Pensions Management Institute
Knowledge

The Pensions Management Institute (PMI) Environmental, Social & Governance (ESG) Report 2022

Pensions Management Institute
Knowledge & Integrity

Foreword

Letter from the CEO

There was a time when the application of Environmental, Social and Governance (ESG) principles to UK pension schemes seemed novel and problematic. However, recent years have seen a significant shift in the thinking of the Government and also on trustee boards. Policy led by Guy Opperman during his time as Pensions Minister has seen ESG given particular prominence in the thinking of the UK's pension schemes. A more sophisticated approach has seen trustees appreciate that ESG as being far more than paying lip service to environmental issues, and trustees now have a deeper understanding about their responsibilities - not just in respect of addressing climate change but also with regard to ethical workplace practices. Crucially, trustees also have an understanding of the benefits of effective governance and the positive impact it has on scheme management.

However, applying ESG effectively is not without its challenges. Legislative requirements have become increasingly demanding, and trustees find themselves having to work hard to incorporate ESG effectively in their schemes' funding arrangements. There are also alternatives open to boards when it comes to effective implementation.

PMI's 2022 ESG Report serves as a vital guide to today's trustees. It considers all the issues that trustees are required to address if they are to apply Environmental, Social and Governance principles effectively to the stewardship of their schemes. A range of highly-respected industry professionals has contributed to this report, and their input considers not just the benefits of effective ESG implementation but also the pitfalls to be avoided. Trustees need also to consider how best to apply ESG principles, from the adaptation of traditional stewardship models to the alternatives of Fiduciary Management.

This report addresses the key issues associated with both approaches. The importance of effective member communications is also addressed, and PMI's report examines routes to achieving this objective that would suit schemes of all sizes.

Achieving effective ESG implementation will by now be a key concern for all trustee boards. The new PMI report addresses the principal issues in a through but accessible manner and will provide a priceless insight into the challenges of ESG.

Gareth Tancred
Chief Executive

PMI ESG Report / Barnett Waddingham

Stewardship: Developing your approach

Introduction

With the Financial Reporting Council (FRC)'s latest list of signatories published in September 2022, we are now two years into using the updated UK Stewardship Code reporting framework. At the same time, there has been additional guidance from the Department of Work and Pensions (DWP) this year on reporting on stewardship through trustees' Statement of Investment Principles (SIP) and the Implementation Statement. Plus, a new Code of Practice from The Pensions Regulator with a section on stewardship is expected before the end of the year.

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Since the UK Parliament declared a climate emergency in 2019 and became the first major economy in the world to pass laws to end its contribution to global warming by 2050, it's been clear major change is coming in the way we look at climate change across the whole economy, including for investors. The effects of changing actions from consumers and government policies on climate change are increasingly starting to feed through to the companies that pension schemes are invested in.

Investors need to be aware of these actions and their implications. One of the most important roles they can undertake in navigating this journey is ensuring effective stewardship of their investments. Investors can exert a positive influence on companies to promote strong governance, manage risk, increase accountability and drive improvements in the management of environmental, social and governance (ESG) issues, including climate change.

We think stewardship plays a vital role in sustainable investment practices. We're signatories to the UK Stewardship Code to demonstrate the importance we place on effective stewardship activities, and we report annually on our activities and the outcomes we have delivered using the Code's principles framework.

Preparing a report and becoming a signatory is not a simple, tick-box exercise. We look to continuously improve our approach across the six principles for service providers, evaluating ourselves and our effectiveness each year, with our report then rigorously assessed by the FRC to make sure we meet the standard to remain on the list. We think stewardship is only going to continue to increase in importance for investors going forwards, so we keep developing our approach as new information and innovations come to the market.

The DWP's 2022 guidance also gives greater attention to stewardship for trustees, providing a framework for improving their approach where they want to do more, but might be unsure of where to start. The DWP clearly wants to discourage simply reporting that stewardship is delegated to managers and instead are looking to encourage increasing trustee governance and oversight. The guidance recognises the challenges of owing assets via a pooled fund. Nevertheless, the expectation is for trustees to set their own voting policy or understand and monitor their managers' policies.

Trustees are encouraged to set out their stewardship priorities, which should help to focus their governance time on the issues or themes they consider have the greatest impact on investments for their particular scheme membership and time horizon; these could be things like climate change, packaging and waste, and sustainable land use. This can mean engaging with managers and asking questions about their approach, their recent engagements, the outcomes the manager has achieved and the escalations they are making to get the outcomes they are looking for, in the areas trustees have identified as priorities.

Day to day, we help investors understand, refine and agree their approach to stewardship, including setting their stewardship priorities. To support their group decision making we use Swarm AI, a collective intelligence technology mimicking the biological principle of swarm intelligence to allow groups of decision makers to collaborate and quickly converge on solutions that maximise their combined intelligence. This drives more accurate insights, faster, and works by connecting decision-making teams like boards into a real-time interactive platform moderated by AI algorithms and a BW consultant.

The interactive platform amplifies the knowledge and wisdom of a team, while reducing the impact of biases. Research shows that combining the knowledge of a group with Swarm AI consistently outperforms individual experts, traditional crowd-based methods such as polling, as well as deep learning AI. This helps teams to make optimised decisions, risk assessments, prioritisations and forecasts. We use Swarm AI with investors to help develop investment strategy and stewardship policies.

The DWP suggests a number of activities for investors, including assessing manager stewardship when selecting a manager. Stewardship is a key part of our sustainable investment rating system, where we set out for clients the credentials of asset managers who can run their investments. One part of our rating is where we assess managers on the extent to which they use their voting rights and engagement opportunities to influence companies' business activities.

We then give a rating of high conviction, acceptable and low conviction, and present our clients with one overall sustainable investment rating (covering sustainable investment research, sustainable investment integration and stewardship), along with sub-ratings for each of the three elements so that investors have full transparency on the manager's performance.

PMI ESG Report / Barnett Waddingham

For public markets (equities and fixed income), our stewardship assessment focuses on key voting and engagement data relating to activities and outcomes, rather than policies and people. We look at things like voting on specific categories of resolutions, voting on controversial resolutions, and level of engagement activity by sustainability theme.

For private markets, our stewardship assessment is tailored to the asset class and focused on the investment manager's activity in the most relevant investment phase (pre-investment and/or post-investment) for the asset class. For real estate, infrastructure, and private equity, the focus is post-investment activity. For private debt, the focus is pre-investment activity, with some consideration of post-investment activity. Research meetings are conducted to assess the investment manager's stewardship approach, as well as activity over the last twelve months.

For fund of funds, our stewardship assessment is focused on the investment manager's approach to assessing, monitoring, and engaging managers, as well as activity over the last twelve months, with research meetings conducted to gather this information.

The DWP guidance also asks trustees to monitor managers' stewardship behaviour. This aligns with the recent consultation from TPR on the new Code of Practice, asking trustees to ensure they are familiar with their investment manager's stewardship policies and that they monitor and review the manager's stewardship practices.

We help clients to understand managers' voting and engagement, including the significant votes undertaken on their behalf, as part of helping to prepare Implementation Statements. We help clients identify which issues are important to them. Some of our clients are also beginning to set out their own thematic engagement policies, identifying the ESG and sustainability themes they consider will be drivers of long-term value and where they would prioritise engagement activities. Our research seeks to help identify developing themes in the solutions that managers are offering and, in turn, feedback to them in order that they can develop appropriate solutions.

More stewardship activity is a welcome and useful development to help investors tackle the challenges arising in navigating the transition to a net zero global economy. With this increasing focus on stewardship and attention from the Government and regulators, we are starting to see some innovation in managers' voting and engagement policies and practice. One recent development allows investors in certain equity index pooled funds to incorporate their own voting policy or adopt a third-party voting policy. Since these options have been available, we have been helping investors to consider alternative voting policies to the manager's default policy, which may be better aligned to their objectives. These approaches can give investors the opportunity to adopt a policy which better reflects their specific objectives, whilst maintaining the advantages of holding pooled vehicles.

With stewardship rising up the agenda, there are plenty of actions trustees can start to take, all of which evidence their effective governance of investments and will support future reporting on governance, stewardship and climate change.

PMI ESG Report / Blackrock

BlackRock

Climate-risk reporting: The challenges and pitfalls

Introduction

It's been another challenging year for UK pension schemes. Against the volatile backdrop of soaring inflation and shocks to global supply chains following the tragic conflict in Ukraine, Trustees have had plenty of matters to juggle. One area that continues to dominate the agenda is sustainable investing and in particular, how schemes plan to navigate through the transition to net-zero.

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What is a net zero economy?

A net zero economy is one in which emissions of greenhouse gases are significantly minimised and where any residual emissions are appropriately offset. Achieving a net zero economy involves companies and governments working in tandem to significantly reduce global emissions. The preferable aim of the 2015 Paris Agreement is to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels, recognising that this would substantially reduce the long-term economic consequences of climate change. This transition to net zero will involve a massive reallocation of resources, with economies being reshaped as carbon emissions are cut. As an asset manager, BlackRock's fiduciary role includes helping our clients to navigate this economic transformation, so they can be resilient to the risks and able to capture the opportunities.[1]

What are the challenges and opportunities that the transition creates?

We believe that climate risk is investment risk. As policymakers, regulators, and consumers accelerate the transition to a net zero economy, companies that are not prepared for this transition – i.e., companies that remain dependent on producing or consuming fossil fuels for too long – risk being left behind by their consumers and shareholders.

The transition also presents a significant investment opportunity. Every company and industry will be transformed – we believe companies that are best prepared for the transition will provide better long-term returns, as they will be better able to function in an economy that looks vastly different from today's. As an early example, we have all watched innovators re-imagine the auto industry and today, every car manufacturer is racing toward an electric future.

Engineers and scientists are working around the clock on how to decarbonise cement, steel, and plastics; shipping, trucking, and aviation; agriculture, energy, and construction. The decarbonising of the global economy is going to create the greatest investment opportunity of our lifetime.

When positioning portfolios to navigate the challenges and opportunities presented by the transition, the following points should also be considered:

- We don't think market prices fully reflect the transition's risks and opportunities yet. We believe companies that are prepared for the transition and more able to seize its opportunities should continue to benefit relative to others over time.[2] As the economy rewires, both the expected value of, and uncertainty around, future company cashflows will change. Ahead of those changes actually happening, markets are repricing risks.
- We don't think the likely transition is fully priced yet – in other words, company valuations still need to adjust further to reflect how exposed companies are to, and how prepared they are for opportunities in, the transition. A possible acceleration from the current transition path, plus repricing that could have further to go, provide an investment case for including investments linked to the transition in a portfolio. And that doesn't just mean companies that are low carbon already.

- Most of the investment needed to decarbonise the economy is in sectors that are currently high carbon. So, investing in the transition also means investing in carbon that supply the materials, equipment and services sectors will not get the world to net zero.
- Investors should also consider how to mitigate the impact on their portfolios of possible supply constraints during the transition process. If carbon intensive production falls faster than lower-carbon alternatives are phased in, there could be periods of supply shortages and high prices for the carbon intensive outputs that economies can't yet function without. Excluding carbon-intensive exposures could mean portfolios are less able to weather these supply shocks.

Partnering with a fiduciary manager can ease the governance burden

We have extensively supported our fiduciary management clients with building strategies that embed ESG considerations into the investment process, to help them with navigating through the transition. We are also revisiting our assumptions around the climate transition on a regular basis, to reflect the ever-evolving environment, helping our clients to be appropriately positioned.

There is also the backdrop of an ever-evolving regulatory environment. Since October 2019, trustees have had to include ESG issues in the list of financially material considerations in their Statement of Investment Principles. Furthermore, from October 2022, trustees of schemes with more than £1 billion in assets will be required to report on the financial risks of climate change within their portfolios, as the 2nd year of TCFD reporting requirements is effective.[3] We have helped our clients to comply with all of the new regulatory requirements that have come into effect.

The focus on ESG is likely to continue its ascent in 2022 and beyond. We are committed to providing trustees with the solutions, tools and the data need to navigate the transition and to help them achieve the outcomes they seek on this journey to a greener future.

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Sources

[1/2:] BlackRock, Positioning for the net-zero transition, June 2022, https://www.blackrock.com/us/individual/literature/whitepaper/bii-positioning-for-the-net-zero-transition-june-2022.pdf

[3.] Department for Work & Pensions, Governance and reporting of climate change risk: guidance for trustees of occupational schemes, Page 4, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1006024/statutory-guidance-final-revised.pdf

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PMI ESG Report / Capita

Capita

Connecting members with issues that matter

Introduction

When it comes to pension schemes communicating ESG decisions and actions to their members, it's very easy to take an obligation-driven approach. There are boxes to tick, disclosures to make, reports to file – all good and necessary things – but what would it look like to take a more strategic, member-centric approach? What if ESG communication isn't just an obligation but an opportunity?

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Think opportunities, not just obligations

For as long as we've had pensions, we've had the challenge of getting people to care about their pensions. Typically, they only get animated when there's some sort of large-scale scandal or breach. For most people, pensions are a dry topic with little impact on day-to-day life.

The environment, however, is something plenty of people care about – just think back to the crowds outside the COP26 summit in Glasgow in 2021. People care about social issues like healthcare, education and housing, where well-invested money makes a tangible difference. And people care about governance because it's often seen as a matter of justice and fairness – we want things to be transparent and above board. These issues matter to members: a 2021 survey by Aviva found that 72% of pension savers consider ESG factors important when investing[1].

All of which means that ESG presents the pensions industry with a massive opportunity to connect something of felt importance with something often felt to be less important: a member's pension. ESG has the potential to help us connect members with their pension in a truly meaningful way.

But if you want to use ESG to reach the members other topics can't reach, it isn't enough just to produce your Statement of Investment Principles, your Implementation Statement, and your TCFD Climate Change Report. Those documents provide a level of detail that might be fascinating to a few members, but which renders them impenetrable to the vast majority. Those obligatory publications get the job done in one sense, but if the aim is to really let members know what you've decided, what you're doing, and what they can do – well, they probably fall short.

Take an opportunity-driven approach, however, and the picture looks quite different. Instead of just asking "What do we have to tell members?", you ask "What do we want to tell members?" – or, if you want to be truly member-centric, "What do our members want to know?" The Pensions Regulator's guidance for DC scheme management even encourages the use of surveys and forums to gauge member views on proposed ethical investment positions.[2] Best practice would be to get some insight into your members' knowledge and interests as part of your strategic planning process.

Then, when you've established what you're going to say, it's time to think about how you want to say it. Chances are that, buried in your meeting papers and investment manager reports, there are some really positive ESG stories you could tell – and those could be the key to tapping into member interest.

Think stories, not just reports

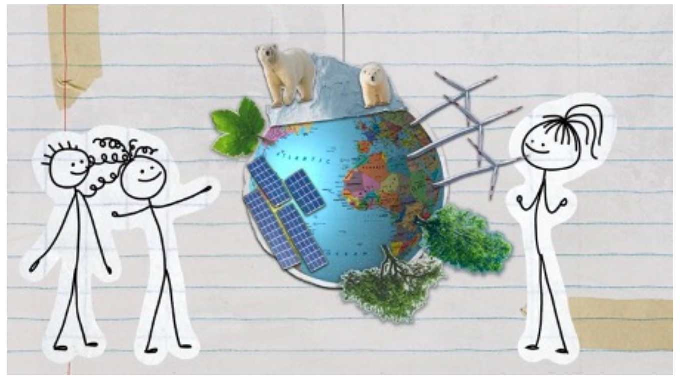
There's a whole sub-category of business literature dedicated to the power of stories. Books like Nancy Duarte's Data Story or Rob Biesenbach's Unleash the Power of Storytelling show how tapping into the human instinct for narrative can make even the most arid subject matter burst into life. Most of us find stories more compelling than tables, graphs and pie charts.

We're already seeing investment managers take this approach, with quarterly reports that don't just give ESG ratings of funds, but give a couple of paragraphs about specific companies or projects that ESG-tilted funds invest in. In recent months we've told the stories of a US water technology management company whose products help improve water usage and efficiency, and a Danish wind turbine supplier which has performed well as the shift to renewable energy continues to accelerate. Your scheme will have its own examples – so why not bring these to life, and share them with members so that they can see some of the good their savings are doing?

You might want to think too about your own scheme's sustainability story. ESG isn't just the responsibility of investment managers. Your scheme might have a net zero carbon target for a particular date, or be implementing a new diversity strategy for the trustee board. These are journeys you're on – and so they're stories to tell your members.

And when your ESG communication strategy is story-shaped, it naturally lends itself to creative ways of getting the message across to members. At Sparks we've produced a short animation that tracks three stick-figure children as they "Follow the money, and see where it goes." It ends with these lines:

Your pension, you see, is not just about you:
There's more that the money you're saving can do.
So join things together, connect up the dots:
The funds that you've got, whether little or lots,
Can be used to pollute, to cut down or destroy,
Or to finance a future we all can enjoy.



PMI ESG Report / Capita

ESG issues – particularly the big ones like climate change – can seem overwhelming, with the size of the problem having a paralysing effect on people who want to take action but aren't sure where to start. Good ESG communication can show them that, through their pension scheme, they've already started – their money is already making a difference.

Of course, if we want to do all we can to tackle some of these big issues, information won't be enough. We also need to encourage members to take action – and that's our third point:

Think action, not just information

The ESG disclosure requirements are focused on what schemes have done rather than what members can do. They aren't the sort of documents that include calls to action. But your other ESG communications can – and arguably should.

And those actions don't have to be directly investment related. While DC schemes might want to encourage their self-selecting members to take a look at ESG fund options, most are likely to be in a default lifestyle fund and happy enough to stay there – even more so if they know their money is doing some environmental or social good. And of course, for DB members the investment decisions are out of their hands – though they still want to know that the scheme is being run sensibly and sustainably.

Thinking more broadly and strategically, ESG communications are an opportunity to encourage members to sign up for – and make use of – digital communications. Where there's high digital adoption, everybody benefits: it's convenient for members, cost-effective for schemes, and represents good stewardship by saving paper and reducing your carbon footprint. And when members are on board with digital channels and you have appropriate infrastructure in place, your entire scheme management strategy can pivot towards a more efficient, more dynamic way of doing things.

That's not to reduce ESG to a means to an end. It's very much an end in itself. We all want to see these important issues addressed – and that's precisely why this is such an important communication opportunity. At the macro level, trillions of pounds are being invested, giving pension funds incredible potential to do good. And as more and more members understand that fact through positive, proactive communication strategies, they'll be equipped to make small, individual decisions that, collectively, could make an enormous difference.

Sparks is the creative communications agency within Capita Pension Solutions

Sources

[1]https://www.aviva.com/newsroom/news-releases/2021/08/72-percent-of-consumers-with-pensions-consider-esg-factors-important-when-investing/

[2]https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/investment-guide-for-dc-pension-schemes-

cardano

PMI ESG Report / Cardano

How do you value an elephant?

Introduction

Sustainability is dominating Trustees' agenda with climate change squarely at the top. But the other side of the climate change coin is biodiversity loss, a topic that deserves Trustees' attention in its own right, with many experts considering it a threat more serious than climate change.

A cartoon circulating on NGO websites depicts waves of crises in orders of magnitude. First, COVID-19, then recession, then climate change, and last, the biggest risk of them all, biodiversity loss. The World Economic Forum seems to agree. Biodiversity loss is rising in its annual ranking of global risks, currently coming in third.

But what is biodiversity and how is it relevant to pension funds?

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Inevitably, we must start with definitions and consider three terms often used interchangeably: Biodiversity, nature and natural capital. Nature is the term most familiar to us and can be defined as the natural world. Biodiversity is the variability of living things. In other words, we can think of nature as land and biodiversity as the richness of that land.

Natural capital is "the stock of resources (e.g. plants, animals, air, water, soils, minerals) that combine to yield a flow of benefits to people". The definition is taken from the Natural Capital Protocol, a group set up in 2016 that works to standardise how we understand these topics.

The economic value of natural capital is considerable. The construction industry, food and beverage sector, agricultural and apparel sectors, chemicals and materials, travel, tourism and real-estate are all dependent on natural capital, including issues such as soil quality, access to sources of fresh water, water filtration, pollination and reliable weather patterns. The second-order effects are systemic, including disruption to food supply chains.

In 2016, I joined a group of investors visiting palm oil plantations in Indonesia. Palm oil is an edible vegetable oil. WWF estimates that more than half of all packaged goods Americans consume contain palm oil – it's in lipsticks, soaps, detergents and even ice cream.

Palm oil is a major cause of deforestation, and can be found in our investment portfolios, along with other commodities that cause deforestation such as beef, soy and timber.

From Jakarta, we flew to Pekanbaru, the economic capital of Sumatra Island – Indonesia's largest. From Pekanbaru we drove about 150 kms south east.

The roads were slow, a mix of tarmac and dirt, and it took just over 4 hours. The clock on the dashboard of the Landcruiser clicked by but the scenery was essentially unchanged. Row after row after row of palm trees standing in regiment like a military parade. There was little in between the palm trees, just sandy strips of dirt, perhaps a fern, perhaps some grass. Each palm was planted with precision, not a metre of space to be wasted.

The lack of biodiversity was by design. Animals could disrupt palm oil yields.

Palm oil is an issue on four fronts. First, the rainforest, which acts as a carbon sink, is bulldozed. Second, any remaining forestry is burnt. The ground is high carbon peatland releasing toxic clouds of greenhouse gases into the atmosphere. The fires can continue under ground for months. Third, palm trees are planted creating a monoculture, degrading soil.

Fourth, there is a social dimension too. At one of the plantations, the workers wore brand new goggles, yellow vests, sturdy trousers and shoes. But I didn't need to look too far to see barefoot children with a talent for climbing trees. Modern slavery, including child and forced labour, is common.

This is not an issue unique to Indonesia. Many a tropical country is deforesting apace. Indeed, take a train across the British or French countryside and its field after field of wheat, barley, sunflower or grape.

Deforestation sounds like a huge problem, and deforestation may well be in our investment portfolios, but doesn't it require a policy response? How is deforestation in Indonesia relevant to a pension fund in the UK? We think there's a few reasons:

- Company-specific financial risk. If companies in our portfolio rely on natural capital, nature and biodiversity loss is a threat to companies' profitability. An interesting example is pollination. Supply chains of companies in which we invest may rely on a variety of pollinators to ensure that each plant is pollinated at the right time. There are examples where farmers are having to "install" beehives because there is no longer sufficient natural pollination.
- Systemic financial risk. Disruption to supply chains could affect multiple parts of our portfolio at the same time in the same direction, for example, a food crisis. An example have global impact, particularly in low income communities. Another example is the steep rise in coffee price due to drought in Brazil. The drought is directly related to deforestation impacting local weather patterns.
- Reputational risk. NGOs are increasingly engaging companies – and investors – on deforestation. In turn, consumer pressure and changing consumption habits can impact a company's reputation.
- Engagement opportunity. Deforestation is rising on the agenda of shareholder AGMs.
- Policy risk. Efforts to stop deforestation involve a complex web of domestic policy, import policies, international diplomacy and corporate regulation.

Pension schemes can hold their asset managers and advisors to account asking: What are the at-risk sectors and at-risk companies in our portfolios? Which metrics, or combination of metrics, are used to identify risks? What are the upcoming shareholder resolutions on deforestation?

What other steps can we take?

The first is to incorporate PBAF, the Partnership for Biodiversity Accounting Financials, in investment decision-making. PBAF provides guidance on how to understand, assess and take action to mitigate biodiversity-related risks.

The second is TNFD, the nature equivalent to TCFD. TNFD is working to standardise and organise nature-related disclosures across the financial intermediation chain. This year and next, TNFD will propose methodologies to measure nature-related financial risks and support nature-positive investment and publish guidance on target-setting.

The frameworks are helpful, because measuring nature and biodiversity loss is complex. A ton of greenhouse gas, whether emitted in the UK or Indonesia, has the same atmospheric effect. But an acre of land in the UK will have very different environmental characteristics to Indonesia. On its own, an aggregated portfolio-level metric is not particularly useful, as it depends on sector and geography.

Groups like Finance for Biodiversity Pledge seek to raise awareness, undertake research and pool expertise.

We're also seeing innovative engagements. ACTIAM, a Cardano company, is partnering with Satelligence, which uses satellite data to detect and quantify changes in vegetation cover in at-risk countries, allowing for real-time corporate engagement. ACTIAM has also pioneered bioacoustics – literally microphones. The more biodiverse, the more noise. And ACTIAM has set land and water-use targets across its investment strategies.

At COP 26, the UN climate conference that took place in Glasgow in November 2021, biodiversity was a major part of the agenda. A speaker from the government of Gabon asked the audience "how do you value an elephant?"

Gabon remains the last stronghold of African forest elephants, having taken steps to protect its rainforest. But Gabon is an outlier: "If we assume a carbon price of $100 a ton", the speaker said, "in the Democratic Republic of the Congo, around $25 billion of value is destroyed every year through deforestation. And that's just one tropical country of many."

At the COP 26 meetings, governments pledged just under $20 billion globally and the timeline is unclear. It's not nothing, but it's just not enough. In other words, for all the recent attention to climate change, globally we're continuing to deforest apace, we don't have the financing measures in place to address deforestation, and as such, biodiversity loss continues and will get worse. A biodiversity COP, COP 15 in Montreal, will meet later in 2022, and is expected to set new global targets. As pension schemes, this is a financial risk we must address – but we also have agency. There is an investment and engagement rationale for taking action to address biodiversity loss – but we can also approach biodiversity loss first principles. Taking action is the right thing to do.

As an industry, we are becoming clearer on the actions investors can take. Adding biodiversity loss to the next pension scheme trustee meeting is an important first step.

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A better way

Gaining a greater understanding of the ESG risks

Introduction

Trustees are increasingly bombarded with Environmental, Social and Governance (ESG) information. Regulations are focusing on ESG matters, specialist ESG organisation are emerging, and traditional investment firms are beginning to develop and demonstrate their ESG credentials. But it wasn't always this way.

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It is strange to think that only a decade ago Environmental Social and Governance (ESG) considerations were still fringe. At the time, ESG was widely accepted as a detractor from returns. The prevailing train of thought was that a bounded investment universe limited opportunities which led to reduced return potential. As trustees' decisions are driven by their fiduciary duty, trustees previously felt they must purely focus on investment returns and could not be derailed by other considerations.

Today, things are very different. Many studies over the past decade have demonstrated that performance of ESG focused investment portfolios can, in fact, enhance returns. And, vitally, both the Department for Work and Pensions (DWP) and The Pensions Regulator (TPR) are clearly focusing on pushing ESG considerations further up trustees' priorities, notably through the introduction of the Task Force on Climate-related Disclosures (TCFD) reporting for larger schemes, implementation statements for all schemes with more than 100 members and ongoing discussions on social factors. On the latter, the view of the erstwhile Pensions Minister is that "trustees who do not factor in financially material social factors are at risk of not fulfilling their fiduciary duty".

ESG considerations are no longer fringe, they are certainly mainstream. It's not a matter of considering if ESG factors should be considered but, rather, how they should be incorporated into approaches. The "How" question, is not simple. ESG is a rapidly evolving area of investments and is filled with market participants with different perspectives and different approaches. Even in areas where there is agreement, such as climate change being a material risk to portfolios, there is still vast divergence in views.

At the time of writing, we are almost one year since COP26. Here the Glasgow Financial Alliance for Net Zero, an alliance covering a broad range of financial services from pensions funds to banks to credit agencies, announced that more than $130tn of capital has been committed to reducing emissions by 50% over the next decade and achieving net zero by 2050. Yet, the best approach to climate aware investing is still highly contested. The longest standing approach has been focused on carbon disinvestment. Today, there is increasing interest in how to invest for a "just" transition, an approach that allows for countries at different stages of development, as well as investing to benefit from return opportunities offered by companies enabling the carbon transition. Like all things in life, there is no one solution for trustees and they must work to determine the most appropriate approach for them, their membership, and their sponsor.

Climate change has been where attention has recently been focused, but ESG considerations are much broader. Considerations range from biodiversity and circular economies to human rights and labour rights to corporate governance, and beyond. A trustee board cannot solve all the problems of the world, but it can establish the scheme's key investment priorities and look to ensure they are incorporated in their investment objectives and strategy. This is easier said than done. The ESG universe is both flooded with opinions and perspectives, yet at the same time is plagued with data issues. This means trustees must fight through information overload first and are then faced with wide ranging problems around data quality, data methodologies, data availability, and data affordability. The data problems are particularly stark when you look across asset classes, with equities and corporate bonds leading the pack in ESG disclosure and private assets certainly lagging behind.

One problem we've observed in improving data requirements is that regulation is being placed on some areas of the pension industry and not on others. For example, TFCD requirements are on the pension schemes and not the asset managers. However, regulations are drafted in recognition of the current data issues. The view of regulators is clearly that we need to be doing something now, even if we're not yet in a perfect world and that the increased demand and pressure on asset managers to improve disclosures, alongside increasing company disclosure requirements, will over the long run lead to improved data used by pension schemes.

PMI ESG Report / Dalriada

ESG factors are beginning to be referred to as the third pillar of investing, alongside risk and return. This currently feels aspirational. If the industry wishes to move in this direction, which I strongly believe it does, then we need ESG data to be disclosed in a consistent manner by investment managers, using reliable data and agreed methodologies. We currently see reports of varying quality, compiled using different approaches. The asset managers, supported by investment consultants and asset owners', have much work to do to improve the reporting they, on aggregate, provide. Collaboration between managers will be key. The current position of many managers appearing to follow bespoke reporting must shift to place asset owners' needs at the forefront and move to a more standardised reporting approach.

It is easy to become bogged down in the very evident ESG issues the industry faces. However, the opportunities offered through improved ESG integration are tantalising! Data quality will improve. Trustees will gain a greater understanding of the ESG risks and opportunities in their schemes' investments. We must accept the reality of where we are at, there is still much to be done. However, the pensions and investment industry is working hard to make improved ESG integration a reality.

The future of biodiversity

Introduction

The last year has seen the biggest pension schemes in both the defined benefit and defined contribution arena having to meet the challenge of reporting under the Taskforce for Climate Related Disclosures (TCFD) regulations. Inevitably, this will be cascaded to smaller schemes over the passage of time, and in theory, should become easier as data improves. So, with the largest schemes having jumped the first hurdle what lies ahead for them?

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We are beginning to see industry and regulatory focus switching to biodiversity issues. There's a recognition that relying on TCFD and climate change initiatives alone will not be enough to drive change across the wide spectrum of biodiversity risks that exist. In the same way that we have sought to understand and report on climate issues, the financial system needs to acknowledge the existence of biodiversity related risks and support participants in measuring and managing these risks and the impact that economic activity has on nature.

What is Biodiversity Loss?

Biodiversity loss can be described as "the loss of life on Earth at various levels, ranging from reductions in genetic diversity to the collapse of entire ecosystems. Biodiversity is declining faster than at any time in human history. Since 1970, there has been on average almost a 70% decline in the populations of mammals, birds, fish, reptiles and amphibians. We're in the midst of the sixth mass extinction event, the last of these having wiped out the dinosaurs.

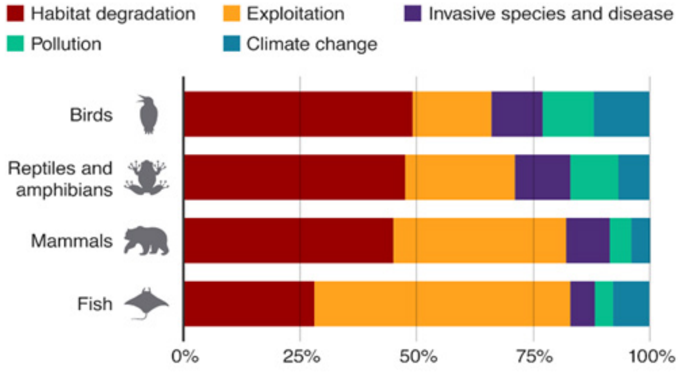
In addition to its intrinsic value, biodiversity underpins the provision of ecosystem services such as carbon sequestration and biological pest control, as well as food and other raw materials. Recognising that our economy and society are a subset of the natural world, we must therefore understand that nature and biodiversity represents the backbone on which our economy depends.

Healthy ecosystems support trillion-dollar industries such as agriculture, pharmaceuticals, tourism, fishing and forestry. It is estimated that over 50% (more than USD44 trillion) of global GDP relies directly on these ecosystem services. The World Wildlife Fund has suggested that if biodiversity loss were to continue on its current trajectory, this would result in a loss of over USD10 trillion in global GDP by 2050.

As society gains a much greater understanding of the impact of our existence on our world, what is becoming very clear are that steps need to be taken now to address it.

What are the causes of biodiversity loss?

The chart below from the World Wildlife Fund Living Planet Report in 2018 outlines at that time the causes or drivers of loss with exploitation, pollution and climate change featuring highly as drivers of loss. These causes are not independent, with the impact of climate change serving to accelerate the change from other factors.



Note: A sample of 3,789 populations evaluated by the Living Planet Index

In order to quantify the impact that a company is having from a biodiversity perspective, and to understand the potential impact of biodiversity loss on a company, we need a common framework for information gathering, assessment and reporting.

Taskforce on Nature-related Financial Disclosures (TNFD)

TNFD is an international initiative that provides a framework to help organisations address environmental risks and opportunities, aiming to encourage improved reporting of nature-related financial information. The approach suggested by the TNFD is to identify where companies and institutions interact with nature, then to evaluate their dependencies and impacts on natural capital. This allows us to assess nature-related risks and opportunities.

For example, an agricultural company may depend on the availability of pollinators to generate its output. Biodiversity loss may see a reduction in pollinators thereby creating the failure of crops. This offers not just a source of financial risk to the company but a broader risk to society.

What can investors do to understand and assess biodiversity issues?

Given the severity and urgency of the crisis, it's important that investors are able to take action to understand and address the impact of their portfolios on biodiversity. Whilst part of that process should be educational, by monitoring appropriate biodiversity related metrics, investors' understanding of nature related dependencies and impacts in a portfolio can be increased.

The type of information it may be appropriate to collect can range from understanding which risks companies may be exposed to, to the more granular reporting on particular exposures. However, given the broad range of biodiversity factors, the collection of data is more challenging as data needs to be collected in respect of each issue. It is helpful to consider the different types of data that can be collected.

PMI ESG Report / Hymans Robertson

- **Business involvement:** To what extent do the products and services provided by a company contribute to biodiversity loss?
- **Exposure:** To what extent does a particular biodiversity issue present a direct risk to a company's operations?
- **Management:** Does a company have a policy in place to address the biodiversity issues? How extensive is their management of the issue?

At present, assessment and disclosure of biodiversity risks is not mandatory for companies. However, there is an increasing expectation that this will change. France, for example, has already mandated disclosures in this area and it is expected that the UK will follow in the near term. Whilst the reporting of data is not a requirement, the role of organisations in the collection and publication of data is helpful. For example, Global Canopy through its Forest 500 initiative has gathered data and assessed those companies most influential in driving tropical deforestation.

The fact that some metrics already exist and the evolution of further data tools to enable analysis such as ENCORE (Exploring Nature Capital Opportunities Risks and Exposure) means that disclosures in this area are becoming increasingly reliable. ENCORE, used as part of the TNFD framework itself, is a tool to help users better understand and visualise the impact of environmental change on the economy. By focusing on the goods and services that nature provides to enable production, it helps users understand how businesses potentially depend and impact on nature, and how these might represent a business risk.

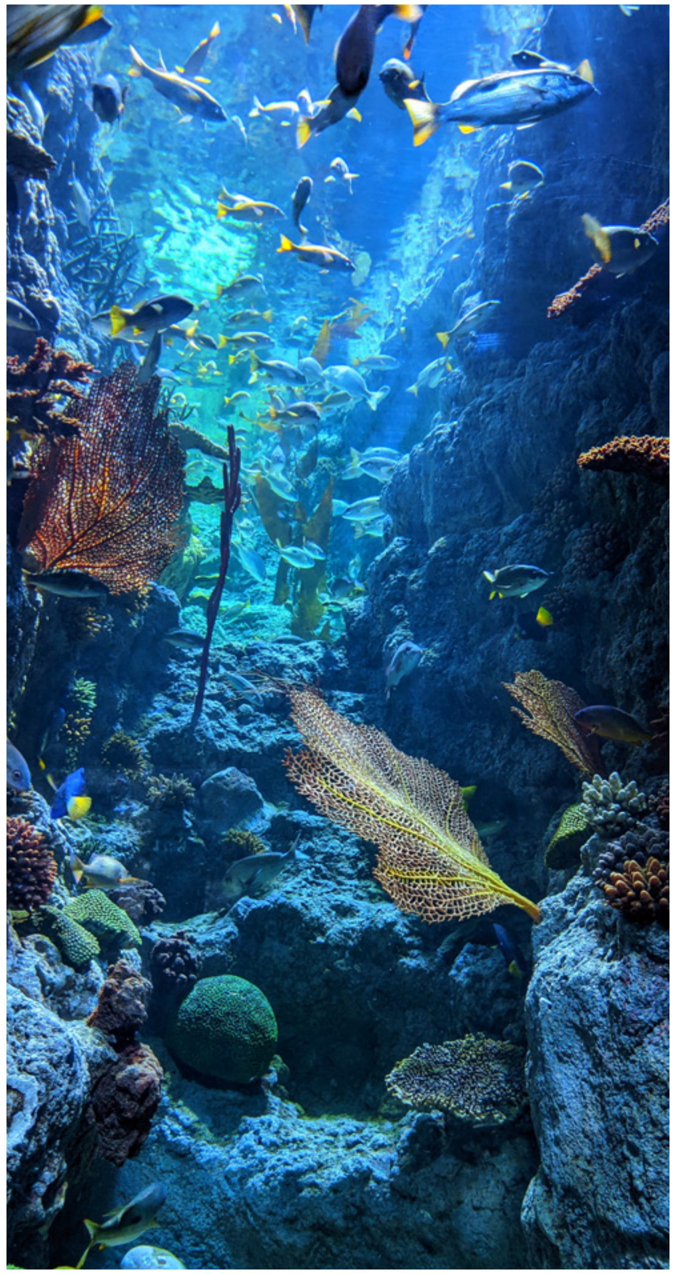
Working towards TNFD

Whilst corporate disclosures and the availability of information may be immature, what of asset managers? Many now have publicly stated policies on biodiversity and how they manage the risk. However, few of them report on impact at this time. Increased regulatory interest through, for example, UN Biodiversity Conferences in 2021 and 2022, the increasing willingness of investors to act such as the Consortium for Biodiversity footprint and now new accounting metrics and tools to measure biodiversity risk such as TNFD itself are making disclosure easier. The impact on the economy of the destruction of ecosystems and on our daily lives in terms of the world we live means that TNFD disclosure is becoming top of the agenda in terms of requirements from a regulatory perspective.

Despite progress there inevitably remains challenges to reporting on biodiversity risks and opportunities.

- Interdependencies in ecosystems – in a similar way to TCFD, double counting is an issue
- The best proxy – which metrics represent the best proxy to use in reporting? Thinking in this area is yet to be refined
- Analysing a portfolio relies on corporate disclosures which at present are few and far between
- Geographical concentration and limitations – many biodiversity risks are geographically concentrated and having clear oversight of where they arise is not complete
- Similarly, to TCFD it's important to analyse the whole supply chain. Data here again is inherently opaque and there are similar interdependencies as there are with TCFD
- Once identified, how do you then assimilate the risks either for a company or for a portfolio

As with TCFD, the first step is to take a step when it comes to TNFD. The absence of data should not be an excuse to do nothing. Only by starting will we increase understanding, evolve the structures we need and ultimately reduce the impact we have on our world.



Net zero – trustees' fiduciary duties and the new climate regulations

Introduction

"Net zero" refers to achieving a balance between the amount of greenhouse gas ("GHG") emissions produced and the amount of GHG removed from the atmosphere. When human activities add no more GHG emissions than we take away, we reach net zero. Achieving net zero is vital to tackle climate change by reducing global warming. What we do in the next decade to limit emissions will be critical to the future.

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As net zero is increasingly becoming something of a standard for trustees looking to progress their environmental, social and corporate governance ("ESG") activities, it is not always clear what such a commitment means and what trustees should be thinking about when making one. In this article, we will consider the legal aspects trustees should address, including fiduciary duties, as well as how net zero fits with the new climate regulations, metrics and targets.

What does a net zero target look like for pension scheme trustees?

For an asset owner, setting a net zero target means identifying a point in time by which the net GHG emissions of all companies invested will be zero. For trustees, this does not necessarily mean they can only invest in businesses which have achieved GHG neutrality themselves. The key is that the net emissions of the portfolio are balanced so, in the future, GHG intensive business may still be held as long as those emissions can be offset elsewhere by carbon capture or other emerging technologies.

How does net zero align with fiduciary duty?

In broad terms, trustees' legal duties include:

- Exercise their investment powers for their "proper purposes", namely the provision of members' pensions
- Take account of factors which are relevant to that purpose, usually those that are financially material
- Do so in accordance with the "prudent person" test – this is the principle that trustee investment powers must be exercised with the "care, skill and diligence" a prudent person would exercise when dealing with investments for someone else for whom they feel "morally bound to provide"

Taken together, these fiduciary duties will usually act as good reason for trustees to act on ESG factors and to take account of climate-related risks and opportunities in their investment strategy, where to do so is financially material. Indeed, many would argue that given their likely financial materiality, trustees are now under a positive obligation to take account of such factors as part of their trust law and fiduciary duties.

The law is generally more restrictive on the circumstances in which is it permissible for trustees to take account of "non-financial" factors in making any investment decisions where these are not in the best financial interests of the scheme's beneficiaries. Non-financial factors may include expressions of moral disapproval, political or ethical motivations or furthering external purposes not directly attached to the pension scheme and the financial best interests of its beneficiaries. The distinction between financial factors which trustees are legally able to take into account and "non-financial" factors which they generally cannot is not always a clear line. Many issues, including those relating to ESG, will have both financial and non-financial aspects. The key is that trustees must base their investment decisions on what is financially relevant to the pension scheme.

Recent judgments in both the case of *Butler-Sloss v The Charity Commission for England and Wales* and that of *McGaughey v Universities Superannuation Scheme Ltd* confirmed that while trustees should ensure that their investment decision making is aligned with the purpose of the trust (and should not be based on un-related ethical or moral grounds), ESG can and should be considered where it is of financial relevance.

Trustees' consideration of any net zero commitment must be taken in this context – i.e. trustees must be satisfied that the commitment (and the actions that follow from making it) will support financially the provision of members' pensions from their pension scheme.

Ultimately, it will be up to the trustees and their investment advisers to consider these issues. However, in doing so they are entitled to take account of the commitments made by governments and policy makers to keep temperature rises to well below 2 degrees and the rapid reduction in GHG emission required in the coming years to achieve this. This will require a significant change in the fundamental structure of the global economy. As investors, all pension schemes are exposed to financial risk from these issues and trustees may reasonably take into account the financial risks to their pension scheme of holding an investment strategy that is not aligned with this anticipated global transition.

Making a net zero commitment should not fetter the future investment discretion of trustees and should be considered as an overall objective. Trustees should retain an ability to determine, in respect of any give investment decision, what is in the best financial interests of their pension scheme.

PMI ESG Report / Sackers

Do regulations require trustees to set net zero targets?

Under the Pension Schemes Act 2021 and the accompanying Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (the "Regulations"), trustees of in-scope schemes are required to meet certain governance and disclosure obligations in respect of climate-related risks and opportunities which underpin the recommendations of the Taskforce on Climate-related Financial Disclosures ("TCFD").

The requirements are being phased in, with larger schemes whose net assets are £5bn or more, and master trusts, already required to comply and schemes with £1bn of more of assets needing to comply from 1 October 2022.

The Regulations focus on improving climate change risk, governance and reporting. They include requirements on selecting and reporting on climate-related metrics (two emissions-based and one "additional" non-emissions based metric). The Regulations also require trustees to set targets in respect of at least one of their chosen metrics, although it should be noted that they do not require trustees to set mandatory targets to reduce portfolio emissions or to set a net zero target.

Might the law change?

A mandatory net zero requirement was proposed during the legislation's passage into law, but ultimately did not make it into final legislation. However, recent amendments to the legislation introduce some new reporting of scheme alignment, albeit without mandatory targets.

On 17 June 2022, the Department for Work and Pensions ("DWP") published its response to its October 2021 consultation on proposal to require trustees of schemes in scope to measure and report on the "Paris alignment" of their investment portfolios. The DWP confirmed that with effect from 1 October 2022, trustees of schemes in scope will be required to calculate and report a metric setting out the extent to which their investments are aligned with the Paris Agreement goal of limiting global warming to well below 2degrees and pursuing efforts to limit it to 1.5 degrees above pre-industrial levels.

This adds a fourth metric to the three existing metrics already mandated, although the Government continues to steer away from imposing mandatory net zero targets on pension schemes. Whether a new Government would maintain this line though remains to be seen.

Conclusions

A net zero commitment may be adopted by trustees where it is considered to be consistent with the primary purpose of the pension scheme of paying members' pensions.

Regulations require trustees to report certain climate metrics and to set targets but they do not go so far as to mandate emissions reduction targets or net zero. That said, many larger schemes have now chosen to adopt a net zero target for their investments over the past year or so. This is an approach that has been commended by TPR in its Climate Change Strategy and is becoming increasingly explored by trustees.

Trustees thinking of making a commitment will need to take their own investment and legal advice but they are entitled to act prudently in making their investment decisions. This can include basing their assessments on an expectation that governments and policy makers will seek to deliver on their commitments to achieve net zero. Trustees may find that this helps to support their own making of a net zero commitment as part of a prudent investment approach.

Schroders solutions

How Fiduciary management can help you reach your ESG and climate goals

Introduction

Environmental, Social and Governance ("ESG") demands on UK pension schemes have mushroomed over the last 18 months as the government looks to pursue its green agenda. In what was already an extremely governance heavy role, trustees are now expected to understand a new raft of terminology and dedicate time to ever more complex climate and stewardship requirements.

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We believe strong ESG integration makes good business sense and should generate better risk-adjusted returns over the long term. But as trustees can only dedicate a set time on agendas for investment, we now see ESG taking up much of that space with high-level strategic discussions and governance having to compete with these new demands. For some, this new governance burden is making them reconsider their level of delegation. If you don't have the governance budget to have an Investment Sub-Committee and an ESG Sub-Committee, it might be time to consider fiduciary management. Trustees can't delegate their responsibilities, but they can work with a partner to help them achieve best practice in all areas of investment.

Here we'll describe how fiduciary management can help you to:

- Meet your obligations to consider financially material factors, including all areas of ESG;
- Meet your stewardship requirements on voting and engagement; and
- Report on your climate data and implementation of the most significant votes.

PMI ESG Report / Schroders

Considering financially material factors

Every investment must be evaluated based on its ability to generate return and the risks associated with that return. Those risks may be because of ESG factors and the recent focus on this reflects the fact that the first two - Environmental and Social - have probably not been considered that specifically in the past. But if you consider the fines companies can receive from polluting the environment or the significant reputational damage from human rights abuses in their supply chain, these risks are most definitely financial. The Department of Work and Pension's (DWP) guidance[1] specifically states that "Climate change risks are financial risks" and that this is a "systemic risk". And in its recent publication in July 2022[2], the DWP highlighted trustees should include "all elements of ESG" when taking financial material considerations into account–highlighting, in particular, the links between climate and social factors "as millions of people will face challenges" because of climate change. So, it's no longer a point of debate-these are factors trustees must consider and document the actions that they are taking.

Implementing ESG philosophy

When selecting a fiduciary manager, it is important to understand the manager's ESG philosophy and whether it aligns with the trustees' views as well as the flexibility within their toolkit to cater for specific preferences. There are a multitude of ways to implement an ESG philosophy into investment portfolios. These can include exclusions, targeting minimum ESG scores, ESG factor tilts, or targeted engagements.

At Schroders, our ESG assessment is a core component of our fiduciary management investment process, with managers and companies subject to minimum sustainability standards concerning "People" and "Planet" as described on the right.

People: Making companies work for everyone

We're proud of our inclusive corporate culture and believe we should reflect this in our portfolios. Human capital management plays an important role in the success of firms and we champion human rights and diversity and inclusion (D&I). We believe investment return is driven by people who can learn, grow, and take care of their well-being.

Planet: Protecting the world's resources and tackling climate change

Governments and investors addressing our world's finite stock of natural resources is creating a seismic shift. We believe the prepared will be the most successful. We track and hold companies and managers to account on issues such as greenhouse gas emissions to evidence action on climate change.

For our fiduciary clients, we assess companies on People factors, including training & development opportunities and employment benefits & initiatives, with Planet factors ranging from carbon footprint to toxic emissions to implied temperature rise. Where we use external managers, ESG is factored into the selection and monitoring process, from the manager's corporate sustainability strategy (e.g. D&I initiatives at their own company) and ESG policies, right down to ESG integration in their investment process and their approach to stewardship with underlying portfolio level companies.

PMI ESG Report / Schroders

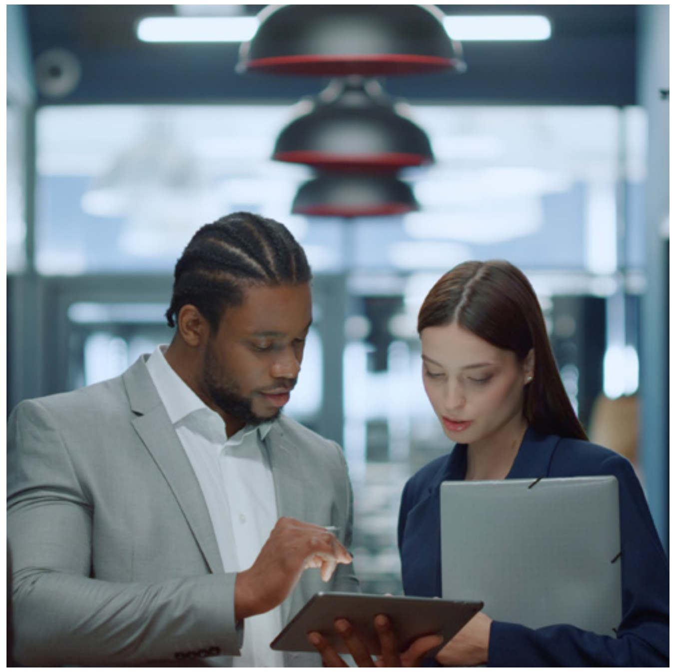
The merits of engagement versus exclusion must also be considered. Whilst our preference is for engagement over exclusion, we believe there must be a threat of divestment for poor progress. Hence, we won't hold companies or managers that don't meet our minimum standards (and show no signs of improvement). But we recognise that sustainability is a journey! We look for positive ESG momentum (even if from a low starting point), and we value a willingness to engage.

Stewardship

The pensions industry has published its first round of Implementation Statements, and the result is? Must do better. DWP has produced further guidance to say these should reflect trustees' stewardship policies and their most significant votes. In addition, the DWP's recent statutory and non-statutory guidance[3] states that trustees cannot "simply report that they delegate engagement"– if they can't engage with companies directly, they must engage with investment managers and other providers to understand their engagement policies and whether they align with the trustees' own.

One of the benefits of having a fiduciary manager is that they can do much of the legwork for you. The first step is to define stewardship priorities and then work with your fiduciary manager on a policy document. Not only should client priorities guide your fiduciary manager when carrying out votes on your behalf, but by knowing your priorities Implementation Statements can be tailored to showcase the engagement activity most relevant to you. For our clients, we highlight their largest holdings, the votes aligned with their stewardship priorities and explain how we voted. If they don't agree with our stance, they can provide challenge and feedback.

There are some cases where we pre-declare our voting intentions and we can take feedback on board in advance. We specifically designed our survey, SchrodersAsks, to capture clients' stewardship priorities and feed them into our Engagement Blueprint. We believe in the power of our size in voting and engaging and that stewardship should be linked to the investment decision, i.e. if you buy a company because you believe in their future potential for decarbonisation, your voting should be consistent with this thesis. However, if we hear from our collective clients that their wishes are different, we can adapt - both the investment and engagement strategy. We help trustees engage with us so they are informed and able to challenge, and then we ensure our engagement with the underlying managers and companies is aligned and executed efficiently.



ESG Data and reporting

Introducing mandatory reporting on climate metrics and climate scenario analysis represents another new challenge for trustees. This is another area where fiduciary management can be invaluable. The data needed to report on climate and ESG metrics is difficult to collate and patchy at best. But it's crucial to allow trustees to govern their climate impact and as a basis for engagement in this area. Sourcing data from multiple managers and trying to aggregate is cumbersome and a recipe for inconsistency. Many players are working to standardise data across the industry to make this more workable, but in the meantime, a fiduciary manager with oversight of your entire portfolio can take ownership of sourcing the data and ensuring it is consistent and aggregated meaningfully. Whilst some fiduciary managers are still struggling to produce timely data[4], our clients have been receiving climate metrics every quarter for the past 18 months. We've also helped our clients meet their reporting requirements in line with TCFD, providing scenario analysis and helping them set targets for carbon metrics to reduce over time. And we're watching the developments for Taskforce for Nature-related Financial Disclosure ("TNFD") very closely. All of this is part of the service.

So we believe it is part of your fiduciary duties as trustees, and our duty as a fiduciary manager, to make sure material financial considerations are taken into account in all investment decisions, that stewardship is implemented effectively, and regulatory reporting is in line with best practice. You cannot delegate your responsibilities as trustees, but you can partner with an expert to manage these additional governance burdens every step of the way.

Sources

[1]Governance and reporting of climate change risk: guidance for trustees of occupational schemes - GOV.UK (www.gov.uk)

[2]Government response: Consideration of social risks and opportunities by occupational pension schemes

[3]Consultation version: Reporting on stewardship and other topics through the Statement of Investment Principles and the Implementation Statement: statutory and non-statutory guidance (October 2021) - GOV.UK (www.gov.uk)

[4]Source: EY Parthenon, ESG investing under fiduciary management, September 2021

PMI ESG Report / Travers Smith

Good governance: the legal bedrock of ESG

Introduction

It can be very easy to get trapped in the detail of all the different ESG laws that now apply to workplace pension schemes. As lawyers, we are bound to say that complying with the specific requirements is non-negotiable. However, we believe that the pensions sector is likely to get better value from ESG by treating it as a bigger picture *governance* matter. Our view is that the law supports this, but to deliver it effectively there needs to be genuine collaboration between schemes and their different professional advisers.

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Legal obligations around ESG

ESG can be complex and nuanced. In that context, a compliance-focussed approach is only natural: it emphasises more comfortable, concrete things like actions and deliverables. But there is a bigger picture beyond compliance, and helpfully the law gives schemes a set of legal tools to help them address this, using governance as the foundation.

At the top of this toolkit are the well-known trust law principles about how trustees take valid decisions. In brief, these require trustees to build up sufficient knowledge to understand the decision they're looking at, take account of relevant issues, take advice and ask questions as necessary, and then balance all the relevant issues together to reach an overall rational decision. Where a proper process has been followed a Court would not overturn the trustees' decision even if someone else might have made a different one. In the investment context, it is also clear that trustees are not judged with the benefit of hindsight (or with the expectation of perfect foresight). In our view these principles are, fundamentally, a *governance* duty.

Governance also features heavily elsewhere in the ESG legal toolkit. Regulations require most schemes to make public a host of ESG-related policies in their statement of investment principles, and then in many cases track how far those policies have been followed in an annual, public, implementation statement. One way of looking at this is to focus on the written deliverables the legislation requires. But a deeper look reveals that in practice, they will involve trustees thinking through what their policies should be, how they will be tracked, and how to report on them: what is this, if not a governance process? The point is even clearer for schemes that are in scope of the Task Force on Climate-Related Financial Disclosures (TCFD) climate reporting regulations, where there are specific governance and risk requirements.

Should we treat ESG as a means or an end?

From a financial perspective too, the emphasis within ESG is on evaluation and decision-making, with a broader assessment of risk and opportunity than conventional financial analysis may cater for. For example, if a company's core products were detrimental to public health (a 'social' or 'S' factor within ESG), ESG analysis might consider how to price the likelihood and impact upon the business if consumer demand fell away or its key products were regulated out of existence. It may not have been possible to consider these risk factors in the past through traditional assessments of financial statements or forward planning. Of course, the analysis may or may not lead the trustees to immediately divest or move into different assets at that point in time. It will depend on what makes sense at the strategic and portfolio level over the scheme's expected life-cycle. But whatever the trustees decide to do, their decision will certainly have been a better informed one and they will have a better understanding of potential risks in their strategy.

Viewed in that way, ESG is a *means*, not an end. It is an analytical tool that enables more sophisticated and holistic decision-making.

This naturally complements the emphasis the law places upon good governance.

Of course, for some members and other stakeholders, ESG or positively impactful investing can be a desirable end goal in itself. These perspectives are legitimate, but it takes some care to ensure they do not conflict with trustees' wider legal duties. This is possible up to a point, but it is also a major ongoing debate in the pensions industry, and definitely a topic for another day.

What does good look like?

From an understanding of ESG as a governance matter, the next step is to think about what ESG governance looks like. In our view it requires some good choreography between and among schemes and their professional advisers. Sensible steps would include:

- Making sure everyone is clear from the outset about the trustees' fundamental investment beliefs and the scheme's strategic objectives (and similarly funding, covenant and covenant support arrangements in defined benefit schemes).
- Assessing an ESG proposal against those beliefs and objectives to make sure they are genuinely aligned. This could involve a sense-check of what is really motivating the proposal: the purpose and goals of the scheme, or some wider or collateral purpose?
- Establishing and documenting a positive business case for the ESG decision in the scheme's specific circumstances. How does it help manage the scheme's risks and performance better over the relevant time horizon(s)?
- Making sure lawyers are fully briefed on the above before they advise. In our experience things can sometimes go awry if this does not happen, as the example below illustrates.

PMI ESG Report / Travers Smith

Example: green gilts and greeniums

Green gilts are UK government securities issued to finance projects that have defined environmental benefits.

Typically there is a spread between green gilt yields and yields on traditional (or 'brown') gilts: the so-called 'greenium'. So, assuming that green and brown gilts carry the same level of credit risk (because the UK government is the debtor under both), trustees might simply ask their legal adviser: can we choose the environmentally-focussed one with the lower yield?

If the question is posed in that way, many lawyers will feel duty bound to say "no": why should trustees actively choose a lower return for the same level of risk? Are they investing for the purposes of the scheme, or for the collateral purpose of improving the environment?

In fact, the problem here is the lawyer working in a silo. A more open dialogue between lawyers, trustees and investment advisers could have brought to light a number of other significant points, none of which would necessarily have come through in the narrower discussion above:

- Whether green gilts and brown gilts are as directly comparable as investments as has been assumed (we are aware of investment consultants who query whether this comparison is valid).
- Understanding the different potential secondary market for green gilts and the implications and opportunities this may create for the trustees.
- Explaining the proposal in the context of the scheme's portfolio as a whole, as opposed to considering the issue a potential investment.
- The reasons why the green gilts are considered suitable from an investment advice perspective (and potentially why other investments are less suitable), taking account of the scheme's strategy and objectives as referred to in the scheme's statement of investment principles.
- Recording the thought process and the issues that were reached a different final conclusion, a proper process was followed and a rationale outcome reached.
- Making clear that the motivation for investing in green gilts is their financial role for the scheme Environmental benefits might be noted, but they are an output of the investment rather than a driving purpose for investing.

Looking at the issues in that way, the key question becomes whether the proposal to invest in green gilts has been properly considered and makes financial sense within the scheme's investment strategy. That could produce a very different legal answer, where trustees and advisers share a mutual understanding of both the investment rationale and the legal tramlines: a much more joined-up approach to decision-making.

Conclusions

There are good reasons why it can be helpful to approach ESG as a governance matter. A governance focus encourages careful decision-making processes where new but valid risk and performance considerations are brought to the table. It helps set the issues into the proper context of the scheme's own circumstances. It can help trustees feel more comfortable that their decisions will be legally resilient if challenged (and that the trustees will be able to demonstrate this if asked). But above all, it means decisions will be better informed and more rounded. That might sound a little dull – but it is surely a good outcome for everyone in pensions.

PMI ESG Report / Russell Investments

2022 Annual ESG Survey: The ESG journey accelerates

Introduction

Our annual ESG manager survey of active managers assesses the integration of ESG considerations in investment processes among equity, fixed income and private markets managers, and spotlights firmwide policies, use of data, engagement and integration.

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Biggest ESG issues among clients

This year marks our eighth annual ESG manager survey. The survey participants have a broad representation by asset size, region and investment strategy offerings. Of the 236 participants, 184 offer equity strategies, 147 offer fixed income strategies, 77 offer private markets strategies and 66 offer real assets strategies. 58% of the respondents are headquartered in the U.S., 16% are based in the United Kingdom and 9% are based in continental Europe, with the rest located in other regions. 28% of the respondents have assets under management (AUM) of less than $10 billion, while 33% of the participants have over $100 billion in AUM.

Biggest ESG issues among clients

We asked survey participants to select the single largest ESG issue they tend to hear from their client base. In a sign of increasing awareness of the climate crisis, 45% of respondents selected climate risk, versus 39% from the previous year. Climate risk was identified as the biggest issue among managers' client bases in Canada, the United Kingdom and Australia and New Zealand.

Interestingly, 10% of respondents selected diversity, equity and inclusion (DEI), compared to 15% from the previous year. Many in this category cited both climate risk and DEI as equally large issues.

Growth in ESG product offerings

We asked firms to classify the types of products they currently offer, including exclusionary screen-based mandates, ESG integration, best-in-class/positive tilt-based mandates and impact/thematic strategies. Across all asset classes, the strategies that provide ESG integration make up the largest proportion of strategies offered to date. Additionally, we asked asset managers which type of strategies saw the most interest and asset growth over the past 12 months. The results show proportionally more demand in ESG-integrated strategies, which are often mainstream strategies that are benchmarked against traditional public indices, such as the MSCI EAFE Index and the Bloomberg Barclays Global Aggregate Index.

Biggest challenge of incorporating ESG for asset managers

While ESG integration has reached universal recognition among the asset management community, there is still a wide range of views on how asset managers treat ESG considerations. We asked participants to identify the single biggest challenge of incorporating ESG-related information into a portfolio's construction.

18% of respondents cited the challenge of serving different client needs as the largest issue - and that is understandable since specific ESG preferences vary depending on the client. Also of significance, 16% of respondents cited the challenge of unclear ESG pricing impact. It is also worth highlighting that 35% of respondents selected the "other" category, with the majority stating that data transparency and consistency were the key issues.

Regulations and sustainability

Regulators, particularly in the EU, are stepping in to provide guidance for what qualifies as sustainable investments. The regulatory disclosure requirements bring greater transparency to sustainable investing. However, where to go from here remains unclear. In addition to the challenge of ESG data quality and how it actually contributes to the financial impacts of corporations, different regulators appear to be heading in different directions. The EU is expanding further regulations to encourage incorporation of non-financial aspects with Article 8 and Article 9 products - both popular demands in the region. On the other hand, the U.S. Securities and Exchange Commission (SEC) has expressed caution around incorporating ESG factors, likely to divest from a fiduciary-duty standpoint. At the same time, regulators across the globe appear to be united in acknowledging the many issues around the practice of greenwashing. We believe that acknowledging both the data disclosure challenges and establishing industry-disclosure frameworks are important steps for building greater transparency in sustainable investing.

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ESG reporting

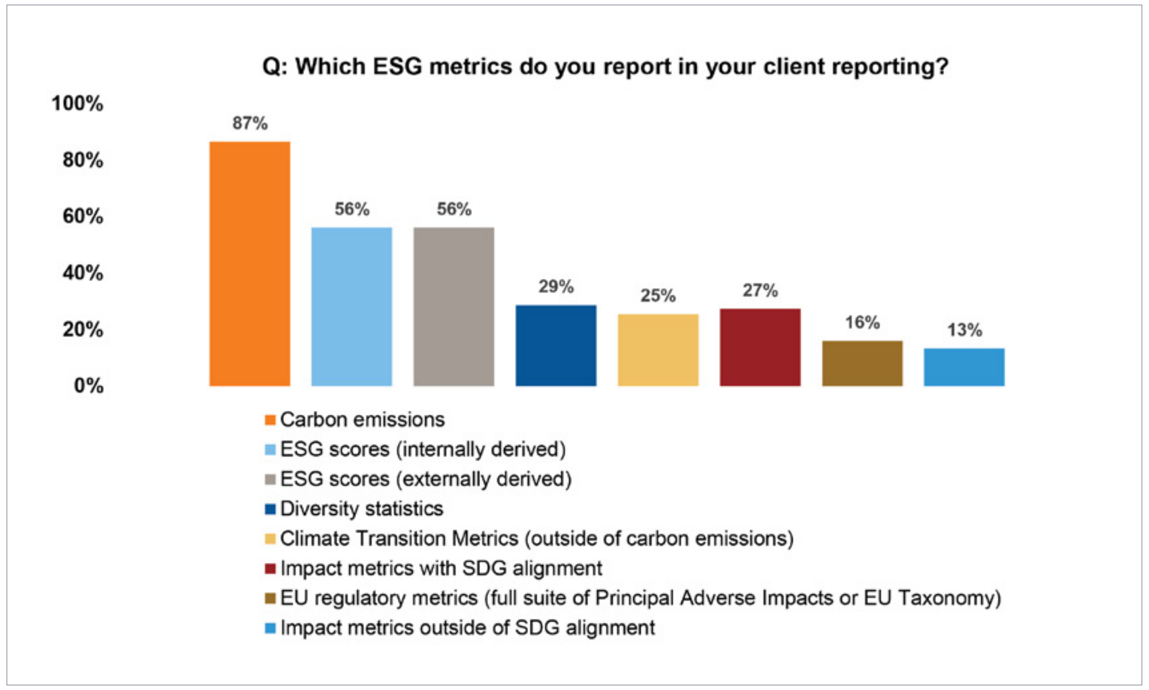
While ESG-related reporting guidance continues to grow in prominence the reporting contents still vary widely. Our survey indicates that carbon emissions data is currently the most popular of the reporting items.

For ESG profile reporting, the results showed an equal level of respondents who disclose their internally derived ESG metrics versus those who rely on and report to third-party ESG data vendors' outputs. Asset managers were evenly split when it came to using third-party ESG data or their own metrics. This suggests that investors want standardisation of disclosures in key ESG metrics, and that asset managers are increasingly responding to this request.

In addition to carbon emissions and ESG-profile metrics, managers identified diversity statistics, climate-transition metrics and UN SDGs (sustainable development goals) alignment as other popular ESG metrics included in reports.

Diversity, equity and inclusion

There continues to be a growing effort to promote DEI practices in the asset management community. We asked participants what the female representation is at the following levels: total firm, investment team, senior investment team and board membership. We also asked the same set of questions about ethnic minority representation. We have observed that disclosures are greater for gender than for ethnicity - likely due to the fact that some firms only have data on the gender of their employees (often due to legal prohibitions or other difficulties in gathering information about ethnicity). For instance, 85% of respondents disclosed the percentage of their total female employees, while only 69% did so for ethnic minorities.



For the ethnic minority disclosure, this was greatest in the U.S., where 85% of U.S.-based respondents disclosed their DEI statistics around ethnic minorities, and 90% disclosed their gender demographics. The ethnic minority disclosure was lowest among firms based in continental Europe.

Of the firms that disclosed their DEI statistics, most (54%) have investment teams comprised of less than 20% women, and 40% have investment teams where less than 20% of the members are ethnic minorities.

The bottom line

The 2022 Russell Investments ESG Manager Survey shows that the ESG journey is continuing, and at a markedly escalated pace, with regulators across the globe aggressively stepping in as the investment community tries to digest and accommodate new ideas and practices at an incredible rate of speed.

The results indicate that client demand and risk mitigation are among the key reasons that asset managers are integrating ESG factors into investment processes. The survey also shows that efforts around climate risk management continue to rapidly expand, and that this is reflected in resourcing, reporting and engagement activities. While roughly half of asset managers think that ESG-related risks aren't priced in much today, a majority expect that to change within the next few years.

At Russell Investments, we believe that ESG topics, including DEI and climate change, can have material impacts on capital flows, which can influence asset prices. An integrated ESG process allows ESG issues to be understood and managed holistically.

[Request the full report]

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