

Material change: a five-step ESG checklist for trustees

How can pension trustees prepare for new requirements on the financial materiality of environmental, social and governance (ESG) factors?

‘ESG considerations’ mean many things to many people – not least regulators, who are now viewing them as core to the duty of pension scheme trustees.

New guidelines from the Department of Work and Pensions (DWP) make it clear that it is not sufficient to focus on a narrow definition of the bottom line in order to meet schemes’ core objective: providing retirement benefits for members. Instead, trustees must also consider the financial materiality of ESG considerations. But what does this mean in practice?

This guide will help cover the key areas, in order to enable trustees to be fully prepared, touching on:

- What has changed
- An introduction to ESG integration
- The Statement of Investment Principles (SIP)
- Investment strategy and asset allocation
- ESG integration in asset manager selection
- Reporting requirements



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In addition to showing how to adjust to the shifting regulatory landscape, this guide will also demonstrate why we believe the guidelines are a positive step for defined contribution (DC) and defined benefit (DB) trustees, as well as scheme members.

WHAT HAS CHANGED?

In June 2018, the DWP heralded the importance of ESG issues in a consultation on clarifying and strengthening trustees’ investment duties. In September 2018, the department issued new regulations clarifying that:

- “Financially material” considerations cover ESG considerations, including climate change
- ESG issues are not “to do with personal ethics, or optional extras” (as opposed to ethical investing, for example)

The regulations aim to strengthen the policies and disclosures regarding:

- “Financially material considerations over the appropriate time horizons, including how those considerations are taken into account in the selection, retention and realisation of investments”
- Stewardship obligations, such as voting on and engaging with investee companies

In addition, they require all trustees of occupational pension schemes with over 100 members to update their SIP by 1 October 2019. Trustees of ‘dual section’ and DC pension schemes must also update their SIP, regarding their default investment strategy.

STEP 1: DEFINING ESG INTEGRATION

ESG factors – from climate change to the quality of management – pose potential risks and opportunities, which can have a material impact on the performance of investments.

As a result, ESG integration aims to identify and support good management, as companies that are aware of their impact on wider stakeholders should be less likely to face political or regulatory pressure.¹ Such companies can reap multiple benefits, from more efficient operations to attracting and retaining talent.²

Frequently discussed ESG considerations:

- climate change
- labour standards
- supply chain sustainability
- board diversity
- director independence
- executive pay
- audit standards

Historically, ESG integration has been associated with screening out companies or entire sectors (an approach taken under ‘ethical’ investing). But instead of exclusions, we believe other, data-driven approaches may promote capital allocation to companies that are well managed, using information that has fallen outside of traditional financial analysis.

Over 50% of European asset owners are aiming to incorporate ESG factors in some of their index investing strategies³

Other approaches, such as stewardship, are less quantitative: it is in the financial interest of asset owners to demand high standards from the companies in which they invest, through their corporate engagement and voting activities. By holding to account companies that fall short, investors contribute to market stability, a key driver of investment performance.

80% of asset owners conduct direct shareholder engagement on ESG issues⁴

1. BofAML, ESG Part II: a deeper dive, June 2017

2. <https://www.tandfonline.com/action/showCopyRight?scroll=top&doi=10.1080%2F20430795.2015.1118917>

3. <http://www.ftserussell.com/sites/default/files/smart-beta-2018-global-survey-findings-from-asset-owners-final.pdf>

4. Morgan Stanley – *Sustainable Signals. Asset Owners Embrace Sustainability*, 2018 survey

DOES ESG LEAD TO OUTPERFORMANCE?

There are two ways in which we view ESG considerations as 'financially material':

- As a protection against risk
- As a potential source of financial outperformance

At LGIM, we believe that responsible investment approaches, which integrate ESG considerations, can indeed help mitigate risks and have the potential to lead to better, long-term financial outcomes.

The 'Dieselgate' emissions scandal is a reminder that companies will try to conceal irregularities. Therefore, incorporating ESG considerations can serve as a means to reduce risk in a portfolio, on issues ranging from conflicts of interest on the board to the protection of employee rights, product safety or the transition to a low-carbon world.

78% of asset owners cite risk mitigation as a key reason for ESG integration⁵

The relationship between ESG considerations and financial performance is a relatively new area of research. But the overwhelming majority of 2,250 peer-reviewed studies analysed by Hamburg University and Deutsche Asset Management identified a positive overall relationship between ESG and corporate financial performance.⁶

Strong corporate governance has been found to be highly correlated to financial performance, given that failures in this area (such as an oil spill by an energy company) tend to have an immediate negative effect on a company's stock.⁷ Heightened sustainability standards show a less strong correlation to performance, but have been linked to a lower cost of capital for companies and improved operational performance.⁸

Some studies point to potential share-price gains following successful engagements with companies on ESG issues⁹, alongside potential outperformance by portfolios holding stocks that score highly on material sustainability issues.¹⁰

There is no unequivocal evidence that ESG-integrated portfolios outperform, although back-tested data may not accurately reflect the current, constantly evolving investment landscape. For example, investors can now 'tilt' a portfolio towards 'best-in-class' companies in a sector (e.g. the most efficient, least polluting energy companies) rather than exclude sectors altogether.

Moreover, some ESG factors, such as climate change, may not have an impact on any particular company's ability to generate returns, but leaving them unaddressed can have a material impact on the wider market.¹¹

5. Morgan Stanley – *Sustainable Signals. Asset Owners Embrace Sustainability*, 2018 survey

6. https://www.db.com/newsroom_news/K15090_Academic_Insights_UK_EMEA_RZ_Online_EN_151216_R2a.pdf

7. https://www.db.com/newsroom_news/K15090_Academic_Insights_UK_EMEA_RZ_Online_EN_151216_R2a.pdf

8. https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf

9. Elroy Dimson, O'uzhan Karakas, and Xi Li, *Active Ownership*, Review of Financial Studies, 2015.

10. Mozaffar Khan, George Serafeim and Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality*, Harvard, 2015

11. Sources: Bank of England, Prudential Regulation Authority, FTSE Russell, Carbon Tracker Initiative

HOW COULD CLIMATE CHANGE AFFECT PENSIONS?

There are two broad types of investment risks associated with climate change:

- Physical risks
- Transition risks

Physical risks are largely driven by inaction, as the effects of climate change are allowed to intensify, disrupting agriculture, industrial productivity and trade, in addition to creating social and political unrest. These are likely to have an impact on companies across the world, and therefore on future investment returns. We are already seeing some of these effects: in the last three decades, insurance losses from extreme weather have risen over five times, reaching a record high in 2017.

Transition risks are driven by action, as changes in regulation, technology and consumer preferences put pressure on high-carbon sectors. In some parts of the world, it is already cheaper to build new renewable energy capacity than to run existing coal plants. More broadly, up to a third of the world's stocks and bonds – the most common asset classes for pension schemes to invest in – are linked to high-carbon sectors that might be at risk from the transition to a low-carbon economy. Transition and physical risks can affect the investments of most pension schemes. For DB schemes, they raise additional questions about their impact on the scheme sponsor and covenants.

On the positive side, climate change also brings investment opportunities across different asset classes, from listed equities to infrastructure and private debt. The 'green' economy is now estimated to be equal in size to the oil and gas sector's market capitalisation. For DC schemes, providing members with evidence of positive environmental impact may help members increase their engagement with their pension as well as contribution rates.¹¹

It is worth bearing in mind that the fact an issue is usually discussed in a non-financial context does not exclude the existence of financial considerations bearing on the issue.

As the Law Commission notes, there is a difference "between withdrawing from tobacco because the risks of litigation make it a bad long-term investment, and withdrawing from tobacco because it is wrong to be associated with a product which kills people."¹² The former decision is based on considerations of financial materiality – and might therefore be permitted – the latter is not, and would generally not be permitted with the exception of some mission-based organisations (e.g. a cancer research charity).

WHAT DOES ESG INTEGRATION MEAN FOR PENSION SCHEMES?

Trustees in the UK were already under a legal obligation to take into account financially material considerations. And the Law Commission had previously made it clear that fiduciary duty does not require trustees to focus exclusively on 'maximising returns'.

Trustees must weigh returns against risks, including long-term risks.
– Law Commission¹³

11. Sources: Bank of England, Prudential Regulation Authority, FTSE Russell, Carbon Tracker Initiative

12. Law Commission Report on Fiduciary Duties of Investment Intermediaries, 2014, 6.48

13. Law Commission Report on Fiduciary Duties of Investment Intermediaries, 2014, 5.52

The new regulations do not aim to direct the investment decisions of trustees. But they require trustees to articulate and provide evidence for how they are managing certain risks. It is this level of detail required that might pose a challenge for some trustees.

	Old regulations	What's changed?
ESG and ethical considerations	<p>Environmental, social and ethical issues were grouped under the same category.</p> <p>Trustees were required to explain how they were incorporated into investments, if at all.</p>	<p>A clear separation between material ESG issues (which trustees <i>must</i> take into account) and the ethical views of their members (which trustees <i>may</i> take into account)</p> <p>(For DC schemes) Trustees are expected to explain how material (ESG) risks are managed in the default strategy, not just the self-select option.</p>
Reporting against SIP (for relevant schemes)	'Red flag' approach: report only in case of a breach of policy.	'Green light' approach: report on how the SIP has been implemented
Stewardship	Trustees were asked to report on the 'policy (if any) in relation to the exercise of the rights (including voting rights) attached to the investments.'	<p>All schemes must have a policy on stewardship.</p> <p>The definition has been broadened to include more than just voting, including engagement with 'relevant persons' (directly with companies, indirectly via asset managers, or with fellow shareholders) and on 'relevant matters' (which include ESG issues).</p>

STEP TWO: DEFINING INVESTMENT BELIEFS IN THE SIP

The SIP sets out the principles governing how decisions about investments must be made. Within it, trustees are expected to provide comprehensive details on their scheme's overall governance structure. In some schemes, for example, monitoring ESG considerations may fall under the remit of internal investment teams, while for other schemes – particularly smaller ones – this might be delegated to external asset managers.

Although SIP requirements may appear generic, the government cautions trustees against adopting 'boilerplate'

explanations. As the regulations refer to the "selection, retention and realisation of investments", we encourage trustees to conduct a robust review of policies, risks and opportunities throughout the entire investment process – which can also reassure members.

This message is reinforced by upcoming changes to the regulator's code of practice, which will require trustees to conduct and document their own risk-assessment of "new or emerging" material ESG issues.¹⁴ This is also aligned with new guidance from the International Organisation of Pension Supervisors.¹⁵

14. https://www.responsible-investor.com/home/article/dwp_esgpv/

15. <http://www.iopsweb.org/resources/2019-Public-Consultation-Supervisory-Guidelines-ESG-factors.pdf>

STEP THREE: REVIEWING STRATEGY AND ASSET ALLOCATION

Beyond the scheme’s governance, trustees should be prepared to give an account of how an investment strategy incorporates ESG considerations within its asset allocation. This includes the default investment strategies for DC schemes, not just the self-select options.

Trustees may adopt multiple ways of integrating ESG considerations into a portfolio: by taking direct action in investments; committing to support responsible investing organisations and initiatives (e.g. through investor networks); or by setting explicit expectations when selecting and monitoring asset managers.

For DB schemes, trustees should aim to understand how ESG concerns may affect the scheme’s assets and liabilities. The government has emphasised the importance of choosing “appropriate time horizons”.

For some schemes, this can mean decades in terms of the timescales over which the financial impacts of ESG risks can manifest. A recent study estimated that the coverage ratio of pension funds could drop by up to 80% if global temperatures rise by 4°C.¹⁶ Conversely, a growing number of asset owners are exploring responsible investing opportunities across asset classes – either as a source of growth, or a mechanism to better discharge liabilities¹⁷ (e.g. through cash-flow matching).

We expect DC members to be increasingly engaged with efforts to integrate ESG considerations into their default and self-select options. If they knew their pension was having a positive social impact, 53% of respondents to an LGIM member survey said they would engage more with their pension. 27% of respondents said they would even pay more into it.¹⁸ This demonstrates a clear increased awareness and appetite for ESG integration on the ground.

STEP FOUR: ESG INTEGRATION IN ASSET MANAGER SELECTION

Some schemes will not have the in-house capacity to conduct ESG research, and so will depend to a significant extent on their asset managers in order to do so. The

regulations are not intended to change this, but will require trustees to be able to give an account of their managers’ approaches to material issues, including ESG considerations.

When awarding new mandates or monitoring existing ones, trustees should seek information on the responsible investing policies and practices of their designated managers. These practices will vary between active and index funds, with further variation due to mandates.

It is within the discretion of the manager of an active fund to sell the holdings in a company that is seen as risky due to governance concerns or incoming environmental regulations. By contrast, managers of index funds may require explicit permission from the trustee board to shift from a standard, market-capitalisation-based benchmark to an ‘ESG benchmark’.

The starting point would be to assess the manager’s ESG integration capabilities, including stewardship, as a routine part of requests for information/proposals as well as through other regular reporting channels. Trustees can then use this information to compare and monitor the performance of their managers in this area.

Asset owners Asset managers	Need to make an explicit decision?	Need to monitor the managers?
In active funds: use ESG data to enhance the fundamental analysis of companies	X	✓
In index funds: track ESG-tilted benchmarks which increase /or decrease the weight of securities according to their performance on ESG criteria	✓	✓
For all funds: conduct stewardship activities to raise ESG standards at investee companies	X	✓

16. <https://www.ipe.com/countries/eu/ortec-climate-change-could-reduce-funding-ratios-by-up-to-80/10027735.article>

17. See the discussion of renewable energy infrastructure: <http://ieefa.org/wp-content/uploads/2018/07/Renewable-Energy-Infrastructure-Investment-Opportunity-for-UK-Pension-Funds.pdf>

18. Source: LGIM survey of 1,000 respondents, made up of contract-based members, mastertrust members and L&G staff members, 2019.

Understood as the “active and responsible management of entrusted resources”, stewardship activities are essential in raising standards across companies and markets.¹⁹

The depth of engagement conducted by asset managers varies. Some may only vote with their shares on a subset of investee companies, or limit engagements to the ‘G’ of ‘ESG’ (issues such as executive pay or director appointments). However, asset managers do not need an explicit mandate to engage with companies on material ESG issues.

Engagement is a key mechanism – the only mechanism, in the case of index funds, which cannot buy and sell securities – for investors to hold companies to account on how they are preparing for long-term growth. In addition, many asset managers will have made explicit commitments to engage, as signatories to the UK Stewardship Code and similar initiatives around the world.

The upshot of the above is that trustees are likely to find that elements of ESG information will already be incorporated into their investments in some form. The key question is whether this is sufficient or can be improved.

At LGIM, we believe there are general principles underlying effective stewardship. At a corporate level, this is reflected in the following activities:

- Company engagement
- Using our voting rights globally, with one voice across all our active and index funds
- Addressing systemic risks and opportunities
- Seeking to influence regulators and policymakers
- Collaborating with other investors and stakeholders

The new regulations require scheme trustees to have a stewardship policy. This includes engagement with ‘relevant persons’ (directly with companies, indirectly via asset managers, or with fellow shareholders) and on ‘relevant matters’ (which include ESG issues). As uniquely long-term investors, pension schemes have an important role to play in encouraging companies to create sustainable value.

Recently, a government survey found that the majority of pension scheme members want their schemes to engage with investee companies.²⁰ Not only can stewardship help protect the long-term health of companies, it also offers an opportunity for improved communication with members, given the current information gap.

Over 80% of UK pension scheme members did not know or have not asked about their scheme’s approach to voting or engagement.²¹

Larger schemes may be in a better position to undertake their own direct engagements either individually or in collaboration with other, smaller schemes delegating this entirely to their managers. To fill this gap and be able to formulate an effective policy, we would encourage trustees to ask for detailed information from their asset managers, on issues such as:

- The scope of voting
- The consistency between voting policies and professed engagement aims: asset managers may not make full use of their voting capabilities to drive change at investee companies
- The levels of disclosure: is there detail around the issuers and issues that were the object of engagement? Are all votes publicly available? Are there details (and rationales) for votes at contentious resolutions?
- The extent of reliance on proxy advisers (and how voting activity differs from their recommendations)
- The willingness to collaborate with other investors to drive market changes
- The level of engagement with key actors (regulators, stock exchanges, index providers) to raise market standards and positively influence company behaviour
- The extent of engagement in asset classes other than equities

19. Tomorrow’s Company, Better Stewardship: an agenda for concerted action

20. DWP – Clarifying and strengthening trustees’ investment duties

21. DWP – Clarifying and strengthening trustees’ investment duties, questionnaire results on p. 43

STEP FIVE: REPORTING REQUIREMENTS

Trustees of DC and dual class schemes are required by law to produce a public report detailing the implementation of the SIP by 2020.

Above and beyond regulatory compliance, trustees will have gained valuable information which can be harnessed to spur members to become more engaged with their savings. By giving beneficiaries tangible examples of how engagement has led to positive outcomes at companies, or by providing details about ESG targets and mandates, trustees have the opportunity to make them aware of the impact that their investments are having.

Increased transparency and ambition from asset owners can help send an important signal across the investment chain. Asset owners can help raise the standards of ESG reporting, for example, by supporting initiatives such as the Taskforce on Climate-related Financial Disclosures.

ESG INTEGRATION – IN SPIRIT AS WELL AS LETTER

Despite the new regulatory framework, the benefits of ESG integration remain subject to heated debate within the industry. But as investors increasingly recognise that ESG factors play a crucial role in determining asset prices, we believe responsible investment approaches in which they are fully integrated are destined to become the new normal.

We hope that in addition to helping trustees to prepare for the new DWP guidelines – most importantly by engaging with their asset managers – this guide shows how embracing the spirit of the regulation can have a positive impact on investment portfolios. In the case of DC schemes, it also may bring significant engagement opportunities for members, as public awareness and demand for responsibly managed investments increases.

ESG checklist for trustees

Five steps to help you navigate the recent Department for Work and Pensions (DWP) regulatory changes

1. Build knowledge on the relevant ESG issues

- “Financially material” considerations cover “environmental, social and governance considerations”, including climate change
- ESG issues are not “to do with personal ethics, or optional extras” (as opposed to ethical investing, for example)

2. Define your investment beliefs and incorporate them into the Statement of Investment Principles (SIP)

- What is the scheme’s governance structure?
- Review ESG policies, risks and opportunities throughout the entire investment process

3. Review strategy and asset allocation

- What is the impact on the scheme’s assets and liabilities?
- What is the impact on the default and self-select investment strategies?

4. Incorporate ESG issues into the selection and monitoring of asset managers

- How are asset managers assessed on their ESG activities, including stewardship?
- Do you know what your asset managers are investing in?

5. Report publicly

- Check to see if you are reporting in line with the recommendations of the Taskforce on Climate-related Financial Disclosures
- Use this information to engage your members

We will be examining what an ESG-tilted portfolio actually looks like, and the financial impacts of divesting from controversial sectors, in an upcoming article.

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