Aligning responsible business policies with pension investments

How do you ensure alignment between your responsible business policies and your pension scheme assets?

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BUSINESS IN THE COMMUNITY
The Prince's Responsible Business Network

isio.

Executive Summary

With companies across the globe increasing their sustainability ambitions, we know that the pensions industry plays a key role in driving change across these issues. With rising industry and market expectations, employers and pension scheme trustees are increasingly faced with changing laws and regulatory guidance to reflect a new sustainable agenda. Aligning the values and sustainability ambitions of the employer with that of their pension schemes is crucial.

Why should you align your responsible business policies and your pension scheme assets?

1

Improved alignment of responsible business policies and corporate strategy with sustainability integration in pension assets unlocks opportunities for the employer, including:

Managing or reducing corporate reputational risks and increasing brand recognition with increasing pressures within the investment industry.

Employee and customer engagement may lead to improved recruitment and retention, as the next generation of savers are keen to make an impact.

2

Improved sustainability integration in pension assets is a powerful tool, with other benefits including:

Better investor outcomes as sustainable investing can increase long term risk-adjusted returns.

Regulatory push is setting clear benchmarks for pension scheme expectations when considering sustainability issues and risks.

Delivering impact on issues that are important to employees and the employer, this can be across environmental and social issues.

Collective influence can be achieved on important issues given the scale of investments across pension assets.

How can you align your pension scheme assets with your responsible business policies?

1. Communicate your responsible business policies (e.g. any priority areas, net zero ambitions etc.) with the pension scheme trustees (across both DC and DB schemes), relevant advisor or provider to seek alignment.
2. Understand what's important to your employees.
3. Understand how sustainability issues are currently integrated in your pension arrangements (across both DB and DC) – in terms of policies and implementation.
4. Monitor alignment and track progress against a set of ESG metrics and provider/manager activity.

In this paper, we delve into each of these topics in more detail.

Pensions hold significant power in creating an impact in this area and corporates can play a key part. If you would like a further conversation, please reach out to Isio or your Business in the Community (BITC) contact.

Introduction

We are increasingly seeing companies embedding environmental, social, and governance (ESG) considerations into strategy and decision-making to ensure they keep pace with the transition to a more sustainable economy, this may include adopting a net zero strategy.

Employers offering Defined Benefit (DB) and/or Defined Contribution (DC) pension schemes cannot afford to ignore these movements. **The argument for sustainable investment is clear, and aligning the values and sustainability objectives of the employer with that of their pension schemes is crucial.**

The pensions industry plays a key role in driving change across a range of sustainability issues. As we seek to move to a more sustainable world, employers and pension scheme trustees have a significant part to play and are also increasingly faced with changing laws and regulatory guidance. Some pension arrangements do not have trustees in place, in these situations we note that best practice involves employers setting up internal governance committees responsible for these pension arrangements (e.g. the provider selection and default design of the DC scheme). Therefore, whilst we note a trustee board's ESG journey below, this is also relevant for other arrangements.

This paper covers why alignment between responsible business strategy and pension assets is important, as well as best practice guidelines on how to ensure alignment, and how we can help.

Part 1

Why should your pension scheme be aligned with your responsible business strategy?

Why should your pension scheme be aligned with your responsible business strategy?

Improved sustainability integration in pension assets is a powerful tool and unlocks opportunities for the employer, we note a few benefits below.

Potential benefits to the business

Corporate reputational risks

Ensuring there is consistency in beliefs across your responsible business strategy and how your pension assets are invested is key from a reputational perspective. We are seeing increasing pressures within the investment industry from groups such as Just Stop Oil and Make My Money Matter, that seek to raise awareness on sustainability issues, as part of this we are seeing increasing media coverage. As an example, although the Universities Superannuation Scheme won the appeal, recently the Scheme faced legal action from its members over its continuing investments in fossil fuel (particularly coal, natural gas and petroleum) and lack of credible plan to divest, despite the company's stated ambition to be carbon neutral by 2050[2], which resulted in some reputational damage.

Another example was the Church of England pledging £100m to "address past wrongs", and an apology from the Archbishop of Canterbury. It was found, in a report last year, that its investment fund had long-standing historic links to slavery via an investment in the South Sea Company, which was involved in transporting thousands of slaves during its 30 years of operation[3].

Employee and customer engagement

Research shows the next generation of savers are keen to make an impact; 8 in 10 millennials would increase their pension engagement if its investments had a positive influence on society[1]. This is an opportunity for employers to engage with employees to seek to improve outcomes and employee retention, as well as potentially retaining customers.

"Following press exposure of our fund in 2003, the realisation that our pension's investment strategy was not aligned to our values was a game changer for us. Alongside the collaboration with our trustees to embed ESG within our strategy, we now have a pension investment strategy to be proud of- one with strong focus on responsible and sustainable investment."

Emma Howard Boyd
Chair of the Environmental Agency

1 Finding the greenest generation – DC ESG report (stoneshot.com).
2 McGaughey & Davies v. Universities Superannuation Scheme Limited - Climate Change Litigation (climatecasechart.com).
3 Church of England announces £100m fund after slavery links - BBC News.

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Potential benefits to the pension scheme

Better investor outcomes

There is evidence to show that sustainable investing can increase long term risk-adjusted returns. From a DB scheme perspective, a sustainable long-term approach can provide more certainty for the sponsoring employer on the capital required. For DC schemes, pension providers are increasingly developing and offering sustainable investment opportunities, giving members more flexibility to align investments with their individual beliefs.

Delivering impact

By incorporating ESG considerations into investment decisions, corporate pension funds can help to play a pivotal role in scaling up efforts to tackle some of our most pressing global challenges. Globally, pensions account for half of all the money in the world, and in the UK alone they are worth £2.6 trillion[4]. This means pensions hold significant power in driving action across sustainability issues, from climate change, to rising inequalities, to tackling nature degradation.

Regulatory push

Recent mandatory compliance reporting (including the Taskforce on Climate-related Financial Disclosures (TCFD)) are setting clear benchmarks for pension scheme expectations when considering ESG issues and risks. Regulation continues to evolve and expand, increasing the requirements for corporates and trustees of pension funds to consider and report on their stance on ESG considerations (including climate), as well as disclosing their processes, various metrics, and future intentions. Regulatory focus is now turning towards social and nature-related issues, for example the UK's Department for Work and Pensions has set up a social taskforce to develop possible future guidance for pension schemes on social risks and opportunities. More detail on the pensions regulatory landscape can be found in the appendix.

Collective influence

Given the scale of investments across pension assets, better ESG integration within pension schemes is an opportunity to influence on ESG issues that align with the employer's responsible business strategy and employee interests. There are differing ways of investors influencing companies, whether this be engaging with investee companies to initiate change or to move money away (i.e. divest) from companies that do harm.

4 ShareAction | Pension Power: What world is our money building?

Publicly available reporting, such as schemes' TCFD reports, is a way of showcasing alignment between your responsible business policies and your pension scheme assets.

There are a number of industry initiatives seeking to drive collective influence across investors, examples include Climate Action 100+ and the Net Zero Asset Owner Initiative.

Part 2

How do you better align your pension scheme with your responsible business policies?

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How do you better align your pension scheme with your responsible business policies?

Whilst we go into more detail below, we start with a graphic showcasing the typical ESG journey for a trustee board of a pension scheme. Corporates should consider the most effective way of engaging with this journey.

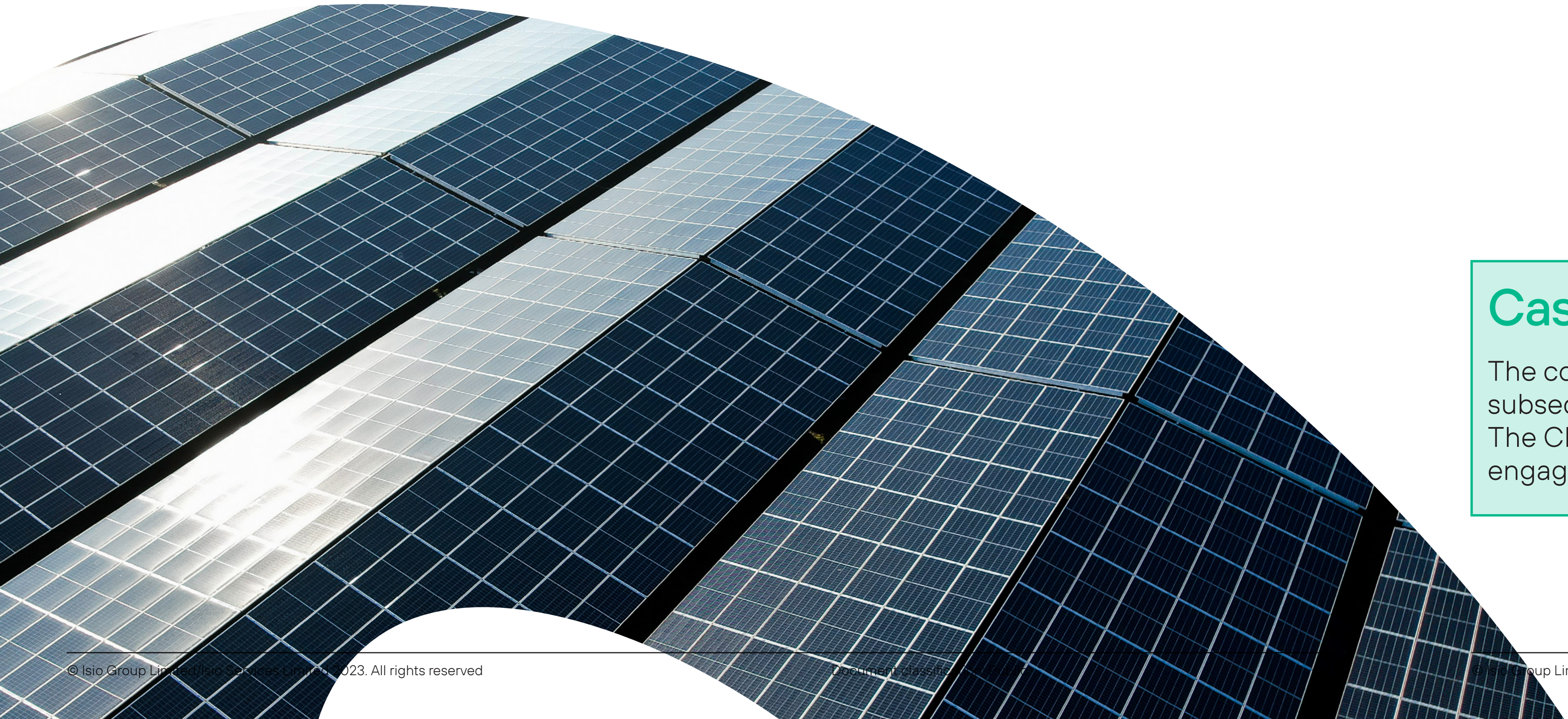
A trustee board's 'typical ESG journey' graphic

Training
Given the pace of change within the sustainability landscape, frequent training for trustees on a range of topics is important to ensure effective decision-making.

Objective setting
Trustees will typically agree a set of bespoke ESG beliefs and accompanying targets and focus areas (e.g. net zero or specific UN SDGs).

Implementation
Once the objectives are set, consideration should be given to the investment strategy to ensure alignment. This would also include seeking sustainable opportunities where possible

Monitoring and reporting
Trustees will then monitor investment managers/providers' activities and potentially a set of ESG metrics. There are also a number of regulatory reporting requirements (detailed in the Appendix).



Communication

Have you communicated your responsible business policies with the trustees? And how involved are employees?

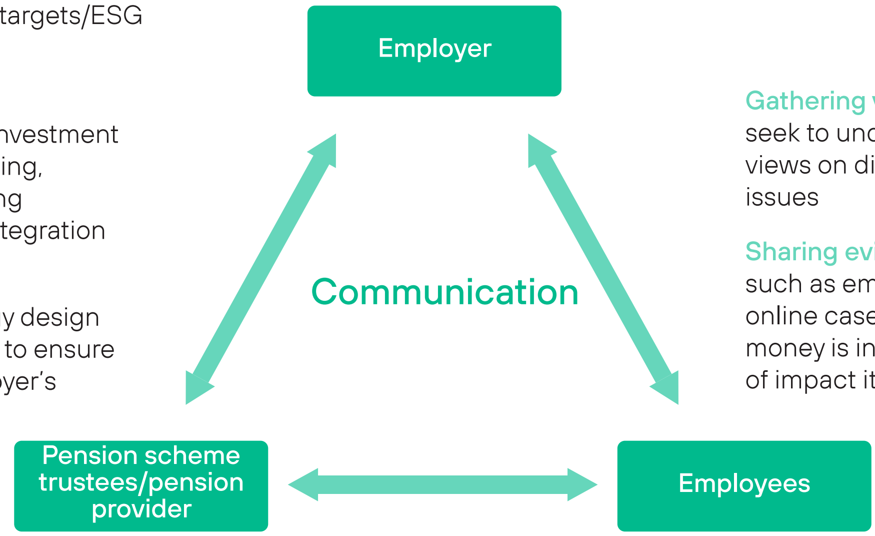
Captured within all aspects of the 'typical ESG journey' graphic.

Communication between employer, employees, and trustees is key. We depict an example communication flow below; however this will vary from employer to employer and scheme to scheme. A three-way communication program will encourage input from all perspectives and help identify any blind spots within alignment.

Policy sharing
such as covering the employer's sustainability policies and targets/ESG priority areas

Knowledge sharing
such as engaging on the investment case for sustainable investing, discussing new and exciting opportunities for further integration

Ensuring alignment
such as discussing strategy design and new investment ideas to ensure these align with the employer's ambitions



Gathering views
seek to understand employee views on different sustainability issues

Sharing evidence
such as email bulletins and online case studies e.g. how money is invested and the type of impact it is having

Information sharing
investment updates via online portals, webinars, including signposting relevant information and educational campaigns

Gathering views
seek to understand employee views on e.g. voting preferences (DC)

Case Study – Tesco

The company asked 1,500 of its employees where they would like their pension to be invested and subsequently updated the investment and stewardship policies to reflect its members' preferences. The CFO said "For me, it is essential that Tesco plc works with our pension trustees together in engaging with members on ESG so that values of plc and pension are reflected as one".

Aligning objectives

Does your pension scheme have scheme level ESG objectives/priority areas? How aligned are these to your responsible business policies?

Captured within the 'objective setting' aspect of the 'typical ESG journey' graphic.

We are increasingly seeing pension schemes and providers set ESG-related objectives, and unsurprisingly, net zero being a key focus. An effective objective setting exercise should also involve the employer to ensure alignment and debate any differences.

Net zero: Multiple schemes (both DB and DC) are setting longer term net zero targets (typically 2050) and accompanying interim decarbonisation targets. Clearly, there is widespread focus on climate action across corporates and so there should be alignment between corporate ambitions and pension scheme assets. We note, however, that for pension schemes, there is a balance of setting an ambitious net zero target (i.e. earlier than 2050) whilst ensuring a diversified investment strategy can be maintained. It is important to note that only an estimated 32% of companies with net zero targets have set targets of sooner than 2050[5]. Having said that, we have seen some ambitious targets being set, including the BT Pension Scheme setting a net zero by 2035 target[6], which reflects BT's own ambitions in this space.

Other priority areas: Primarily within DB schemes, we are also seeing trustees adopt ESG priority areas that are aligned with the employer. A typical approach adopted in this space is focusing on the UN Sustainable Development Goals (UN SDGs) e.g. agreeing priority areas such as 'gender equality' or 'zero hunger', and sharing an ambition to ensure investments are aligned to these goals. Whilst these objectives are not typically quantitative, it ensures that pension scheme trustees and employers have aligned these high level focus areas.

Exclusions: As part of the objective setting discussions some schemes agree a set of standard exclusions, i.e. certain sectors (e.g. tobacco or thermal coal/tar sands) or specific companies (e.g. high emitting companies with no decarbonisation plan) that they will not invest in. These exclusions should be aligned with the scheme's broader ESG objectives, trustees and members beliefs', the employer's responsible business policies as well as with consideration of any employee views. An example of this is that the Cancer Research UK Pension Scheme excludes tobacco-related investments, in line with the charity's focus[7].

The arrangement of each pension scheme will determine how much flexibility there is in setting these objectives and targets e.g. within the DC space, the targets adopted will typically need to align with the specific pension provider used. Focus should therefore instead be on alignment with the pension provider's central ESG policies.

5 Zerotracker.net
6 BTPS245_Climate_Change_Policy_April2023.pdf
7 sip_-_november_2020.pdf (cancerresearchuk.org)

We have seen employers' sustainability leads attend trustee meetings to summarise the employer's own responsible business policies for the trustees to consider extent of potential adoption, with key examples including alignment of net zero ambitions (noting investment restrictions) and UN SDG targets.

Sustainable opportunities: We define sustainable opportunities, as those with strong ESG and/or climate-focused objectives or credentials.

Impact opportunities: We define impact as investing in companies, assets or funds that provide solutions to social and/or environmental issues, and support the transition to a more sustainable economy, alongside looking to deliver market rate financial returns. Commonly aligned with one or a number of the UN SDGs.

The quality of ESG metrics data is improving and can be an effective way of communicating impact to employees and quantifying alignment with your responsible business policies.

Implementation

Do you understand the pension scheme's investment strategy from a sustainability lens?

Captured within the 'implementation' aspect of the 'typical ESG journey' graphic.

When considering implementation options, these may differ depending on the type of scheme.

DB schemes:

Once the ESG objectives/priority areas are agreed, we are seeing some DB pension schemes allocating to impact or sustainable opportunities in order to achieve these objectives. There are opportunities across all major asset classes, from sustainable passive equity products, active impact equity products, renewable infrastructure, natural capital solutions, and more. Employers should engage with trustees to ensure these opportunities are being considered. We note more detail in the Appendix.

Agreeing the appropriate investment managers to manage the scheme's assets is also an important consideration to manage risks such as greenwashing. The ways in which different asset managers incorporate ESG considerations into their investment approach can vary tremendously, with some looking to simply exclude the worst offenders whilst others take a more active or holistic approach.

DC schemes:

For DC schemes, should the scheme be invested via a platform or a master trust, there is typically less control on allocating to specific impact or sustainable opportunities as this may be controlled at platform level. Hence the focus here should be on selecting the right platform or master trust that aligns with any ESG objectives/priority areas, via initial and continued due diligence. The DC landscape is evolving quickly with clear advancement within the sustainability space.

We often see sustainable or impact focussed products available within the self-select range so that engaged employees can reflect their own views.

Some DC schemes that are structured as an 'own trust' will have similar considerations to those noted in the DB section above.

Risk and return considerations

Sustainable investing is often considered to increase the long-term risk-adjusted returns through incorporating ESG considerations, however this may not be true for all types of investment opportunities. For example, some investors may look to integrate personal values (i.e. no exposure to alcohol, fur, or animal testing), or desire philanthropic investments (accepting a lower than normal market return in search of additional ESG impact) that could hinder the expected risk and return.

For DB schemes, these risk and return considerations are important when it comes to employer contributions and funding plan discussions.

For DC schemes, default strategies and self-select ranges may include sustainable or impact products. The impact on risk and return should be a factor for trustees to consider and potentially communicated to employees, where relevant.

Monitoring

How do you monitor alignment and track progress over time?

Captured within the 'monitoring and reporting' aspect of the 'typical ESG journey' graphic.

Frequent check ins: As noted above, communication should continue throughout the ESG journey, and this is very important in terms of monitoring alignment and tracking progress.

ESG metrics reporting: We would expect pension providers/advisers to be providing some degree of ESG metrics reporting on the pension scheme's assets. The metrics monitored should align with any objectives and priority areas agreed. For example, should a net zero target have been agreed, then the pension scheme's investment portfolio's carbon footprint should be monitored annually as well as measuring progress against the target (this may well be reported within TCFD disclosures).

Monitoring provider/manager activity: As noted above, selecting the right partner to manage the scheme's assets is important and so monitoring their activity should be central to the ongoing management of the scheme. Trustees will typically monitor stewardship activity (including voting and engagement) as this is a regulatory requirement for pension schemes. This is an opportunity for employers, and trustees, to assess alignment of beliefs.

Case Study – HSBC

The trustees of the HSBC Bank (UK) Pension Scheme took the decision to use a new climate tilted fund in the strategy of the DC section to better integrate its climate change beliefs. Adopting this approach is expected to benefit HSBC meaningfully in a number of ways:

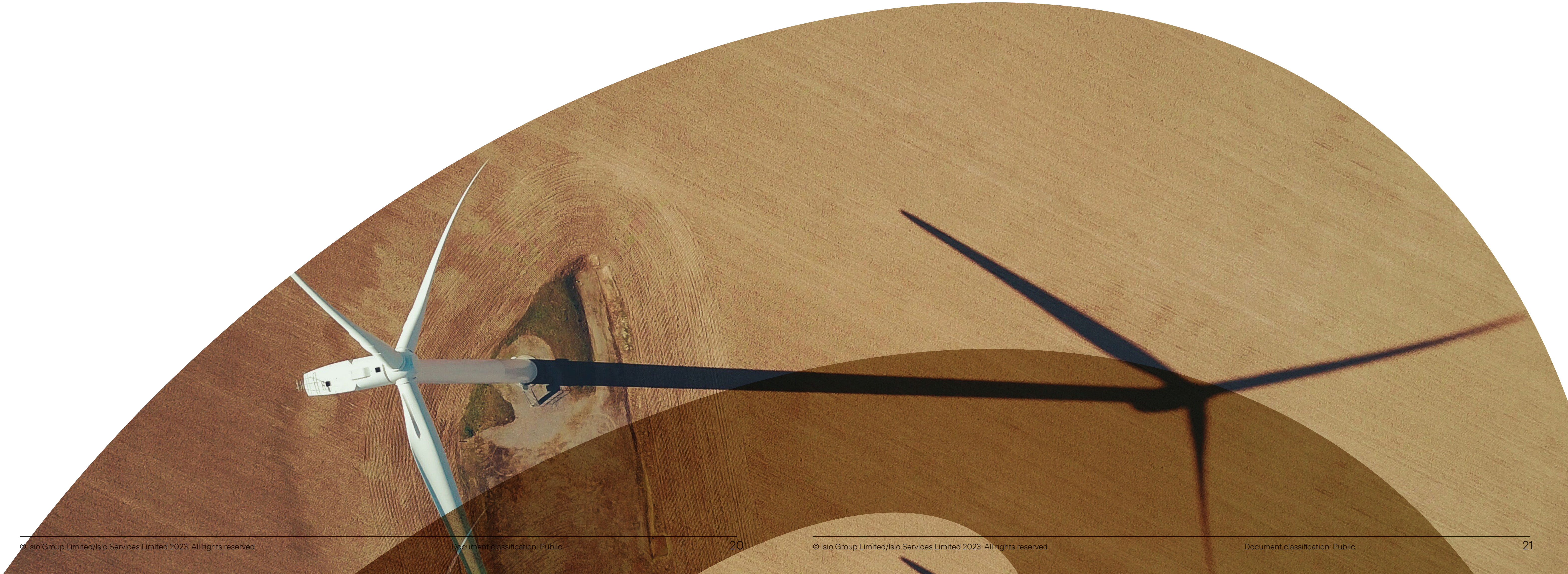
- It is expected to generate better outcomes in retirement for its employees compared to a fund which does not consider climate-related risks.
- The investment process is consistent with HSBC's support of a transition to a lower-carbon economy, given the aim of achieving the objectives of the Paris Agreement.
- Increased engagement from employees as they can see their pension savings being put towards an objective (managing the risk of climate change) that is increasingly important to them.

Case Study – Best Practice - Environmental Agency

The Environmental Agency Local Government Pension Scheme serves as an exemplary case study of best practice. For over 15 years, they have consistently achieved strong financial return through their unwavering commitment to invest in socially and environmentally impactful activities. Naturally, their investments have come with responsibility; recognising that climate change represents a substantial threat and thus utilising their *power in pensions* to help drive a positive impact. Among numerous objectives within its portfolio, decarbonisation features as a top priority and the Scheme aims to reduce their coal exposure by up to 95% by 2025 and oil and gas by up to 90%, consistent with the objectives of the Agency. A key aspect of this strategy involves integrating employees' perspectives, which plays a crucial role in shaping the overall approach. Employees are kept well-informed, ensuring transparency and clarity in the responsible management of their investments and incorporating their beliefs into the overall portfolio. This type of engagement remains crucial to their process and is widely encouraged with regular employee feedback using a variety of surveys and webinars.

How can we help?

We can help throughout this journey, starting with education and training in setting bespoke ESG beliefs and objectives for both the corporate and/or pension schemes, to expanding on policies with alignment in mind, and developing and implementing investment strategy and monitoring frameworks. Pensions hold significant power in creating an impact in this area and corporates can play a key part in this journey. If you would like a further conversation or to know more reach out to Isio or your Business in the Community contact (BITC).



Appendices

Appendix A

Overview of current pensions landscape and regulation timeline

2018 The Department for Work and Pensions (DWP) made changes to the Occupational Pension Schemes (Investment) Regulations 2005, requiring trustees to disclose and set a policy on how they have considered ESG (including climate change) and stewardship matters within their investment approach.

2019 Trustees required to update their Statement of Investment Principles (SIP) to reflect their policy on ESG issues.

2020 Trustees are further required to ensure alignment with policies and monitor stewardship activities of managers via an implementation statement.

2021 Pension Schemes Act 2021 requires trustees of large schemes (>£1bn) to take specific actions to integrate the consideration of climate-related issues into their governance processes, as well as assessing, managing, and reporting climate-related risks (reported in line with the TCFD framework).

2022 DWP increased focus on stewardship, requiring all trustees to further consider their stewardship-related policies, acknowledging their responsibility in relation to stewardship, and suggesting adoption of stewardship priorities.

2023 onwards

2023 Regulatory focus is now turning towards social issues, as the DWP have, in 2022, set up a social taskforce to develop possible future guidance for pension schemes on social risks and opportunities. Likewise on nature considerations, with proposals under consultation regarding the Taskforce on Nature-related Financial Disclosures (similar to TCFD).

Appendix B

Investing sustainably across asset classes

Equities

When investing in equity (owning a proportion of a company), investors may look to; buy companies with strong ESG practices, avoid those with negative ESG practices, or use ownership to change the way those companies are run (through stewardship activities such as voting or engagement). Typically, DC pension schemes invest higher allocations in public equities, while the majority of DB pension schemes are mature and de-risking, therefore hold smaller allocations to public equities. There are a broad range of passive (systematic and lower cost) and active (active stock selection) sustainable and impact equity products available to both DB and DC investors, this is typically where most schemes start their ESG journeys.

Credit

We are also seeing an increasing range of sustainable and impact credit (investors provide funding to companies) products, however this is not as developed as the equity space. The ability to integrate sustainable or impact considerations in credit broadly focuses on; lending to companies with strong ESG practices, through the selection of companies by which the Scheme provides funding and the associated engagements, this is typically relevant for both DB and DC (albeit in stages nearer members' retirement) pension schemes.

Real assets

Holding real assets directly (such as property, infrastructure or even forests and agriculture) typically involves complete ownership by the investor allowing for impact opportunities (such as social housing, renewable infrastructure and natural capital including forestry and agriculture) or direct management of ESG risks and opportunities. DB pension schemes have historically had greater allocations to real assets, compared to constrained DC pension schemes, which until recently were unable to invest across the spectrum of real assets given the illiquid nature of the asset class. However, current innovation in the market is happening, allowing DC pension schemes to access private markets, like private equity, and other illiquid assets (including renewable infrastructure and natural capital assets).

Appendix C

An overview of key pension terms

Defined Benefit (DB): A pension scheme where the amount paid at retirement is based on years of service and salary and is a liability to the employer (often termed the sponsor). They pay out a secure income for life which typically increases in line with inflation. This type of pension scheme is typically now closed to entrants and future accrual and is managed in order to pay future benefits to deferred and retired members.

Defined Contribution (DC) is the most common type of pension available today where both employee and employers contribute into an investment pot for the purposes of a members' retirement (at age 55 or over). The choice of investment lies with the employee (they can select a default strategy or from a self-select range).

The main difference between a DB and DC pension scheme is that the former promises a specific income or benefit at retirement and is funded by the employer, whereas in the latter model the employees (and employers) make contributions into the scheme to save for retirement, and retirement funds depend on the level of contributions as well as the investment performance. In a DB pension scheme, the financial risks are ultimately borne by the business and therefore ESG integration has typically been centred around the extent to which these considerations affect the ability to pay any promised income. Whereas for DC pension schemes, individual members bear the financial risks, it is more typical for trustees to consider individual preferences and ensure suitable choice and flexibility of investment choices.

Department for Work and Pensions (DWP) is a UK ministerial department responsible for welfare, pensions and child maintenance policy.

Taskforce on Climate-related Financial Disclosures (TCFD) is an organisation that aims to develop voluntary and consistent climate-related financial risk disclosures for use by companies globally. DWP ran a consultation on how pension schemes can implement the TCFD recommendations, providing guidance across governance, strategy considerations, scenario analysis and risk management, and monitoring metrics and targets.

Appendix D

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The Prince's Responsible Business Network

Contact

Cadi Thomas
Head of Sustainable Investment
+44 (0)117 3746 467
cadi.thomas@isio.com

Mark Irish
Deputy Head of Sustainable Investment Consulting
+44 (0)207 1236 126
mark.irish@isio.com

Ajith Nair
Head of Research
+44 (0)207 1236 003
ajith.nair@isio.com

Charles Pringle
Sustainable Investment Consultant
+44 (0)131 3781 726
charles.pringle@isio.com