

Engaging with ESG: The story so far

PPI Briefing Note Number 124

Introduction

The financial implications of Environmental, Social and Governance (ESG) factors are becoming increasingly important considerations in pension schemes' investment decisions as these issues become more pressing, both in terms of being more widely recognised as material risks, as well as a result of external pressures such as increased regulation and a broader societal focus. Schemes are now required to show that they have at least considered ESG factors when formulating their investment strategy. Understanding and awareness has grown, particularly since the introduction of new Statement of Investment Principles (SIP) requirements, and there is an increasing focus on the financial risk-mitigation component of ESG investment. However, even among those with a good understanding, determining how to implement ESG factors can be challenging given the range of factors that may need to be considered and the various approaches available. Although regulation has strongly encouraged trustees, providers and Independent Governance Committees (IGCs) to become more informed on ESG issues, there are concerns that some trustees are still not engaging with ESG issues in a meaningful way.

This Briefing Note provides an overview of historical developments and regulatory changes that have led to the current ESG landscape in the UK.



Background to the research

In 2018, PPI published '[ESG: past, present and future](#)', a report that explored the definition of ESG, its interpretation by those involved in making decisions about investment strategy, as well as the drivers of and barriers to greater engagement with ESG factors. The report found there to be a lack of consensus regarding how to define and implement ESG considerations, as well as barriers related to the resources available to smaller schemes. However, the report also highlighted that awareness and understanding of ESG was growing, as was the availability of off the shelf products that can make ESG investment more accessible to smaller schemes.

Two years on, awareness and understanding has continued to grow, particularly driven by the increased regulations that have come into force since then. However, there is still a long way to go before all schemes have appropriately integrated ESG risk-factors into their investment strategy to ensure that their members are adequately protected against long-term risks.

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This Briefing Note is the first in a series of three publications which will delve deeper into the attitudes and approaches currently being implemented in relation to ESG, with the aim of highlighting areas where further support or intervention could be beneficial in order to improve engagement and implementation of appropriate risk management. The two subsequent reports in this series will explore the approaches available to schemes and the opportunities and barriers they may face in choosing and implementing an approach.

This Briefing Note sets out the key regulatory and industry developments that have led to the current landscape of ESG investment among UK pension schemes by influencing thinking around ESG in the UK:

- Firstly, the **early beginnings** of ESG in the form of ethical funds and a growing focus on responsible investment (page 3).
- Followed by a period of **establishing parameters** and benefits of ESG investment, which paved the way for increased ESG focus and engagement among pension schemes (page 5).
- This continued with a period that focused on clarifying definitions of ESG, identifying targets as ESG issues become more pressing, and **addressing barriers** to greater engagement (page 7).
- In more recent years, **growing regulation** on schemes' duties in relation to ESG has been established and this looks set to continue with further consultations ongoing (page 9).

Figure 1: There are a broad range of issues that fall under each area of ESG considerations

Environmental factors:

- Climate change;
- Resource depletion, including water waste and pollution;
- Air pollution; and
- Deforestation and biodiversity loss.

Risks include:

- Poor environmental practices leading to depletion of resources and/or hindering production and development;
- Reputational risk;
- For climate change particularly, the risk of stranded assets as policy changes and market shifts transition to a lower carbon

Social factors:

- Working conditions, including slavery and child labour;
- Health and safety;
- Employee relations;
- Diversity;
- Social unrest; and
- Income inequality.

Risks include:

- Reputational risk;
- Poor productivity; and
- Potential for legal difficulties (fines, sanctions, being forced to close or change).

Governance factors:

- Executive pay;
- Bribery and corruption;
- Board diversity, structure and culture.

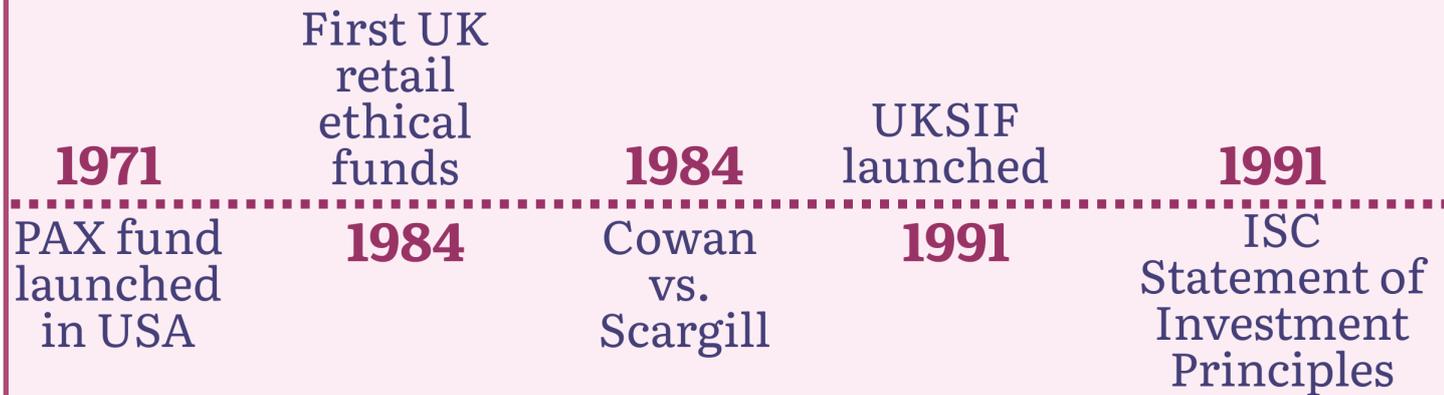
Risks include:

- Some stakeholders being prioritised over others and/or disaffected;
- Poor strategic and operational decision-making; and
- Legal and regulatory risks.

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Early beginnings



Early beginnings

In the early years of ESG and responsible investment, funds were predominantly focused on ethical rather than financial considerations. Perceived conflation of ESG and ethics created some confusion and a belief that ESG investment was in opposition to schemes' fiduciary duties.

ESG investment strategies have existed for many years in varying forms

Although UK focus on ESG investment considerations has accelerated rapidly in recent years, funds that take responsible investing into account have existed for decades. In 1971, the first 'modern' ethical fund was launched in the USA as a result of opposition to the Vietnam War, designed by Luther Tyson and Jack Corbett, both of whom worked for the United Methodist Church.

This was followed by the first UK retail ethical fund in 1984, the Friends Provident Stewardship fund.

Early ethical approaches to investment tended to be focused on negative screening—disinvesting from companies and industries that were deemed unethical, for example weapons and tobacco industries.

While this approach still exists in ethical funds today, there is now a much broader range of investment approaches that can be used to integrate ESG into investment strategy, with strategies that involve higher levels of stewardship and engagement arguably more effective than total disinvestment.

1984: It was ruled that schemes must prioritise the best financial interests of the scheme members over trustees' views

A legal case took place in 1984, which had a long-term effect on ESG: the case of Cowan vs. Scargill (both trustees of the National Coal Board (NCB) pension scheme). The National Union of Mineworkers (NUM) sought to gradually disinvest the NCB's pension fund from businesses that competed with the UK coal industry, in line with Union policy (and based in turn on views about the long-term interests of members). Judgement was handed down against the NUM; investment in line with Union policy was not considered a legitimate basis to discharge the fiduciary duty to act in members' best financial interests.

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The case led to fiduciaries subsequently favouring a narrower definition of members' interests, that often excluded consideration of ESG. However, there was nothing in the judgement that required an exclusive focus on members' short-term financial interests.

Cowan vs. Scargill caused confusion among trustees, who believed that it conflated ESG with ethical investment and led some to believe that ESG referred only to non-financial factors.¹

1991: SRI membership organisation UKSIF launched

The UK Sustainable Investment and Finance Association (UKSIF) (originally the UK Social Investment Forum, until a name change in 2009) was launched in 1991, building on the work of earlier groups: the Socially Responsible Investment Network and 'Socially Useful Money' (SUM)/'Social Use of Money Organisation' (SUMO). The Forum's primary purpose, as stated in its founding Mission Statement, is to promote and encourage the development and positive impact of Socially Responsible Investment (SRI) throughout the UK.

1991: The ISC published *The Responsibilities of Institutional Shareholders in the UK* which encouraged engagement with companies

In the 1980s/90s the need for a more consistent investment approach became apparent as schemes were investing in a variety of ways, not all of which prioritised the long-term sustainability of scheme returns or accounted for all of the potential risks.

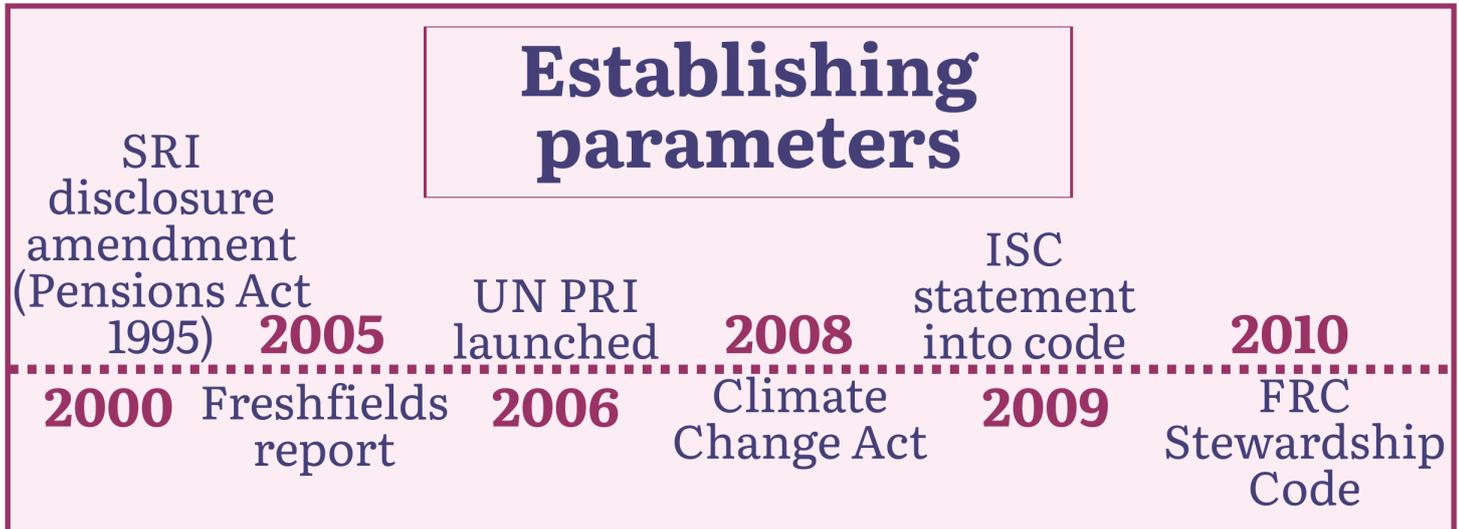
In order to properly evaluate the potential risks and returns associated with investing, it is often necessary to study, monitor and engage with companies. In 1991, therefore, the Institutional Shareholders Committee (ISC), published a statement on *The Responsibilities of Institutional Shareholders in the UK*, subsequently updating it in 2002.

1995: The Pensions Act established new requirements for trustees in relation to investment

While not making reference to ESG specifically, the investment provisions and regulations laid out in the Pensions Act 1995 establish the requirements and capabilities of pension scheme trustees in relation to investment approach more broadly. The Act introduced the requirement for schemes to produce a SIP outlining the scheme's investment strategy and illustrating the assessment of risks that has formed the basis of this strategy. The Act also provides that any decision about investments may be delegated by trustees to an external investment manager.

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Establishing parameters

Following the initial years of ethical funds, the area of ESG and responsible investment continued to grow, with increased focus on financial aspects and interaction with schemes' legal duties. During this time, voluntary codes and targets began to be introduced.

2000: Amendments made to the 1995 Pensions Act first required consideration of responsible investment in SIPs

From 2000, trustees had to state in their Statement of Investment Principles (SIP) the extent (if at all) to which social and environmental or ethical considerations are taken into account in the selection, retention and realisation of investments, as well as their policy (if any) in relation to the exercise of the rights (including voting rights) associated with their investments. These amendments were the first requirements on trustees relating explicitly to ESG considerations. However, the way that the legislation was set out did not disentangle the financial risk-mitigation components of ESG investment from ethical considerations, which may have contributed to some trustees' hesitance to consider these factors in light of Cowan vs. Scargill.

2005: The Freshfields United Nations Environment Programme report presented a legal framework for integration of ESG issues into institutional investment

The report highlighted the fact that ESG considerations could affect investment decision-making in two distinct ways: in terms of the financial value of the investment and its returns, and in terms of broader objectives, such as meeting climate targets for example.

This dichotomy, identified by the Freshfields report, feeds into the perceived barrier wherein some trustees and providers feel there is a direct conflict between integrating ESG considerations into their investment strategy and their fiduciary duty to prioritise 'profit maximisation' above all other considerations.³

2006: The UN launched its Six Principles for Responsible Investment, prioritising ESG

In 2006, the United Nations (UN) launched its Principles for Responsible Investment (PRI): *The Six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible*

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actions for incorporating ESG issues into investment practice:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.⁴

2007: The UN published a report showing that ESG consideration was associated with positive returns in 10 out of 20 case studies

In 2007, the Asset Management Working Group of the United Nations Environment Programme Finance Initiative, and Mercer, released a review of research on using ESG factors in investment. In ten of the 20 studies covered, there was a positive correlation between using ESG factors and portfolio performance, in seven cases there was a neutral effect and in three there was a negative effect.⁵

2008: The UK passed the Climate Change Act, which seeks to enable the UK to become a low-carbon economy

The Climate Change Act introduced a target for UK greenhouse gas emissions to remain below 80% of baseline emissions in 1990 by the year 2050.

The Act led to an increase in research into low-carbon alternatives, widening the pool for potential investors who want to invest in more environmentally friendly options.⁶

2009: The ISC statement became a code

The Institutional Shareholders Committee's (ISC) statement on 'The Responsibilities of Institutional Shareholders and Agents', which was first published in 2005, was converted into a voluntary code in 2009. This paved the way for the Financial Reporting Council's (FRC) Stewardship Code, which was published the following year.

2010: The FRC published *The Stewardship Code* obliging signatories to engage with companies that pension schemes invest in

Following the 2008 financial crisis, the Walker Report, published in November 2009, recommended that:

- The FRC's remit should be extended to cover the development and encouragement of adherence by institutional investors to best practice in stewardship of UK listed companies;
- That the FRC should ratify and regularly review the Code of Responsibilities of Institutional Investors issued by the ISC; and
- That this Code should operate on a 'comply or explain' basis with appropriately independent monitoring.

In 2010, the FRC published the UK Stewardship Code, which defined stewardship to include engagement with companies and intervention, potentially through using voting rights where appropriate. The intended result of the Code was for institutional investors exercising their stewardship responsibilities on matters such as strategy, performance, risk, capital structure and corporate governance to have more accountability for, involvement with, and better long-term performance of, companies in which they are invested.

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Addressing barriers

Focus on clarifying definitions of ESG and establishing codes and targets continued in the 2010s, while broader societal focus on ESG issues also grew.

2012: The Kay Review recommended addressing barriers to investor engagement with companies

In 2012, the (government commissioned) Kay Review, published its final report recommending that the government do more to address disincentives and perceived regulatory barriers for trustees and providers of contract-based schemes to engage with companies by establishing an investors' forum and making it easier for schemes to engage collectively and share information.

The Kay Review, which focused on promoting a greater focus on long-term impacts of investment following the lessons learned from the financial crisis, highlighted that **scheme trustees were generally focusing too heavily on short-term asset performance and neglecting consideration of long-term risks, including environmental risks**. The Review recommended that the Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.

2014: The Law Commission highlighted the lack of regulatory clarity around ESG

In 2014, the Law Commission published a report which highlighted the lack of regulatory clarification on financial and non-financial investment factors.

The lack of clarity arose, in part, from discussion in the regulations conflating "ethical" considerations with ESG factors.

The Law Commission highlighted that ethics refer to moral issues, while ESG is related to risks, returns and sustainability. The 2014 report discussed the need to consider material ESG factors when devising investment strategies as these can be financial factors which affect the long-term sustainability of companies in which pension funds are invested. The 2014 report recommended that trustees be required to state their stewardship policy, if they have one.

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2015: The Paris Agreement was adopted

The Paris Agreement was adopted on 12 December 2015 by Parties to the United Nations Framework Convention on Climate Change. Signatories pledge to determine, plan, and regularly report on their activities for mitigating global warming. The overall aim is to limit the average global temperature rise to 1.5°. As of 9 September 2018, there were 195 signatories (countries signed up) and 180 parties (countries who consent to be legally bound) to the agreement.

The Paris Agreement has led to a greater focus on mitigation of climate change and moves to low-carbon resilient economies and has increased the focus of institutional investors on the issues highlighted in the agreement.

2015: Government responded to the consultation on the Law Commission's 2014 report

Following its response to the Law Commission's 2014 report, in 2015 the Government consulted on legislative changes but instead announced that The Pensions Regulator (TPR) would issue guidance which clarified the differences between financial and non-financial factors and how ESG issues were relevant to these:

- TPR subsequently advised trustees to state in their Statement of Investment Principles (SIPs), whether they consider ESG factors in their investment strategy.
- The Financial Conduct Authority (FCA) issued a statement emphasising the importance of Independent Governance Committees (IGCs) assessing member views on ESG factors, on use in the default of ethical and long-term social investments, while at the same time considering the risks and potential impact on pension outcomes.

2017: The Law Commission called for more clarity and transparency

In 2017, in response to the emerging social impact agenda, the Law Commission published a report recommending that more needs to be done in law to clarify requirements around ESG and more guidance needs to be provided for contract-based schemes in order to help schemes who are struggling to understand their obligations around ESG. The report called for schemes to provide more transparency about their stewardship policy and how ESG factors are considered in relation to investment decisions.

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Growing regulation

In the last two years, focus on ESG considerations has grown rapidly, with many trustees and providers increasing their understanding and knowledge of this area, particularly driven by changes in regulation. With consultations on climate change disclosure regulations ongoing, this trend looks set to continue. Scheme members are also increasingly engaged on ESG issues, which may provide an additional driver of increased ESG integration into schemes' investment strategy in future.

2018: The House of Commons Environmental Audit Committee published two reports, calling for greater focus on sustainability in investing

In May and June 2018, the Environmental Audit Committee published two reports as part of their Green Finance Inquiry. The Committee called for greater regulation on company, investor and asset manager reporting on sustainability and climate-related risks. The Committee recommended that 'the Government should explore how a Sovereign Green Bond could be directly tied to achieving its Clean Growth Strategy.'⁷

2018: The European Commission published Europe-wide regulations which aim to integrate ESG considerations into the investment and advisory process in a consistent manner across sectors

In May 2018, the European Commission proposed regulations on disclosures relating to sustainable investments and sustainability risks and amending the IORP II Directive (IORP - Institutions for Occupational Retirement Provision). The proposals lay the foundation for an 'EU framework which puts environmental, social and governance (ESG) considerations at the heart of the financial system to help transform Europe's economy into a greener, more resilient and circular system. ESG factors should be considered when taking decisions on investments in order to make investments more sustainable.'⁸

2018: The EU introduced the Shareholder Rights Directive II

Updating the previous Shareholder Rights Directive (SRDI [2007]), the EU introduced the Shareholder Rights Directive II (SRDII). The amended Directive aims to strengthen the position of shareholders and to ensure that decisions are made

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for the long-term stability of a company by increasing the level and quality of engagement of asset owners and asset managers with investee companies. It also aims to improve transparency and stewardship of occupational pension schemes, allowing for comparison between schemes, so that engaged members and other stakeholders can better understand their investments.

2018: The EU published recommendations to make ESG investment easier across Europe

In 2018, the EU High-Level Expert Group on Sustainable Finance's final report on *Financing a Sustainable European Economy* recommended:

- Establishment and maintenance of a common sustainability taxonomy (register) which would identify the conditions under which investments would contribute to the EU's sustainability objectives.
- Linking the duties of investors to the sustainability needs and preferences of individuals and institutions.
- Reforming disclosure rules so that companies' sustainability risks are fully transparent.
- Requiring investment managers to engage with investors and provide them with the required information to make active investment choices which reflect their sustainability and ethical preferences.
- Development of sustainability standards and labels which will apply to qualifying assets, starting with green bonds.
- Development of an organisation called 'Sustainable Infrastructure Europe' to support the development of sustainable infrastructure projects across all EU member states.
- Updating 'fit and proper' tests for members of governing bodies in financial institutions to include assessment of their ability to address sustainability risks and understand the needs and relevance of customers and stakeholders.
- Strengthening regulation and supervisory guidance so that private capital flows are pushed towards sustainable investments, including extending the role of European Supervisory Agencies.

The European Commission subsequently published its own action plan incorporating these recommendations and is currently working on integrating sustainability considerations into its financial policy framework.

2018: the Department for Work and Pensions (DWP) introduced regulations strengthening trustee duties around ESG

In September 2018, the Government introduced regulations to strengthen the obligation of occupational pension scheme trustees to consider ESG factors in investment decisions.

Since these regulatory changes came into force on 1 October 2019, where trustees are required to produce a Statement of Investment Principles (SIP), it must set out:

- How they take account of financially material considerations, including (but not limited to) Environmental, Social and Governance considerations, including climate change;
- Their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with investments;
- The extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments.

For trust-based schemes providing Defined Contribution (DC) benefits:

- To publish their SIPs on a website so that it can be found and read by both scheme members and interested members of the public, and inform scheme members of its availability via the annual benefit statement;
- In relation to the default arrangement, to prepare or update their default strategy to set out: how they take account

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of financially material considerations, including (but not limited to) ESG considerations, including climate change; and (for DC trust-based schemes with 100 or more members) their policy on stewardship.

From 1 October 2020, these regulations increased further, with trustees of DC schemes with 100 or more members now required to produce an implementation statement explaining how they have followed and acted upon the stated investment policies set out in their SIP. The Pensions Regulator has said that, ‘the purpose of this report is to help ensure that “action follows intent” as much as possible.’⁹ This includes reporting on the way in which the scheme monitors its asset managers who undertake investment and engagement activities on its behalf and whether these managers have acted in accordance with the trustees’ stated policies.

As of 1 October 2020, Defined Benefit (DB) schemes are also required to publish their SIP alongside a narrower implementation statement covering their engagement and voting behaviour.

2019: The FCA introduced similar reporting requirements for contract-based schemes

In December 2019, the FCA published rules extending the remit of Independent Governance Committees (IGCs) in two areas, including a new duty for IGCs to consider and report on their firm’s policies on ESG issues, member concerns and stewardship, for the products that IGCs oversee.¹⁰

These rules address recommendations made in the Law Commission’s 2017 report, that the FCA should:

- Make rules requiring IGCs to report on the firm’s policies on how it takes account of ESG risks and member concerns in investment decision making;
- Make a rule requiring IGCs to report on the firm’s stewardship policy, if the firm has a policy; and
- Issue related guidance for firms to clarify how the firm should take account of ESG risks and member concerns in investment decision-making for pensions.

As well as identifying and implementing ESG considerations into investment strategies, schemes have ongoing stewardship duties

Though schemes predominantly outsource their day-to-day investment decisions, for example through pooled funds, they retain a responsibility to monitor the ESG activities being undertaken on their behalf.

Regardless of scheme size or type and the level of direct involvement with ESG approaches, there is a need for all trustees and providers to have a sufficient level of knowledge and understanding in order to best fulfil this role to effectively scrutinise managers —which may require active improvements to be made in the case of some schemes.

The high availability of pooled funds, alongside the governance and budget required to establish them, mean that **most schemes do not have their own detailed voting and engagement policies**. Even before the introduction of implementation statement requirements in October 2020, some schemes have had clear voting and engagement policies, and in some cases schemes have voluntarily made these publicly available. However, for smaller schemes, such an undertaking adds costs in terms of resource and governance.

This has contributed to some schemes’ belief that this duty can be entirely delegated to external managers and a resultant limited focus on monitoring asset managers on these areas.

Now that schemes are required to provide implementation statements, there is likely to be an increase in the number of schemes setting out their own voting and engagement policies clearly, but this will be a slower and more challenging process for some schemes which have not previously defined these policies.

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2020: The Pensions Climate Risk Industry Group consulted on non-statutory guidance on climate change reporting

The Pensions Climate Risk Industry Group (PCRIG) was established in 2019 as part of the Government's Green Finance Strategy. From March to July 2020, PCRIG consulted on non-statutory guidance for trustees of occupational pension schemes on assessing, managing and reporting climate-related risks in line with recommendations made by the international industry-led Taskforce on Climate-related Financial Disclosures (TCFD).

The consultation highlighted that 'all pension schemes are exposed to climate-related risks, whether investment strategies and mandates are active or passive, pooled or segregated, growth or matching, or have long or short time horizons. Many schemes are also supported by employers or sponsors whose financial positions and prospects are dependent on current and future developments in relation to climate change.'¹²

The Task Force on Climate-related Financial Disclosures (TCFD) recommends disclosures on four broad areas:

- **Governance:** Disclose the organisation's governance around climate-related risks and opportunities.
- **Strategy:** Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.
- **Risk Management:** Disclose how the organisation identifies, assesses, and manages climate-related risks, including undertaking climate-related scenario analysis.
- **Metrics and targets:** Disclose metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

2020: Both the FCA and DWP have consulted on TCFD recommendations

In March 2020, the FCA published a consultation paper on *Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations*. Similarly, DWP has recently consulted on policy proposals to require trustees of larger occupational pension schemes to address climate change risks and opportunities through effective governance and risk management measures, in line with TCFD recommendations.

2019-21: Pension Schemes Bill will pave the way for greater disclosure on climate change

The Pension Schemes Bill (2019-21) will enable regulations to be made requiring trustees to consider, in depth, how climate change will affect their pension scheme and its investments and to publish information relating to the effects of climate change on the scheme.

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Future opportunities and challenges

While the pensions industry as a whole has come a long way on ESG issues, there is still a long way to go before all schemes have fully integrated ESG into their investment strategies

Although regulation has strongly encouraged trustees, providers and IGCs to become more informed on ESG issues, there are concerns that some trustees have treated the changes in regulation relating to ESG risk factors as a 'tick box exercise' rather than engaging with it in a meaningful way.

For example, in a survey carried out in the months immediately following the 2019 regulation changes, 38% of pension professionals said that 'a tick box exercise with the minimum required changes to the SIP, but no changes to the investment portfolio' best describes the approach taken by most of their clients; 57% said the most common approach taken was no change yet to the investment portfolio but a genuine interest shown in ESG, while only 2% said that material changes has been made to the investment portfolio.¹³

Similarly, a review of SIPs published in the first few months following the 2019 regulatory changes found that almost all SIPs recognised that ESG factors 'can' or 'may' be financially material, but far fewer (58%) explicitly stated that the trustees believe ESG factors 'will' affect the scheme's investments.¹⁴

In terms of delegation to external asset managers, most schemes expect managers to integrate ESG risk factors into investment strategy, but very few have this as an absolute requirement, and less than half (42%) state that they consider ESG in selection and retention of managers (Chart 1).¹⁵

Chart 1:¹⁶ While nearly three quarters of trustees expect their investment manager to integrate ESG risks, only 4% require this, and less than half (42%) said they consider ESG issues in selection and retention of managers

Proportion of SIPs that explicitly state these beliefs/actions, October/November 2019



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Member attitudes towards ESG issues are shifting and becoming more influential in some schemes' decision-making process

Two thirds (66%) of DC scheme members report being worried about the state of the world and feel personally responsible for making a difference, up from 59% in 2018.¹⁷ While schemes are not obligated to take into account member views when formulating investment strategy, provided members are adequately protected from financial risks, **member views are likely to play an increasing role going forward as scheme members, perhaps especially those in younger generations, become more engaged on these issues.** Trustees and providers that are confused about the perceived conflict between the financial and ethical components of ESG investing may find it more difficult to engage with members on these issues.

While environmental issues, particularly climate change, have traditionally received more attention than social and governance issues, focus on these areas is increasing

Traditionally, much of the focus on ESG issues has been on environmental issues, in particular climate change, sometimes to the neglect of social and governance considerations. Many of the regulations and reports discussed in this Briefing Note relate to climate change specifically, while others address ESG as a whole. This does not, however, mean that nothing is being done to address issues that relate to social and governance factors, rather that development of these individual areas has been slower and less well publicised comparative to environmental efforts.

The Workforce Disclosure Initiative, for example, which is run by ShareAction and part-funded by the Department for International Development (DIFD), has been working to improve the social element of ESG by encouraging companies to increase disclosure of data about their workforce.

The current COVID-19 pandemic has also increased focus on social issues particularly, with labour rights and public health a major concern for most people in the UK, and globally, during 2020.

In November 2021, the UK will host the major UN climate summit, COP26

In November 2021, the UK will host COP26, the major UN climate summit, in Glasgow. This summit will bring together heads of state, climate experts and campaigners to agree coordinated action to address climate change.

While focus on social and governance considerations are growing, there will continue to be a strong, and even increasing, focus on environmental, particularly climate change, issues.

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Conclusions

There has historically been confusion among some trustees, resulting firstly from Cowan vs. Scargill (1984), which was perceived to categorise ESG with ethical investment and led some trustees to believe that ESG referred only to non-financial factors. Some trustees and providers perceived there to be a direct conflict between integrating ESG considerations into their investment strategy and their fiduciary duty to prioritise the narrowest range of financial factors in relation to profit maximisation, which can lead to the neglect of wider financially material risks and opportunities.

Because some schemes didn't recognise the financial nature of ESG risk-factors, not all schemes were investing in ways that prioritised the long-term sustainability of scheme returns or accounted for all of the potential risks. Some schemes were focusing too heavily on short-term asset performance and neglecting consideration of long-term risks.

ESG has developed as an area of focus for pension scheme investment, from the early days of responsible investment that focused on ethics and values, through periods of clarification and definition that have highlighted the financial risk-mitigation aspects of ESG investment. As the responsible investment landscape has matured, the benefits of integrating ESG considerations have become clearer to many institutional investors. At the same time, strategies for ESG integration have become more varied and complex, moving away from negative screening approaches (disinvestment) towards strategies that involve greater levels of engagement and stewardship.

Environmental issues, particularly climate change, have traditionally received more focus than social and governance issues. Focus on environmental issues will continue to be strong, with the UK due to host COP26 in 2021. However, focus on social and governance issues is also increasing, particularly in the wake of the COVID-19 pandemic, which has put labour rights and public health at the forefront of many discussions.

While awareness and understanding of ESG factors has grown and there are some schemes that are doing a lot in regards to ESG investment, others may still need more support to understand the practical steps they can and should be taking in order to comply with regulations and appropriately protect members from long-term risks. Meanwhile, there are still some trustees who struggle to recognise the value of integrating ESG considerations into their investment strategy, and for whom support and clear guidance will not be enough if they are unwilling to engage.

As focus on all areas of ESG grows, it is increasingly important that schemes of all size and type consider and engage on these issues where they represent a financially material risk. While some schemes are doing a lot on ESG, others are earlier in the integration process and some may need greater support to overcome challenges. The following reports in this series will explore the approaches available to schemes and the opportunities and barriers they may face in choosing and implementing an approach. The series will also identify areas where there may be a role for increased support from government and industry to enable greater engagement with ESG issues.

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