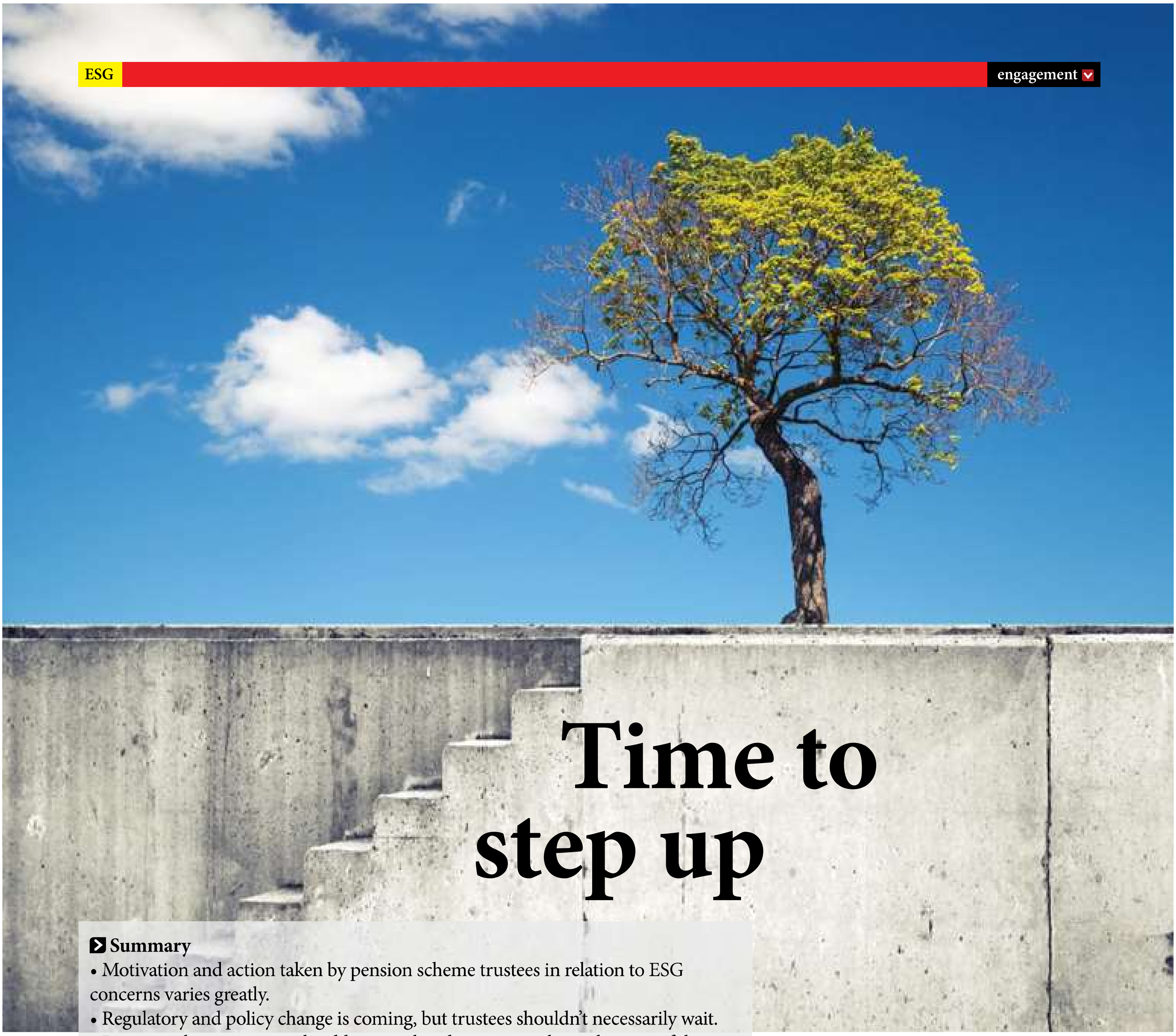

# Time to step up

**Summary**
• Motivation and action taken by pension scheme trustees in relation to ESG concerns varies greatly.
• Regulatory and policy change is coming, but trustees shouldn't necessarily wait.
• Pension scheme trustees should accept that they are merely on the start of their ESG journey, and look for opportunities, as well as mitigating risks.

**Sophie Smith considers to what extent pension scheme trustees are proactively engaged with ESG concerns when investing, or if they are just responding to regulatory pressure, and whether their focus on ESG is likely to increase in the post-Covid 'new normal'**

"Pension schemes hold almost £2 trillion in assets. They have tremendous influence in our fight against threats as large as climate change, and their financial returns will be impacted by the decisions we take as government and society. So how their investments are affected by climate change, and the actions we take to limit it, should be central to what trustees consider when they come to invest."

These are the recent words of Pensions Minister, Guy Opperman, who, in March of this year, described climate change as probably the largest threat facing pension schemes. It's perhaps no surprise then, that environmental factors have increasingly been moving up the agenda. Especially considering the recent joint report from the Association of Luxembourg Fund Industry and PwC Luxembourg, which described the UK as the "leading European market" for environmental, social and governance (ESG)-related investments.

However, research has consistently shown that trustee engagement may be little more than surface level, with 95 per cent of pension schemes surveyed in a recent report by the Society of Pension Professionals (SPP) having made no ESG changes to their portfolios. Furthermore, 57 per cent stated that whilst schemes had shown "a genuine interest" in ESG, they had made no changes to their investment portfolio to reflect this.

## Starting the journey

"Trustees have recognised the relevance of ESG issues for some time, but were often unsure about the genuine difference they could make," explains Insight Investment senior ESG analyst, Josh Kendall. He clarifies however, that while there is a genuine interest from all trustees, their approach can vary greatly. For instance, whilst some utilise effective questioning of their portfolio managers and have a clear understanding of what they want, others may rely on more blanket industry guidelines.

Dalriada Trustees investment specialist, Vineet Sood, highlights a similar disparity in terms of motivation, noting that whilst regulatory changes have driven some, others have taken this issue more seriously, as it aligns with their "broader business beliefs".

However, Sackers partner and Pensions Climate Risk Industry Group (PCRIG) chair, Stuart O'Brien, points out a "common misunderstanding" around whether regulations introduced a new requirement on trustees to factor ESG into their investment decision making.

"They don't," he clarifies, "they simply require trustees to disclose their policies on them. And to the extent that such factors are financially material to trustee investment decisions, they should always have been taking them into account.

"But it's often said that the sunlight of transparency is the best disinfectant, so no doubt many trustees have had to up their game in response to a regulatory obligation to disclose", he adds, predicting a move "on apace" once the requirement for annual implementation statements comes into force in October.

Whilst the SPP research did reveal that over two-thirds of scheme members are only reacting to regulatory changes as a tick-box exercise, UN Principles for Responsible Investment (PRI) director of climate change, Sagarika Chatterjee, stresses that this approach could actually be making their life harder.

"It's actually quite hard to do Task-Force on Climate-related Financial Disclosures (TCFD) reporting, unless you actually are doing something about climate and are looking at it in a serious way," she explains, stating that these types of disclosures look closely at how scheme boards are thinking about climate. This in turn, requires schemes and trustees to have genuinely taken a closer look at the impact of climate risk on their portfolio.

She adds: "It's very short-sighted not to consider these factors for any pension scheme that has a global portfolio, that's investing across asset classes, regions, and sectors, as all of these will all be impacted by climate risk and opportunity."

Kendall emphasises that ESG investing is not about applying an ethical criterion to mandates, but rather should be considered "a core part of the evaluation of managers", giving a "window into the culture and purpose of a fund manager", and how diligently they consider the needs of asset owners.

However, a recent report from AMNT, PLSA, PMI and Mallowstreet found that 21 per cent of trustee chairs actually believe ESG investment would detract from returns. However, Sood notes that whilst trustees often continue to view ESG factors as a "secondary consideration" when seeking to achieve good returns, the outperformance of some ESG funds throughout the pandemic could serve as evidence of enhanced returns in future.

## Picking up the pace

He explains that this strong performance throughout the market volatility could see ESG issues brought to the forefront of trustees' minds, a stance echoed by various industry experts.

Kendall for instance, adds that whilst there has been a long-standing trend of engagement by clients on ESG, this has accelerated throughout the crisis. Equally, Chatterjee says she has been surprised by the traction the PRI has seen from some "fairly large asset owners, post Covid-19".

However, as Sood highlights, the crisis has also thrown up a lot of issues in the day-to-day running of schemes, as well as the long-term sustainability for some sponsoring employers. While Chatterjee agrees that pension schemes must first tackle the challenges arising amid the current pandemic, she adds that they might also take it as an opportunity when having conversations with portfolio managers, to start engaging climate issues, as well as potential prospects.

"There's a real opportunity set there," she explains, "we're going to see some sectors and funds go through massive changes, so it could be a good moment to start thinking about these broader issues."

Indeed, PLSA policy lead for investment and stewardship, Caroline Escott, adds: "ESG is already playing a role in policymakers' thinking about a post-Covid recovery. I think we may see the government look to kill two birds with one stone in getting the economy up and running, while also ensuring progress towards a net-zero economy."

With a recent Ipsos Mori poll revealing that 65 per cent of savers support a green recovery following Covid-19, Chatterjee agrees that this could be a "strong driver" for more climate aware investing. She adds that whilst there will be regional differences in policy response, it's likely that some governments will see this as an opportunity to potentially restructure the economy, and to think about areas such as fossil fuel subsidies or carbon pricing, and how they can be "stepped up".

Covid-19 has also had an impact on timelines, with Escott predicting slight delays to the Pension Schemes Bill and the ongoing consultation on TCFD requirements. But this doesn't mean that trustees should also postpone their plans.

### Awaiting the inevitable

"The trustee duties to act prudently and consider relevant factors in their investment decision making remain unaltered," clarifies O'Brien, "on that basis, it wouldn't be wise for trustees to use any regulatory delays as an excuse for inaction in tackling the big issues."

This perhaps seems a wise attitude to have, as Opperman states that despite delays, change will likely come sooner rather than later.

"I intend to use powers included in the Pension Schemes Bill, currently progressing through parliament, to mandate schemes to produce annual reports in line with the TCFDs' recommendations. We will consult, but I want to move quickly," he states.

"We need these requirements to capture as much of the occupational pensions market and as many pension savers as possible – and without delay," Opperman continues. "We want to further accelerate pension schemes' governance considerations and disclosure on sustainability. The urgency of action on climate change demands it."

Escott adds that trustees should also be mindful of broader policy changes, highlighting what the UN PRI has named the Inevitable Policy Response (IPR).

The IPR states that there will be "forceful, abrupt and disorderly" policy response from governments by 2025. And whilst UK regulation may be delayed by the Covid-19 pandemic, Chatterjee states that analysis has found that timings for the IPR are not, meaning that the 'run-up' period of 2023-2025 will likely see an increase in activity.

"Even the few sceptics who don't believe climate change is happening, need to understand that policy makers know it is happening, and regulating accordingly," Escott states. "All this regulation will have a knock-on impact on the sectors affected. Trustees should now be keeping a close eye on what policy makers and regulators are committing to do both now and in the future."

### One step at a time

"The subject can feel pretty overwhelming when starting out," acknowledges O'Brien however, emphasising that trustees should be realistic and accept that this will be the beginning of their journey.

"A good starting place," he continues, "will often be to understand what you have…After that, trustees should consider whether these are compatible with their own investment objectives and get a better handle on what risks are lurking in the approach they have."

In addition, Chatterjee highlights climate scenario tools and carbon footprinting as key measures in evaluating your scheme progress, emphasising that the increasing number of off-the-shelf tools designed for this task means there is no need for a giant price tag.

She adds that 'baby steps' in three key areas, invest, engage and policy advocacy, can play a crucial role in approaching the issue of ESG, even when starting small, such as opening a dialogue with portfolio managers on ESG issues.

Chatterjee also highlights the role of organisations such Climate Action 100+, urging schemes to use their existing partnerships to better engage with corporates and influence change. The effectiveness of these 'baby steps' is already evident, with the Brunel Pension Partnership, for example, engaging with mining firms to drive the creation of the first global database of tailing dams, designed to help avoid a repeat of the Brumadinho dam tragedy.

The exclusion of especially problematic sectors has become more commonplace, with USS Investment Management recently announcing the removal of a number of "financially unsuitable" sectors, such as tobacco.

Sood meanwhile, calls for greater education on ESG issues, urging trustees to use firms that have a history of integrating ESG and have not simply jumped on the bandwagon. "Working with knowledgeable and skilled advisers can help trustees to see through 'greenwashed' funds," he adds.

Kendall also highlights "robust due diligence" as essential for trustees to avoid falling victim to greenwashing, adding that greater transparency is needed on all levels, to ensure that investors can gain truly relevant information when comparing ESG performance.

"Our own research has shown sub-optimal data to be an industry-wide problem that must first be addressed," he explains. "For example, increased investment in data infrastructure would help facilitate the necessary disclosure and allow managers to be even more efficient in their reporting. Only by asking questions can trustees truly have confidence in their portfolio managers."

While they may seem small first steps, trustees need to start taking these baby steps now or face a "forceful and abrupt" change further down the road.

**Written by Sophie Smith**