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PENSIONS AND ESG: THE EVOLVING LEGAL AND REGULATORY LANDSCAPE

A PRACTICAL GUIDE

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Contents

	page
Foreword	02
1. Introduction	03
2. What is ESG?	05
3. Are ESG considerations financial or non-financial factors?	08
4. What are trustees, pension providers and asset managers required to do?	09
5. How do trustees meet the new legal requirements?	11
6. Is ESG investing good for returns?	14
7. Common misconceptions	15
8. Conclusion	17
9. Useful resources	18

Foreword



Steve Webb
Director of Policy,
Royal London

"Scarcely a month seems to go by without a government body or regulator coming up with new proposals or rules around how savers' money is invested. The language used can be different, but in most cases those rules boil down to whether peoples' money is being invested in businesses that are well governed and that have a positive impact on the environment and on wider society.

In the past, such considerations were often viewed as optional extras, perhaps only relevant to investors who had a particular moral or ethical standpoint. But there is now growing recognition that ESG considerations can have a very real impact on the financial performance of investments and are an increasingly important part of effective risk management.

We hope through this paper to guide trustees, advisers and investors through the maze of language and regulations to better understand both what they must do, and also what they can do, to take account of these vitally important issues when investing money on behalf of others."



Samantha Brown
Head of Pensions,
Herbert Smith Freehills

"ESG is no longer an optional extra for trustees, pension providers and asset managers. New legal requirements mean that trustees have to develop and publish their policy on how they take account of material financial risks, including environmental, social and governance risks, in their investment decision making. The FCA is planning to introduce similar requirements for pension providers and new legal and regulatory requirements, that will apply directly to asset managers, are also in the pipeline.

It is essential that trustees and providers are able to demonstrate that they are taking ESG factors seriously and that they don't just treat this as a tick-box exercise. Where ESG risks may materially impact the financial performance of a fund, the question is 'how' not 'if' they should be taken into account.

There is a growing risk of legal challenge for schemes that fail to do this. Failure to act also runs the risk of causing reputational damage to the scheme and also the scheme's sponsoring employers."

1. Introduction

Environmental, social and governance (ESG) issues are becoming increasingly high profile with the spotlight on issues such as climate change, diversity, single use plastics, the rights of gig economy workers, the use of non-disclosure agreements and the negative social and economic impact of poor corporate culture.

The focus on ESG factors such as these in investment decision-making and the wider economy is also growing as these issues receive increasing attention from policymakers, regulators, financial institutions, consumers and pressure groups alike.

These issues are also moving up the agenda for trustee boards, pension providers, corporate advisers and asset managers as they respond to new legal and regulatory requirements, to pressure from savers and action groups and to changing social norms. Indeed, rather than the onus being on those who raise ESG concerns to justify their position, the challenge now for trustees, providers and asset managers is to be able to demonstrate that they are taking these risks seriously. ESG investing is not simply a way of avoiding risk, it is also about having a positive strategy which seeks to take advantage of changing social and economic trends and the commercial opportunities which they provide.

Growing demand from savers

There is growing evidence that savers in general, and younger savers in particular, want to know that their money is invested in a way that has a positive social and environmental impact. For example, research undertaken by YouGov (and cited in a report by the House of Commons Environmental Audit Committee published in May 2018¹) found that 57% of the UK public with a pension believe that '...investment managers have a responsibility to ensure holdings are managed in a way that is positive for society and the environment'.

On investment in fossil fuels specifically, 40% wanted to be offered fossil free investments 'as standard', but with a strong age gradient – 54% of under 35s supported this proposition compared with only 34% of over 55s. This suggests that as the current cohort of younger savers age, the pressure on trustees and pension providers from scheme members and savers to address ESG issues may well increase.

New legislative measures

Legislative measures to be introduced from 1 October 2019, will require pension scheme trustees to set out their policy on how they take account of financially material factors, including ESG considerations, in their investment decision making. Some trustees may be tempted to see this merely as a tick box exercise. However, trustees need to consider how they can demonstrate that they are taking ESG factors seriously, as the risks associated with paying lip service to them are increasing.

The Financial Conduct Authority (FCA) is also consulting on proposals which could see a new legal duty placed on independent governance committees (IGCs) to report on and monitor pension providers' policies on ESG issues, consumer concerns and stewardship, in relation to workplace personal pension plans and pension decumulation investment solutions.



'57% of the UK public with a pension believe that investment managers have a responsibility to ensure holdings are managed in a way that is positive for society and the environment'

1. 'Greening Finance: embedding sustainability in financial decision making', House of Commons Environmental Audit Committee, May 2018, HC 1063.

1. Introduction

UK and EU action

Alongside this, the UK Government has recently set out plans designed to ensure that the issue of climate change is taken seriously by companies, asset owners, asset managers and financial markets. In its Green Finance Strategy² the Government outlined its ambitions:

- for all listed companies and large asset owners to disclose in line with the Taskforce on Climate Related Financial Disclosures recommendations by 2022
- to clarify responsibilities for the Prudential Regulation Authority, the FCA and the Financial Policy Committee to have regard to the Paris Agreement when carrying out their duties
- to establish a joint taskforce with UK regulators, chaired by the UK Government, which will examine the most effective way to approach disclosure, including exploring the appropriateness of mandatory climate-related reporting, and
- to establish an industry working group on climate change which will produce guidance for pension schemes on climate-related practices across governance, risk management, scenario analysis and disclosure. The Pensions Regulator expects to consult on this guidance in late 2019 with a view to putting it on a statutory footing during 2020.

In May 2018, the European Commission also adopted a package of measures on sustainable finance. This included proposals aimed at:

- establishing a unified EU classification system ('taxonomy') of sustainable economic activities
- improving disclosure requirements on how institutional investors integrate ESG factors in their risk processes, and
- creating a new category of benchmarks which will help investors compare the carbon footprint of their investments.

In June this year, the European Parliament has adopted revised drafts of these proposals, the legislative texts of which will be finalised over the coming months. A key amendment made by the European Parliament is to include a requirement for financial market participants (including asset owners and asset managers) to take account of and disclose the impact of investment decisions on sustainability factors alongside the requirements to integrate ESG risks into investment decision-making and disclose how this is being done. This goes significantly beyond the scope of the original proposals and would bring ESG factors further into the financial mainstream.

Growing risk of legal challenge

The risk of legal challenge against trustees and pension providers in this context is also growing. In the UK, ClientEarth are supporting members who are requesting information about their scheme's approach to ESG matters and are threatening legal action if the response is deemed inadequate. A similar threat has materialised for the Retail Employees Superannuation Trust in Australia, where a member is taking the Trust to court for failing to disclose information on the potential impact of climate change on his investments and how the Trust is addressing this. The primary aim of these actions is to drive behavioural change.

Employers also run the risk of reputational damage if their pension scheme or chosen provider is not seen to be taking ESG issues seriously enough, particularly if the employer is taking a stand on these issues itself.

Confusion remains

Despite attempts to clarify the law in this area, confusion still remains about the extent to which trustees and providers are required to take account of ESG factors in their investment decision-making. Trustees owe a fiduciary duty to their scheme members and may feel that wider societal, environmental and ethical concerns are a matter for governments and not trustees, especially if they perceive that applying an ESG lens might reduce investment returns. Similarly, providers may feel that the focus should be on delivering the best financial returns for savers rather than being distracted by, what some may see as, extraneous issues.

In this guide we cut through the confusion and:

- set out the legal and regulatory requirements that apply to trustees, providers and asset managers
- consider how trustees, providers and those who advise them can meet these requirements in practice
- examine whether taking account of ESG considerations is likely to boost or dent investment returns, and
- address some of the common myths around ESG, pensions and investing.

2. Green Finance Strategy, HM Government - July 2019

2. What is ESG?

What's in a name?

A wide and growing range of terms are used in the context of ESG investment, including 'sustainable investing', 'responsible investing', 'impact investing' and so forth. The following chart provides a simple way of understanding the distinction between some of the main terms that are commonly used.



Understanding the risks

A common mistake in the debate about the extent to which trustees, providers and asset managers are required to take account of ESG considerations is the tendency to lump the various risks inherent in ESG factors together. Another is a failure to recognise the financial risks (and opportunities) inherent in ESG considerations and simply dismiss them as subjective, non-financial concerns.

Although ESG risks can be interdependent (for example, the failure by a company to address environmental concerns may raise wider social considerations), to address these risks effectively it is essential that the different components of E-S-G and the underlying risks are considered separately. This is the only way that those tasked with making investment decisions can ultimately determine the extent to which they need to take individual ESG factors into account, if at all.

Environmental

Environmental considerations cover a range of issues. The most obvious is climate change, but other key areas include the impact of a company on biodiversity, its record on pollution, its impact on water scarcity and so forth.

Climate risk is the most high profile environmental risk at present and the new legislative requirement that will shortly apply to pension scheme trustees identifies it as a specific risk that trustees must set out their policy on. But climate risk itself is made up of different components, including:

- physical risk – for example, the threat of business disruption posed by extreme weather conditions which might damage vital infrastructure and interrupt supply chains, and
- transition risk – for example, the threat to a business' long-term performance and viability if it fails to respond to the shift to green technology and a low-carbon economy.

Pension scheme trustees need to understand what their asset managers are doing to assess these risks and to monitor and influence what investee companies are doing to address them. They also need to consider the extent to which scheme assets may be exposed to other environmental risks, such as pollution, sustainability and waste generation.

Pension providers also need to consider environmental risks including climate change in their investment decision-making process and in the design of their default funds and wider investment offerings.

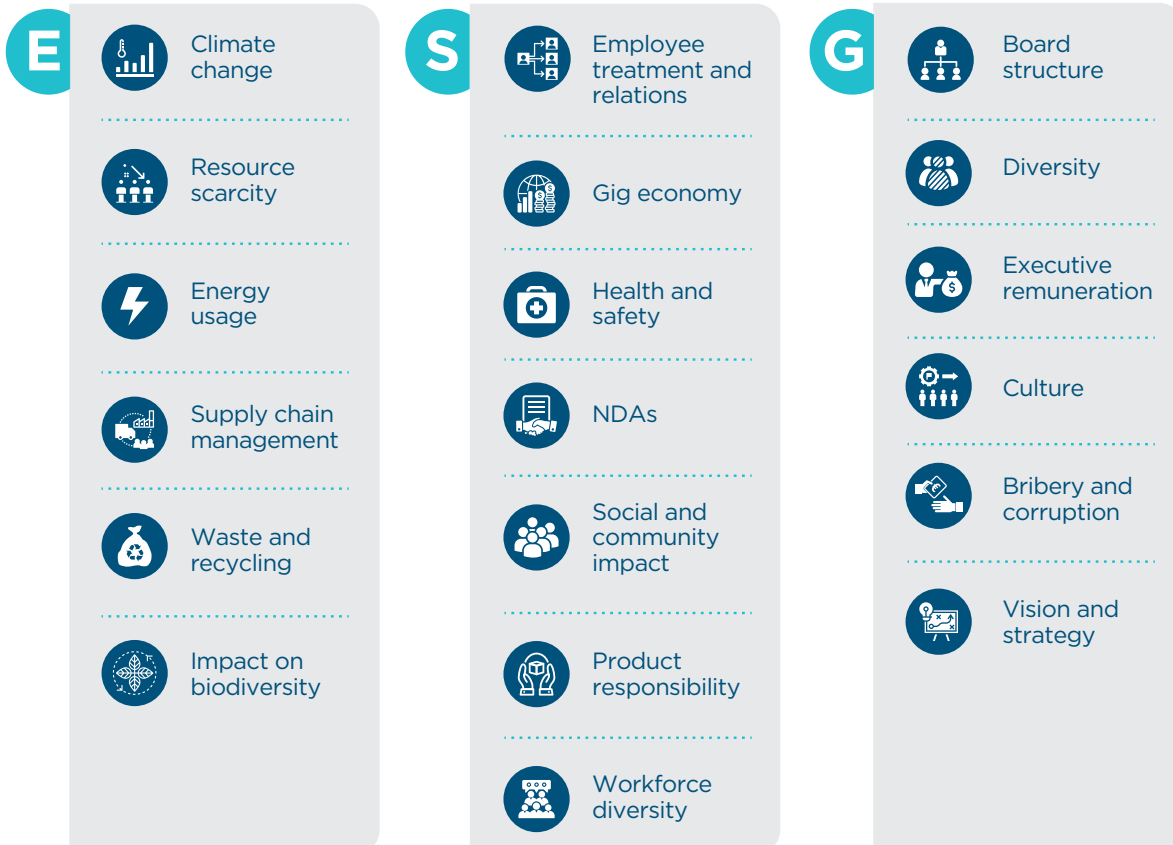
3. Source: Based on graphic produced by the UK Taskforce on Social Impact Investing

2. What is ESG?

Social

Trustees and pension providers should also consider the extent to which they will take account of the impact of companies and assets in which they invest on wider society. Although these factors can sometimes be more nebulous than environmental or governance considerations, they can still be highly significant. For example, for those investing in tech stocks, socially important issues such as data privacy and the impact of social media on society will be highly material, not least because of the potential financial impact of regulatory interventions to address social concerns or of users switching to alternative platforms. Other examples include changing social attitudes to things like single use plastic and the inappropriate use of non-disclosure agreements. Although these may also be environmental or governance issues, the impact on the performance of a business of its responsiveness or resistance to changing social attitudes needs to be considered.

Trustees and providers may also take wider ethical issues into account, for example, where they have good reason to believe that a particular approach reflects the views of members and where this would not be financially detrimental to the fund. But they do not have to and, in many cases, identifying a consensus may not be straightforward.



2. What is ESG?

Governance

Recent high profile corporate failures led to the introduction of a new UK Corporate Governance Code in 2018. A revised Stewardship Code is also in the pipeline.

The 2018 UK Corporate Governance Code recognises that the relationships between companies, shareholders and stakeholders and the ability for companies to build and maintain trust lie at the heart of the long-term sustainable growth for individual companies and the UK economy as a whole. As such the Code seeks to promote trust through good corporate governance which is reflected in (amongst other things):

- a corporate culture which aligns with a company's purpose, values and business strategy and which promotes openness, integrity, diversity and responsiveness to the interests of shareholders and other stakeholders
- proper and open engagement with and fair treatment of a company's workforce
- boardroom diversity, and
- fair and reasonable executive remuneration.

It is essential that trustees press their investment advisers and asset managers to understand how they are responding to these initiatives and what steps they are taking to engage with investee companies to promote high governance standards. Pension providers also need to consider how they (and third party asset managers they engage) take account of corporate governance related risks in the design of their investment funds and their investment decision making processes.



3. Are ESG considerations financial or non-financial factors?

Financial factors

Case law already requires trustees to take account of financial factors when making investment decisions⁴. The new legislative requirements that will apply to occupational pension schemes from 1 October 2019 will make this explicit and require trustees to set out their policy on how they take financially material factors into account in their investment decision-making. Pension providers also need to take account of factors that may impact the performance of their investment funds.

Many ESG considerations fall into the category of financial factors and, therefore, they cannot be ignored. Fundamentally, the ability of the financial system to deliver attractive risk-adjusted investment returns over the long-term depends on the sustainability of the underlying economic, social and environmental systems. A long-term approach to investment therefore implies investing in a way that supports the long-term sustainability of these systems.

Examples of the financial impact of ESG considerations

- The Bank of England has indicated that the reduction in capital allocation required within the fossil fuels sector to meet a 2° scenario is in the region of US\$15 trillion.
- The Chief Executive of Volkswagen has warned that German car manufacturers face an existential threat if they do not embrace the move to green technology.
- The demise of Carillion and BHS demonstrate how poor corporate governance can lead to the failure of household name companies.

In a recent [joint statement](#) on climate change⁵, the regulators of UK banks, financial services firms, asset managers, pension funds, accountants and auditors have left their regulated communities in no doubt about their view of how financially material climate change is, declaring that “Climate change is one of the defining issues of our time” and that “it presents far-reaching financial risks”. Charles Counsell, the new Chief Executive of the Pensions Regulator, stated that “Climate change is no longer simply a social responsibility issue. It is a core financial risk impacting broadly across business, the economy and markets”.

The materiality of ESG considerations to the long-term success of a business is also highlighted by the fact that directors of UK

companies are required by law⁶ to promote the success of their company having regard (amongst other matters) to:

- the likely consequences of any decision in the long term
- the interests of the company’s employees
- the need to foster the company’s business relationships with suppliers, customers and others
- the impact of the company’s operations on the community and the environment, and
- the desirability of the company maintaining a reputation for high standards of business conduct.

Non-financial factors

In contrast, some ESG considerations will be non-financial factors.

Non-financial factors are factors that are not motivated by ‘financial’ concerns of balancing risk and reward and that do not relate to the financial performance of a particular investment.

Trustees and pension providers are not required to take account of non-financial factors. However, following its review of the fiduciary duties of investment intermediaries in 2014, the Law Commission concluded⁷ that trustees may, if they choose, take account of non-financial factors (such as members’ moral or ethical concerns) in their investment decision making:

- if they have good reason to think that scheme members share a particular view, and
- their decision does not risk significant financial detriment to the fund.

Although not all lawyers agree with the Law Commission’s conclusion on the extent to which non-financial factors may be taken into account, the Pensions Regulator has endorsed this approach in its updated guidance on investment governance for trustees of DC schemes⁸. Therefore, some trustees may decide to take account of non-financial ESG factors where the tests set out by the Law Commission are met. However, it is currently rare for trustees to do this. In addition, asset managers can only take account of non-financial considerations where they are directed to do so by trustees.

Separately, the FCA has proposed that IGCs should play a role in reviewing the extent to which, if at all, pension providers take account of savers’ ethical and other concerns.

4. Cowan v Scargill [1985] Ch 270

5. [Joint statement on climate change - PRA, FCA, FRC & TPR](#)

6. Section 172 Companies Act 2006

7. [“Is it always about the money?” Pension trustees’ duties when setting an investment strategy: Guidance from the Law Commission - 1 July 2014](#)

8. [Investment Governance for DC pension schemes: guidance from the Pensions Regulator](#)

4. What are trustees, pension providers and asset managers required to do?

4.1 Trustees

By 1 October 2019, trustees of schemes with more than one hundred members are required to ensure that they update their Statement of Investment Principles (SIP) to set out their policies on:

- how they take account of financially material considerations, including climate change and other ESG factors, in the selection, retention and realisation of investments
- the extent (if at all) to which non-financial matters (such as members' moral and ethical views) are taken into account in the selection, retention and realisation of investments
- undertaking engagement activities including the methods by which, and the circumstances under which, they monitor and engage with investee companies regarding issues such as performance, strategy, risks, social and environmental impact and corporate governance, and
- exercising rights (including voting rights) that attach to their investments.

Before they can update their SIP trustees will need to seek advice from their investment advisers on these issues and consult with their scheme's sponsor on any changes to their scheme's SIP.

Trustees of money purchase schemes of all sizes must also update their default investment strategy to take account of financially material considerations and, where they are required to produce a SIP in relation to their default fund, they must update this to reflect any changes in their approach.

Trustees will be required to make their updated SIP publicly available on their scheme's website (from 1 October 2019 in the case of money purchase schemes and from 1 October 2020 for defined benefit schemes).

Arrangements with asset managers

As a result of changes to the Occupational Pension Schemes (Investment) Regulations 2005 to implement the revised Shareholder Rights Directive in the UK, trustees will also be required, by 1 October 2020, to set out in their SIP the following matters in relation to their arrangements with their asset managers (or explain why they are not set out):

- how the arrangement with the asset manager incentivises the asset manager to align its investment strategy and decisions with the trustees' investment policies including their policies on financially material ESG matters
- how the arrangement incentivises the asset manager to make decisions based on assessments about medium to long-term financial and non-financial performance of an issuer of debt or equity and to engage with issuers of debt or equity in order to improve their performance in the medium to long-term

- how the method (and time horizon) of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with the trustees' investment policies
- how the trustees monitor portfolio turnover costs incurred by the asset manager, and how they define and monitor targeted portfolio turnover or turnover range, and
- the duration of the arrangement with the asset manager.

Trustees must also set out the methods by which they monitor and engage with investee companies and other stakeholders in relation to their capital structure and the management of conflicts of interest.

Implementation statement

By 1 October 2020, trustees of money purchase schemes with more than one hundred members will be required to produce an implementation statement setting out:

- how they have acted on their policies in relation to financially material factors, non-financial factors (if they have one) and stewardship, and
- the trustees' voting behaviour during the past year, including the most significant votes cast by the trustees or on their behalf.

Trustees will be required to publish this online in the same way as their SIP and to inform scheme members of its availability via the annual benefit statement (although the information on trustees' voting behaviour does not need to be published online until 1 October 2021).

A tick-box exercise or an opportunity for trustees?

Although some trustees may be tempted to see this as a tick-box exercise or to put the onus on their asset managers to ensure compliance, it is important that trustees take this opportunity to:

- review their investment approach and consider the extent to which ESG factors, including climate change, may be financially material and how this should be reflected in their investment strategy
- discuss with their investment advisers and asset managers and test how they take account of and monitor financially material factors, including ESG factors, when implementing their investment strategy and making investment decisions
- consider their approach to engagement and the exercise of voting rights and discuss with their investment advisers and asset managers how they approach this
- consider the extent to which (if at all) they will take account of non-financial factors, such as broader ethical considerations or members' views, in their investment strategy, and
- review and, where necessary update, their mandates with investment advisers and asset managers to ensure that they

4. What are trustees, pension providers and asset managers required to do?

reflect the trustees' approach and provide levers to enable the trustees to monitor how effectively this is being implemented in practice.

Trustees who simply adopt a tick-box mentality and who fail to properly review their investment approach and their mandates with their asset managers may face criticism from the Pensions Regulator and also from members of their scheme. There is also a growing risk of legal challenge in this area, particularly for high profile schemes.

Trustees should also be alert to the reputational damage (and the knock on financial impact) that their sponsor could suffer if its pension scheme is seen as not taking ESG risks, including climate change, seriously.

4.2 Pension providers and IGCs

The FCA is consulting⁹ on proposals that would mean that providers of workplace personal pension schemes are subject to similar requirements to those that will apply to pension scheme trustees.

In particular, the FCA is proposing to require IGCs to report on their provider's:

- policies on financially material issues, including ESG issues and climate change
- policy on how much (if at all) the ethical and other concerns of savers are taken into account in investment strategies and investment decision making, and
- stewardship policy.

In reporting on their provider's policies on ESG issues, member concerns and stewardship, IGCs will be required to:

- consider the adequacy and quality of these policies, and should raise any concerns they may have with the provider, and
- report on how the provider has implemented its policies on these issues, to help make sure that providers follow their stated policies.

The FCA is proposing that the requirements for IGCs to report on their provider's policies on the above issues, and their implementation, should cover the provider's pensions decumulation solutions as well as its workplace personal pensions.

4.3 Asset managers

One of the challenges with ESG is being clear on whose responsibility it is. This can quickly descend into a somewhat circular discussion, as the first question many trustees ask is "what are our asset managers doing?", the asset managers in turn ask "what is it that trustees want?".

Whilst the approach of asset managers will to a large extent be driven by demand from asset owners, steps are being taken to ensure that asset managers are also subject to direct legal and regulatory obligations which will require them to take ESG risks into account in their investment decision making, due diligence and risk management processes, their organisational requirements and their remuneration policies. In addition, legislative proposals adopted by the European Parliament earlier this year also suggest that asset managers and asset owners will be required to disclose the impact of their investment decisions on sustainability factors.

The European Securities and Markets Authority (ESMA) has provided technical advice¹⁰ on how sustainability risks and factors¹¹ may be integrated by portfolio managers and investment advisers into the services they provide to their clients. ESMA recommended that they should be required to reflect sustainability risks and factors within their organisational structures, resourcing and remuneration policies and also ensure that senior management is responsible for compliance with these requirements. Further, asset managers will be required to make disclosures on their websites on the manner in which sustainability risks and factors are integrated into their investment decision-making and in the provision of investment advice.

The first question many trustees ask is "what are our asset managers doing?", the asset managers in turn ask "what is it that trustees want?"

9. [Independent Governance Committees: extension of remit, FCA consultation paper - April 2019](#)

10. ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II - April 2019

11. These include financial risks stemming from climate change, resource depletion, environmental degradation and social issues.

5. How do trustees meet the new legal requirements?

There are several steps that trustees need to take in order to comply with their legal requirements and demonstrate that they are taking ESG considerations seriously. These include:



Understanding ESG

Trustees are required by law to be familiar with the law relating to pensions and trusts and the principles of scheme funding and investment. Therefore, trustees need to be familiar with:

- their core investment duties, including the extent to which they are required to take account of ESG risks
- the new legal requirements regarding their policies on ESG risks and stewardship, the design of DC default funds and the content of their scheme's statement of investment principles
- the different risks covered by ESG considerations
- the financial risks and opportunities related to these, and
- the extent to which they can take account of non-financial factors.

It is critical that trustees understand the nature of ESG risks and their legal obligations and that they are in a position to meaningfully challenge their investment advisers and asset managers in this regard. Trustees who do not feel equipped to do this should undertake appropriate training.

Developing an ESG policy

Once trustees have a solid understanding of ESG risks and their legal obligations, they can begin to identify the risks that are financially material and formulate their policy on how they will take these into account in their scheme's investment strategy.

There is no one size fits all approach to this. The approach will inevitably differ between defined benefit and defined contribution schemes. It will also need to take account of scheme specific factors such as:

- the trustees' investment beliefs
- the maturity of the scheme and the duration of the liabilities
- the nature of the scheme's investments (e.g. passive or active, type of assets, whether sums are invested directly or via pooled funds etc), and
- whether the ESG risks in question are material in the context of a particular investment.

5. How do trustees meet the new legal requirements?

Trustees should work with their investment advisers to identify and agree their ESG related investment beliefs. These should not be confused with the trustees' own personal (eg moral or ethical) beliefs, which are not relevant where they are acting in their capacity as a trustee.

Example ESG related investment beliefs

- ESG factors may materially impact long-term investment returns and must be taken into account.
- ESG issues may not be relevant to every asset class or mandate but where they are, evaluating ESG portfolio risks is a prudent part of a long-term investor's investment process and is aligned with trustees' fiduciary duties.
- ESG issues can create attractive investment opportunities across asset classes and investment styles.
- A proactive approach to evaluating ESG risks and opportunities is more likely to result in long term benefits for the scheme.
- Investing responsibly, taking account of ESG factors and engaging as long-term owners reduces risk over time and can positively impact investment returns.
- The ability of the financial system to deliver attractive risk-adjusted investment returns over the long-term depends on the sustainability of the underlying economic, social and environmental systems. Therefore, we should invest in a way that supports the long-term sustainability of these systems.

For defined benefit schemes, where trustees are responsible for setting their scheme's overall investment strategy, trustees need to consider:

- how they will take account of ESG risks in setting their strategy
- how the asset managers that they appoint take account of ESG risks when deciding on the selection, retention and realisation of particular assets, and
- how they and/or their asset managers undertake engagement activities and exercise their voting rights.

For defined contribution schemes, a significant focus will need to be on the extent to which ESG considerations are reflected in the scheme's default fund, given that somewhere in the region of

between 80% and 100% of members are likely to be invested in this. Trustees of DC schemes will also need to consider:

- whether to offer a separate ESG investment fund
- how ESG considerations should be reflected in the design of the other funds that they make available to members
- how the asset managers run their scheme's various funds take account of ESG considerations when deciding on the selection, retention and realisation of assets
- how they (or, more commonly, their asset managers) undertake engagement activities and exercise their voting rights, and
- how they communicate with members on the ESG aspects of the different investment funds to help members make informed investment decisions.

Trustees should also consider the attitudes and values of their scheme's sponsor regarding ESG matters and have regard to the reputational damage that could be caused if the scheme is out of step with the sponsor on material ESG issues or not seen to be taking ESG matters seriously enough. In the context of a defined benefit scheme, this is particularly important, where negative publicity in this regard could be detrimental to the sponsor's business and the strength of its financial covenant in respect of the scheme.

Implementing ESG

Once trustees have identified their ESG related investment beliefs and developed their policies, they will need to determine how these will be implemented in practice. There are a number of elements to this, including:

- understanding how their existing asset managers assess ESG risks, how these affect their investment decisions and how they will report on this to the trustees
- understanding their existing asset managers' approaches to stewardship and engagement and, where relevant, the exercise of voting rights
- where necessary, selecting new asset managers whose approach to ESG related risks and stewardship is better aligned with the trustees' own investment beliefs and policies, and
- setting specific parameters and objectives in their mandates with their asset managers which reflect the trustees' approach to ESG matters.

5. How do trustees meet the new legal requirements?

The ways in which ESG issues can be incorporated into investment decisions and how this is implemented will vary by asset class. The approach of different asset managers will also vary. For example:

- **negative or positive screening** - some managers may adopt a “negative screening” approach where they exclude assets related to certain sectors, companies, activities or practices based on specific ESG criteria; whereas others may adopt a “positive screening” approach where they only invest in companies that comply with certain international standards and norms (such as the UN Global Compact or OECD Guidelines for Multinational Enterprises), so-called “norms-based screening”, or they may only invest in companies or assets that are best in class in terms of sustainability performance, so-called “best-in-class screening”.
- **ESG integration** - some managers may take account of financially material ESG risks within the investment decision making process. The specific details of how this is done will vary by manager and fund type.
- **thematic investment** - some managers may make investment decisions based on certain macro ESG themes, such as investing in clean technology or in companies or assets that are considered to be positive for the environment.
- **impact investment** - some managers may make investment decisions with the primary goal of achieving specific and measurable positive environmental and social benefits while also delivering financial returns.

How do investors avoid ‘greenwashing’?

Trustees will need to be sure that ESG claims made by those managing assets on their behalf are substantiated and are not simply a green ‘gloss’ on an investment approach largely unaffected by ESG considerations.

Trustees should consider the history and track record of fund managers and funds on ESG. If ESG is a relatively new consideration for a particular fund manager, trustees will need to ask probing questions and seek evidence of specific examples where ESG issues have influenced the manager’s investment decisions. Where fund managers rely heavily on third party ESG data systems, trustees should understand how those systems are used and what level of oversight is applied. Whilst ESG factors will not always be material to every investment decision, fund managers should be able to explain how and where they think they are material.

To the extent that ESG factors are financially material, asset managers (and trustees) should already have been taking these into account in their investment decision-making. Therefore, it is questionable whether the label ‘green’ or ‘sustainable’ should even be attached to funds that do no more than include ESG risks in their financial risk management matrix.

Monitoring and shaping performance

As with all delegated investment functions, once trustees have selected specific asset managers and/or portfolios which reflect their ESG investment beliefs and policies, it is essential that they monitor the performance of those asset managers and/or portfolios to ensure that they operate in line with the stated approach and with any specific objectives that have been agreed.

This could be achieved through:

- regular meetings with the relevant assets managers, where this is proportionate, to assess their approach to ESG matters on an ongoing basis, and/or
- regular reporting by the asset managers on ESG matters and on stewardship and engagement activities that they have undertaken, and how these have impacted investment decisions and the performance of the relevant fund (positively or negatively).

Trustees (with the help of their advisers) also need to keep their ESG policies under review and stay on top of new and emerging ESG risks and, where relevant, consider how these should be reflected in their investment policies and the mandates with their asset managers.

How can trustees influence manager behaviour?

- **Ask the question** - asking the question of their asset managers about how they are thinking about ESG risks can send important signals internally. This is often best done in person as part of a dialogue.
- **Use surveys and questionnaires sparingly** - due to the volume of requests fund managers receive trustees may find they’ll receive boilerplate responses. This approach also runs the risks that fund managers spend more time filling in surveys than actually implementing their ESG strategies. If trustees need to send a survey, ensure there is lots of time for the fund managers to prepare a response and work with other asset owners to avoid duplication of effort.
- **Regular performance monitoring meetings** - monitoring is best done in regular meetings, which gives trustees the opportunity to test fund managers’ performance, knowledge and sophistication. It also gives trustees a better opportunity to detect ‘greenwashing’.
- **Treat data with caution** - fund level reporting on ESG performance is still in its infancy, so trustees should treat any data with caution and be mindful that when using third party systems there can be significant data gaps (particularly in asset classes like fixed income).

6. Is ESG investing good for returns?

In 2018 Royal London Group, commissioned external research on the impact of ESG performance on:

- corporate financial performance
- equity
- fixed income, and
- property

and tested a range of hypotheses about the interaction between ESG and outcomes for each asset class.

The research found sufficient evidence from academic and market studies to conclude, on balance, that:

- companies that demonstrate strong performance on ESG have better corporate financial performance generating higher stock returns than those with weaker ESG performance. The corporate bonds of those companies exhibit lower costs of debt and are less likely to be downgraded. Amongst ESG considerations, good governance appeared to be a particularly important determinant of good performance
- companies with strong performance on ESG demonstrate lower volatility in their stock returns. The corporate bonds of such companies have higher credit ratings
- strong ESG performance leads to higher company valuation and lower likelihood of adverse company specific incidents (such as bankruptcy or extremely high levels of drawdown) due to poor risk management processes, and
- returns from ESG integration have not (so far) declined as ESG is 'priced in' – the relationship between ESG integration and financial performance has been stable over time.

Some of the key pieces of research used to reach these conclusions included:

- Friede et al. (2015)¹² which aggregated the evidence from over 2,000 studies on the link between corporate financial performance (CFP) and ESG performance, published between 1970 and 2015. They found that, on an aggregate level, approximately 90% of studies demonstrated either a neutral or positive relationship between ESG and CFP.

- Eccles et al. (2014)¹³ which compared the financial performance of 'High' and 'Low Sustainability' companies. The authors found that 'High Sustainability' firms, or firms that have incorporated a substantial number of environmental and social policies since the mid-1990s, have outperformed 'Low Sustainability' firms' on accounting measures such as return-on-equity (ROE) and return-on-assets (ROA), and on stock market performance in the long run.
- Fulton et al. (2015)¹⁴ which analysed fourteen individual academic studies showing a link between ESG ratings and the cost of capital in terms of debt (loans and bonds) and equity. Out of the fourteen studies included in their review, all showed a positive relationship between ESG ratings and lower cost of capital in terms of debt in developed markets.
- Giese et al (2017)¹⁵ which split the MSCI World Index into five categories based on each companies' ESG rating. They find that ESG 'laggards' were more likely to exhibit high stock volatility and suffer from a higher frequency of bankruptcies or extremely high rates of drawdown from the business.

In separate research, Morningstar analysed the investment performance of Europe-based sustainable investment funds. They found that funds which were explicitly marketed as 'sustainable' were over-represented in the top quartile of performers (with 34% of sustainable funds in the top quartile of all funds) and the top half (with 63% in the top half).¹⁶

There are obviously limitations to some of these studies, not least as the nature of ESG practice has evolved over time. However, the strong message from a growing body of research appears to be that integrating ESG considerations into investment decisions is unlikely to be detrimental to returns and performance and may well produce better outcomes than ignoring those considerations.

12. 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies.' Friede, G, Busch, T & Bassen, A. (2015). Journal of Sustainable Finance & Investment, 5 (4), 210-233

13. 'The Impact of Corporate Sustainability on Organisational Processes and Performance.' Eccles, R., Ioannou, I. and Serafeim, G. (2012). Management Science, 60 (11), pp. 2835-2857, February 2014

14. 'Sustainable Investing: Establishing Long-Term Value and Performance.' Fulton, M., Kahn, B. and Sharples, B. (2012). DB Climate Change Advisors. https://www.db.com/cr/en/docs/Sustainable_Investing_2012.pdf

15. Giese, G., L. Lee, D. Melas, Z. Nagy and L. Nishikawa (2017). 'Foundations of ESG Investing.' MCSI ESG Research LLC. <https://www.msci.com/www/research-paper/foundations-of-esg-investing/0795306949>

16. Source: <https://www.ft.com/content/9e71cf86-ba2d-345c-bb3b-0d5887abb6a> Accessed on 13th August 2019

7. Common misconceptions

“This is just a fad”

The momentum around ESG matters has been increasing for some time due to growing public pressure and a greater focus from policymakers and regulators.

On the issue of climate change, the direction of travel is clear following the Paris Climate Agreement. Most major economies, led by the UK and the European Union, are committed to moving to low carbon economies. This will inevitably impact the flow of capital and the sustainability, or otherwise, of certain business models. An increase in extreme weather also poses a threat to business' infrastructure and supply chains. Therefore, trustees and pension providers should be taking climate related risks into account in the allocation of their capital.

Other matters, such as corporate governance, workforce practices, waste generation, energy usage, resource availability and corporate culture may also impact the performance of investments and should, where relevant, be factored in to investment decision-making.

“We can't change the world, we are just a small scheme”

Small shareholders can sometimes be the most effective in bringing about change within a company. Size doesn't always dictate power.

Trustees can also act collectively with other investors to influence behaviour. For example, 360 institutional investors from around the world have signed up to the Climate Action 100+ Group, which is an investor initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. Trustees can also collaborate through other organisations such as the 30% Club's Investor Group and the PRI.

“But we only invest in pooled funds”

There are more and more options for investors in pooled funds. The key thing is to pick a manager that integrates ESG as a matter of course into its investment process and take their voting and engagement commitments seriously. Trustees can also select pooled funds with exclusions that match their ESG investment beliefs and they can also push for certain types of asset to be excluded within pooled funds in which they are already invested.

Ultimately, the message to trustees is “if you don't ask you won't get”. The best time for trustees to exert their influence is when they are making decisions about which funds to invest in or reviewing their choice of fund.

“But we only invest in passive funds”

There are some interesting innovations happening in passive, such as ESG or carbon tilted funds. If you're in mainstream passive funds, check that your fund manager votes its shares at annual meetings and undertakes engagement with issuers.

The EU is also drafting legislation to drive the creation of ESG indices which should make it easier to find ESG-friendly passive funds in the future.

“But we have a duty to only invest in our members' best financial interests”

Yes, trustees are under a legal duty to invest in their members' best financial interests. However, ESG factors may impact the financial performance of an investment. Trustees are required by law to take these “financial ESG factors” into account when making investment decisions. How they decide to do this is a matter for trustees to determine working together with their advisers and asset managers. Their approach must form part of their policy on how they take account of financially material considerations in their investment decisions, which must be included in their scheme's statement of investment principles from 1 October 2019.

The Law Commission has also concluded that trustees may, if they chose, also take account of non-financial factors (such as members' moral or ethical concerns) in their investment decision making:

- if they have good reason to think that scheme members share a particular view, and
- their decision does not risk significant financial detriment to the fund.

Although not all lawyers agree with the Law Commission's conclusion on the extent to which non-financial factors can be taken into account, the Pensions Regulator has endorsed this approach. Therefore, some trustees may decide to take account of non-financial factors where the Law Commission's tests are met.

7. Common misconceptions

“Isn’t that our asset manager’s job?”

Trustees are primarily responsible for how their scheme’s assets are invested, as legally, they are the asset owner. Trustees are also required by law to take account of factors which may impact the financial performance of their investments, including ESG factors, when making investment decisions.

Most trustees will delegate day-to-day investment decisions to one or more asset managers. Therefore, in order to fulfil their legal duties, trustees should ensure that their asset managers have appropriate systems and processes in place to assess and monitor any ESG risks that may impact the performance of their investments. Trustees should also ensure that the approaches adopted by their assets managers are consistent with their own ESG related investment policy and beliefs.

Trustees also play an important role in driving change. Therefore, it is essential that they press their asset managers on ESG matters and that they understand the different approaches that may be adopted by different managers. Trustees should also be willing to push for change by engaging with their existing asset managers or by selecting new managers where their existing asset manager’s approach does not go far enough or is out of step with the trustees’ policies and beliefs and their existing asset manager is unable or unwilling to change.

“ESG risks have already been factored in by the market.”

ESG risks are not fully reflected on financial markets. For example, in relation to climate change, the Bank of England has estimated that the reduction in capital allocation within the fossil fuels sector to meet a 2 degree scenario is in the region of US\$15 trillion.

In addition, the very nature of ESG risks is they are often long-term, idiosyncratic and difficult to measure. Today’s ESG risks won’t be tomorrow’s risk, so ESG risks must be kept under regular review and there also needs to be a constant horizon scanning.



8. Conclusion

Trustees and pension providers are under increasing pressure to consider ESG factors when making investment decisions and when engaging with companies in which they invest (either directly or through asset managers). This pressure comes from a variety of sources:

- **Regulatory and legislative**, as regulators and lawmakers step up the duties on trustees, providers and the businesses in which they invest to take greater account of ESG factors and to report on their policies; this pressure is increasing both at a national and a global level
- **Financial performance**, as growing amounts of research indicates that companies that are well-governed and that take account of their environmental and social impact are likely to perform better financially than those that do not
- **Members and savers**, and younger members and savers in particular, are increasingly keen to see that their money is invested in a positive way, in line with their values, and
- **Legal challenge and activism**, as the threat of legal challenge from members and savers, supported by pressure groups grows.

Against this backdrop, the question for trustees and providers is not 'whether' they should be considering ESG risks when making investment decisions but rather 'how' they should do so?

Asset managers have a key role to play in helping trustees and pension providers monitor and assess ESG risks and implement their ESG investment policies effectively. However, the onus is on trustees and providers to take the lead and to demonstrate that they are taking ESG considerations seriously. Those who fail to do so are likely to face increasing scrutiny from regulators, policymakers and pressure groups. They also face a growing risk of legal challenge from members and savers.

"The Principles of Responsible Investment found in 2016 that in 38 of the 50 largest economies, regulators had already implemented or were in the process of implementing regulation promoting the role of ESG considerations in the evaluation of investment decisions."

9. Useful resources

General

[ESG and Stewardship: A practical guide to trustee duties](#) – PLSA, June 2019

[Trustees and ESG – Are you ready for 1 October 2019?](#) – Herbert Smith Freehills, June 2019

[DC investment governance: Guidance](#) – The Pensions Regulator, updated June 2019

[“Is it always about the money?” Pension trustees’ duties when setting an investment strategy: Guidance](#) - The Law Commission, July 2014

[Independent Governance Committees: extension of remit](#) - FCA consultation paper, April 2019

[ESG: past, present and future](#) – The Pensions Policy Institute, October 2018

Environmental

[Green Finance Strategy](#) - HM Government, July 2019

[Taskforce on climate related financial disclosures](#)

[Pensions in a Changing Climate](#) – ShareAction, November 2018

Corporate Governance

[The UK Corporate Governance Code](#) – FRC, July 2018

[PLSA Corporate Governance Policy and Voting Guidelines](#)

Stewardship and engagement

[The UK Stewardship Code](#) – September 2012

[FRC Consultation on the revised Stewardship Code 2019](#)

[PLSA Stewardship Policy](#)





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