fund we are invested in, please can you set out one example where you have:

- Invested due to ESG and stewardship considerations?
- Not invested or disinvested due to ESG and stewardship considerations?
- Engaged with companies on ESG issues?
- Used your vote on an ESG or other issue?
- Managed a conflict of interest?

What are the main ESG risks for X asset, and how did you get comfortable with them in order to invest? How did you engage and vote on Y issue and how does doing so align with our investment beliefs and objectives?

How has the portfolio evolved over the last year, and has the ESG focus of the portfolio changed significantly?

Can you provide an example where you voted against management and explain why?

Has your approach to ESG added value, and how can you demonstrate that?

Can you describe your governance arrangements for dealing with conflict of interest that may arise from your stewardship activities?

CASE STUDY 6 – APPROACH TO COMMUNICATING WITH MEMBERS

In a membership survey NEST conducted in 2018, nearly half of scheme members (47%) said that it was very important to them that their pension scheme makes investment decisions that consider how companies and markets are run and how they treat people and the planet. 26% agreed that doing so would produce better returns, while just 12% of members said it didn't really matter to them at all.

In discussions about the role of ESG in pension scheme investment, it is frequently suggested that raising awareness of how a scheme takes account of ESG factors can help engender trust in pensions, improve engagement and provide members with a greater sense of ownership and appreciation for their pension.

NEST decided to test this, to see whether it rang true with its members. NEST gave a sample of its membership a bit of information about what it does as a responsible investor and how it helps deliver better results. Half of those surveyed said this information improved their impression of NEST, while 44% said it made them more interested in their pension. Nearly the same number (45%) agreed it made them feel more confident about saving with NEST.

ACCESS MORE SCHEME CASE STUDIES ONLINE

CONCLUSIONS

This guide maps out a journey for trustees getting to grips with ESG, climate change and stewardship considerations both in response to the new regulatory requirements for schemes but also to help schemes achieve good practice in the future. As with any other compliance or investment issue, trustees should seek to obtain specialist advice where appropriate but we hope that this guide provides an additional tool for schemes to use when working with their advisers and managers.

Recent years have seen several distinct yet overlapping developments on ESG and stewardship issues from both a policy and market perspective, and at the UK, EU and global levels. It is likely that the direction of travel is for ESG and stewardship to become increasingly embedded into investment decision-making and implementation. Future trends in this space could include:

- Traditional market capitalisation-based indices may start to look more like today's ESG focused funds, accelerating the challenges for carbon emitters and companies that display poorer corporate governance practices;
- Further cross-government action and policy change in response to the risks from climate change, which could have a significant impact upon financial markets and key sectors or industries;
- Technology which facilitates greater personalisation of investments, leading to a more engaged membership profile, who may have strong views on how their investments are invested; and
- Greater availability and standardisation of ESG data which will allow more transparency of manager performance against stated goals.

We think it remains likely that trustees will need to increasingly focus on how they meaningfully consider, implement and communicate their approaches to ESG and stewardship, demonstrating that the decisions taken by trustees in this area today will have a positive impact on the value of individuals' retirement savings in the future.

APPENDIX 1: RESOURCES

The resource list below is not intended to be exhaustive, but rather to give an indication of some useful and publicly available tools and reports should trustees wish to explore specific issues further. PLSA members should contact *caroline.escott@plsa.co.uk* if they would like to be signposted towards reading on related issues not covered here.

REGULATORY AND LEGAL BACKGROUND

- *EU IORPII* (in force from January 2017)
- *Pension Funds and Social Investment* (Law Commission, 2017)
- *Occupational Pension Schemes (Investment) Regulations 2005* (amended in September 2018)
- *Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019*

INDUSTRY FRAMEWORKS AND TOOLKITS

- *ICGN Model Mandate* (International Corporate Governance Network, 2012)
- *Stewardship Disclosure Framework* (PLSA – ongoing)
- *Aon Pension Trustee Checklist - Understanding trustee decision making* (Aon, 2017)
- *The ABC of ESG* (Mercer, 2018)
- *Red Line Voting Initiative* (AMNT, 2018)
- *Holding Investment Consultants to Account: A guide for trustees* (AMNT/UKSIF, 2018)
- *Corporate Governance and Voting Guidelines* (PLSA, 2019)
- *ESG and climate change for pension funds - Putting the law into practice* (Sackers, 2019)
- *Responsible Investment: A guide for Defined Benefit trustees and Responsible Investment: A guide for Defined Contribution trustees* (Hymans Robertson, 2019)
- *ESG: Are you asking the right questions* (ARC Pensions Law/River and Mercantile, 2019)

FURTHER READING

- *The Bridges Spectrum of Capital - How we define the sustainable and impact investment market* (Bridges Fund Management, 2015)
- *ESG risks in Default Funds: Analysis of the UK's DC Pension Market* (PLSA, 2017)
- *More Light, Less Heat: A framework for pension fund action on climate change* (PLSA/ClientEarth, 2017)
- *Recommendations of the Task Force on Climate-related Financial Disclosures* (TCFD, June 2017)
- *The Investment Association Stewardship Survey* (Investment Association, 2018)
- *Sustainable investment, show me the evidence* (Willis Towers Watson, 2018)
- *2018 Responsible Investment Policies* (Principles for Responsible Investment (PRI), 2018)
- *Pensions for the Next Generation: Communicating What Matters* (ShareAction, 2018)
- *Winning Climate Strategies* (Asset Owners Disclosure Project, 2018)
- *Sustainable Ownership Report 2018* (RPMI Railpen, 2018)
- *A Guide to Climate-Related Risks* (LCP, 2017)
- *Climate Change Challenges: Climate change scenarios and their impact on funding risk and asset allocation* (Aon, 2018)
- *In search of impact - Measuring the full value of capital: Update: The Investment Impact Framework* (Cambridge Institute for Sustainability Leadership, 2019)
- *Investing in a Time of Climate Change, the Sequel* (Mercer, 2019)

ACCESS ALL FURTHER READING ONLINE

APPENDIX 2: RELEVANT REGULATORY DEVELOPMENTS

Recent years have seen several relevant UK and EU policy and regulatory developments relating to ESG investment and stewardship. We highlight some of the most important for schemes here. Links to most of the documents can be found in Appendix 1.

December 2016	IORP II published
June 2017	Law Commission report – *Pension funds and Social Investment*
October 2017	*Patient Capital* Industry Panel Review published
November 2017	*Growing a culture of social impact investing in the UK* report
January 2018	*High-Level Expert Group on Sustainable Finance* Final Report published
March 2018	Parliament's *Environmental Audit Committee* writes to top 25 UK pension funds regarding their approach to
Sept 2018	DWP publishes final response on Occupational Pension Schemes (Investment) Regulations
March 2019	FRC *Stewardship Code consultation closes*

THE EU'S SECOND INSTITUTIONS FOR OCCUPATIONAL RETIREMENT PROVISION DIRECTIVE (IORP II) – *came into force, June 2017*

This requires schemes to have a proportionate, effective system of governance in place. This includes consideration of ESG issues in investment decisions.

LAW COMMISSION REPORT – PENSION FUNDS AND SOCIAL INVESTMENT (2017)

In 2017, the Law Commission published the final report of its investigation into whether there were legal or regulatory barriers to using pension funds for social impact and set out options for reform. Its recommendations in this area set the basis for the *Investment Regulations* themselves as well as the FCA's work on the extension of Independent Governance Committee (IGC) remits on ESG and stewardship issues (see below).

THE EU'S AMENDED SHAREHOLDER RIGHTS DIRECTIVE (SRD II) – *laid before Parliament June 2019*

This requires schemes to develop and publish a shareholder engagement policy on the scheme website which describes how investee companies are monitored on matters such as financial and non-financial performance.

In transposing SRD II into national law, DWP noted that many of the new requirements were already covered by the 2018 changes to the Investment Regulations. However, the *Occupational Pension Schemes (Investment and Disclosure) (Amendment)* Regulations 2019 which implement SRD II do still place further additional duties on DB and DC schemes.

2018 CHANGES TO THE OCCUPATIONAL PENSION SCHEMES (INVESTMENT) REGULATIONS 2005 – *amended in September 2018*

These changes sought to clarify how trustees could consider financially material ESG factors in their investments and also broadened the definition of stewardship to include engagement. It placed new disclosure requirements upon DB and DC schemes.

THE FCA'S WORK ON EXTENDING THE REMIT OF INDEPENDENT GOVERNANCE COMMITTEES – *2019 (ongoing at time of writing)*

For contract-based schemes, the FCA is considering new duties for Independent Governance Committees (IGCs) to report on their firm's policies on ESG Issues, consumer concerns and stewardship, for the products that IGCs oversee.

THE EUROPEAN COMMISSION'S HIGH LEVEL EXPERT GROUP ON SUSTAINABLE FINANCE (HLEG) – *2016 to present*

This work aims to unite sustainability with finance across the EU. Notable developments include work towards a unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low-carbon indices, and metrics for climate-related disclosure.

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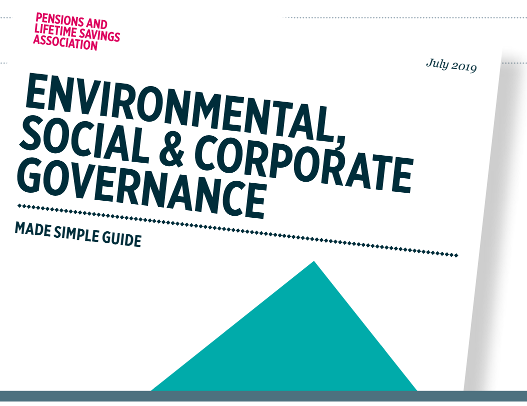
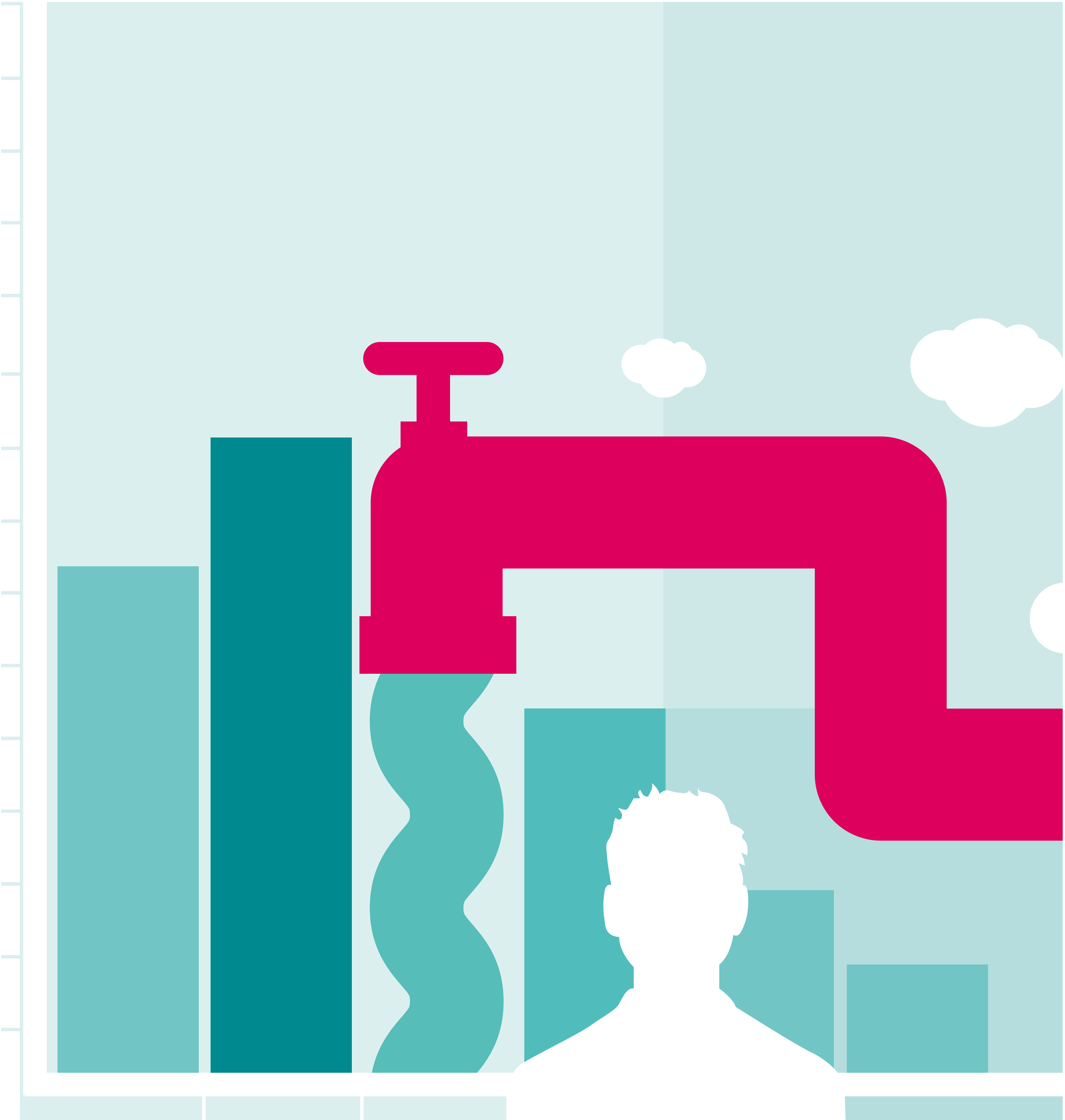
WANT TO KNOW MORE?

Look out for *ESG Made Simple*, sponsored by Kames Capital, in July 2019





PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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