Summary

• Pension schemes with weak employer covenants are less able to implement ESG strategies.
• Trustees can benefit from engaging with employers to align ESG values and objectives.
• Appointing independent external advisers can help trustees with weak employer covenants to formulate an effective responsible investment strategy.

Employer covenant: Watering ESG goals

Gill Wadsworth considers how the strength of its employer covenant may influence a pension scheme's sustainable investing appetite

Not content with being the first administration to insist its pension schemes report their climate-related financial risks, the UK government is expanding its remit to encourage funds to take account of specific environmental issues.

This March, Pensions Minister, Guy Opperman, announced he would be "reaching out to UK pension funds, to help them further understand deforestation issues and how to manage this risk as effectively as possible".

Already schemes with 100 members of more are obliged to have a clear environmental, social and governance (ESG), climate change and stewardship policy, and by 2023 all occupational funds will need to report under the Taskforce for Climate-related Disclosures (TCFD).

The latest announcement from Opperman suggests they might also need to be transparent about how they are "using *[members']* hard-earned money in a way that jeopardises or prioritises the future for which they are saving", in relation to biodiversity, specifically the destruction of the world's forests and woodlands.

Size matters

While these climate-related disclosures will be important in helping the UK to meet its net-zero carbon emission targets by 2050, there is evidence to suggest pension schemes with weaker employer covenants are struggling to keep pace with their ESG demands.

A survey of 160 trustees and pensions professionals published by MallowStreet and Janus Henderson Investors at the end of 2021 found 45 per cent of schemes with a strong covenant are focused on ESG integration, but this proportion drops to 17 per cent of schemes with a sponsor which is 'tending to weak'.

The survey also finds that schemes with high funding levels are more likely to have included a policy on responsible investing in their statement of investment principles (SIP). Four out of five schemes funded to a level above 90 per cent have one, compared with just over half of schemes with a funding level below 80 per cent.

Meanwhile, 88 per cent of less well funded schemes have policies of financially material ESG considerations. This leads the researchers to conclude that "underfunded schemes still view ESG risk as something to consider rather than act on".

The survey also found that a strong covenant also helps increase the focus on responsible investments and climate change.

The research states: "Over 80 per cent of schemes with a sponsor leaning towards strong have added a policy on responsible investing to their SIP. In contrast, 70 per cent of schemes with a covenant tending to weak have made such adjustments. A stronger covenant also increases the chances of the scheme having a policy on alignment with

managers and consultants, as well as a specific policy on climate change."

Money concerns

Sackers partner, Stuart O'Brien, says trustees may "lack the time and bandwidth" to manage a weak employer covenant and poor funding level, alongside formulating an ESG strategy.

He says: "If your roof is falling in you are not going to focus on double glazing the windows. I am not suggesting for a moment that ESG and climate change aren't material financial risks, but if you have got a massive concern about whether your employer is going to be around in the short or medium term, that will be the focus for your attention."

O'Brien's comments are borne out by the MallowStreet survey, which found those trustees with the lowest weakest employer covenants were most concerned with improving their scheme funding and agreeing an endgame plan.

This later point, O'Brien says, may limit schemes with weak employers even further from prioritising ESG strategies.

"Schemes with stressed employer covenants will likely be trying to de-risk their investment strategies, which tends towards allocation to defensive assets like gilts while lowering their equity exposure. That doesn't mean that ESG is irrelevant, but there is usually more stewardship involved in the equity space than there is in fixed income or LDI portfolio."

Even though engagement opportunities may lessen with a de-risked portfolio, that does not mean pension schemes should discount ESG investment, particularly as there is growing evidence that they offer outperformance potential.

WTW partner, and member of the Pensions Management Institute, which collaborated with MallowStreet on the research, Jed Newton, says: "ESG funds can outperform their non-ESG equivalents, and their use in a return-seeking component of a scheme's strategy could generate higher excess returns and reduce a pension scheme's deficit more quickly. This would increase the security of scheme benefits and reduce the corresponding risk that the scheme in question fails and is transferred to the Pension Protection Fund."

ESG transition

He adds: "Even though some ESG funds may outperform – and others underperform – their non-ESG equivalents in the short term, pension schemes usually have a very long investment horizon. This means that ESG funds may remain a suitable investment option."

Data from MSCI published in 2020 show that over a 13-year period, companies that scored highly across all three E, S and G pillars outperformed the bottom-scoring companies by between 27 per cent on a cumulative basis.

Despite the compelling evidence in favour of transitioning to an ESG weighted strategy, Teneo client development director, Simon Kew, says that trustees are reliant on advisers to drive allocations.

He suggests that trustees working under a weaker covenant may also find they have fewer resources available to help formulate an ESG approach.

"Less well-resourced employers may be likely to have a less well-resourced scheme which begs the question whether they have the right advisers to be able to hold their hand through that process."

Kew adds: "And where trustees have an investment adviser suggesting an ESG strategy, the trustees must kick the tyres and question what the investment adviser is telling them. Without other advisers there, it may be challenging."

Kew suggests that schemes consider bolstering their advisers to help them implement an ESG strategy.

"An under-resourced scheme that just has board of trustees – as good as they may be – will probably only have seen one scheme, so they don't have other experience to draw on. The great thing with any external adviser or lawyer is that they will have other trustees clients and they can bring that experience to bear."

PTL managing director, Richard Butcher, agrees that navigating the 'grey areas' of ESG investing is a challenge for less well-resourced schemes and those that have their hands full dealing with their number one objective: Pay beneficiaries in full and on time.

"Despite the assertions made by some, ESG investing is an incredibly complex subject, and the reality is most trustees have very little leverage when it comes to these matters," he states.

However, Butcher reminds trustees that it is worth working with employers to ensure their ESG priorities are aligned, and that the pension scheme investment strategy does not undermine the company's objectives.

"The delivery of a pension scheme should be a team effort between trustees, employer and advisers. And as far as possible, it is sensible to make sure that your values are aligned. If you are going to adopt ESG strategy as trustee that could include exclusions those values should be consistent among the team members. It makes sense to engage with the employer and agree that strategy," he adds.

As more regulation comes into force obliging trustees to report their ESG risks, even trustees battling with weak employer covenants and poor funding levels will need to have a policy in place.

Prioritising the interests of beneficiaries will always remain the number one priority but as Butcher says this need not be 'mutually exclusive' from adopting a responsible and sustainable investment strategy.

The key to balancing ESG obligations with responsibilities to members lies in appointing credible advisers that are understand the scheme's specific objectives and can find an ESG strategy that delivers for the long term.

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