Responsible investment in DC schemes

Responsible investment has become a mainstream consideration for pension scheme trustees. This guide sets out the key things you need to know, including an overview of your responsibilities and some suggestions for putting responsible investment into practice.

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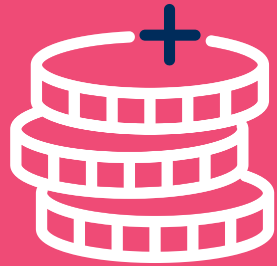


Introduction

It is now generally accepted that responsible investment (RI) is part of good practice for all pension schemes since environmental, social and governance (ESG) factors can affect the performance of assets, both individually and collectively, over both the short and long-term. The Pensions Regulator (TPR) has set out clear expectations for trustees in relation to ESG factors and stewardship, and trustees are required to state their RI policies in their Statement of Investment Principles (SIP). In addition, members often want and expect their pension assets to be invested responsibly. It is therefore important that DC trustees can demonstrate that they are adopting RI practices in both the default strategy and the self-select range.

What is responsible investment?

RI incorporates ESG factors into investment decisions and adopts stewardship (active ownership) practices such as voting and engagement, with the aim of achieving long-term sustainable returns.

RI has at times been confused with ethical investing, which in the past sometimes meant accepting lower returns by screening out certain investments that fail to meet ethical considerations (eg avoiding tobacco shares). However, RI focuses on ESG factors that are financially relevant and have the potential to improve risk management as well as help generate sustainable, long-term returns. We believe in taking a pragmatic approach to RI that aims to enhance the long-term risk-return profile of a scheme's assets.

What do trustees need to document in their SIP?

In summary, trustees must state their policy on:

- Taking account of factors they consider to be financially material, including ESG factors, including climate change, over the appropriate time horizon of the investments.
- Taking account of non-financial matters, such as members' ethical views (if the trustees have such a policy).
- Exercising rights (eg voting rights) that are attached to investments.
- Undertaking engagement activities in respect of their scheme's investments.

Click here to access the latest guidance from the Pensions Regulator

What else are trustees expected to do?

The Law Commission's guidance clarifies trustees' legal obligations in relation to ESG factors:

- You should take into account factors which are financially material to investment performance.
- You may take into account financial factors that are not financially material to the scheme.
- Where you think ESG factors are financially material, you should take these into account; likewise if you think certain ethical issues are financially material.
- While the pursuit of a financial return should be your main concern, the law is sufficiently flexible to allow you to take other, non-financial factors into account if you have good reason to think that scheme members share your view and there is no risk of significant financial detriment to the fund.

In addition, trustees are expected to follow TPR's investment guidance. This says that trustees will want to assess the financial materiality of ESG factors and allow for them accordingly in the development and implementation of their investment strategy. The actions they might take include making changes to the default arrangement or self-select options, or engaging with investee companies via their investment managers.

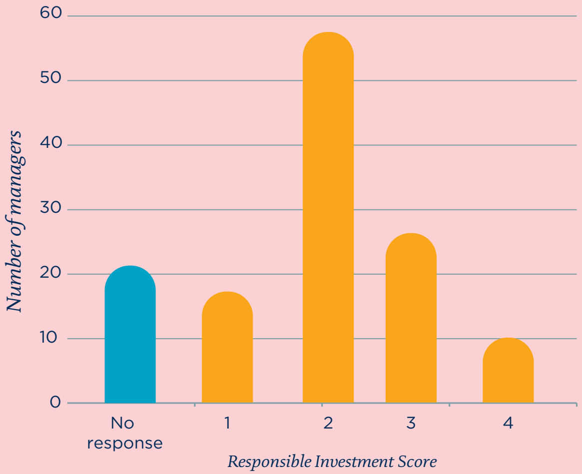
TPR also says it is up to the trustees to exercise stewardship and ensure, as far as they are able, that this is done through the whole length of the investment chain. It notes this is particularly relevant for the management of macro-economic, systemic risks such as climate change, which cannot be sufficiently hedged through portfolio construction and asset allocation alone.

What are your investment managers doing on your behalf?

The day-to-day implementation of trustees' RI policies is typically carried out by their investment managers. Many managers will say they take account of ESG factors and exercise stewardship, but they do this in different ways and with varying effectiveness. Therefore, trustees should oversee what their managers are doing on their behalf.

Our manager research programme incorporates RI as part of the due diligence process, so we have a wealth of in-depth information on investment managers' RI approaches and credentials. We can use this information to help you understand how your managers measure up on RI and support you in your discussions with them.

The chart below shows the headline scores from our latest RI survey where 1 is weak and 4 is strong.



Default or self-select?

As RI can affect financial performance, it is relevant to all investments. It is particularly important that trustees consider RI in relation to the default strategy since that is where the majority of schemes' money is invested. Members in the default strategy are relying on the trustees to make good financial decisions on their behalf.

RI is relevant to self-select funds too. For example, if the trustees believe it is important that investment managers have a sound understanding of ESG matters and strong stewardship practices, these criteria should be applied to self-select as well as default funds.

Some members may have strong views on ESG factors that go beyond financial considerations. Trustees could cater for this by including funds in the self-select range with greater emphasis on ESG and/or ethical matters.

Should trustees do something different when it comes to climate change?

The amended SIP requirements specifically reference climate change in the definition of financially material considerations. There is a trend towards trustees having a specific policy on climate change, in addition to a more general ESG policy. The reasons include:

- Strong evidence that climate change will be financially material, supported by scientific and public policy consensus.
- Climate change is an issue that affects all sectors of the economy and poses risks to the stability of the financial system as a whole.
- Expectations set by regulators, eg climate change and management of it as a systematic, macro-economic risk features prominently in TPR's guidance.
- Expectations set by policymakers, eg the results of the MPs' Environmental Audit Committee review of the climate practices of the largest 25 UK pension schemes in the first half of 2018.
- Increasing availability of credible investment products that seek to protect against climate-related risks and/or invest in climate-related opportunities.

What do members expect?

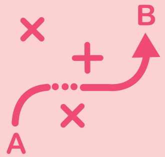
Trustees are not required to investigate their members' views on ESG and other matters, but may wish to do so. They could do this through a member survey, focus groups or just inviting comments in the next member newsletter.

Alternatively, they could look at the results of published surveys. Several recent surveys suggest that members want trustees to be adopting RI practices. The results include:

- 61% of DC members are very or somewhat interested in investing their DC pension savings responsibly, rising to 80% among 22-34 year olds [1]
- 70% of UK adults 'felt it important for pension providers to invest in companies that concentrate on avoiding unethical practices' [2]
- NEST found that information about its RI practices would make 44% of members more interested in their pension (score 8+ out of 10) and would be neutral (score 5-7) for a further 38% of members. [3]

61%

interested in RI



70%

want to avoid unethical practices

44%

RI information would increase interest in their pension

Should trustees have a policy on non-financial matters?

In addition to taking account of ESG factors with the aim of improving financial performance, trustees may wish to take account of member views on matters such as:

- Ethical and moral issues
- A desire for their investments to have a beneficial social or environmental impact
- The impact of the investments on members' present and future quality of life.

Trustees are not required to take account of such matters, but the Law Commission has said they can do so if two tests are met:

- They have good reason to think scheme members share their view
- There is no risk of material financial detriment to the fund.

Examples of schemes that have taken these matters into consideration in the design of the default strategy include:

- A scheme not investing in controversial weapon manufacturers, in line with social norms.
- A scheme sponsored by a health charity excluding shares of tobacco manufacturers on ethical grounds.
- A scheme sponsored by a religious organisation applying a broad range of ethical screens.

Many DC trustees offer an ethical option in the self-select range for members who do not wish to invest in companies involved in (say) gambling, alcohol manufacture or animal testing.

[1] DCIF (2018), Navigating ESG: A Practical Guide.

[2] NAPF (2014), What do scheme members expect of how their savings are invested?

[3] NEST (2018), Building new norms: An update on our responsible investment activities 2018.

Putting responsible investment into practice

Best practice is to embed RI throughout your investment and wider risk management processes.

Here are some suggested actions.

Governance	• Make RI a standing item at investment committee / trustee meetings. • Undertake trustee training on RI at least annually, to stay abreast of developments in this fast-moving area.

Investment beliefs	• Develop a consensus set of beliefs about how ESG factors and stewardship affect investment performance. For example:
	  • do market prices fully reflect ESG factors? If not, can investment managers add value by taking account of ESG factors?
	  • should trustees consider long-term environmental, social and economic sustainability when making investment decisions?
	• Document your beliefs and use them to inform your RI policies.

Default strategy	• Review the strategy's current exposure to ESG factors and consider whether to reduce its exposure to ESG risks and/or increase its exposure to ESG opportunities, for example by incorporating:
	  • passively managed funds that track an index that is tilted towards companies with lower exposure to climate risks and vice versa; or
	  • actively managed funds (where the charge cap allows) that specifically seek to invest in companies that are aligned with long-term social and environmental sustainability.

Self-select options	• Consider offering specialist funds for members who want to place additional emphasis on ESG factors, for example:
	  • an ethical fund that does not invest in sectors such as tobacco, weapons, alcohol, gambling or fossil fuels; and
	  • an impact investment fund that seeks to have a demonstrably positive social and environmental impact, as well as delivering good financial returns.

Manager selection	• When selecting a new investment manager:
	  • consider setting minimum RI standards (eg must be a signatory to the Principles for Responsible Investment);
	  • ask RI questions at the beauty parade (eg can the portfolio managers give good examples of how ESG factors affect their investment decisions?); and
	  • make RI one of your criteria for ranking managers.

Manager monitoring	• Understand how your default and self-select investment managers are implementing RI on your behalf (see box on p3) and ensure their approach is consistent with your RI beliefs. • Review managers' voting and engagement reports regularly, eg each quarter. • Identify any areas of weakness and encourage your managers to address them.
Communication	• Document your policies on ESG considerations, climate change, voting and engagement in your SIP, as required by the regulations • Tell members about your RI activities. Seek to engage them on pensions through demonstrating the links between real-world issues and their investments.
RI leadership	• Sign up to the Principles for Responsible Investment, UK Stewardship Code and Task Force on Climate-related Financial Disclosures (TCFD) recommendations. • Join investor collaborations that encourage companies, regulators and policymakers to adopt good ESG practices that enhance long-term investment returns.

Three simple steps for you to get started

1. Undertake training to find out more about ESG factors and stewardship, and how you can implement RI in practice.

2. Develop and document your consensus view about ESG factors and stewardship.

3. Find out how your investment managers are implementing RI on your behalf by reviewing their responses to LCP's RI survey and engaging in dialogue with them.

Learn more by visiting our responsible investment hub

LCP INSIGHT CLARITY ADVICE

Want to find out more?

If you would like more information please contact your usual LCP adviser or one of our specialists below.

Laura Myers - *Partner*
+44 (0)20 7432 6639
laura.myers@lcp.uk.com

Nigel Dunn - *Senior Consultant*
+44 (0)20 7432 7795
nigel.dunn@lcp.uk.com

Paul Gibney - *Partner*
+44 (0)20 7432 6653
paul.gibney@lcp.uk.com

Claire Jones - *Principal*
+44 (0)1962 873373
claire.jones@lcp.uk.com

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Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands B.V. (operating under licence)
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com

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