Changing course?

How pensions are approaching climate change and ESG issues following recent UK reforms

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1. Executive Summary

Pension scheme trustees’ policies on ESG factors like climate change are vague and non-committal, and many have not even published their policies - despite their legal obligation to do so.

This report presents the findings of our review of trust-based DC pension schemes’ investment policies, which trustees were required to update following the introduction of new legal requirements (‘the ESG regulations’). The ESG regulations require pension schemes to prepare a policy for managing financially material risks arising from climate change and other environmental, social or governance issues. The ESG regulations also require schemes to develop policies in relation to stewardship, and these are also reviewed. Schemes were required to update their policies and publish them by 1st October.

Our findings indicate large scale non-compliance among trustees, who have mostly failed to publish their SIPs as the ESG regulations require. Our findings indicate that two thirds of trustees have not complied with the requirement to publish their policies. Among those who have published their SIPs, policies are mostly vague and trustees commit to few concrete actions. However, some schemes are starting to think more carefully about ESG policies, and a few leaders have devoted time and resource to developing a sophisticated understanding of financially material ESG risks.

The Pensions Regulator (TPR) must urgently conduct a thematic review, investigating the state of compliance with the regulations, and the government should look at a new way of ensuring the publication of schemes’ policies to help smaller schemes overcome the practical difficulties. From 1st October 2020, trustees will have to publish statements detailing how they have implemented the policies in their SIP. TPR should issue guidance requesting that trustees report on what specific actions have taken place to implement their policies.

We believe one of the most effective things trustees can do is to incorporate ESG considerations into the selection and retention of investment managers, but trustees need good advice to do this. TPR can help them do this by giving them advice and guidance when tendering for advisers. TPR should also provide more guidance to trustees on how they can interrogate their investment manager’s approach to ESG issues, and we provide more detailed suggestions of how trustees can do this in this report.
2. Introduction

As large, long-term investors, pension schemes need to take account of financially material environmental, social and governance risks. This is a key part of protecting the savings of UK workers.

Few industries involve such large sums of money or touch as many lives as the UK pensions sector. Auto-enrolment means that the vast majority of UK workers now have private pension savings. As long-term investors, pension schemes are the sleeping giants of the investment industry. They are universal owners, exposed to every geography, every asset class and therefore a range of financial risks arising from environmental, social and governance (ESG) factors. UK occupational pension schemes have an estimated £1.6 trillion in assets, making them among the world’s largest investors.

These risks include everything from mismanaged companies going insolvent to the physical effects of – and governments’ responses to – climate change. Climate change in particular presents big risks to UK pension schemes. Meeting the 2015 Paris agreement will require signatory governments to enact policies that penalise companies which emit carbon dioxide. A young person entering the workforce for the first time, auto-enrolled in a pension scheme, will retire well after 2050, which is when the world needs to have reached net zero emissions to prevent global average temperatures rising further than 1.5 degrees above preindustrial levels. Their pension scheme needs to put policies in place now to deal with these risks.

At the outset of this review, we intended to produce policy recommendations to government and the regulator, which we have done. However, this report has developed a second purpose: to highlight some examples of what schemes can do when they revisit their ESG policies in the light of further regulatory changes, or ahead of their triennial reviews. We found some examples of good practice, which we hope may be helpful to trustees looking to improve and update their ESG policies.

<table>
<thead>
<tr>
<th>Scheme size (members)</th>
<th>Number of schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro (2-11)</td>
<td>1,830</td>
</tr>
<tr>
<td>Small (12-99)</td>
<td>760</td>
</tr>
<tr>
<td>Medium (100-999)</td>
<td>237</td>
</tr>
<tr>
<td>Large (1,000-4,999)</td>
<td>106</td>
</tr>
<tr>
<td>Very Large (5,000+)</td>
<td>88</td>
</tr>
<tr>
<td>Total</td>
<td>3,021</td>
</tr>
</tbody>
</table>

Table 2: DC trust schemes broken down by scheme size (Source: TPR ‘DC Trust’)

This review focuses only on trust-based schemes that offer a defined contribution (DC) arrangement, and with more than 100 members, highlighted in green in tables 1 and 2. This is a large part of the market, with nearly 20 million members, representing 61% of UK private sector workers. It is also growing, with this type of scheme being popular for employers meeting their auto-enrolment obligations. In 2018, total contributions to DC trust schemes grew by 22%.
3. Policy background

A recent change in the law means that trustees of pension schemes that offer defined contribution benefits must prepare a policy on how they manage financially material ESG factors, such as climate change. From 1st October 2019 trustees had to publish their policies.

3.1 Introduction

In 2014, the Law Commission found a common misapprehension among trustees, that considering environmental, social or governance factors would violate their fiduciary duty. Their report recommended the government review and consider updating the legislation. The Law Commission also published guidance for trustees clarifying that their fiduciary duty permits them to consider any financially material factor, including ESG factors (Law Commission, 2015). After a second review in 2016-2017, the Law Commission recommended that the government change the law to require trustees to state a policy on financially material environmental, social and governance factors.

In 2018, the government agreed with the Law Commission’s analysis. DWP stated that trustees’ misapprehensions about their fiduciary duties had “discouraged some trustees from considering risks and opportunities that may be financially material over the long term, and from acting as engaged asset owners, even where they have a duty to do so.” Guidance had, in the government’s view, “not been sufficient to correct current practice by trustees.” DWP concluded that a change in the law was necessary (DWP, 2018, paras 7.9-11).

3.2 The ESG regulations

In October 2018 the Department for Work and Pensions made regulations requiring trustees to have a policy on their approach to financially material environmental, social and governance factors, and to state certain details of their policy on stewardship. The regulations amended trustees’ duties in respect of their statement of investment principles (SIP), the statutorily mandated document which sets out trustees’ strategic approach to investment.

Section 35 of the Pensions Act 1995 requires trustees to prepare a SIP setting out their overall strategic approach to investment. Section 36 of the Act gives the SIP a role in limiting trustees’ investment powers: “the trustees, or the fund manager to whom any discretion has been delegated […], must exercise their powers of investment with a view to giving effect to the principles contained in the statement [of investment principles]”.

The Occupational Pension Schemes (Investment) Regulations 2005 specify the information trustees must include in their SIP. The ESG regulations introduced a requirement for trustees to state their policy on “financially material considerations over the appropriate time horizon of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments”. The regulations specify that ‘financially material considerations’ includes “environmental, social and governance considerations (including but not limited to climate change), which trustees of the trust scheme consider financially material”, and ‘appropriate time horizon’ means “the length of time that the trustees […] consider is needed for the funding of future benefits”.

The ESG regulations also introduce a requirement for schemes to state their policy in respect of the exercise of voting rights (including voting rights) attaching to the investments, undertaking engagement activities in respect of the investments (including the methods by which, and the circumstances under which, the trustees would monitor and engage). The ESG regulations introduced a requirement for schemes offering DC benefits to publish their SIP from 1st October 2019. By 1st October 2020, trustees must have produced an implementation statement, setting out how they have implemented the policies in their SIP.

3.3 What the government expects to see

The government made the ESG regulations to remove any confusion that trustees had about their duties. The government has stressed the regulations are not a departure from its longstanding policy of not directing trustees’ investment decisions, and the ESG regulations are not intended to encourage or support divestment campaigns (DWP, 2018, para 7.12). But, having clarified that trustees must consider financially material ESG factors as part of their fiduciary duty, what should trustees be doing differently? This section looks at what the government and regulator have said in answer to that question.

The Pensions Minister, Guy Opperman MP, has said he wants trustees to take responsibility for considering financially material ESG risks, and for them to design an investment strategy on the basis of a sound understanding of those risks. In a House of Commons debate about pension funds and investments in international oil companies, he said:
Aside from the ethical considerations, there are real financial risks resulting from climate change. With the long-term horizons of pension investing, trustees must now consider that when they set out their investment strategies. Trustees who do not consider those matters will be breaching their statutory and potentially fiduciary duties not only to current but future members. (HC Deb 23 May 2019, Vol 660, Col 393)

In fulfilling their duties, the minister has said that trustees must not simply expect their asset managers to take care of managing the financial risks associated with climate change and other financially material ESG factors. Addressing asset owners at an event as part of London Climate Action Week in July 2019, the minister said:

Pensions lawyers say that trustees must abide by the prudent person principle – using the ‘care, skill and diligence’ a prudent person would exercise when investing for someone for whom they feel ‘morally bound to provide’. Let’s consider what prudence means in the scenario of those oil and gas holdings and climate change.

Perhaps some of those trustees think they are being prudent by timing the market perfectly and realigning their portfolios just before valuations tumble. But I don’t see how every trustee is able to do that. [...] I don’t want to hear any more that ‘climate change is important, but we leave it to our investment managers’; if you leave the room saying that then we have all failed. I want to hear what trustees are doing having reached that recognition. (Opperman, 2019a)

The minister has said he wants to see trustees making more demands of their investment managers. Writing for The Daily Telegraph in July 2019, the minister set out his desire to see trustees “engaging much more forcefully with investment firms who fail to take environmental and social issues seriously” (Opperman, 2019b). In an article for Responsible Investor, the minister suggested four questions trustees should ask of their investment managers:

- “How often do they vote against company resolutions?”
- “Do they support shareholder resolutions on climate change?”
- “Do they propose their own shareholder resolutions?”
- “Where the manager doesn’t want to, do they let the trustees cast their own votes?” (Opperman, 2019c)

In updated guidance issued three months before the deadline for trustees to have updated and published their SIP, TPR provided trustees with three practical steps they could consider taking when implementing the ESG regulations. It advised trustees to consult their investment manager and investment adviser, to consider the recommendations of the Task Force on Climate-Related financial Disclosure, and to consider engaging with investee companies as well as governments and policymakers. However, TPR’s guidance gives no further detail or practical steps on how trustees should interrogate investment managers’ approaches or strategies, nor on how to go about engaging with companies (TPR, 2019, p. 11).
4. Methodology

This review aims to assess the immediate effect of the ESG regulations. We did this by collecting and reviewing a sample of SIPs from affected schemes. Trust-based schemes which offer money purchase benefits (‘DC schemes’) and have over 100 members were required to publish their updated SIP by 1st October 2019. We looked for schemes in three size categories (see table 3).

<table>
<thead>
<tr>
<th>Scheme size</th>
<th>Number of DC trust schemes</th>
<th>% of schemes in scope of the ESG regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium (100-999)</td>
<td>237</td>
<td>54%</td>
</tr>
<tr>
<td>Large (1,000-4,999)</td>
<td>106</td>
<td>24%</td>
</tr>
<tr>
<td>Very large (5,000+)</td>
<td>88</td>
<td>20%</td>
</tr>
</tbody>
</table>

Table 3: The size breakdown of the UK’s DC trust-based schemes with more than 100 members (Source: TPR ‘DC Trust’)

With the help of TPR, we obtained a sample of trust-based DC schemes weighted to reflect the size distribution of the industry (see table 3). We attempted to obtain their SIPs as they should have become available in October and November 2019. Where we were unable to find a scheme’s SIP online, we wrote to schemes requesting that they direct us to where their SIPs were published.

The response rate was poor (15%), although it helped us eliminate some schemes that had wound up or transferred into master trusts. Two schemes replied to say that they published their SIPs shortly after the deadline due to practical difficulties creating a website.

For the schemes that had not published a SIP or responded to our letter, we wanted to establish which of the following reasons was most likely to explain the lack of a published SIP:

- The scheme had recently wound up,
- The scheme had transferred into a master trust, or
- The scheme’s trustees were in violation of their legal duties.

To establish whether schemes had wound up, we searched news outlets for winding up notices. The Pensions Act 1995 requires schemes to publish a notice before they wind up. This allowed us to eliminate a few schemes. We were able to establish that some schemes had transferred into master trusts, either because we found a report from the scheme’s trustees which had been published which mentioned it, because the master trust had some mention of it on their website, or because it had been reported in the press.

Using data from TPR’s data series ‘DC Trust’, which publishes the number of trust-based DC schemes that wind up or transfer into a master trust each year, we were able to estimate the number of schemes in our sample which we can reasonably assume had wound up or transferred into a master trust. Matching this estimate against replies to correspondence and evidence that a scheme had wound up allowed us to estimate the number of schemes in our sample which had not wound up or transferred, and which should have published their SIPs.

From our original sample, we were able to obtain 21 SIPs. Very large schemes were over-represented in this sample. We therefore sought to expand our sample of SIPs by searching for more schemes’ SIPs until we had a sample of 30 SIPs, comprising 17 medium-sized schemes, 7 large schemes and 6 very large schemes, and therefore broadly representative of the composition of the industry (cf. table 3).
5. Findings

5.1 Compliance

Only one third of the schemes who we believe should have published their SIPs had done so by mid-November 2019. Our findings suggest that very large schemes (more than 5,000 members) were the best at complying with the publication requirement, whereas the large (1,000-4,999 members) and medium (100-999 members) sized schemes had very poor publication rates. All of the very large schemes in our sample complied with the requirement, whereas 80% of medium-sized and 50% of large schemes had not published their SIPs, apparently in violation of their legal duties.

Of the schemes that had published their SIPs, two thirds had approved updates to their SIPs to comply with the ESG regulations towards the end of September 2019. Of the other third, almost all updated their SIPs between May and September 2019. One scheme had a publicly available SIP which had not been updated since the ESG regulations were announced in October 2018.

Discussion

Our findings suggest an appallingly poor rate of compliance with the requirement for trustees to publish their SIP. This is concerning for two reasons. First, schemes cannot be held to account on the quality and appropriateness of their policies on financially material factors if they do not publish their SIPs. Second, if the new requirement to publish a SIP has gone unnoticed by trustees, this could indicate that they have missed, or even ignored, other parts of the regulations, and are failing to prepare policies to manage financially material risks to people's pension savings.

Two schemes told us they were shortly planning to publish, but had not managed to create a web page in time to meet the legal deadline. Publishing a SIP online may pose bigger problems for medium and large schemes since, as our search revealed, these schemes mostly do not have websites.

The poor rate of compliance with the ESG regulations could be linked to TPR’s decision to publish guidance only three months before the compliance deadline. Trustees may have been unaware of the publication requirement until receiving TPR’s guidance in June 2019. That most SIPs were updated in September fits with this possible explanation.

5.2 Trustees’ beliefs about ESG

Almost all the SIPs we reviewed stated the trustees’ beliefs in relation to ESG factors. The ESG regulations do not require this statement of beliefs, but it was a common feature of SIPs nonetheless. We looked at whether and how trustees consider ESG factors to be financially material, whether they consider them with respect to the time horizons of the scheme and its members, and whether the SIPs discussed specific ESG risks and the different ways in which they create risk for the schemes investments.

Financial Materiality

Almost all the SIPs we reviewed say ESG factors can, or may, be financially material. This was commonly expressed using a variant on the following statement:

_The Trustee believes that environmental, social and governance (ESG) factors may have a financially material impact on investment risk and return outcomes..._

Of the trustees who stated that ESG factors can, or may, be financially material, a little over half of SIPs went on to state that the trustees believe ESG factors will affect the scheme’s investments. As one scheme put it:

_The Trustees recognise that Environmental, Social and Governance (ESG) issues can and will have a material impact on the companies, governments and other organisations that issue or otherwise support the assets in which the scheme invests._
The size of the scheme appears to have no effect on whether the trustees believe that ESG factors are material, or whether they believe ESG factors may be material. The split between these two approaches to ESG factors obtains equally across size brackets.

### Consideration of time horizons

A third of the SIPs we reviewed consider how ESG issues are likely to affect the scheme in the future. There was consensus among these SIPs that, since they are long-term investors acting on behalf of long-term savers, ESG issues will become more important in the future.

### Specific ESG issues

The only individual ESG issue mentioned in the SIPs we reviewed is climate change. Half of the SIPs mentioned climate change, although only in passing. These SIPs typically referred to ‘ESG issues, such as climate change’, using wording which mirrors the ESG regulations. However, only two SIPs discussed climate change in any level of detail. The most detailed of the two, representing a medium-sized scheme, briefly discussed the ways in which climate change poses risks to its investments, stating the trustees’ view that both the physical effects of climate change and policy interventions to mitigate climate change create sources of risk.

### 5.3 Trustees’ approaches to managing ESG risk

Having stated their beliefs, SIPs then set out their policies in relation to financially material ESG factors, as the ESG regulations require. Here we review the different policies schemes have adopted.

#### Delegation

Almost all SIPs in our sample stated that they have given their investment manager full discretion for managing financially material ESG risks. Three quarters of SIPs set an expectation that their investment manager should consider financially material ESG issues. These SIPs contained a statement such as the following, which appeared almost word for word in many of the SIPs we reviewed:

> The Trustees have given the investment manager full discretion when evaluating ESG issues and the Trustees expect that their investment manager will take account of all financially material considerations including the potential impact of ESG factors in the implementation of their mandate.
Only two SIPs (representing one very large scheme and one medium-sized scheme) stated that the trustees explicitly require their investment manager to consider ESG issues.

**Scrutinising investment managers**

While trustees seemed reluctant to set any explicit requirements of their investment manager, some do consider their investment manager’s approach to ESG issues in the selection, retention and evaluation of investment managers. Around half of SIPs stated that the trustees consider the manager’s approach to ESG issues in evaluating their performance. This practice is no more or less common among any scheme sizes.

However, no SIPs set out any details about how investment manager’s approaches to ESG issues are scrutinised, or the timescales over which this takes place. Most SIPs made only vague references to scrutinising their investment manager ‘from time to time’ or ‘when appropriate’.

Just two SIPs gave further details about how the trustees scrutinise their investment manager. One medium-sized scheme’s SIP stated that the trustees review their investment manager’s approach to and policies on ESG issues annually, as part of wider work to be sure that their scheme responds adequately to “emerging trends and developments”. One very large scheme’s investment committee prepares an annual report that evaluates its investment manager’s approach to ESG issues.

**Selecting and appointing investment managers**

Slightly fewer than half of SIPs said the trustees consider ESG factors when deciding whether to appoint or retain an investment manager. The extent to which ESG factors are considered in these decisions varies. For example, some SIPs said:

The Trustees’ duty is to act in the best financial interests of the Scheme’s beneficiaries. This includes undertaking due diligence when appointing Investment Managers, by reviewing each potential Investment Manager’s policies and procedures regarding Environmental, Social and Governance issues.

Alternatively, some SIPs contained the following phraseology:

In selecting new investment managers for the Scheme, where relevant to the investment mandate, the Trustees explicitly consider potential managers’ approach to responsible investment and the extent to which managers integrate ESG issues in the investment process as a factor in their decision making.

Almost none of the SIPs we reviewed said how investment managers’ approaches to ESG issues are judged in appointment and retention decisions. However, there were some notable exceptions. One medium-sized scheme’s SIP stood out. First, it states that the trustees “will” consider the manager’s ESG credentials in appointment decisions. Second, it sets out the specific ways that the trustees monitor and engage with the manager, such as regular meetings to update the trustees on ESG issues facing the scheme’s investments. Lastly, the SIP states that the trustee may choose to replace the investment
manager, should the manager not satisfactorily address any question or concern the trustees have relating to an ESG issue.

Two very large schemes use an industry body to set minimum standards for their investment managers, stating that they would require any investment manager they appoint to be signatory to the PRI.

Discussion

The Pensions Minister said that he wanted trustees to take responsibility for assessing financially material ESG risks, and acting on them. Our findings indicate that this has not happened. Instead, the majority of trustees leave it to their investment manager.

Scrutinising investment managers is one of the most effective ways for trustees to implement ESG policies, and we welcome the fact that so many trustees recognise this. However, few trustees appear really to interrogate the investment manager’s approach to ESG issues. Schemes’ policies on selecting, retaining and evaluating their investment managers were thin on details and often couched in language that made little or no firm commitment to do anything.

The best SIPs in our sample gave details about how the trustees discuss ESG with their investment manager. This is best done regularly, and could feature as an agenda item at an annual update meeting. Trustees could include ESG issues in the Request for Proposals (RFP) process, or include ESG issues in their mandate. Mentioning that investment managers may be replaced if the trustees decide their approach to ESG factors is inadequate - as one SIP did - would send a very strong signal.

Few SIPs gave any information about the information that trustees look for when appointing or evaluating an investment manager. Those which did mentioned things like looking at the firm’s overall approach to ESG issues. This could be evidenced by published materials containing commitments to sustainable finance, or memberships of industry associations or initiatives. Trustees could also look at the size of the responsible investment team, or whether responsible investment is integrated across the investment manager’s approach to investment. Trustees could interrogate how a firm integrates ESG factors into its investment process, and ask for case studies where ESG factors have been relevant to company analysis.

There are myriad ways for trustees to interrogate their investment managers’ approach to financially material ESG factors, yet the SIPs we reviewed were disappointingly vague. This can only be due to a lack of willingness, or because the trustees lack the skills, knowledge and advice they need. We note that TPR’s guidance on implementing the ESG regulations made no mention of considering ESG factors in manager selection or retention, nor did it advise trustees on how to scrutinise their managers.

5.4 Stewardship

The ESG regulations require trustees to state their policy in relation to the exercise of voting rights attaching to investments and undertaking engagement activities in respect of the investments. Approaches to fulfilling this requirement were among the most diverse elements of the SIPs we reviewed. Trustees exhibited a wide range of attitudes towards stewardship from, on the one hand, full delegation to the investment manager with few or no expectations to, on the other hand, a sophisticated policy based on a detailed understanding of how investors can influence investee companies.

Trustees’ perceptions of stewardship

The SIPs we reviewed typically set out what activities they consider to be ‘stewardship’. Almost all SIPs said that stewardship includes exercising voting rights. Three quarters said that it involves ‘engagement by the investment manager’. Half said that it involves monitoring investee companies. A quarter of SIPs said stewardship involves engagement between the trustees and investment managers. A small number of SIPs discuss other activities that fall under the ambit of ‘stewardship’, such as requesting meetings and sending letters.
Delegation

The vast majority (85%) of sample SIPs stated that the trustees have given their investment manager full discretion over the exercise of stewardship. These SIPs typically contained a near word for word version of the following statement:

*The Trustee has given the appointed investment managers full discretion in evaluating ESG factors, including climate change considerations, and exercising voting rights and stewardship obligations attached to the investments.*

A third of schemes stated that the basis of this delegation is to preserve or enhance long-term value for beneficiaries, but that they give the manager full discretion over how to achieve this objective (i.e. how and whether to exercise voting rights). Two thirds of SIPs set no expectations of how they wish stewardship rights to be exercised, or express a vague expectation that it should be done in line with 'best practice' or 'the investment manager’s policies'.

A little over half of SIPs stated that the trustees monitor their investment manager’s stewardship activities. Some SIPs said how they do this, such as reviewing how votes were cast, summaries of meetings and other engagement activities. Slightly fewer than a quarter of SIPs stated that monitoring is done on an annual basis. The rest did not state a timescale, or made only a vague commitment to monitor ‘on a regular basis’, for example.

Just one SIP stated that the trustees require their investment managers to be signatory to the UK Stewardship Code.

Box 2: An example of an advanced stewardship policy

One scheme in our sample stood out for the quality of its stewardship policy. The scheme is very large, and likely to be the largest in our sample. The scheme is among the few that does not invest in a pooled arrangement and is the only scheme in our sample with an in-house investment manager. There are four elements to this scheme’s stewardship policy. First, the trustee sets the investment manager a clear outcome to aim for:

*The Trustee requires [the investment manager] to, where consistent with the Trustee’s fiduciary duties and applicable to the Scheme’s investment strategies, actively engage and use voting and other rights attached to the Scheme’s investments to drive up ESG standards in the organisations in which the Scheme invests.*

Secondly, the SIP sets expectations as to what stewardship should involve and how the objective is to be achieved. Stewardship activities, the SIP says, can relate to an investee company’s “performance, strategy, risks, ... [and] the investee company’s ESG practices and performance” as well as other activities aimed at building a long-term relationship between the investment manager and investee company management.

Thirdly, the SIP requires the investment manager to keep records of stewardship activities and the outcomes they have achieved. Fourthly, it suggests courses of action should engagement with an investee company not produce the desired outcome. Ultimately, the SIP says, should the investee company fail to respond to engagement by the investment manager, this “may result in a decision [...] to divest from the investee company.”
Discussion

The quality of stewardship policies was highly varied. Setting aside the best practice example in box 2, most were limited by the fact that the schemes we looked at mostly invest in pooled funds. However, as we explore in the next section, there are ways to influence managers.

However, building a market in stewardship will require a step change in trustees’ approaches. As we found in the previous section, the problems may relate to a lack of knowledge and expertise on the part of trustees. TPR’s guidance does little to bridge this knowledge gap. Going forward, DWP and TPR must prioritise building trustee knowledge and understanding about how they can influence asset managers to implement the stewardship policies in the SIP.

5.5 Approaches to pooled funds

The vast majority of sample SIPs stated that their schemes invest in pooled funds. A third of sample SIPs contained a statement to the effect that investing in pooled funds inhibits the trustees’ abilities to develop policies on stewardship (and ESG issues). Many SIPs contained the following statement almost word for word:

The Plan is invested in pooled funds (i.e. it owns rights in investment funds in which a number of investors invest). It is not commercially possible for a single investor, like the Trustee, to require managers of pooled funds to make specific changes to their investment approach (e.g. in relation to integration of certain factors like ESG or stewardship).

Despite the apparent problems presented by pooled arrangements, some schemes have developed policies on ESG and stewardship nonetheless. Some incorporate consideration of stewardship policies and practices in the selection and retention of pooled products, a practice which five sample SIPs have adopted. Other approaches include group engagement, where several investors in the pooled fund work together to seek to influence the asset manager.

One SIP, representing a medium-sized scheme, is notable among our sample for having a made an effort to develop ESG policies despite investing in a pooled arrangement. Although the scheme delegates the policy and practice of stewardship to the manager of the pooled fund, it focuses on monitoring the manager’s stewardship activities and engaging with the manager. Once a year, the scheme receives a report from the manager on the exercise of voting rights and other stewardship activities. The trustee reviews this report with its investment consultant, and identifies issues to follow up with the manager. The trustee then requests a meeting with the manager to discuss stewardship at which the manager is expected to present their stewardship activities, their policies, and the outcomes achieved.
6. Conclusion

Our findings suggest an appallingly poor rate of compliance with the ESG regulations. Of the SIPs we were able to review, policies were thin, non-committal, and suggest that trustees are not adequately interrogating their investment manager’s approaches to financially material ESG factors.

We are unable to assess what the vast majority of trustees are doing to comply with their duty to consider financially material ESG factors. Medium and large schemes have largely not published their SIPs, apparently in violation of their legal duties. This is worrying; it not only means we cannot assess whether trustees have adequate policies on ESG, but raises broader questions about how well the UK’s trustees, who safeguard the pension savings of millions of UK workers, are doing their job. Addressing compliance issues is job number one for government and the regulator.

Among those we have assessed, many schemes resorted to vague language that allows schemes and their investment managers to do very little. With the exception of one very large scheme which had a stewardship policy whose quality was head and shoulders above its smaller peers, there was no noticeable difference between medium-sized, large, and very-large schemes’ policies on ESG or stewardship. Trustees have, by and large, simply left issues to their investment managers, applying varying degrees of scrutiny to how their investment managers approach these issues. This is precisely what the Pensions Minister said he did not want trustees to do. Trustees who have developed advanced policies are the exception, not the rule. Measured against the government’s aims, we conclude that the ESG regulations have had limited success so far.

The central aim of the ESG regulations was to change trustee behaviour, to get them to give greater attention and attach greater importance to financially material ESG factors. The ESG regulations have sparked new conversations in the UK pensions industry. Our findings suggest that a significant minority of trustees have discussed ESG issues – perhaps for the first time – and are starting to develop their investment beliefs, and then policies. It is encouraging that we found schemes which had given serious consideration to the nature and scale of ESG risks, and had formulated policies on the basis of this.

Winning the battle for trustees’ hearts and minds will require a more comprehensive programme of communication and education by DWP and TPR so that trustees do not simply draft vague policy that enables them to tick the regulatory box while making no changes to investment policies. Some of this can be done in future guidance from TPR to trustees on how to complete implementation statements and in guidance around a recent Competition and Markets Authority (CMA) order relating to the recruitment of investment advisers, and our recommendations follow.

However, raising governance standards among trustees, not just on ESG, is a long-term project, which requires not just legislation but significant work by the regulator to educate trustees. In doing this, neither the regulator nor government should rule out making more granular risk management prescriptions, such as the Prudential Regulation Authority has issued to banks and insurers in relation to climate change (PRA, 2019). Forthcoming guidance from DWP on how trustees can implement the recommendations of the Task Force on Climate-related Financial Disclosures will be welcome. Looking ahead, one of the biggest barriers to achieving the governance improvements the Pensions Minister wants to see is the fragmented nature of the UK’s pensions industry. The government must be creative in finding ways to overcome it.
7. Recommendations

To achieve what the Pensions Minister wants, DWP and TPR need to bring about a step change in trustees’ approaches to financially material ESG factors. The ESG regulations are a good first step, but the job is not yet done. Here we set out what action government and the regulator could take to remedy the problems we found and promote best practice.

Compliance

The scale of noncompliance with the ESG regulations must be addressed as a priority. TPR should urgently launch a thematic review of the state of compliance with the ESG regulations.

It may be that the only part of the regulations with which trustees are failing to comply is the requirement to publish a SIP. The Department for Work and Pensions and the Pensions Regulator should create a SIP repository, maintained on TPR’s website and accessible to the public. This could be modelled on the Modern Slavery Registry. A public SIP register would allow the quality and adequacy of schemes’ investment policies to be scrutinised. It would reduce the practical burden on smaller schemes which often do not have a website. In the forthcoming Pension Schemes Bill 2019-2020, the government should introduce a new requirement for trustees to send a copy of the latest version of their SIP to the Pensions Regulator for publication, and a duty on TPR to create and maintain a public SIP repository.

TPR must find new ways to engage with trustees to inform them of their updated legal duties, and to share and promote best practice ESG risk management. This might take the form of a series of events for trustees at which they could discuss changes to pensions law. A series of events could also help the pensions industry share best practice about how to deal with emerging financially material risks, such as climate change.

Future TPR guidance

The ESG regulations require trustees to prepare a statement setting out how they have implemented the policies in their SIPS by 1st October 2020. TPR must provide guidance to trustees on what they should include in their reports. TPR should also provide guidance for trustees running tendering processes to recruit advisers, following a recent Competition and Markets Authority Order requiring trustees to set strategic objectives for their investment advisers (CMA, 2019). These pieces of guidance must address the following points.

Clarifying vague commitments

Many of the SIPs we found contained vague commitments that were qualified by phrases such as ‘where appropriate’, or which made no commitment to do something regularly or within a specific time horizon. TPR should ask schemes to list under each policy what action has been taken to implement that policy. For example, if trustees say that they discuss ESG issues with their investment manager when appropriate, trustees should say how many meetings they have had to discuss ESG issues, and if so, how many times. It would be helpful if TPR requested that trustees include a copy of their SIPs as an annex to their implementation reports.

Advisers

Schemes need to ensure they are getting the best advice on ESG issues. TPR should clarify in its guidance for the CMO order that, trustees should consider investment advisers’ ESG credentials in the tendering process for new investment advisers.

Investment manager scrutiny

Many trustees have not developed sophisticated policies on ESG factors, instead leaving it to their investment managers. Trustees must scrutinise their investment manager’s approach to ESG factors. In guidance to trustees, TPR should request that trustees report on how they have scrutinised their asset manager’s approach to ESG issues. TPR implementation statement guidance should suggest that trustees report on:

- How often they have discussed the investment manager’s approaches to ESG factors,
- Whether the trustees have put ESG factors on their risk register,
- After taking advice, which ESG factors they believe pose a financial risk to the scheme’s assets, and
- A case study, obtained from the investment manager, showing where ESG factors have been relevant to company
Investment manager selection and retention

Since many SIPs we reviewed said that trustees consider investment managers' approaches to ESG factors in evaluation, selection and appointment decisions, TPR should request that trustees report on how this is done in their implementation statements, including:

- What aspects of a firm-level commitment to ESG factors they look for,
- The specific aspects of a responsible investment team’s approach to ESG factors which trustees consider,
- Whether an investment manager’s approach to ESG factors has ever been a deciding factor in selection or retention decisions,
- Whether they have signed the Stewardship Code, and
- Whether trustees specify consideration of ESG factors in the RFP.

Pooled products

Many schemes which invest in pooled products have not developed ESG or stewardship policies. TPR should request schemes to report on when they will develop ESG or stewardship policies, suggesting ways schemes could develop policies despite investing in a pooled arrangement. This could include some of the examples of policies that we found, such as considering ESG factors in the selection or retention of pooled products.
8. Bibliography


Prudential Regulation Authority. (2019, April). SS3/19: Enhancing banks’ and insurers’ approaches to managing the financial risks from climate change.


The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018.


A summary of the trustees’ views for each asset class in which the Scheme invests is outlined below.

**Equities.** The trustees believe that ESG issues will be financially material to the risk-adjusted returns achieved by the Scheme’s equities.

- **Passive equities** – The trustees accept that the fund manager must invest in line with the specified index and, therefore, may not be able to select, retain or realise investments based on ESG related risks and opportunities. However, the trustees believe that positive engagement on ESG factors can lead to improved risk-adjusted returns alongside better environmental, social or governance outcomes more generally. The trustees therefore require that the fund manager takes into account ESG considerations when engaging with companies and by exercising voting rights.

- **Active Equities** – Where equities are actively managed, the trustees expect the fund manager to integrate ESG factors into the selection, retention, monitoring, and realisation of the stocks they hold where this is expected to have a material impact on returns. The trustees also expect their fund manager to take into account ESG considerations when engaging with companies and by exercising voting rights.

**Multi-asset funds.** The trustees believe that ESG issues will be financially material to the risk-adjusted returns achieved by the Scheme’s multi-asset fund managers. The trustees are therefore supportive of the multi-asset fund managers used by the Scheme taking ESG issues into account in the investment process, where relevant. The trustees are satisfied that the managers have suitable processes to consider ESG factors and take them into account (where relevant) in the selection, retention and realisation of the underlying investments within the funds. The trustees also support engagement activities and (where relevant) the exercise of rights attaching the investments by the Scheme’s multi-asset fund managers. However, the incorporation of ESG issues, the exercise of rights and engagement activities should be consistent with, and proportionate to, the rest of the investment process.

**Credit.** The trustees believe that ESG issues are financially material to the risk-adjusted returns achieved by the Scheme’s credit holdings. For active mandates, the manager is expected to consider all financially material considerations, including but not limited to ESG factors, when managing the fund. The trustees recognise that for passive mandates, the fund’s holdings are largely dictated by the index being tracked. The trustees recognise that fixed income assets do not include voting rights, however, they support engagement with companies by their managers, particularly in markets where the manager may be responsible for a larger share of any investment. However, the incorporation of ESG issues and engagement activities should be consistent with, and proportionate to, the rest of the investment process.

**LDI, government bonds and money markets.** The trustees believe there is less scope for the consideration of ESG issues to improve risk-adjusted returns in these asset classes because of the nature of the instruments used and the fact that money market investments are short-term. Gilts and swaps do not have voting rights attached, and the UK Government does not currently engage with gilt holders in this way. Government bonds of developed market countries, and money market investments, typically have very low levels of ESG risk and therefore ESG analysis is less relevant to these investments. It is worth noting that when transacting in LDI and money market funds, the trustees require due diligence is undertaken to assess the credit worthiness of the counterparty both at the start of and throughout any investment, whilst at the same time looking to achieve best execution. The trustees believe this is more relevant for longer term trades compared to shorter term trades and should incorporate ESG factors where these assist with the credit worthiness assessment.