Sackers

FIFTY YEARS OF PARTNERSHIP 50

A practical approach to ESG

A guide for pension trustees

A practical approach to ESG

October 2016

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Abbreviations

ADR: Alternative dispute resolution
AMNT: Association of Member Nominated Trustees
DB: Defined benefit
DC: Defined contribution
ESG: Environmental, social and corporate governance
FRC: Financial Reporting Council
ICGN: International Corporate Governance Network
LDI: Liability driven investment
NAPF: National Association of Pension Funds
OTC: Over the counter
PLSA: Pensions and Lifetime Savings Association
SIP: Statement of Investment Principles
TPR: The Pensions Regulator

Environment

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Introduction

"Welcome to our guide to ESG. Environmental, social and corporate governance issues are increasingly in the news with high-profile companies facing public scrutiny, corporate action or litigation. Pension schemes are an important part of the investment chain but, despite the increased commentary, the scope of the trustee obligations is not always clearly understood. It may not be easy for trustees to see whether and how they can take ESG factors into account.

This guide aims to help trustees to take a step back and think through the issues and how they relate to the law affecting pension schemes, and the practicalities of running a pension scheme's assets in the context of both DB and DC schemes."

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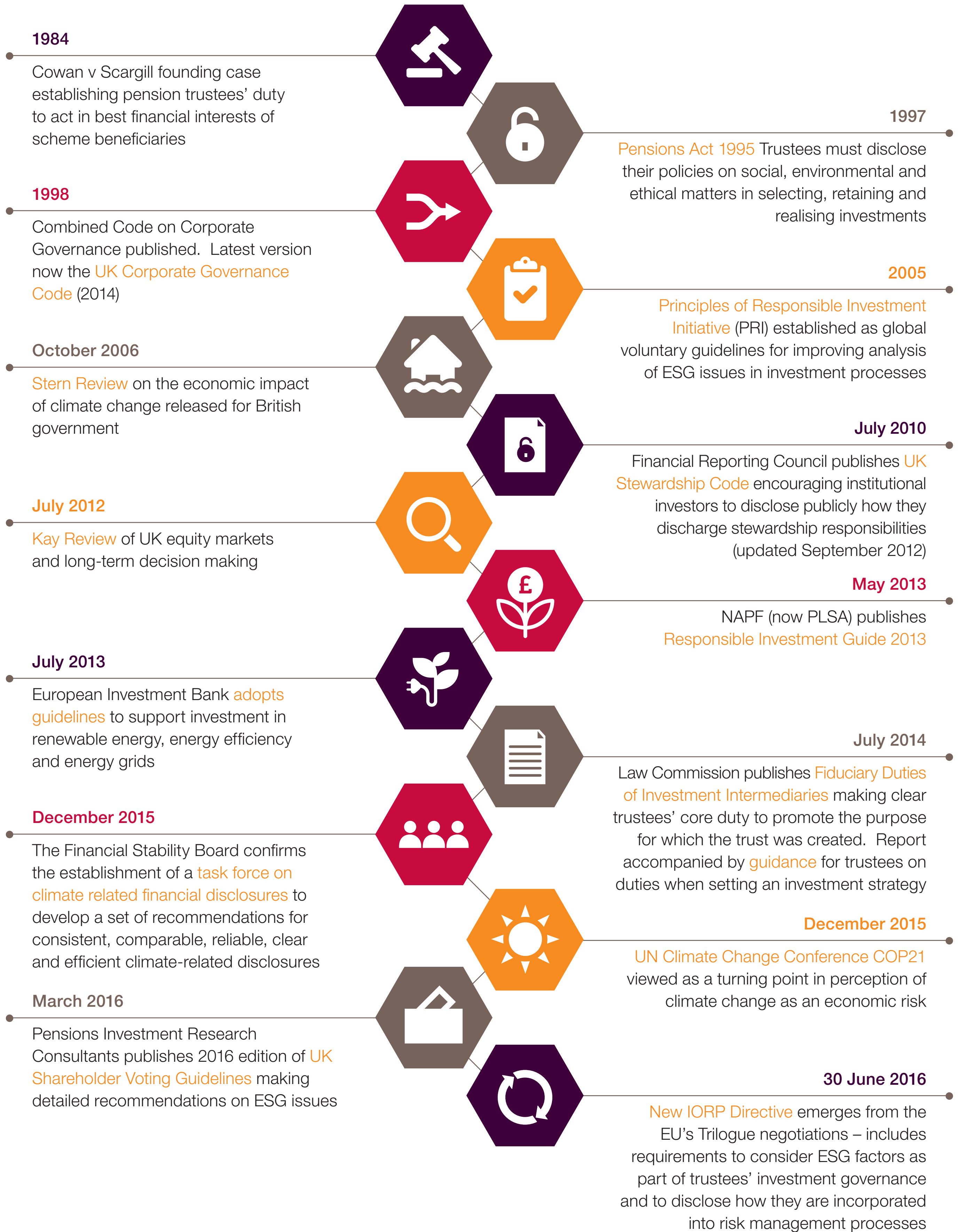
Development of ESG – timeline



Trustees' legal duties – an overview

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The primary purpose of the investment power given to pension trustees is to secure the best realistic return over the long-term, given the need to control for risks.

para 5.56 of the Law Commission report

ESG is becoming more prominent on trustee agendas but trustees need to be clear on the extent to which ESG factors can be taken into account as part of their investment decision making process. Trustee legal duties in this area can frequently be a source of confusion.

Part of the confusion for trustees may stem from the terminology. Trustees can take their pick from any number of expressions including, "ESG", "responsible investing", "socially responsible investing", "sustainable", "socially conscious", "green", or "ethical" investing. Each of these is subtly different. In this guide we refer predominantly to ESG but, as explained below, trustees should analyse any factor in their investment decision making by applying a common set of principles.

Legal clarification

In July 2014, the Law Commission published its report on the Fiduciary Duties of Investment Intermediaries. Among other things their report made clear that, in a pension scheme context, a trustee's core duty is to promote the purpose for which the trust was created – namely, to provide pensions and to act in the best "financial interests" of the scheme's beneficiaries.

As the Law Commission were at pains to point out, trustees are required to balance returns against risk. In other words, the best financial interests of the scheme's beneficiaries are not to be equated with simply "maximising returns". Risks matter just as much as returns. Trustees should first consider what they are trying to achieve with a particular strategy or portfolio, and only then consider how the financial interests of the scheme's beneficiaries are best served. The approach for the growth component of a pension scheme's investment portfolio is likely to be different to an LDI one and the options in an index tracking pooled fund will be different to those available in respect of an active equities manager appointed on a segregated mandate. (We consider this further in "In practice – building ESG into your portfolio" on page 7).

Determining what factors can or should be taken into account

Once trustees have determined their objectives, investment decisions taken need to distinguish between those factors that are financially relevant to the decision and those which are not.

In its guide for pension trustees, which accompanied the Law Commission Report, the Law Commission draws a clear distinction between "Financial Factors" (which trustees should take into account in their investment decision making) and "Non-Financial Factors" (which they should generally ignore, other than in limited circumstances).

- **Financial Factors** – these are any elements which are relevant to trustees' primary investment duty of balancing returns against risks. A wide range of factors may impact the long-term sustainability of an investee company's performance, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. These can all properly be considered by trustees to the extent that they believe they are relevant to the investment as a financial proposition.

  Where trustees consider that such factors are material, they should always take them into account. But the law does not prescribe a particular approach. It is for trustees, acting on proper advice, to evaluate which risks are financially material and how to take them into account.

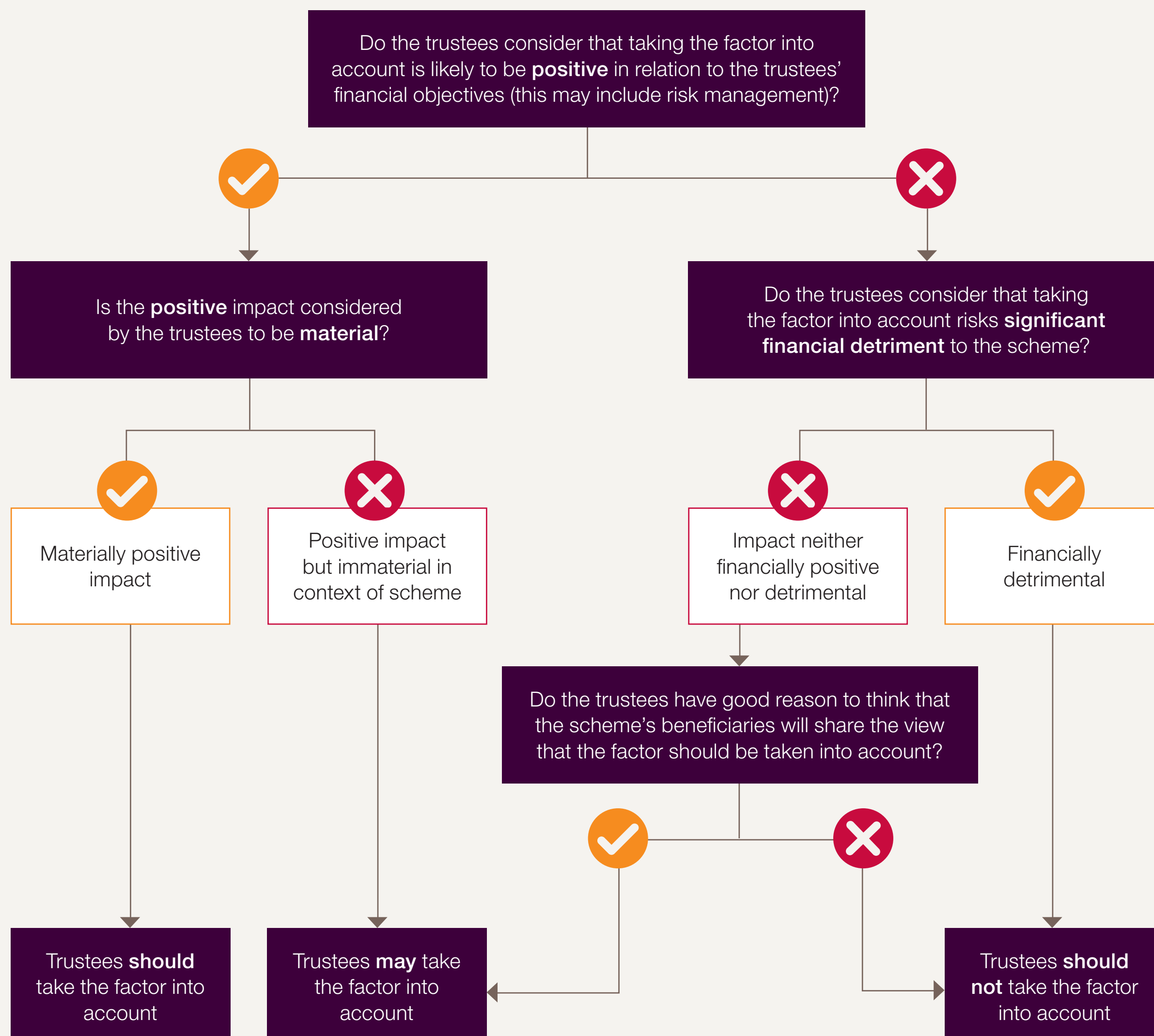
Trustees' legal duties – an overview cont.

- **Non-Financial Factors** – these are issues motivated by concerns other than the trustees' primary investment duty (eg improving members' quality of life or showing disapproval of certain industries).

  Generally speaking, non-financial factors unrelated to risks, returns, or the interests of beneficiaries, should be ignored by trustees in their investment decision making. Trustees must not impose their own moral or ethical views on their beneficiaries. However, the law does offer some flexibility. The Law Commission summarised that trustees may take Non-Financial Factors into account where two tests are met:

  – the trustees must have good reason to think members will share the moral viewpoint, and
  – the decision must not risk significant financial detriment to the pension scheme.

Trustees may find it useful to start with the following thought process when considering the extent to which any given factor may be taken into account as part of their investment decision making:



Evolution of the duty of care – a climate change case

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Recent US litigation shows that ESG issues can be at the heart of pension scheme litigation.

Peabody Energy Corporation and Arch Coal, Inc. are listed US companies with a heavy reliance on coal mining. When the US legislature passed the Clean Power Plan (requiring a reduction of carbon emissions by 32%) both companies' shareholdings were adversely affected. This prompted employees to file actions against the trustees of the companies' retirement plans. The trustees, they complained, had continued to hold stock in coal companies at a time when it should have been clear that climate change was going to have a systemic effect on the value of that stock.

There are features of the Peabody and Arch Coal cases which would not arise in the UK. For one thing, both involved investment in stocks of the schemes' employer companies, which is tightly controlled in the UK. However, the core of the complaint does bear thinking about in a UK context. For whatever reason, the trustees in these cases may have failed to identify or failed to act on a long-term trend driven by an environmental factor. While we think the chances of a successful law suit of this sort in the UK are less likely than in the US, it is also true that there are interest groups who might be very interested in such an action.

A legal challenge could involve close scrutiny of how trustees' beliefs in ESG issues influenced their appointment of, and engagement with, managers. Courts are reluctant to substitute their own decisions for that of the trustees, but they will look at the process and rationality of a decision.

Trustees are not expected to be experts on current climate change science, any more than they are expected to be investment professionals. There is an ongoing and evolving debate around climate change including its causes and effects and there is, in our view, no duty on a trustee to master all aspects of this debate.

However, from an investment perspective, trustees do not need to have a settled view on the underlying scientific arguments to consider the financial risks posed. Whatever your views of the science behind it, climate change regulation is fact. The United Nations Framework Convention on Climate Change's Paris Agreement (with over 180 member states' signatures) will, if ratified, commit to hold the increase in global average temperature to below 2˚C of pre-industrial levels. The impact of a commitment to the Paris Agreement and associated trends could potentially impact the value of some investments. Trustees should consider the extent to which this may have a financial impact on their portfolios.

Timing is also important here. What is obvious in 2016 may not have been obvious in 2006 or 1996. The trustees' discharge of their duty of care would be judged by the standard of the reasonable person occupying the role at the time the decision was made. Trustees therefore cannot afford to be complacent about the advice they are taking and should make sure it is up to date and appropriately forward looking given the nature of the scheme's liabilities.

We don't need an army of actuaries to tell us that the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix.

Mark Carney

No challenge poses a greater threat to our children, our planet, and future generations than climate change.

President Barack Obama

In practice – building ESG into your portfolio

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Journalists and activists have sometimes oversimplified the way pension scheme trustees invest. This can impact people's understanding of trustees' engagement with responsible investing. Trustees are sometimes presented as though they are responsible for individual stock selection, which is highly inaccurate. In fact, a trustee involved in day-to-day dealing might well be committing a criminal offence. The reality is more prosaic. It is essential to look at the practicalities of implementing an ESG approach by reference to the legal rights and obligations associated with the assets pension schemes hold.

SIPs and policies: define your beliefs

Pension scheme trustees are required to maintain a SIP which must cover the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. Trustees wishing to explore responsible investment should start by interrogating the beliefs which inform their SIP. They may well need input and training from their advisors to help with the process of formulating those beliefs from an ESG perspective.

This guide has largely focused on environmental issues, but responsible investing is broader. The NAPF (now the PLSA) Responsible Investment Guide 2013 identifies the following examples:

Material Governance Risks	Material Environmental Risks	Material Social Risks
Board independence	Climate change	Human rights
Succession planning	Energy use	Employment
Board diversity	Natural resources	Health and safety
Auditors	Water	Supply chain

What are your assets and how are they held?

Having established a set of ESG beliefs, the form of a scheme's engagement with these issues will be determined by how the scheme's assets are held and the relationship with the scheme's managers.

Pension scheme assets are typically made up of a mixture of equities, corporate and government bonds, and contractual interests (including derivatives), but these assets are often held through pooled funds. Smaller schemes, in particular, may only hold interests in pooled funds. This will feed into the implementation of the scheme's overall strategy. A multi-billion pound scheme with a large managed portfolio of equities held by a segregated manager will have different opportunities to those of a smaller scheme holding predominantly passively managed pooled funds.

In practice – building ESG into your portfolio

Segregated mandates

A portfolio of assets held in custody in the trustees' name but managed by an investment manager acting as the trustees' agent.

Your legal relationship with the manager will be set out in an investment management agreement which can be tailored in a number of ways to reflect the investor's investment priorities, including as to stock selection and the exercise of voting rights. ESG criteria can inform this relationship at all levels.

- Manager selection – are you appointing a manager whose beliefs are (or at least can accommodate) those of the trustee?
- Defining the mandates and setting benchmarks – a segregated mandate allows trustees to set tailored objectives and restrictions in accordance with their SIP. Perhaps equally important, the criteria for performance measurement (and rewards) can be considered in the context of those objectives. This may be the key battle ground in terms of prioritising a long-term risk adjusted investment approach and creating incentives to reflect this. What incentives does the agreement create for the manager and are they consistent with the priority the trustee wishes to give to ESG issues?
- Monitoring – having established and agreed a policy on responsible investing, the trustees' will want to be able to demonstrate and monitor how their managers are implementing that policy on their behalf.

Pooled mandates

Scheme investments taking the form of an interest in a collective investment scheme.

Unlike a segregated mandate, the trustees' do not hold a direct interest in the underlying assets held within the pool. The pooled fund might manage a portfolio of equities in listed companies or (in the private equity context) hold interests in unlisted companies. The pooled fund manager might be able to exert considerable influence over the companies it holds a stake in. However, the extent to which the pooled fund manager will take ESG issues into account will depend upon its own priorities. As a pooled fund manager is typically offering an investment product which must be on broadly the same terms for all investors, the opportunity to negotiate terms reflecting one investor's priorities may be limited.

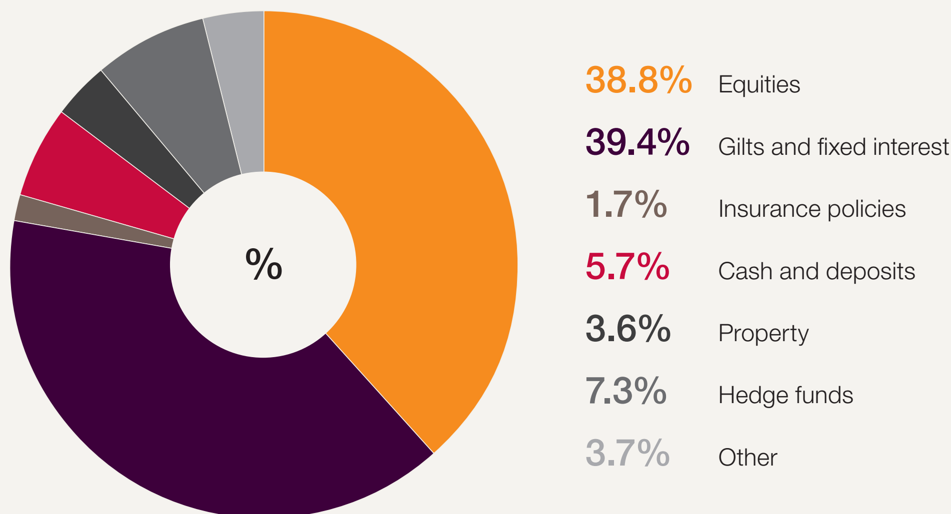
The trustees' primary tool here may be product selection. They must try to identify funds offering priorities consistent with their own. This may mean identifying managers who have appropriate fund selection and retention criteria, and who can demonstrate that appropriate responsible investment criteria are baked into their management practices. If relevant, it may mean stewardship priorities which can accommodate the trustees' voting intentions and engagement.

The nature of the pooled fund's strategy will be very important. For example, a passive fund is designed to manage against an index rather than to select stock based on the fundamental risks associated with the companies held. For a passive manager tracking the FTSE 100 this will preclude taking ESG considerations into account in stock selection. Pension schemes can overlay responsible investment criteria onto the allocation and selection process and thereby move away from a simple index tracker. However, that assumes that an appropriate fund is available or that the scheme is large or influential enough to encourage a manager to create a fund to suit its purposes.

There is a momentum issue here: the more schemes (and consultants) with an appetite for responsible investment, the more managers will be driven to create appropriate products and to adopt the related practices.

In practice – building ESG into your portfolio cont.

Allocation of assets between major classes based on simple average figures taken from TPRs Purple Book 2015



Strategies and ESG

Integrating relevant ESG considerations into the scheme's investment approach may involve some complicated interaction with the scheme's wider strategy. Trustees may well have room in their portfolio for long-term, "buy-and-hold" type mandates which dovetail well with ESG considerations. For example, a buy-and-hold manager might well feel that a poor past history in relation to the violation of local environmental rules is a relevant reason to divest from or disengage with a particular company from a risk perspective.

However, simply achieving long-term risk adjusted returns may only be part of the objective for pension schemes. One instance might be holding liability matching (rather than return seeking) assets as a key strategy for a maturing DB pensions market. This may involve an increased emphasis on long dated gilts or buying-out the pensioner population. More complicated strategies will involve extensive use of derivative instruments to hedge interest rates, inflation or even longevity risk. None of these asset classes are associated with rights which are obviously impactful from an ESG perspective. Equally, it is not necessarily true that all return seeking managers are looking at a long-term horizon. Within a given portfolio, such a manager might well be an attractive part of the portfolio.

Next steps

Implementing ESG strategies requires a careful analysis of the legal rights associated with the assets a pension scheme holds. There may also need to be negotiation and careful documentation of any ESG responsibilities or obligations agreed with the scheme manager. These are legal questions, so please contact us if you would like to discuss.

Focus on ESG for DC schemes

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For DB schemes the job of the trustees is to invest the scheme's assets appropriately to pay the scheme's promised benefits. However, in a DC scheme, the objectives are more subtle and may best be thought of as having two key components:

- to establish a default fund appropriate to the needs of the membership, keeping this under review and updating it as necessary, and
- to ensure an appropriate choice of investment arrangements for those members who do not wish to invest in the default arrangement.

The pitfall

A common trap to fall into in a DC scheme is to focus on ESG as part of the second component but to largely ignore it as part of the first. A not infrequent refrain from a trustee in response to an ESG challenge might be *"but we have an ethical fund among the fund choices for people worried about that sort of thing"*. But to look at ESG in this way is to make two fundamental mistakes. First, it mixes up the non-financial factor of ethical investment with ESG as a financial factor. As we cover in "Trustees' legal duties – an overview" on page 4, the two are not the same. Second, it ignores the fact that the vast majority of members are likely to be invested in the default fund and that the trustee duty is to act in those members' best financial interests.

How to approach ESG in the default fund

Trustees may wish to think about ESG in the context of their default fund in a similar way to how they might approach it if they were considering a DB investment strategy.

Members will judge the success of the trustees' investment policy for the default fund by the size of the pension they receive on retirement. However, this will usually be a longer term assessment. In its DC Code of Practice TPR expects trustees to "take account of risks affecting the long-term financial sustainability of the investments".

DC default funds will almost certainly be held in a pooled fund or a combination of pooled funds, and may be accessed through an insurer platform structure. In practice, therefore, ESG is likely to be a case of:

- selecting a fund (or component funds) for the default strategy, the objectives of which take account of the ESG factors which the trustees have identified as financially significant, and
- monitoring those funds against the trustees' ESG policies.

As with DB benefits, ESG doesn't just stop at portfolio design. Trustees may also wish to consider how stewardship will be approached in the default fund and whether the stewardship policies, practices and reporting of the selected pooled fund managers are appropriate (see "Stewardship – legal obligations and in practice" on page 12).

Focus on ESG for DC schemes cont.

You should bear in mind that most investments in DC schemes are long term and are therefore exposed to the longer-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, unsound corporate governance etc. These risks could be financially significant, both over the short and longer term.

TPR guidance on its Investment governance to supplement the DC Code of Practice

How to approach ESG in selecting a fund range from which members can select

Although the trustees' legal duty is to act in members' best financial interests when investing on their behalf in the default fund, when members make their own investment choices they are not quite so constrained. As the Law Commission noted in its report, members may legitimately decide to sacrifice some income in old age for ethical concerns. Provided that decision is fully informed, trustees cannot be criticised.

It is therefore perfectly appropriate for trustees to include funds for members to select which specifically take non-financial factors into account, even at the risk of financial detriment to the member.

The next question for trustees is whether such funds must always be offered. On this, trustees need to understand the needs and wishes of their membership. Where trustees are faced with members' clearly articulated views they should attempt to provide a suitable choice of fund. This does not mean that the whim of every member must be catered for, but it would be good practice to offer an ethical fund where a demand is expressed for it.

Stewardship – legal obligations and in practice

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What is stewardship?

The ownership of an investment will usually confer on the owner certain rights that can be exercised in connection with that asset. In the context of shares held as part of a pension scheme's assets, trustees will have the right to vote on any matters requiring shareholder approval such as board membership.

Stewardship is not confined to voting shares. It can include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration.

Do trustees have a legal duty to be good stewards of the assets they own?

No – whilst the Law Commission recognised the importance of stewardship, its view was that there is no legal duty on pension scheme trustees or other investors to undertake stewardship activities (other than in the unlikely situation where the trustees' shareholding confers a substantial measure of control over a company).

Why might trustees want to engage in stewardship?

At an investor level, the basic aim of stewardship is to preserve and enhance long-term shareholder value and financial returns for a pension scheme's beneficiaries.

The Kay Review of UK Equity Markets and Long-Term Decision Making famously drew the distinction between the two courses of action available to investors: "voice" – attempting to improve outcomes within the context of the market relationship; and "exit" – withdrawal from the market relationship.

The theory is that better engagement between organisations and shareholders ("voice") should help improve governance and long-term returns. Arguably, this may be a better means of implementing responsible investment practices than simply terminating an investment ("exit"). For trustees holding shares through passive index tracking mandates, this may be the most realistic means of putting ESG principles into practice.

What options are open to trustees to engage in stewardship activities?

Very large schemes may be able to undertake stewardship activities themselves but for most schemes stewardship responsibilities will, in practice, be delegated to investment managers. Before considering how they might undertake stewardship activities, trustees will therefore need to consider how their investments are held (see "In practice – building ESG into your portfolio" on page 7).

Medium or smaller pension schemes will usually invest through pooled funds. Engaging with the underlying companies therefore becomes a task for the pooled fund managers. Trustees will need to consider the terms of their investment in the pooled fund to ascertain the extent to which they can direct the pooled fund manager to undertake stewardship activities on their behalf. This may be limited. Alternatively, trustees may be content to take a more hands-off approach and may consider it sufficient to simply monitor the stewardship activities of the pooled fund manager.

Where trustees operate their investments through a segregated mandate with an investment manager (and, as such, hold shares or bonds in investee companies directly) they are likely to have more control over the stewardship activities of their appointed manager. However, again, it will be important to check the terms of appointment of the manager.

Stewardship – legal obligations and in practice cont.

Stewardship in practice

As noted above, the extent to which trustees are able in practice to direct (or simply monitor) the stewardship activities of their appointed investment managers will depend on the manner in which the investment is made (pooled or segregated) and the contractual terms of the manager's appointment. However, some of the options trustees may wish to consider are:

1

Pooling stewardship activities with other pension funds

A number of forums and collective engagement groups exist for schemes to work with other major institutional shareholders and bondholders ahead of company engagement and voting decisions. Networks such as the Institutional Investors Group on Climate Change provide investors with a collaborative platform to address particular ESG issues.

2

Subscribe to a ready-made set of voting instructions

A number or initiatives have recently been launched to enable greater direction from smaller institutional investors in ESG matters. One such example is the Red Line Voting initiative recently launched by the AMNT which trustees can instruct their investment managers to follow.

3

Outsourcing stewardship activities to engagement and/or voting overlay service providers

Various dedicated third-party solutions exist to provide analysis and voting recommendations and to assist trustees in voting their shares.

4

Monitoring investment manager compliance against existing codes of practice

The UK Stewardship Code and the ICGN Global Stewardship Principles may be seen as benchmarks against which investment managers can be expected to perform and report.

The UK Stewardship Code

The UK Stewardship Code was first published by the FRC in July 2010 and was most recently updated in September 2012.

The Code sets out a number of areas of good practice to which the FRC believes institutional investors should aspire.

ICGN Global Stewardship Principles

The ICGN Stewardship Principles were published by ICGN in 2016.

The Principles offer a basic framework of key stewardship responsibilities with a view towards application in either developed or developing countries.

Dealing with member concerns and complaints – Q&A

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I wish to complain about the default fund in which my DC benefits are invested.

I have recently become aware that 10% of the default fund is invested in funds which have links to companies named as having a poor human rights record. I consider it to be entirely inappropriate for my pension pot to be linked to such organisations.

Not only is it morally wrong for the trustees to be providing support to such organisations but I have real concerns that the profitability of these organisations will suffer in the future as a result of these human rights failings. This is likely to lead to a significant fall in the value of my pension in the long-term.

I also have concerns that a further 7.5% of the fund is invested in a company that has strong links with the animal slaughter industry. As a vegetarian, I consider it totally unethical for pension scheme funds to be used to support and enhance an industry that causes suffering and death to innocent animals.

I demand that the trustees amend the investments to the default fund to remove the funds as I consider they have breached their duties in investing my pension benefits in this way.

Can the trustee ignore this complaint?

Definitely not, legislation requires the trustees to answer any complaints from members which relate to the scheme of which they are a member. This is very wide and this complaint would fall within scope.

To what extent are ethical considerations relevant to investments?

In most circumstances, trustees will want to avoid considering investments in purely ethical terms. It is lawful and simpler to focus on the financial materiality of a particular consideration (and it's important here to stress that risk management can be a relevant financial factor – this is not only about returns). Human rights abuses or issues associated with the treatment of animals might well be material financially, but they are relevant because of their financial/risk impact, not because of an ethical judgement.

Ethics (without a financial dimension) can sometimes be taken into account. Some schemes might have a workforce with a commonly held ethical view on particular issues. It might be possible to take this into account with due process provided doing so will not have an adverse financial effect.

What should the trustees be able to point to when justifying the investments?

In practice, trustees act through managers who are responsible for implementing the trustees' strategies and who are appointed in accordance with the trustees' SIP. Trustees therefore need to be comfortable that their SIP is up to date and reflects their ESG beliefs. They may then need to check that their managers are playing their part.

The trustees are certainly not required to cause their managers to avoid all investments which may have negative ESG factors if the managers feel that the assets are still appropriate for the strategy the manager is pursuing.

Should the trustees be changing the structure of the default fund in light of this complaint?

Not necessarily, the views of a single member should not cause the strategy to be automatically altered. It should, however, prompt the trustees to consider whether proper consideration is given to ESG issues as part of investment decision-making. If the member has raised valid concerns and no consideration has been given to the ESG angle, the trustees may need to revisit the investment choices. Such a review may or may not lead to a change but it is important to demonstrate a robust process that gives due consideration to all relevant factors.

Action plan and further reading

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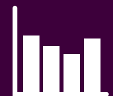
ESG issues in investing have gained a considerably higher profile in recent years and interest continues to grow. These issues cannot be ignored by trustees.

We recommend that trustees have a clear policy on ESG issues and are able to respond fully to questions or challenges from members of their pension scheme. To this end, trustees may wish to take the following steps.

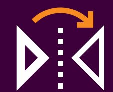
Allocate time within a trustee or investment sub-committee meeting to consider the trustees' overall approach to ESG. Trustees may wish to adopt an ESG policy which should be reviewed and updated periodically.

Consider the scheme's overall investment strategy and how investments are held within each component part of that strategy. Trustees should consider how their policies can realistically be incorporated into each portfolio, based on their overall policy and governance budget.



Consider the extent to which it is appropriate to delegate ESG issues (including stewardship) to investment managers (including within pooled funds). Where ESG issues are delegated, copies of the managers' policies should be requested and reviewed to ensure that they meet the trustees' needs. In the context of segregated mandates, consider whether to request any change to the investment objectives, restrictions and reporting requirements to reflect the trustees' ESG policy.

Ensure that the relevant sections of the pension scheme's SIP reflect the trustees' ESG policies.



Review DC investment options. Consider whether the default fund appropriately reflects the trustees' ESG policy and whether a suitable range of funds is available, taking account of the needs and wishes of members.

Further Reading

Law Commission Guidance on Fiduciary Duties: "Is it always about the money?" – 1 July 2014

PLSA: Environmental, Social and Corporate Governance (ESG) Made Simple – 17 May 2016

The Pensions Regulator's Code No 13: Governance and administration of occupational trust-based schemes providing money purchase benefits and draft DC investment guide

Mercer: Investing in a time of climate change – Environment Agency Pension Fund September 2016

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over fifty lawyers focus on pensions and its related areas, including Sackers' finance and investment group, a team of lawyers who provide cutting edge advice to trustees, employers and providers on all aspects of pension scheme finance and investment. For further information and advice on ESG considerations for UK pension schemes, contact any of the contributors to this guide using the details below, or your usual Sackers' contact.

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