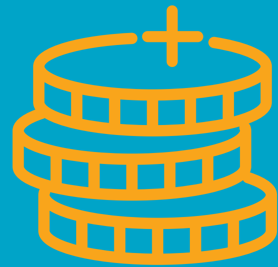
Responsible investment in DB schemes

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 because environmental, social and governance (ESG) factors can affect the performance of assets, both individually and collectively, over both the short and long-term. In addition, members often want and expect trustees to invest responsibly. 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) by 1 October 2019.

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 and 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 does TPR expect trustees to do?

As well as complying with the SIP requirements, trustees are expected to follow TPR's investment guidance. In this guidance, TPR endorses the Law Commission's guidance on trustees' legal obligations:

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

TPR says trustees should decide on the relevance of long-term financial risks — such as climate change, unsustainable business practices, and unsound corporate governance — to inform their investment strategy.

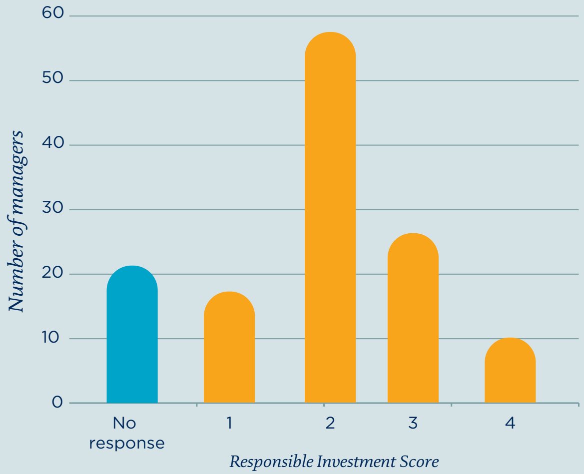
TPR also encourages trustees to understand the stewardship policies adopted by their existing and prospective investment managers and seek to influence them where appropriate.

What are your investment managers doing on your behalf?

The day-to-day implementation of trustees' RI policies is mostly 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.



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 and 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.

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 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 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
- A scheme sponsored by a religious organisation applying a broad range of ethical screens.

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 meetings. • Undertake trustee training on RI at least annually, to stay abreast of developments in this fast-moving area.
Integrated risk management	• Understand your exposure to ESG risks through your investments and sponsor covenant, and any links between them. • Seek ways to mitigate these risks (see rest of table for investment related options). Take account of remaining ESG risks when making funding decisions and contingency plans.

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.

Investment strategy	• Consider how investment options vary in their exposure to ESG factors and investigate whether there are suitable options that have lower exposure to ESG risks and/or higher exposure to ESG opportunities. For example:
	  • actively managed funds that specifically seek a lower exposure to climate-related risks, or invest in solutions to social and environmental challenges; or
	  • passively managed funds that track an index that is tilted towards, or only invests in, companies with good ESG scores.

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 investment managers are implementing RI on your behalf (see 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. • Tell members about your RI activities. Seek to engage them on pensions through demonstrating the links between real-world issues and the scheme's investments.
RI leadership	• Sign up to the Principles for Responsible Investment and the UK Stewardship Code. • Join investor collaborations which 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

INSIGHT CLARITY ADVICE

Want to find out more?

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At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.

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