Call for evidence on consideration of social risks and opportunities by occupational pension schemes

Introduction

On 24 March 2021, the DWP published a call for evidence seeking views on how pension scheme trustees understand social factors, and how they are included in their environmental, social, and governance ("ESG") policies.

Key points

- The Government is concerned that trustees' are focusing too greatly on climate change and neglecting the other elements of ESG, in particular social factors such as diversity and gender.
- Responses to the call for evidence, which closes on 16 June 2021, will help inform the steps the Government needs to take to ensure trustees are better able to meet their legal ESG obligations.

Background

Since 1 October 2019, most occupational pension scheme trustees have been required to set out, in their SIP, how they take account of financially material considerations and stewardship. Financially material considerations which trustees must consider when making their investment decisions include, but are not limited to, ESG factors (including climate change) (see our Alert).

While it sees climate change as "the most urgent risk facing our society and economy", the Government is now concerned that trustees are tending to focus solely on the "E", to the exclusion of the other elements of ESG. This was never the intention.

In February 2021, the Pensions Minister, Guy Opperman, wrote to 40 of the largest schemes seeking information about their ESG policies and stewardship practices. The call for evidence builds on this, asking stakeholders and schemes for input on the effectiveness of current policies, alongside assessing how trustees understand "social" factors and how they are integrating considerations of financially material social factors into their investment and stewardship activities.

Social factors

The DWP sets outs the following list of social factors which may involve financially material risks or opportunities for pension schemes:

- practices within a company and its supply chain, such as workforce conditions and diversity and inclusion
- company products and selling practices, such as product quality and safety, as well as consumer protection
- companies in the community, such as community engagement and use of local workforces.

Poor performance on social factors can also have a negative financial impact where it puts a company at risk of litigation, or reputational damage. There is a positive aspect too. For example, impressive sustainability standards can set a company apart from its competitors and tap into increasing consumer demand.

The Government does not expect trustees to "take on the role of governments" in seeking to fix these issues, but notes that "if social factors are not managed, they could pose financial risks to pension scheme investments, or cause trustees to miss important investment opportunities". Further, "ESG factors are often interconnected. The transition to a lower-carbon economy entails a number of social considerations, including the impact on communities reliant on certain industries and whether new green jobs will include fair working conditions". The Government believes that understanding these interactions can help trustees to manage social factors.

Trustees and their advisers are directed to a variety of resources for data and information about social factors. These include:

- Principles for Responsible Investment, which encourage investors to use responsible investment to enhance returns and better manage risks
- Sustainability Accounting Standards Board Materiality Map, which identifies sustainability issues that are likely to affect the financial condition or operating performance of companies within an industry sector
- Stronger Together, a multi-stakeholder business-led initiative aiming to reduce modern slavery.

Taking social factors into account

There is no single "right" way to consider social factors. Trustees may adopt one or more of the following approaches:

- Screening (exclusion) – avoiding investments in assets associated with poor performance on social factors by simply excluding particular companies, or investment in particular areas (for example, controversial weapons). Conversely, screening can also be used to choose investments in companies that exhibit particular positive aspects
- Tilted funds – tilting the scheme portfolio's exposure to companies performing well on social issues or away from those performing poorly
- Voting – in a way that supports social considerations, either directly or via an asset manager
- Engagement - engaging with companies on social issues, either directly or via an asset manager.

The call for evidence also mentions social impact investing, which involves investing with the intention of generating a positive social impact alongside the financial return. This is more controversial as it may not be compatible with the trustees' fiduciary duty to act in the best financial interests of scheme beneficiaries, a key consideration for trustees at all times.

Each approach involves different implementation considerations that trustees will need to take into account to establish an effective strategy based on consideration of social risks. For example, trustees should consider:

- the extent to which a particular strategy is likely to reduce financially material risks
- the cost of entry to an investment as well as the ongoing costs associated with management and engagement
- whether the social strategy is implemented directly or through a platform or asset manager.

Stewardship (voting and engagement)

At present, it is not clear to the Government that stewardship is happening at a high standard across the pensions sector. For stewardship to be effective, like pension scheme trustees, investors need to understand their investments and the issues they face, and be willing to have a meaningful dialogue with management. Although many scheme trustees invest passively and in pooled funds, trustees can still take account of social factors through their choice of fund and asset manager, as well as through their conversations with those managers.

In November 2020, HMT's Asset Management Taskforce made recommendations to the Government on stewardship in its report "Investing with Purpose". These included the following two recommendations for the DWP:

- UK pension schemes should be required to explain how their stewardship policies and activities are in scheme members' best interests. TPR should issue related guidance on how trustees might evidence that their stewardship policies and activities are in members' best interests
- A dedicated council of UK pension schemes should be established to promote and facilitate high standards of stewardship of pension assets. Members of the council should either be signatories of the UK Stewardship Code or have publicly committed to signing the Code within two years of joining the council.

The Government is closely considering both of the above and investigating the feasibility of a stewardship council for occupational pension schemes.

Next steps

The call for evidence closes on 16 June 2021. For further information on ESG please see our 2021 guide.

If you have any questions on any of the above, **please speak to your usual Sackers contact**.

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