

Engaging with ESG: Environmental, Social and Governance Factors



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The future is ever changing,
but the PPI remains a constant
“Voice of Reason”
in the ongoing debate on the
future of retirement in the UK.

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Sponsor's Foreword



Julian Lyne

Newton Investment Management is delighted to sponsor this important report. We have long believed in the value of connecting research, policy and investment practice, and we share the Pensions Policy Institute's strong commitment to improving retirement outcomes. The PPI's independent analysis and evidence-based output provide valuable contributions to our collective understanding of the issues facing pension schemes, and are an important catalyst for seeking to address those issues successfully.

Occupational pension scheme trustees are under increasing regulatory pressure to consider environmental, social and governance (ESG) factors in their investment decisions, and to report on how they have done so. As this report identifies, they recognise that their work to meet those responsibilities has further to go.

We believe that getting this right is not simply about meeting regulatory requirements, but also a crucial part of setting a pension scheme's investment strategy more broadly. Academic studies show that responsible businesses, which balance the interests of all stakeholders and actively manage their risks over the long term, can produce more resilient returns for all stakeholders. Not to integrate ESG-related considerations in an investment approach is to have an incomplete picture of opportunities and risks, and threatens to diminish the outcomes schemes can achieve.

As a leading investment manager, we have, since our founding in 1978, taken our role as a responsible investor very seriously. We have been voting client shares since that time, and we seek to drive positive change via our engagement activities – not just with companies, but in the development of best practices, standards and regulations too. However, we are far from complacent, and we know that we must continue to adapt to help our clients meet both their investment goals and their regulatory duties.

The PPI's research identifies five key areas where further progress should help support pension schemes in addressing ESG-related issues: the building of a consensus among stakeholders about ESG-focused goals, engagement and stewardship, innovation in products and data provision, increasing knowledge and understanding, and standardised data and definitions.

The report underscores the fact that success in these areas depends upon collaboration between the various parties across the pensions industry. Active asset managers like Newton, and others in the industry, need to work purposefully to engage with schemes and help them not simply to meet their ESG-related obligations, but to do so in the context of achieving strong outcomes too.

We would like to thank the PPI, and Lauren Wilkinson in particular, for their work in carrying out the research and preparing this excellent report. We hope you enjoy reading it.

Julian Lyne, Chief Commercial Officer, Newton Investment Management



Executive Summary

This report explores the way in which pension scheme investment strategies take into account Environmental, Social and Governance factors (excluding climate change, which was covered in detail in the previous report in this series), looks at how strategies interact with the current regulatory landscape, and considers future opportunities, challenges, and proposals for effective support to encourage evolution and improved risk mitigation. This summary covers the main points of the report and acts as the conclusion.

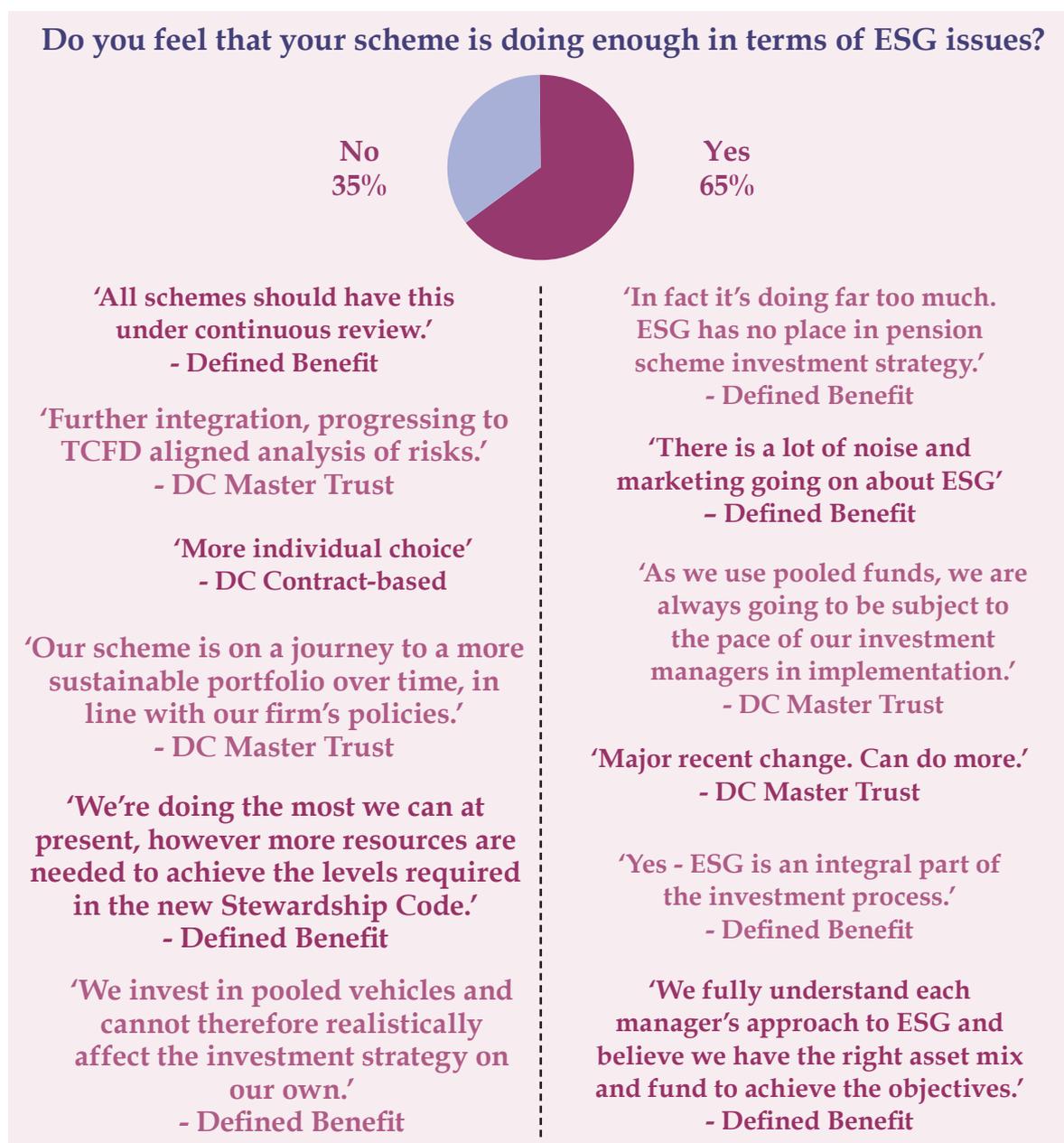
Environmental, Social and Governance (ESG) considerations have become an increasingly important component in pension schemes' investment strategies. In recent years, focus on ESG considerations has grown rapidly, with many trustees and providers increasing their understanding and knowledge of this area of investment, particularly driven by changes in regulation.

For some time, much of the focus on ESG has been skewed towards climate change, which was covered in detail in the previous report in this series. However, as ESG investment becomes more important, focus on other areas of ESG is also growing, as a greater number of schemes recognise the need to mitigate the associated risks.

- **Other environmental factors** have often been overshadowed by climate change, but the paths that have led to more effective integration of climate change risks are now serving as a blueprint for other environmental areas, such as biodiversity.
- **Social factors** are growing in importance, a shift that has been accelerated by the events of the last year, particularly COVID-19 and equal rights movements. However, not all investors are monitoring the social issues that can impact the companies in which they are invested.
- **Governance factors** are well-understood in their own right, with corporate governance frameworks an established component of traditional investment strategies. However, failure to recognise the way in which governance practices interact with environmental and social factors may lead to more fragmented ESG approaches.

Activity around ESG considerations has increased substantially and two thirds of schemes in the Engaging with ESG Survey¹ believe they are currently doing enough to account for these risks in their investment strategy, with some Defined Benefit (DB) schemes even reporting that they feel they are doing more than is necessary. Among many schemes, both those that feel they are doing enough and those that do not, there is a recognition that ESG strategies are a work in progress (Figure Ex.1).

¹ See Appendix for more details.

Figure Ex.1²

The previous report in this series highlighted that while some schemes, and those acting on their behalf such as providers or external asset managers, are doing a lot of work to mitigate ESG risks, there is still a lot of work to be done before all schemes have effectively accounted for these risks in their investment strategy. The report identified five areas where further development could help to further progress towards this target:

- **Integrated goals:** Establishing a consensus across all stakeholders (Government, schemes, asset managers and providers) on goals, and the practical steps needed to achieve them, to ensure that climate change considerations are integrated across the investment landscape by a certain date.
- **Engagement and stewardship:** A greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals.
- **Encouraging innovation from third parties:** Pressure from Government, regulators and industry bodies on those involved in schemes' approach to climate change (such as pension

providers, external asset managers and consultants) to provide products and strategies that meet the needs of schemes in integrating these risks, as well as improving the data they provide schemes about their own activities relating to climate change.

- **Increasing knowledge and understanding:** Improving scheme decision makers' knowledge and understanding of climate change across the industry, especially around more practical aspects such as the implications of different investment approaches.
- **Standardised data and definitions:** Producing a centralised data source which provides a starting point for schemes that are unsure where to begin, or are overwhelmed by the quantity of data available - particularly given inconsistencies across different metrics. Feasibly, this would need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

These development areas are perhaps even more salient for the other ESG factors (which are explored in detail in this report). Some of these factors appear to be on the same path towards more effective integration as climate change, but earlier in the process. The progress that has already been made towards more effective integration of climate change risks can be used as a guide for increasing the effectiveness of efforts to integrate these other ESG risks. Consistency in the way in which the various areas of ESG are approached is likely to yield a greater protection for members against these risks.

The process of designing and implementing an appropriate ESG investment strategy, delegating to asset managers or selecting an appropriate off-the-shelf solution from a pension provider, is complex. Responses to PPI's Engaging with ESG Survey highlight the barriers schemes face when approaching ESG risk factors, including the following:

- The large quantity and inconsistent quality of information available on ESG risks and approaches. Around a quarter of schemes report that the vast quantity of information available and the inconsistency in the quality of information can make it more difficult to know how to approach ESG risks. Although knowledge and understanding of ESG has grown across the industry, there are still gaps in some areas, particularly when considering social factors. **The broad scope and qualitative nature of social factors in particular, and the difficulty associated with evaluating social risks and opportunities, can make it harder for schemes to understand how to integrate these risks effectively into their investment strategy. This is an area where a source of comprehensive and neutral guidance could be especially beneficial for scheme decision makers that don't know where to start in assessing the financially-material nature of social risk factors.**
- ESG data issues - such as availability, cost and divergence between different metrics. Schemes report that consistent and clear data on social factors is especially challenging to find. Many pension schemes will have their research, assessments and engagement carried out on their behalf by their pension provider or external asset managers. This means that scheme decision makers are dependent on the quality of information provided to them. **Schemes must ensure that they have sufficient understanding and that they are being provided with appropriate data on both investment allocation and engagement and stewardship activities being undertaken on their behalf by external managers - even if this is done through other parties such as their provider.**
- Dependence on third-parties, in terms of how this may limit the ESG strategies available to schemes - and especially engagement and stewardship approaches. Stewardship and engagement are an increasingly important component of ESG approaches, which can be challenging when schemes predominantly delegate day-to-day investment procedures to providers or asset managers, and do not always have the internal expertise or governance resources to fully understand or assess activity undertaken on their behalf. More than a quarter (28%) of schemes that responded to the Engaging with ESG Survey said that the need for a platform, asset manager or other third party to implement their strategy proved to be a barrier to constructing it exactly as they would have liked. However, schemes in the survey seemed to accept this status quo as a limit within which they would have to work, rather than a catalyst for engagement with third parties in order to drive forward innovation so that they are better able to implement their preferred ESG investment strategy. **Schemes may need to engage with and challenge their pension provider and/or external asset managers more directly in order to drive forward innovation to ensure that off-the-shelf and pooled products meet their needs and align with internal policies on ESG investment.**

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 and as a result of external regulatory and societal pressures. In recent years, much of the ESG focus has been on climate change, but the events of the last year (particularly the COVID-19 pandemic and equal rights movements) have seen some focus shifting towards social and governance

considerations. While governance frameworks are a well-established component of many traditional investment strategies, the integration of social factors is less developed and, in many ways, more challenging.

This report explores the way in which pension scheme investment strategies take into account ESG factors, explores how strategies interact with the current regulatory landscape, and considers future opportunities and challenges, and proposals for effective support to encourage evolution and improved risk mitigation.

Chapter One presents the background and details about ESG factors and the way that they relate to pension scheme investment.

Chapter Two provides an overview of the current landscape and attitudes towards ESG risk factors.

Chapter Three examines the barriers that schemes, and others involved in the investment process, face when integrating ESG risks.

Chapter Four identifies the practical steps that might be needed to overcome the barriers highlighted in Chapter Three.

This is the last in a series of three publications which delve into the attitudes and approaches currently being implemented in relation to ESG, with the aim of highlighting areas where further support, guidance or intervention could be beneficial in order to improve engagement and implementation of appropriate risk management. The first publication in this series, [Briefing Note 124 - Engaging with ESG: the story so far](#), provides an overview of historical developments and regulatory changes that have led to the current ESG landscape in the UK. The second publication, [Engaging with ESG: Climate Change](#), explores the way in which schemes and others involved in the investment process are approaching climate change - identifying five practical steps that might be needed to improve engagement and integration.

Chapter One: What is the pensions investment landscape relating to ESG?

This chapter presents the background and details about ESG factors and the way that they relate to pension scheme investment.

The ESG investment landscape is complex. The following infographics provide background and details about:

- the key recent developments in legislation and regulation (Figure 1.1)
- the stakeholders involved in pension schemes' approach to ESG (Figure 1.2)
- the investment approaches available to schemes (Figure 1.3)
- the key sources of guidance currently available to schemes (Figure 1.4)

Figure 1.1

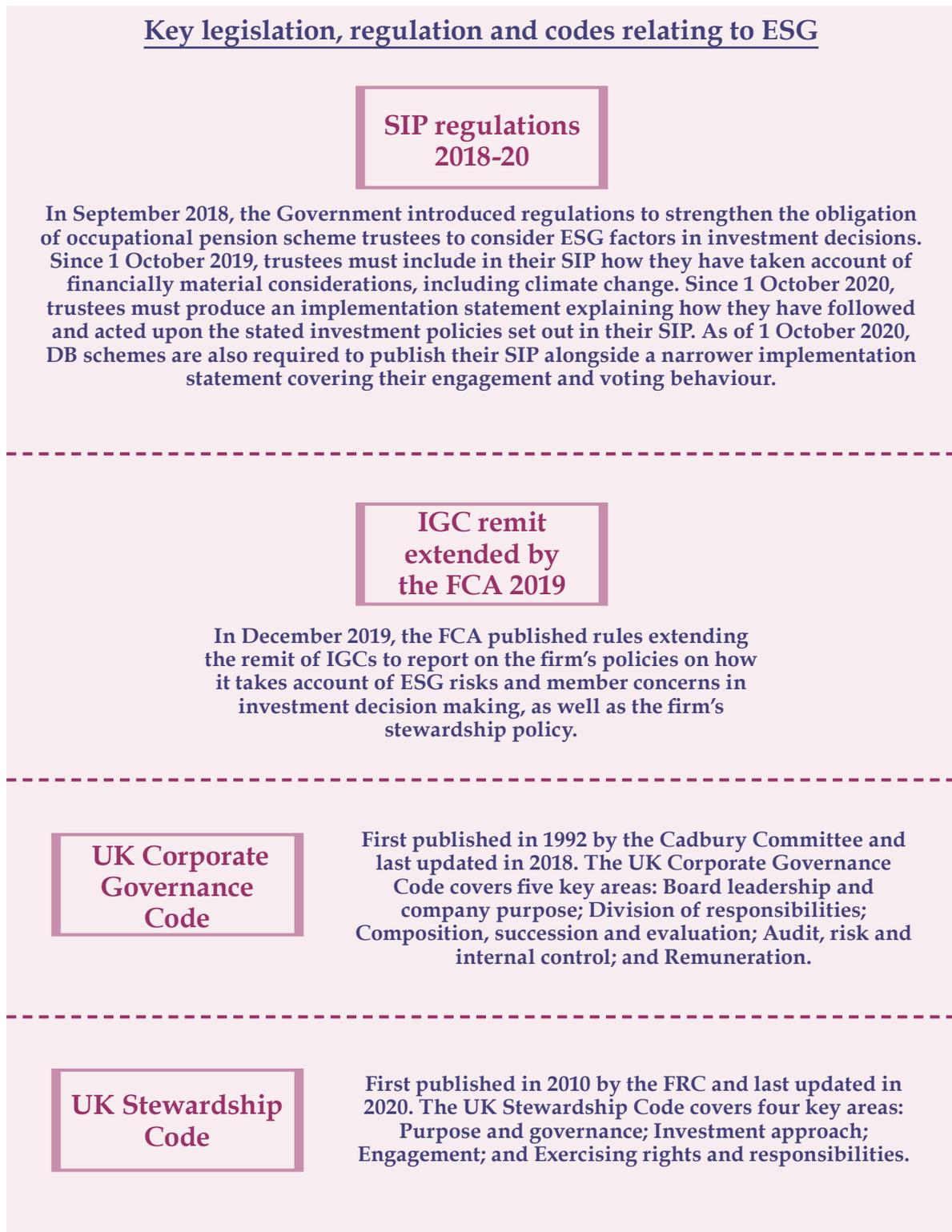


Figure 1.2

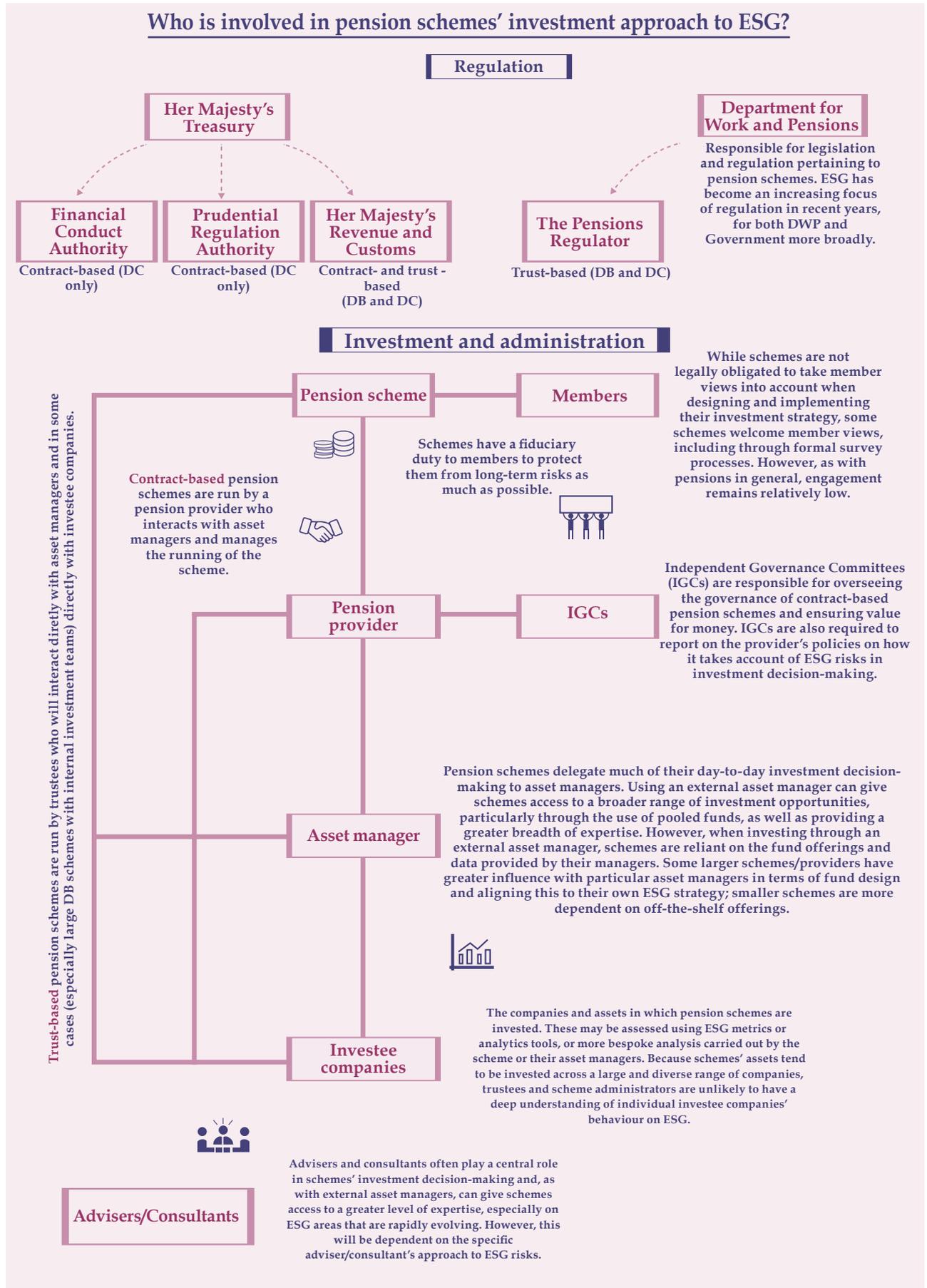


Figure 1.3

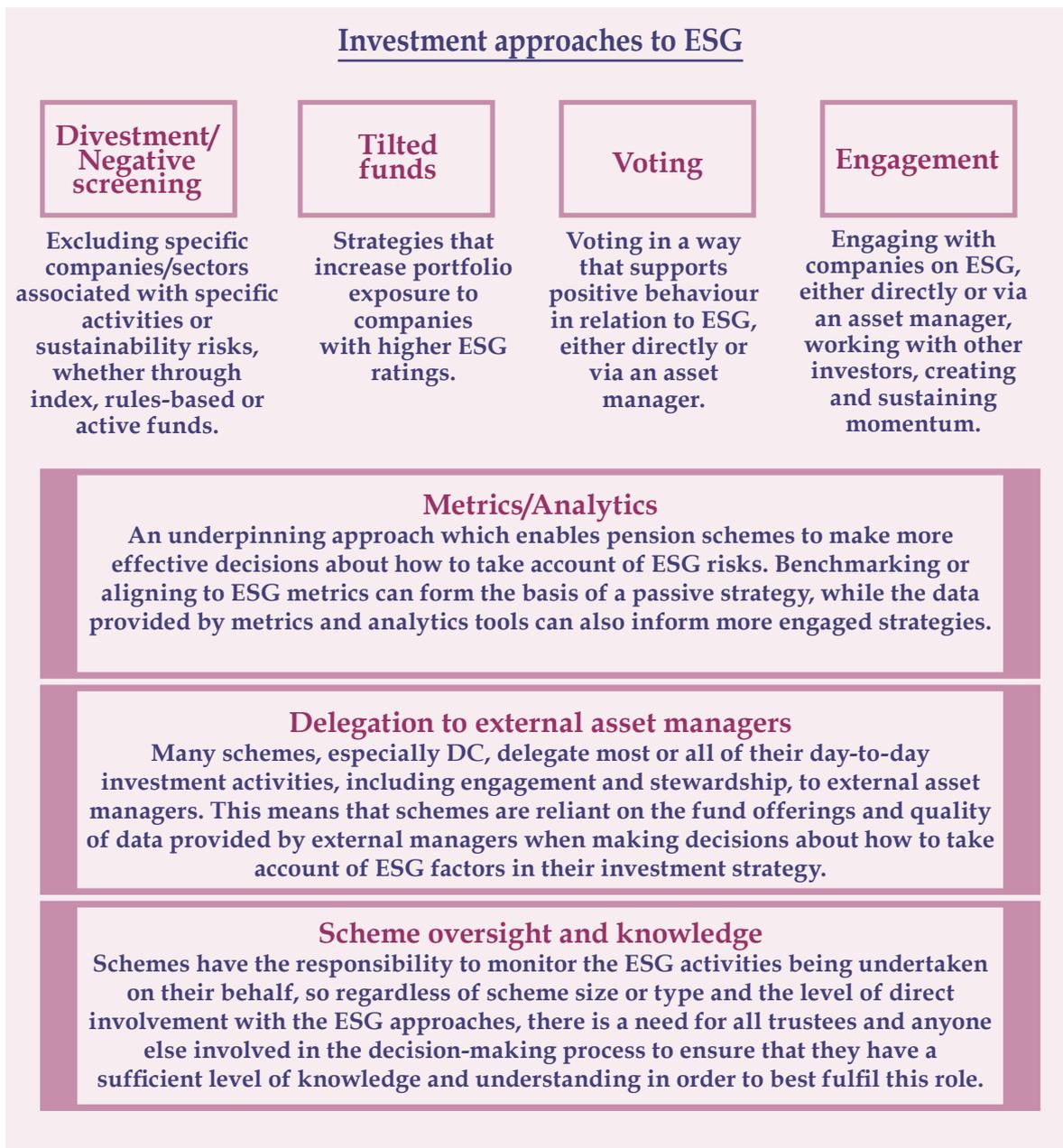
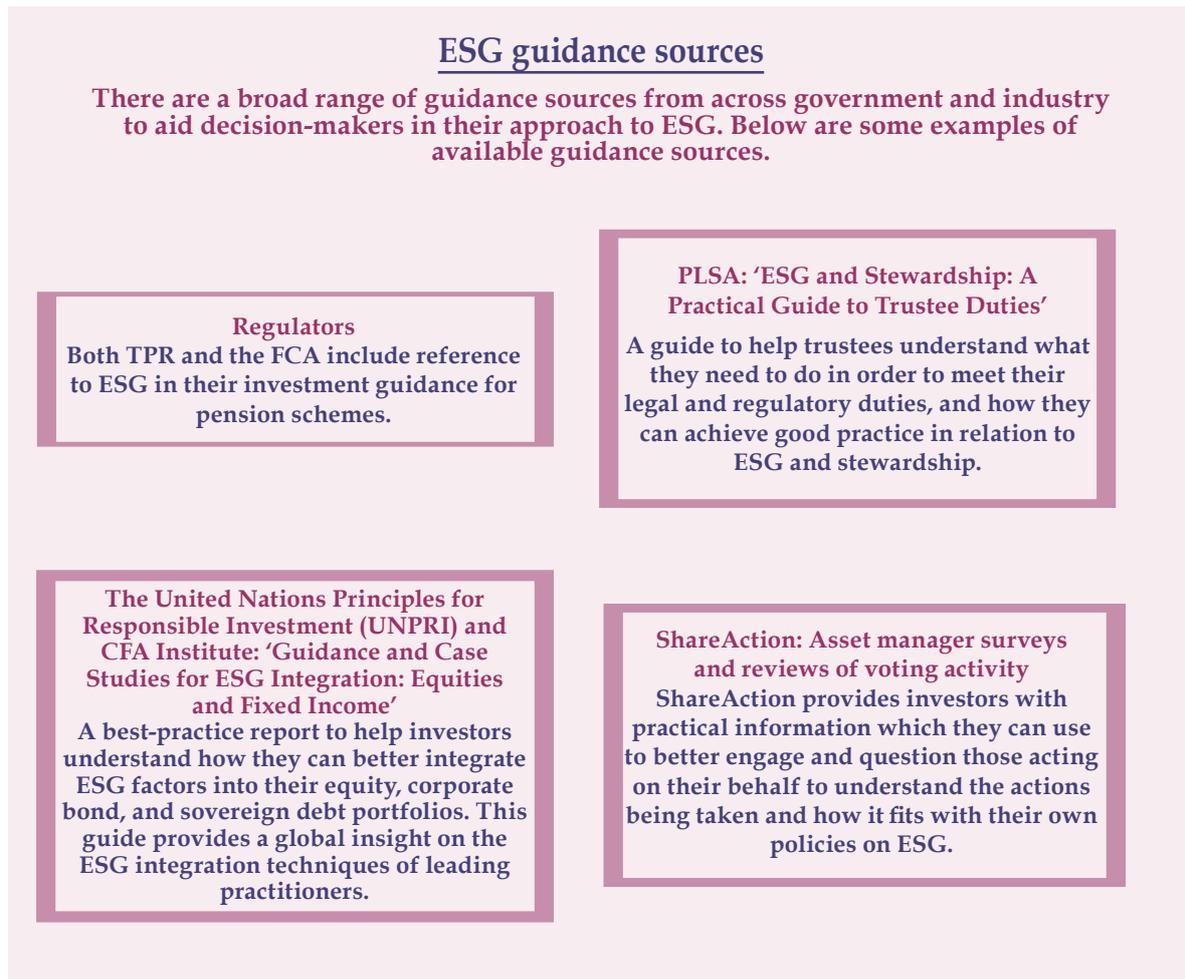


Figure 1.4



Chapter Two: How are approaches to ESG risk factors developing?

This chapter provides an overview of the current landscape and attitudes towards ESG risk factors.

This report uses data from PPI's Engaging with ESG Survey. Carried out in November 2020, the survey sought to gather insight into the approaches being used by schemes in order to take into account ESG risks, and the challenges they have faced along the way. The survey was open to responses from both schemes and third parties involved in the process, such as consultants and asset managers. There were 62 responses in total, including 31 pension schemes, 48% of which were Defined Contribution (DC) and 52% Defined Benefit (DB). When drawing conclusions from the data it should be recognised that the responses cover a subset of the market, and those who responded are more likely to be more engaged on ESG in general. This report has also been informed by qualitative interviews carried out with a broad range of stakeholders across the industry.

Environmental, Social and Governance (ESG) considerations have become an increasingly important component in pension schemes' investment strategies. In recent years, focus on ESG considerations has grown rapidly, with many trustees and providers increasing their understanding and knowledge of this area of investment, particularly driven by changes in regulation.

Following the introduction of new Statement of Investment Principles (SIP) regulations over the last three years, pension schemes are now required to show that they have at least considered ESG factors when designing and implementing their investment strategy. From 1 October 2020, DC schemes with 100 or more members must also produce an implementation statement explaining how they have followed

and acted upon the stated investment policies set out in their SIP. This includes reporting on the way in which the scheme monitors its asset managers who undertake investment and engagement activities on its behalf, and on whether these managers have acted in accordance with the scheme's stated policies. In December 2019, the FCA introduced similar reporting requirements for contract-based schemes, extending the remit of IGCs to include a new duty of considering and reporting on their provider's policies on ESG issues, member concerns and stewardship, for the products overseen by the IGC. As of 1 October 2020, DB schemes are also required to publish their SIP alongside a narrower implementation statement covering their engagement and voting behaviour.

These regulatory changes, as well as greater focus on ESG across the industry, mean that more schemes are engaging with ESG considerations - and to a greater extent. However, there is still work to be done before all schemes are meaningfully taking account of ESG risks in their investment strategies to ensure that their members are appropriately protected.

Box 2.1:

From the Ministerial Foreword to DWP's consultation on consideration of social factors³

'In practice, action on ESG has tended to focus on climate change... But climate change itself is only one part of the "E" of "ESG". The law requires trustees to take account of financially-material environmental, social and governance considerations. Trustees are also required to have policies on engagement and the extent to which they take into account non-financial matters such as members' views on ethical and quality of life issues.'

The consultation 'seeks views on the effectiveness of pension scheme trustees' current policies and practices in relation to social factors. It seeks to assess how trustees of these schemes understand "social" factors and how they seek to integrate considerations of financially-material social factors into their investment and stewardship activities.'⁴

Focus on ESG risk factors is growing, but some areas are less developed and can be more challenging to integrate effectively

For some time, much of the focus on ESG has been skewed towards climate change, which is covered in detail in the previous report in this series. The heavy focus on climate change among pension schemes, policymakers and society more broadly has, at times, left other ESG factors overlooked (although corporate governance considerations have long been a well-developed component of investment strategies in their own right). However, as ESG investment becomes increasingly important, focus on these other areas is also growing, as more and more schemes recognise the need to mitigate the associated risks.

In March 2021, DWP announced a consultation on *Consideration of social risks and opportunities by occupational pension schemes*, which highlights the need for the ESG investment landscape to expand from a specific focus on climate change to a broader approach (Box 2.1).

Two thirds of schemes consider ESG in their investment strategies for financial reasons over regulatory or ethical motivations

Although recent regulatory changes have substantially increased focus on ESG considerations, the financially-material risks posed by these considerations are increasingly being recognised by schemes. Two thirds of schemes in the Engaging with ESG Survey report that their efforts towards ESG integration have been mainly driven by financial motivations (Chart 2.1).

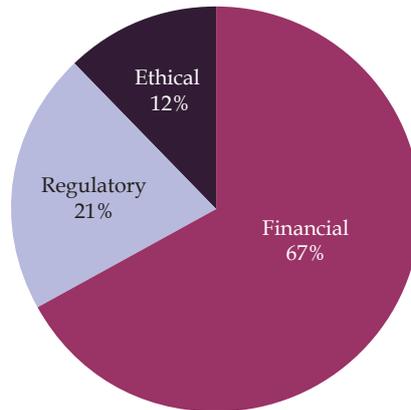
³ DWP (2021) *Consideration of social risks and opportunities by occupational pension schemes*

⁴ DWP (2021) *Consideration of social risks and opportunities by occupational pension schemes*

Chart 2.1⁵

Two thirds of schemes say that the main motivation when considering ESG in their investment approach is financial

PPI Engaging with ESG Survey: ‘What has been your main motivation with regards to considering ESG in your investment approach?’



The prevailing focus on climate change concerns will continue, but focus on social, governance and other environmental considerations is also growing

In recent years, much of the ESG focus has been on climate change, with recent shifts in

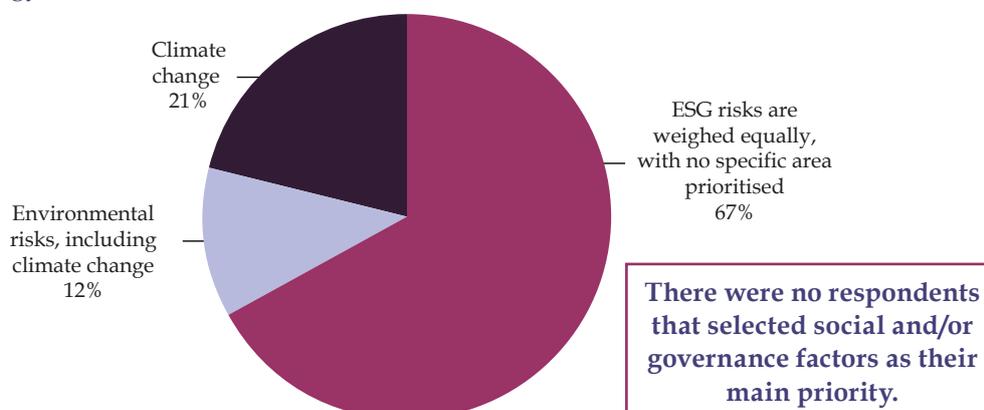
investment strategy largely focused on the shift to a carbon neutral economy (net zero carbon emissions). Environmental risks, especially those associated with climate change, have been, and will continue to be, a top priority for pension scheme investment strategies (Chart 2.2). However, focus on other areas of ESG is growing too.

5 PPI Engaging with ESG Survey 2020

Chart 2.2⁶

While most schemes consider ESG issues holistically, climate change is a top priority for a third of schemes

PPI Engaging with ESG Survey: 'Which area of ESG is your main priority when making decisions about investment strategy?'



Environmental factors

Other environmental considerations have often been overshadowed by climate change

As climate change concerns have dominated the ESG investment landscape, other environmental

risks (Box 2.2) have often been overlooked. While environmental risks associated with energy and waste management have received more focus, as they are intrinsically linked with climate change goals, other environmental considerations (for example, biodiversity) have received less recognition.

Box 2.2⁷

Environmental risk factors include:

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

Scheme 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 economy. This could also become an issue for other environmental issues in future, if policy moves to cover other risks associated with nature.
- Some companies' returns may be affected by environmental changes that are beyond their control, especially in the case of biodiversity loss which may negatively impact many industries.

6 PPI Engaging with ESG Survey 2020

7 Silcock, D (PPI) (2018)

The particular focus on integration of climate change risks offers lessons for the integration of other ESG factors

The progress that has been made towards more effective integration of climate change

risks within institutional investors' investment strategies can serve as a blueprint for increasing the integration of other ESG risks. This is already coming into action for other areas of environmental risk (Box 2.3).

Box 2.3: The Task Force on Nature-related Financial Disclosures⁸

Modelled on the successes of the Task Force on Climate-related Financial Disclosures (TCFD), the Task Force on Nature-related Financial Disclosures (TNFD) will aim to develop a framework for corporate and financial institutions to assess, manage and report on their dependencies and impacts on nature - aiding in the appraisal of nature-related risk. The TNFD is still in the very early stages of development, having been announced in July 2020, but is expected to be formally established in 2021, once the scope, governance, plan and team have been agreed.

Social factors

Social considerations are growing in importance, a shift that has been accelerated and highlighted by the events of the last year

Although for many years much ESG focus has been on climate change, social risk factors (Box 2.4) are becoming increasingly important.

Box 2.4⁹

Social factors include:

- Working conditions, including slavery and child labour;
- Health and safety;
- Employee relations;
- Diversity;
- Social unrest;
- Income inequality; and
- Social development goals, for example around housing or education.

Scheme risks include:

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

⁸ <https://tnfd.info/>

⁹ Silcock, D. (PPI) (2018)

Many of the events of 2020 have brought social issues into greater focus, for example the current COVID-19 pandemic and equal rights movements such as the Black Lives Matter (BLM) movement. The COVID-19 pandemic has emphasised the importance of areas in health and labour practices that may previously have been overlooked, while the BLM movement has shone a light on racial inequalities.

Nearly two thirds (64%) of Principles for Responsible Investment (PRI) signatories surveyed in 2020 said that COVID-19 had highlighted some social issues that were not already a priority, including areas such as:

- Occupational health and safety;
- Social safety nets;
- Worker protection;
- Responsible purchasing practices and supply chain issues;
- Diversity; and
- Digital rights, including privacy.¹⁰

These developments over the course of 2020 emphasised how rapidly focus on social issues can evolve and come to the fore, underscoring the importance of schemes being both proactive and flexible in their approach to social considerations, and ESG more broadly. Social risk factors can have a substantial impact on the sustainability of supply chains and the value of shares held by investors, and so present a material financial risk to schemes that do not appropriately take account of these risks. As focus on social issues grows, there are an increasing number of examples that illustrate the way in which ineffective risk-mitigation can materialise into financial detriment (Boxes 2.5 and 2.6).

Box 2.5: Asda case study

The Equal Pay Now campaign is a collective movement that has mobilised shop workers across major supermarket and high street chains to launch a legal claim challenging pay inequality between shop floor workers (traditionally predominantly women) and warehouse workers (traditionally predominantly men). The basis of this claim is that, under the Equality Act, where two jobs in the same company are different but of equal value, employees must be paid the same (unless the employer can justify not doing so).

More than 40,000 Asda employees have joined this claim and, in March 2021, the Supreme Court ruled that shop floor workers were entitled to compare themselves to distribution centre staff for equal pay purposes. This ruling is the first step towards securing equal pay for shop floor workers and it will likely take several years for the outcome of the overall case to be determined. However, if the Equal Pay Now claim is successful, Asda could be liable to pay around £10,000 in back pay to each of the 40,000 involved claimants, as well as increased labour costs in the future as a result of the need to equalise pay across the business. This could subsequently impact returns for those invested in the company.

Box 2.6: Deliveroo case study

In March 2021, an analysis of the invoices of 300 Deliveroo riders across the UK revealed that one in three made on average less than £8.72 an hour (the national minimum wage for those aged over 25). Some riders earned substantially less than the minimum wage, with one rider in Yorkshire being paid the equivalent of £2 an hour. This analysis calculated average pay based on the length of time that riders were logged onto the app and available to make deliveries, whereas Deliveroo calculates the average pay of its riders according to the time spent actively delivering. In 2019, Deliveroo estimated average pay of its riders to be more than £10 an hour.¹¹

Instances where riders are earning less than the minimum wage are legal as Deliveroo riders are classed as self-employed, removing any legal obligation to offer worker benefits or the minimum wage. However, a recent court ruling on Uber drivers has thrown doubt on this position. In February 2021, the Supreme Court confirmed that Uber drivers should be treated as workers, not self-employed. This means that drivers should be entitled to minimum national wage rates and the entire time drivers are logged on and available for work should be appropriately taken into account when ensuring overall pay.¹² A similar case has been brought successfully against Deliveroo in the Netherlands, finding that Dutch Deliveroo riders are employees and should be afforded the rights and protections of Dutch labour laws.¹³

Deliveroo was listed on the London Stock Exchange for the first time from 31 March 2021, at which point it was valued at £7.6 billion. A week later, the company's value had dropped to £5.26 billion, with share prices falling dramatically and some large asset managers boycotting investment in the company in response to its labour practices.

11 The Bureau of Investigative Journalism (2021)

12 The Bureau of Investigative Journalism (2021)

13 International Lawyers Assisting Workers Network (2021) *Taken for a ride: Litigating the digital platform model*

Attitudes on social issues are becoming increasingly important, however, many pension schemes do not keep track of these societal shifts, despite the impact they can have on companies in which they are invested

Public attitudes towards social issues are shifting, and more people are aware of and concerned about injustice and discrimination. However, pension schemes are not necessarily monitoring public movements that may affect the companies in which they are invested.

61% of schemes in the PPI Engaging with ESG Survey said that social or environmental movements had not affected their investment strategy. Both DB and DC schemes were among the 39% who said that their investment strategy had been affected by social or environmental movements, as well as both large and relatively small schemes (Figure 2.1). However, it is also worth considering that schemes that have delegated most or all of their investment to a provider or external asset manager may be unaware of the impact that environmental and social movements may have had on their investment strategy.

Figure 2.1¹⁴



Changes in regulation and increased focus on ESG across the investment landscape have driven shifts in UK pension schemes’ investment strategies. Overseas, in the absence of the regulatory motivations, specific events

and shifts in society have driven schemes to re-examine the social impacts of their investments (Box 2.7).

Box 2.7:

USA case study

While in the UK, policy and regulation mandates the consideration of ESG risks in pension schemes' investment strategies, in the USA, the regulatory position on ESG investment has fluctuated over time, from a neutral stance to actively discouraging it. The US Department of Labor's (DOL) ESG Rule, introduced on 30 October 2020, for example, suggests a conflict between fiduciary duty and ESG factors - an argument that has largely been dispelled in the UK.

There is a widespread expectation that this will change under the new US administration, which is expected to implement a broad range of policy changes aimed at mitigating climate change and other sustainability risks. These policies may include increasing calls for ESG disclosure, stricter climate regulations and perhaps revisions to the DOL's ESG Rule.¹⁵

Despite the hostile regulatory landscape for ESG investment in the US, public pension funds have mobilised their large pools of capital to put pressure on gun manufacturers in response to mass shootings across the country, with changes in investment and engagement approaches directly prompted by specific incidents. For example, in 2018, as part of a resolution on gun violence prevention and school safety, following the mass shooting at a school in Parkland, Florida, the American Federation of Teachers (AFT) stated that it would explore further divestment of public pension funds from gun manufacturing companies.¹⁶ Both financial and reputational (or 'headline') risks have been raised by the AFT as the basis for this divestment.¹⁷

Many US public pension funds have taken significant action to engage with and/or divest from gun manufacturers, including:

- The California Public Employees' Retirement System (CalPERS), which is the largest public pension fund in the US. CalPERS has divested from many gun manufacturers, including all those that produce and distribute to private persons assault weapons that are illegal under California law. The fund has also directly engaged with other gun manufacturers in its investment portfolio, sending written correspondence articulating CalPERS' concerns about the associated risks. CalPERS reported that four of the five companies engaged reported taking actions as a result.
- The California State Teachers' Retirement System (CalSTRS), which in 2009 began a policy of engaging gun manufacturers first, and then, after exhausting all options to resolve risks, divest. CalSTRS has taken an additional step of including in new private equity agreements provisions that exclude firearms subject to divestment and protect CalSTRS with opt-out options should such investments occur.¹⁸

15 State Street Global Advisors (2021)

16 AFT Resolution: Gun violence prevention and school safety (2018)

17 AFT (2018)

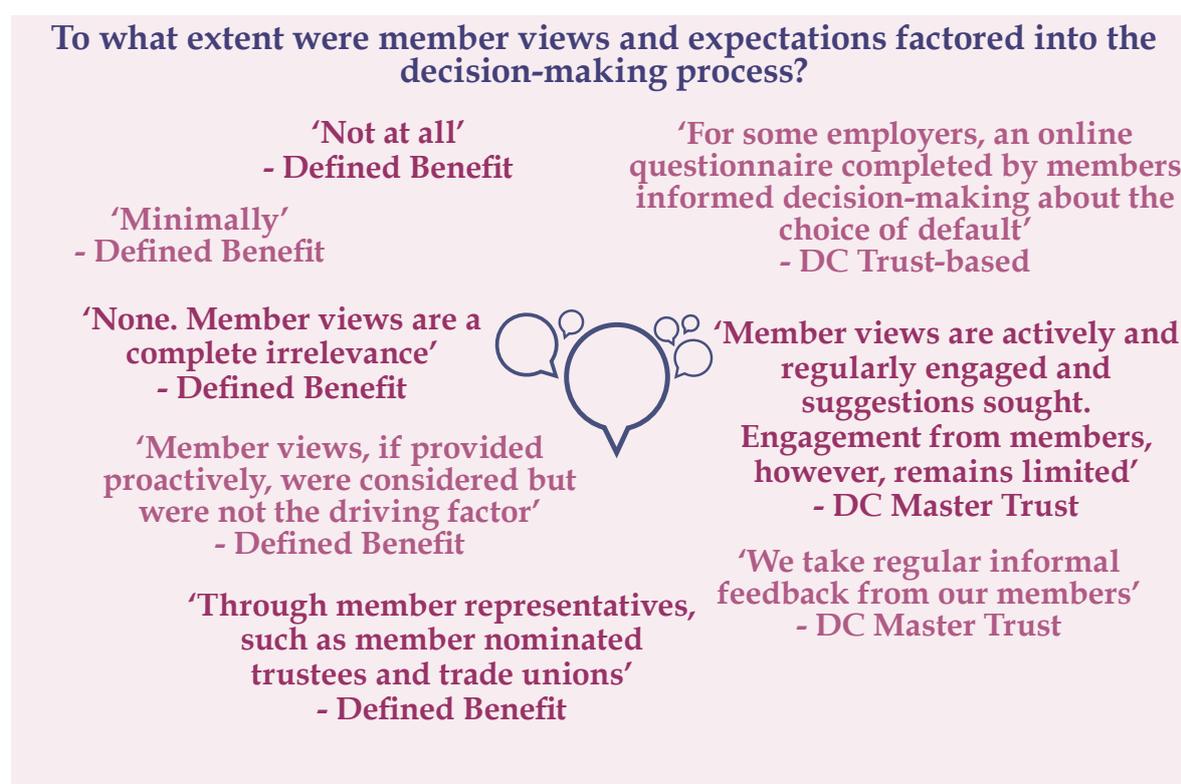
18 AFT (2018)

While the US case study illustrates action that pension schemes have taken even against an unsupportive regulatory backdrop, the action taken by these schemes is primarily driven by ethical considerations, rather than financial materiality, which must be the principal consideration for schemes in the UK. However, ethical considerations such as these can develop into financially-material risks as regulation and societal attitudes shift, so it is prudent for pension schemes to monitor events and trends which might precipitate these shifts.

Social considerations are especially important to scheme members

Member views may become more influential on scheme investment decisions in future, with three quarters (75%) of schemes in the Engaging with ESG Survey expecting this will happen. Although not obligated to do so at present, some schemes, especially larger DC schemes, are actively engaging with members on ESG issues to better understand their views (Figure 2.2).

Figure 2.2¹⁹



There is some evidence that a greater focus on ESG and responsible investment can increase member engagement with their pension, although instances of members directly engaging with their scheme on these issues remains relatively rare, largely due to low levels of engagement with pensions in general.²⁰

Although climate change is an issue of great importance to some, there is evidence that social issues are considered to be even more important by members (Chart 2.3).

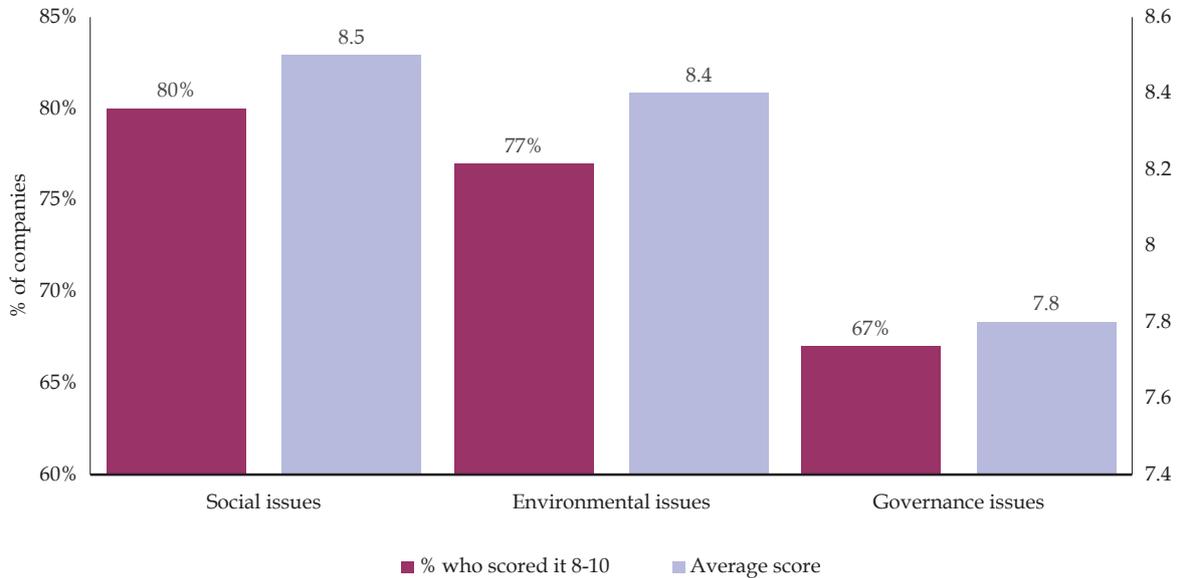
¹⁹ PPI Engaging with ESG Survey 2020

²⁰ The link between responsible investment and member engagement is explored in Chapter Three of *Engaging with ESG: Climate Change*

Chart 2.3²¹

NEST members ranked social issues as more important than environmental or governance considerations

Survey of 255 NEST members (2020) ‘How important are the following sorts of issues to you?’ (importance rating out of 10)



Collective movements such as Make My Money Matter aim to increase awareness among scheme members of the impact of their pension investments. Such movements aim to put pressure on those responsible for investing their savings to ensure that it is invested in ways that do not contradict their values and beliefs about ESG and responsible investment.

While these collective movements do make reference to social risks, such as unsustainable supply chains, focus is still largely on climate change-related risks. However, member engagement may be motivated more by social concerns, especially where these are perceived to have a more immediate impact in members’ own communities.

Governance factors

Principles for good corporate governance are well established in the UK

An understanding of the risks and opportunities of governance factors (Box 2.8) is a well-established component of many

traditional investment strategies, and has been since before ESG became a priority for pension schemes.

21 NEST Insight & LGIM (2020)

Box 2.8²²**Governance factors include:**

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

Scheme risks include:

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

The first version of the UK Corporate Governance Code was published in 1992 by the Cadbury Committee. It defined corporate governance as ‘the system by which companies are directed and controlled.’²³ In the years since, the Code has been revised and expanded to take account of the increasing demands on the UK’s corporate governance framework. The most recent version of the Code emphasises the value of good corporate governance to long-term sustainable success, covering five key areas:

- Board leadership and company purpose;
- Division of responsibilities;
- Composition, succession and evaluation;
- Audit, risk and internal control; and
- Remuneration.²⁴

International governance frameworks are also well-established, with principles that are in line with the UK Code.²⁵ Schemes, and those who invest on schemes’ behalf, can use these frameworks to assess the corporate governance standards of the companies in which they are invested.

Although corporate governance frameworks are well-established, there is still work to be done to ensure that governance risks are appropriately mitigated and accounted for

While corporate governance reporting frameworks are more developed and long standing than measures of social or non-climate related environmental risks, this does not mean that further work cannot be done to improve efficacy. As is the case across the spectrum of ESG considerations, the quality and availability of data on companies’ corporate governance practices is concentrated in larger, listed companies, for which much information is publicly available. The audit regulator has, in recent years, found up to a third of audits carried out by the seven largest audit firms to be in need of improvement or significant improvement.²⁶

Following three independent reviews in 2018, the Department for Business, Energy & Industrial Strategy (BEIS) is currently consulting on proposals aimed at ‘restoring trust in audit and corporate governance’. The consultation highlights that stakeholder and wider public trust in corporate governance and reporting procedures has been shaken by a number of recent corporate insolvencies, including BHS in 2016 and Carillion in 2018.

22 Silcock, D (PPI) (2018)

23 The Committee on the Financial Aspects of Corporate Governance (1992)

24 FRC (2018)

25 E.g. ICGN Global Governance Principles

26 FRC (2020)

Stewardship and engagement are an increasingly important component of ESG approaches, which can be challenging when schemes predominantly delegate day-to-day investment procedures to providers or asset managers, and do not always have the internal expertise or governance resources to fully understand or assess activity undertaken on their behalf

ESG approaches are increasingly incorporating not just decisions about which assets to invest in, but also activities undertaken to engage with investee companies. While strategies that involve greater levels of engagement activity tend to be more cost and governance intensive, there are benefits:

- Engagement allows investors the opportunity to influence the companies they are invested in, in order to improve policies and behaviour relating to ESG.
- Engagement can provide investors with more up-to-date and detailed information about the companies in which they are invested and their policies in relation to ESG.²⁷

With most schemes outsourcing some or all of their day-to-day investment decisions to either a pension provider or asset manager, direct engagement can be challenging. Schemes are often heavily reliant on the activities undertaken by those parties on their behalf, as well as the detail and accuracy of information provided to them about these activities. The PLSA's Stewardship Toolkit highlights that while schemes may need to take varying approaches to engagement and stewardship depending on how much of their investment is outsourced, schemes of all types should ensure that the increasingly important component of investment has been accounted for:

- For pension schemes that manage their investments in-house, the practices outlined in the toolkit can be incorporated directly into their own investment stewardship practices.
- For pension schemes that delegate investment to external consultants and asset managers, the toolkit can be used as a benchmark against which to measure service providers' quality of stewardship when awarding mandates and assessing performance.²⁸

²⁷ PRI (2019)

²⁸ PLSA (2016)

Figure 2.3²⁹

DB and larger DC schemes are more likely to have internal policies for direct engagement with companies they invest in, as well as a greater understanding of stewardship and engagement activities being undertaken on their behalf (Figure 2.3). Other schemes, however, are yet to incorporate these considerations into their decisions about how to delegate investment decisions. **One respondent to the Engaging with ESG Survey** said that

they did not take into account asset managers' engagement and stewardship activities when selecting and retaining managers.

On average, expectations about asset managers' engagement behaviour and reporting appear to be increasing. However, several schemes in the survey reported there was still work to be done before asset managers are fully meeting these expectations (Figure 2.4).

29 PPI Engaging with ESG Survey 2020

Figure 2.4³⁰



While engagement is a vital method for driving ESG progress, divestment can also be a powerful tool, especially when other approaches have been exhausted

Divesting from companies that are performing poorly on ESG can lead to less change than higher engagement approaches would do. However, divestment (or the threat of it) can also be a powerful tool for exerting pressure on companies to improve their ESG behaviours,

particularly when applied across a broad group of investors, especially when engagement is either not possible or has reached the limits of the progress that can be made.³¹ During the 1980s, a campaign of divestment was employed by individual and institutional investors around the globe in response to the ongoing apartheid in South Africa at the time (Box 2.9).

30 PPI Engaging with ESG Survey 2020

31 State Street Global Investors (2020)

Box 2.9:

South Africa case study

South Africa was the second country in the world, after the UK with its 2010 Stewardship Code, to formally encourage institutional investors to integrate ESG factors into their investment decisions. In 2011, the Code for Responsible Investing in South Africa (CRISA) was launched, with principles aligned to those of the UN PRI.

As in the UK, governance frameworks are also an established component of investment in South Africa; the current iteration of the King Code on Corporate Governance (first published in 1994) forming part of the listing rules on the Johannesburg Security Exchange.

Read together, the King Code and CRISA provide 'a framework that relates to the function of all role players in the overall governance system, including boards of companies, institutional shareholders, their service providers and the ultimate beneficiaries. The objective of providing such a framework is to ensure that sound governance is practiced, which results in better performing companies that deliver both economic value as well as value within its boarder meaning.'³²

Focus on social factors

While in the UK, and globally, much focus has been on climate change, ESG investment in South Africa has been heavily focused on social factors. This is largely the result of greater focus on social issues across South African society more broadly, as well as the successful impact of divestment used to affect significant social change in bringing an end to apartheid in the country.

During the 1980s, investors enacted a campaign of 'protest divestment' as a means to put pressure on the South African Government to end apartheid in the country. Individual and institutional investors around the world divested from companies that had business or interests in South Africa. The campaign sought to lower the value of these companies and in doing so, put pressure on them to withdraw economic support from South Africa.³³

Environmental transition

South Africa has a heavy dependence on the use of fossil fuels, especially coal. Although South Africa has set targets to increase renewable energy use to 33% of the energy mix by 2030, coal currently accounts for around 80% of the country's energy output, and it remains among the top 20 emitters of carbon globally.³⁴ If the country shifted away from fossil fuels suddenly, millions of its citizens would suffer, with frequent power cuts, a lack of hot water and no access to internet. There is, therefore, a need to balance environmental pressures with the potential negative social impacts.

32 Institute of Directors South Africa (2011)

33 Schroders (2019)

34 Vezer & Mayaki [Sustainalytics] (2019)

Conclusions

While climate change has and will continue to be a focus of ESG investment, the importance of other environmental, social and governance factors is increasingly being recognised by investors.

- Although other environmental factors have often been overshadowed by climate change, the strategies used to progress climate change investments are now being used as a blueprint for integrating these other environmental factors.
- Social considerations are growing in importance, a shift that has been accelerated and highlighted by the events of the last year. However, not all investors are monitoring these social issues that can impact the companies in which they are invested.
- Principles for good corporate governance are well established in the UK, but failure to recognise the way that it interacts with environmental and social factors may lead to more fragmented ESG approaches.
- Stewardship and engagement are an increasingly important component of ESG approaches, which can be challenging when schemes predominantly delegate day-to-day investment procedures to providers or asset managers, and do not always have the internal expertise or governance resources to fully understand or assess activity undertaken on their behalf.

Chapter Three: What are the barriers to effective integration of ESG risk factors?

This chapter examines the barriers that schemes, and others involved in the investment process, face when integrating ESG risks.

Regulation now requires that pension schemes at least consider ESG risks when making decisions about their investment strategy. Given the financially-material nature of many of these risks, this consideration, if done in a meaningful and appropriate way, will often necessitate that schemes make changes to their investment strategy to ensure that ESG risks have been mitigated appropriately in order to effectively protect members' pension savings. However, the process of designing and implementing an appropriate ESG investment strategy, delegating to asset managers or selecting an appropriate off-the-shelf solution from a pension provider, is complex. Responses to PPI's Engaging with ESG Survey highlight the barriers schemes face when approaching ESG risk factors, including the following:

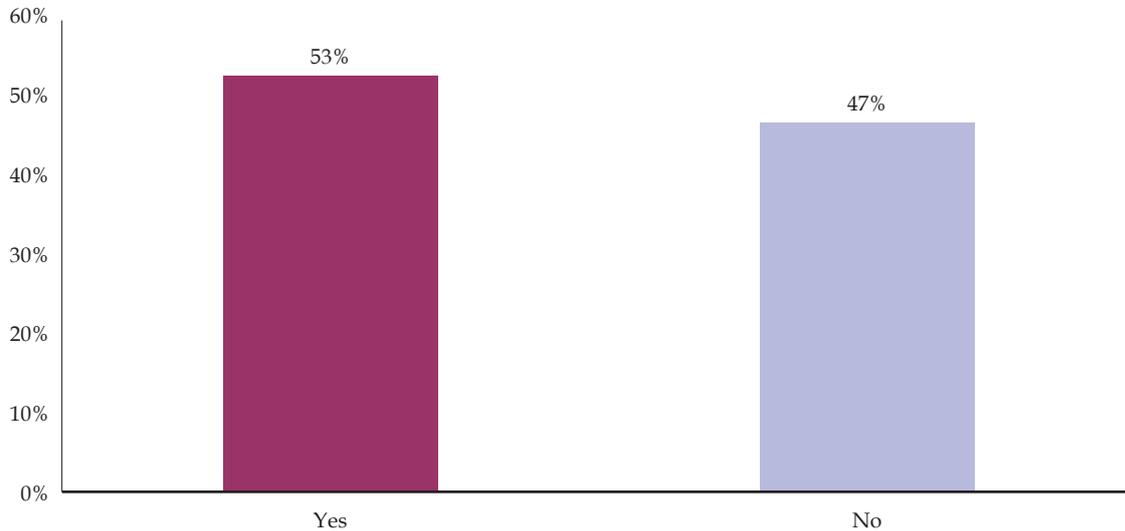
- The large quantity and inconsistent quality of information available on ESG risks and approaches.
- ESG data issues, such as availability, cost and divergence between different metrics.
- The broad scope of social factors in particular, and the difficulty associated with evaluating social risks and opportunities.
- Dependence on third parties, in terms of how this may limit the ESG strategies available to schemes and especially engagement and stewardship approaches.

Around half (47%) of schemes that responded to the Engaging with ESG Survey reported that they did not face any specific barriers when implementing their ESG strategy (Chart 3.1).

Chart 3.1³⁵

Around half of the schemes in the survey reported that they did not face any specific barriers when implementing their ESG strategy

PPI Engaging with ESG Survey: 'Have you experienced any particular barriers during implementation of your ESG strategy?'



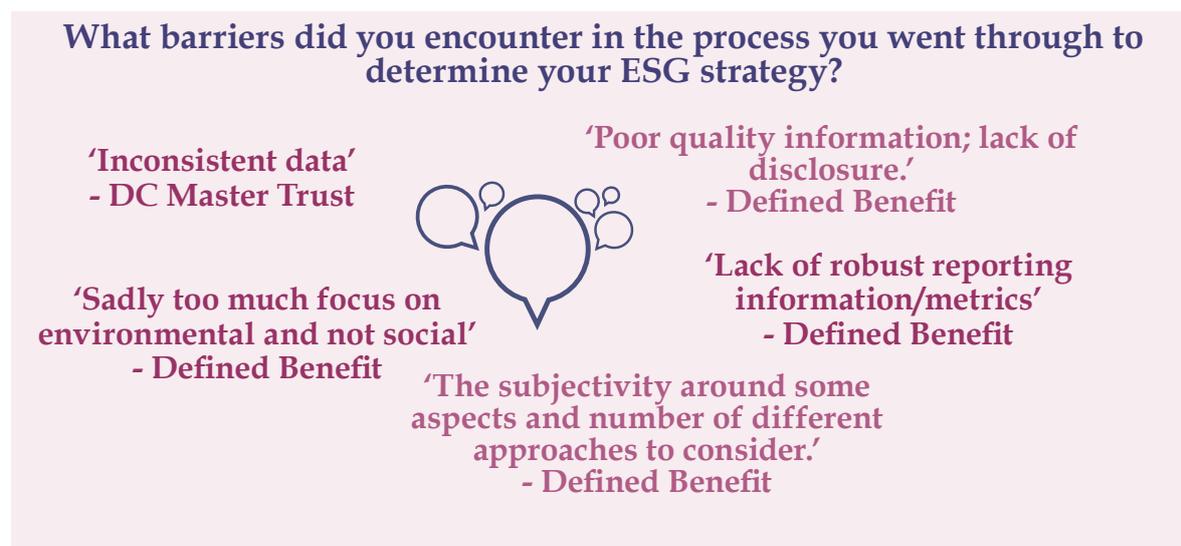
Around a quarter of schemes report that the vast quantity of information available on ESG, and inconsistency in the quality of information, can make it difficult to know how to approach ESG risks

The ESG investment landscape has evolved rapidly over the last three years in particular. SIP regulations introduced over the same period mean that all schemes must take ESG risk factors into consideration, including those schemes that were not previously engaging on ESG issues at all. Many trustees and providers have taken proactive steps to improve their knowledge and understanding of ESG issues, which has seen awareness and engagement grow across the industry. However, as the focus

on ESG has grown, so too has the quantity of information about ESG risks and approaches for integrating them into investment strategies. More easily accessible information can help those responsible for making decisions about pension schemes' investment strategies to improve their knowledge around ESG, in order to make more informed decisions. Too much information and difficulty determining which information is most salient, however, can impede decision-making.

More than a quarter (28%) of respondents to the Engaging with ESG Survey said that too much information had been a challenge when designing their approach to ESG, while 22% said that conflicting information had also been a challenge.

35 PPI Engaging with ESG Survey 2020

Figure 3.1³⁶

Schemes also identified availability, cost and consistency of ESG data as a barrier to both design and implementation of an effective ESG strategy

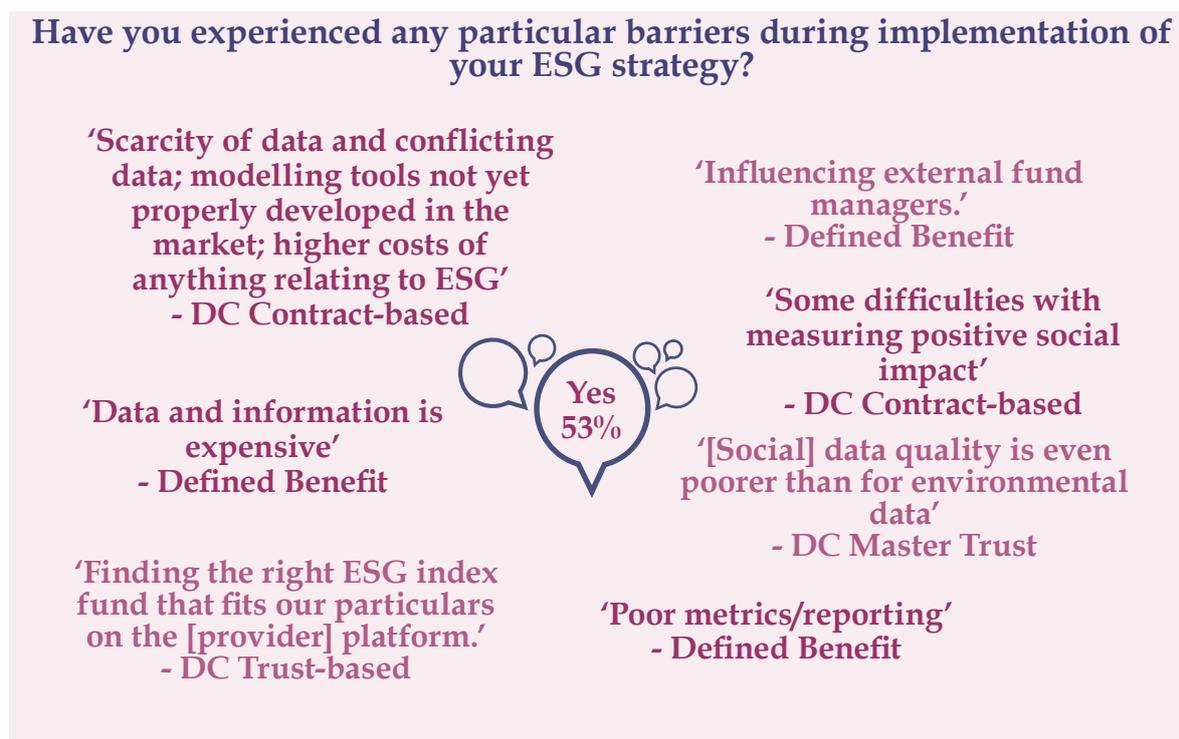
A lack of consistency and clarity in data and reporting is a fundamental barrier to improving the effectiveness of ESG risk mitigation in schemes' investment strategies, during both the design/selection and implementation stages (Figures 3.1 & 3.2). A Defined Benefit (DB) scheme in the survey highlighted that 'data and information are expensive', while a Defined Contribution (DC) provider pointed to 'the higher costs of anything relating to ESG'.

Many pension schemes will have their research, assessments and engagement carried out on their behalf by their pension provider or external asset managers, although larger schemes are more likely to have internal research capabilities. This means that scheme decision makers are dependent on the quality of their asset manager's report when constructing their own. Some trustees report that the quality of asset manager reporting is variable and that some trustees may not be furnished with sufficient evidence of an asset manager's ESG process to comply with regulation.³⁷

36 PPI Engaging with ESG Survey 2020

37 PLSA (2020)

Figure 3.2³⁸



Schemes report that consistent and clear data on social factors is especially challenging to find

The broader scope, qualitative nature and difficulties associated with evaluating social risks and opportunities (discussed in more detail in the next section of this chapter) mean that developing an understanding of data around social factors, and how this relates to scheme investment decisions, is more challenging than for environmental and governance factors. One respondent to the Engaging with ESG Survey, a Master Trust, highlighted that '[social] data quality is even poorer than for environmental data'; another, a DB scheme, said of ESG information more generally that 'sadly [there was] too much focus on environmental and not social'.

Because corporate governance frameworks are well-developed, data is more accessible, but schemes are still reliant on publicly available data or else direct engagement with companies to gather more data

Governance data has been compiled for a longer period of time, comparative to environmental and social risk factors. Similarly, because governance is a more established component of traditional investment strategies, criteria for what comprises good governance and its classification has been more widely discussed and accepted - especially compared to social factors.³⁹ Company disclosure frameworks do still, however, tend to vary by country and regulations, which can make it harder to compare like-for-like across different regions.

38 PPI Engaging with ESG Survey 2020

39 Deutsche Bank (2020)

Investors will often rely on publicly available governance data, which is dependent on the quality of reporting and tends to be more detailed and readily available from companies with better standards of corporate governance. Where sufficient governance data is not available, schemes, or those acting on their behalf, may need to engage directly with a company to obtain the necessary data. If sufficient data on corporate governance standards cannot be obtained, the scheme will either need to avoid investment in the company, which could lead to a concentration of the portfolio in larger companies with better reporting procedures, rather than necessarily better governance procedures per se - or else there is the potential for unforeseen governance risks to impact investment negatively in future.

There have been concerns that the introduction of GDPR may impede accessibility of governance data, but this has not so far been a significant barrier

The General Data Protection Regulation (GDPR) came into effect in May 2018 and imposes obligations on any organisations that collect

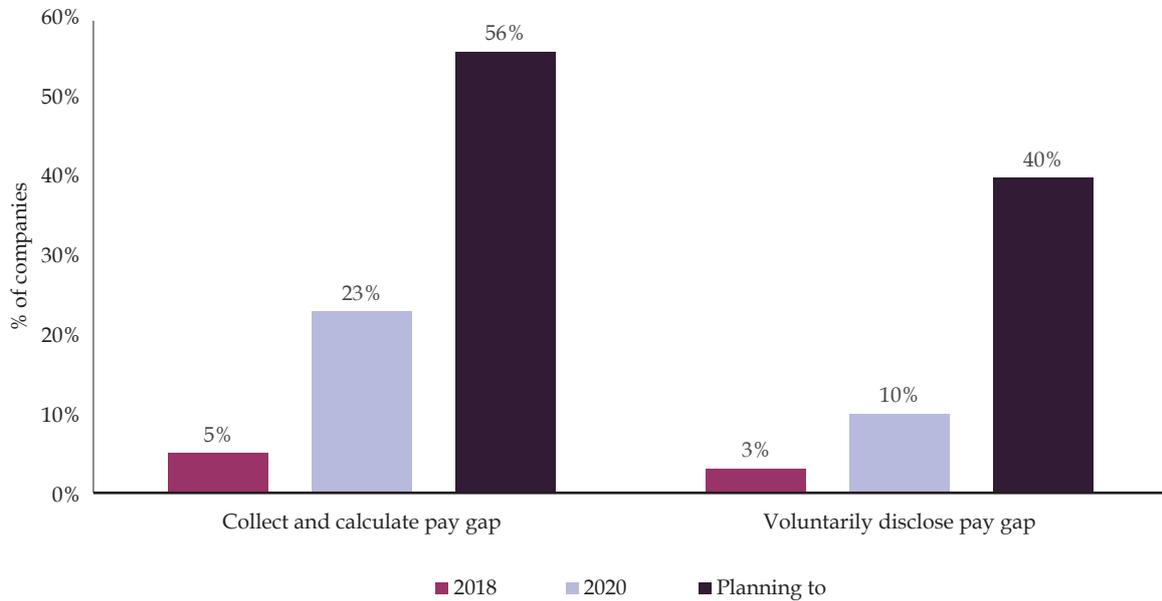
data related to people in the EU, in order to protect their privacy. Although the UK is no longer a member of the EU, the principles of the EU GDPR have been incorporated into UK Data Protection law, so continue to apply in relation to UK citizens' data as well as EU citizens.

Despite concerns that more stringent regulation of data collection and distribution may make it more difficult to access diversity data, the number of companies collecting and disclosing diversity data has grown in recent years - with even more companies committing to collect and disclose this data in years to come. For example, both the proportion of companies collecting data on their ethnicity pay gap and the proportion voluntarily disclosing it have increased since 2018 (Chart 3.2), while reporting on gender pay gaps is now mandatory for employers with more than 250 employees.

Chart 3.2⁴⁰

An increasing number of companies are collecting and disclosing data about their ethnicity pay gap

PWC survey covering over 100 companies, representing approximately 1 million UK employees (2020)



Increased focus and standardised reporting on inequalities will improve the data available to schemes when making decisions about how to take account of social and governance risks in their investment strategy.

The broader scope and qualitative nature of social factors can make it hard to measure impact and understand how to integrate risks effectively

The broader range of issues that fall under the social component of ESG considerations, along with the qualitative nature of social metrics, contributes to the difficulty of integrating social risks into pension schemes' investment strategies.

While financial risk must be the main focus of pension schemes when integrating ESG factors into their investment strategies, the social investment sphere generally focuses not just on limiting potential damage but also creating social benefit. This means that social factors can be more challenging to assess than environmental factors, which tend to focus on reducing harm, or governance, which tends to operate within existing legal or stewardship

frameworks. A respondent to the PPI Engaging with ESG Survey highlighted the existence of 'difficulties with measuring positive social impact'. Considering historical confusion about the extent to which ESG factors are financially material and a perceived conflation between ESG and ethics, the nature of social factors might make some investment decision makers more hesitant to engage where the financial materiality is less obvious than for environmental or governance factors.

There can also be regional and cultural variance in the definitions and importance given to different social issues, which is less problematic for environmental and governance factors that tend to be more globally agreed upon. Because of the broad range of issues encompassed by the social area, there is also the potential for competing considerations, either within the social sphere or with other areas of ESG. Infrastructure projects, for example, may be socially beneficial but can be associated with risks in other areas of ESG, especially environmental or even other social considerations.

40 PWC (2020)

Conclusions

The process of designing and implementing an appropriate ESG investment strategy, delegating to asset managers, or selecting an appropriate off-the-shelf solution from a pension provider, is complex and schemes face a number of barriers. These include:

- Around a quarter of schemes report that the vast quantity of information available on ESG, and inconsistency in the quality of information, can make it more difficult to know how to approach ESG risks.
- Schemes also identified availability, cost and consistency of ESG data as a barrier to both design and implementation of an effective ESG strategy. Schemes report that consistent and clear data on social factors is especially challenging to find.
- The broader scope and qualitative nature of social factors can make it hard to measure impact and understand how to integrate these risks effectively.

Chapter Four: What practical steps may be needed to make ESG approaches more effective?

This chapter identifies the practical steps that might be needed to overcome the barriers highlighted in the previous chapter.

The establishment of joined-up goals across Government and industry will help schemes to more effectively integrate ESG risks into their investment strategies

The previous report in this series, *Engaging with ESG: Climate Change*, highlighted that while some schemes, and those acting on their behalf such as providers or external asset managers, are doing a lot of work to mitigate ESG risks, there is still a lot of work to be done before all schemes have effectively accounted for these risks in their investment strategy. The report identified five areas where further development could help to further progress towards this target:

- **Integrated goals:** Establishing a consensus across all stakeholders (Government, schemes, asset managers and providers) on goals, and the practical steps needed to achieve them, to

ensure that climate change considerations are integrated across the investment landscape by a certain date.

- **Engagement and stewardship:** A greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals.
- **Encouraging innovation from third parties:** Pressure from Government, regulators and industry bodies on those involved in schemes' approach to climate change (such as pension providers, external asset managers and consultants) to provide products and strategies that meet the needs of schemes in integrating these risks, as well as improving the data they provide schemes about their own activities relating to climate change.
- **Increasing knowledge and understanding:** Improving scheme decision makers' knowledge and understanding of climate change across the industry, especially

around more practical aspects such as the implications of different investment approaches.

- **Standardised data and definitions:** Producing a centralised data source which can provide a starting point for schemes that are unsure where to begin, or are overwhelmed by the quantity of data available - particularly given inconsistencies across different metrics. Feasibly, this would need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

These development areas are perhaps even more salient for the other ESG factors which are explored in detail in this report, some of which appear to be on the same path towards more effective integration as climate change, but earlier in the process. The progress that

has already been made towards more effective integration of climate change risks can be used as a guide for increasing the effectiveness of efforts to integrate these other ESG risks. This chapter explores the way in which these practical steps could increase effective integration of other ESG factors in pension schemes' investment strategies. Consistency in the way in which the various areas of ESG are approached is likely to yield a greater protection for members against these risks.

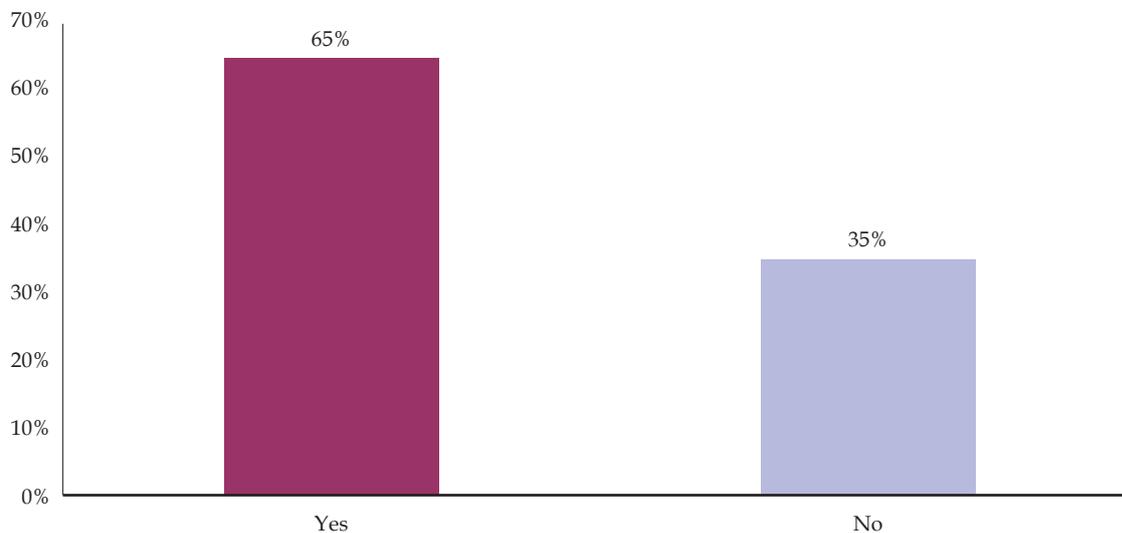
Most pension schemes feel they are currently doing enough to mitigate ESG risks

Activity around ESG considerations has increased substantially and two thirds of schemes in the Engaging with ESG Survey believe they are currently doing enough to account for these risks in their investment strategy (Chart 4.1).

Chart 4.1⁴¹

A third of schemes in the Engaging with ESG Survey think they could be doing more to account for ESG considerations

PPI Engaging with ESG Survey: 'Do you feel that your scheme is doing enough in terms of ESG issues?'

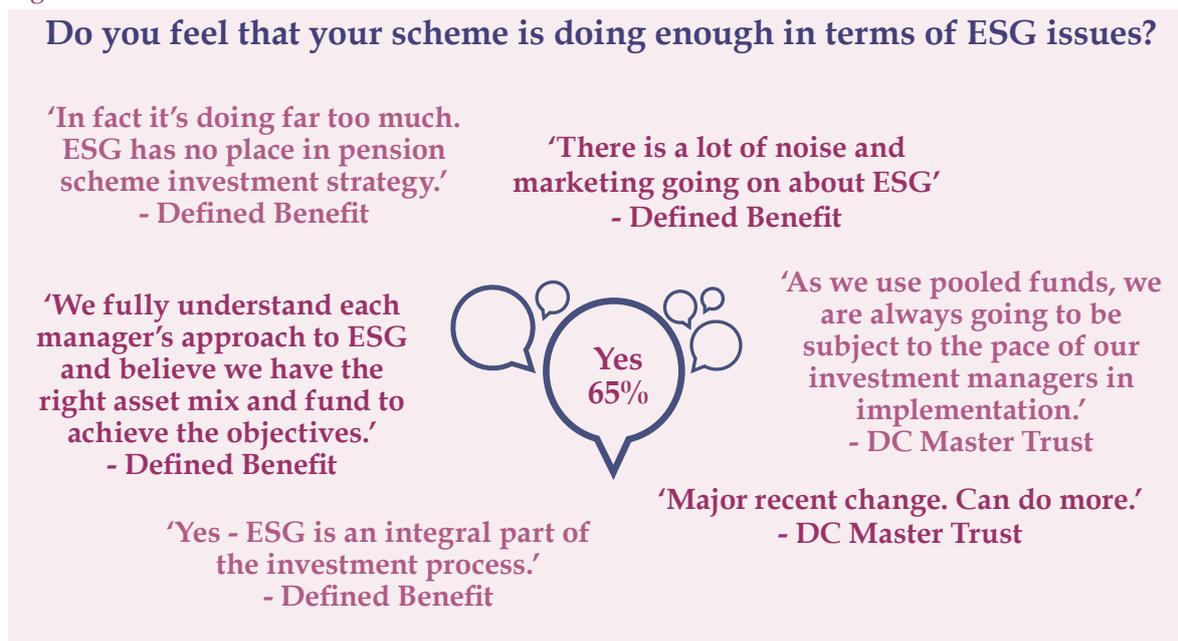


Among schemes that believe they are currently doing enough on ESG, there are a range of views, including some Defined Benefit (DB) schemes in the survey reporting feeling that they are actually focusing on ESG too much (Figure 4.1). DB schemes differ from Defined Contribution (DC) schemes in

terms of goals, distribution of risk and time horizons of investment, so approaches to ESG understandably vary between the two types of scheme. However, these comments suggest that, among DB schemes in particular, there may still be some confusion about the financially-material nature of ESG risks.

41. PPI Engaging with ESG Survey 2020

Figure 4.1⁴²



Among many schemes, both those who feel they are doing enough and those who do not, there is a recognition that ESG strategies are a work in progress (Figures 4.1 & 4.2). Because responses are subjective, some respondents who said that their scheme was doing enough may actually be doing less than others that responded that their scheme was not doing enough. For example, those who feel that their

scheme is perhaps even doing too much may not fully recognise the financially-material nature of ESG risks, while those who said their scheme was not doing enough because approaches to ESG risks need to be constantly reviewed and they are on a path towards full integration may be doing more but recognise that there is still work to be done.

Figure 4.2⁴³



42. PPI Engaging with ESG Survey 2020

43. PPI Engaging with ESG Survey 2020

Integrated goals

Many of the various areas of ESG factors are interconnected. For example, companies with high standards of corporate governance are more likely to have better practices relating to environmental and social considerations. The most effective ESG strategies will understand and reflect this. Given the particular focus on climate change in ESG investment strategies to date, there are also lessons to be learned from the progress that has been made towards effective integration of climate change risks into investment strategy, in terms of what has worked well and what hasn't. Establishing overarching and widely agreed-upon goals, such as the Net Zero Paris Agreement, and industry-wide task forces and working groups, most notably the Task Force on Climate-Related Financial Disclosures (TCFD), has helped to drive forward schemes' engagement with climate change considerations. Similar initiatives are beginning to form elsewhere in the ESG landscape, but will take time and joined-up work to develop to the level reached by climate change initiatives.

In order to make ESG risk mitigation as effective as possible, decision makers must recognise the interconnectedness of different areas of ESG

Investors focusing too heavily on environmental or social factors to the neglect of governance considerations, fail to recognise the link between investee companies with good governance practices and practices relating to environmental and social considerations. For example, lower governance standards stemming from weaker institutions, fewer regulations and lower levels of economic development can make emerging market economies more prone to environmental and social risks compared to developed markets.

Engagement and stewardship

Stewardship and engagement are becoming an increasingly important component of ESG approaches. However, there are concerns that some schemes may be delegating these activities to third parties (providers and external asset managers) without enough understanding of the activities being undertaken on their behalf. While some schemes in the Engaging with ESG

Survey had defined engagement and voting policies of their own, many reported leaving this entirely to their external asset managers (Figure 3.4). This is not an issue in itself, but schemes must ensure that they understand the activities being undertaken on their behalf and how they interact with their stated investment principles.

Schemes are reliant on the information provided by those undertaking engagement activities on their behalf and might not necessarily have a good enough internal knowledge and understanding of what constitutes 'good' engagement if they have not taken the time to develop internal policies or aims. **Schemes must ensure that they have sufficient understanding and that they are being provided with appropriate data on both investment allocation and engagement and stewardship activities being undertaken on their behalf by external managers - even if this is done through other parties such as their provider.**

Encouraging innovation from third parties

Among both schemes that feel they are doing enough to take account of ESG risks in their investment strategy and those that do not, there is the view that reliance on third parties, such as external asset managers, can be a constraint. A DC Master Trust that feels its ESG strategy is sufficient at present said that 'as we use pooled funds, we are always going to be subject to the pace of our investment managers in implementation' (Figure 4.1). Similarly, a DB scheme that feels it could be doing more said that 'we invest in pooled vehicles and cannot therefore realistically affect the investment strategy on our own' (Figure 4.2).

More than a quarter (28%) of schemes that responded to the Engaging with ESG Survey said that the need for a platform, asset manager or other third party in implementing their strategy proved to be a barrier to constructing it exactly as they would have liked. A single-employer trust-based DC scheme in the survey highlighted that they had difficulty 'finding the right ESG index fund that fits [their] particulars' on their chosen investment platform (Figure 3.2).⁴⁴

44. PPI Engaging with ESG Survey 2020

While acknowledging that the need for a platform, provider or external asset manager can constrain their ESG investment strategy, schemes in the survey seemed to accept this status quo as a limit within which they would have to work, rather than a catalyst for engagement with third parties to drive forward innovation so that they are better able to implement their preferred ESG investment strategy.

Schemes may need to engage with and challenge their pension provider and/or external asset managers more directly in order to drive forward innovation to ensure that off-the-shelf and pooled products meet their needs and align with internal policies on ESG investment. Smaller, single-employer schemes with lower levels of assets under management generally have less power to influence external fund managers. However, if enough larger schemes engage providers and external asset managers, this will drive up standards and availability across the industry, to the benefit of smaller schemes.

Increasing knowledge and understanding

Although knowledge and understanding of ESG has grown across the industry, there are still gaps in some areas, especially when considering social factors. The large quantity and inconsistent quality of information available on ESG risks and approaches was highlighted as a key barrier by schemes in the Engaging with ESG Survey. Knowledge and understanding of the importance of corporate governance standards tends to be reasonably developed among scheme decision makers. However, the broad scope and qualitative nature of social factors in particular, and the difficulty associated with evaluating social risks and opportunities, can make it harder for schemes to understand how to integrate these risks effectively into their investment strategy. **This is an area where a source of comprehensive and neutral guidance could be especially beneficial for scheme decision makers that don't know where to start in assessing the financially material nature of social risk factors.** This aim could also be aided by increased integration and cohesion across the industry, as asset

managers and consultants who are especially engaged on ESG could share knowledge with schemes and help to improve standards across the industry.

Standardised data and definitions

Schemes in the Engaging with ESG Survey highlighted availability, cost and consistency of ESG data as a barrier to both design and implementation of an effective ESG strategy. As with more general information on ESG risks, as the focus on ESG grows, so too does the availability of data on ESG ratings. Standards vary across different metrics and analytics tools and can be confusing for scheme decision makers, especially those who have low levels of knowledge on ESG.

As a starting point, **a standard framework clarifying key definitions around ESG and investment would ensure a higher level of shared understanding across the industry.** Collaboration between Government and industry to produce a framework of common language and taxonomy could help to clarify existing confusion resulting from a wide range of competing standards and definitions that currently exist.⁴⁵

Initiatives aimed at improving consistency and quality of data available on social and governance factors are beginning to gather momentum

While much of the focus in recent years has been on climate change, work has also begun to be done on developing data in the social and governance areas. The Workforce Disclosure Initiative (WDI), for example, which is run by ShareAction and part-funded by the Department for International Development (DFID), has been working to improve the social element of ESG by encouraging companies to increase transparency and accountability through disclosure of data about their workforce. This initiative will provide companies and investors with more comprehensive and comparable data on social risks. In 2020, 141 global companies took part in the initiative, representing a 20% increase on 2019.⁴⁶

45. PLSA (2020)

46. <https://shareaction.org/workforce-disclosure-initiative/>

Conclusions

- The progress that has already been made towards more effective integration of climate change risks can be used as a guide for increasing the effectiveness of efforts to integrate these other ESG risks. The five development areas identified for climate change investment are perhaps even more salient for other areas of ESG, which appear to be on the same path towards more effective integration, but earlier in the process, comparative to climate change.
- Schemes must ensure that they have sufficient understanding and that they are being provided with appropriate data on both investment allocation and engagement and stewardship activities being undertaken on their behalf by external managers - even if this is done through other parties such as their provider.
- Schemes may need to engage with and challenge their pension provider and/or external asset managers more directly in order to drive forward innovation and ensure that off-the-shelf and pooled products meet their needs and align with internal policies on ESG investment.
- Knowledge and understanding of the importance of corporate governance standards tends to be reasonably developed, but the financially-material nature of social risk factors, and how to account for them in investment strategies, is less well understood. A comprehensive and neutral source of guidance on social risk factors could be especially beneficial for scheme decision makers that don't know where to start.

Appendix: Engaging with ESG Survey 2020

This report uses data from PPI's Engaging with ESG Survey. Carried out in November 2020, the survey sought to gather insight into the approaches being used by schemes in order to take into account ESG risks, and the challenges they have faced along the way.

The survey was open to responses from both schemes and third parties involved in the process, such as consultants and asset managers. There were 62 responses in total, including 31 pension schemes, 48% of which were Defined Contribution (DC) and 52% Defined Benefit (DB).

When drawing conclusions from the data it should be recognised that the responses cover a subset of the market, and those who responded are more likely to be more engaged on ESG in general. This report has also been informed by qualitative interviews carried out with a broad range of stakeholders across the industry.

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