Consideration of social risks & opportunities call for evidence – PSGS response

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This response represents the views of an organisation Punter Southall Governance Services (PSGS). We work with 235 occupational pensions schemes, covering over £37bn assets and representing the interests of around 475,000 scheme members.

Overview comments

It's admirable the government is working every angle to increase the pace of progress on ESG matters and it is true that, as asset owners, pension scheme trustees have clout in assisting with this within certain parameters.

In the case of defined contribution (DC) master trusts, which are the logical destination for much of the future growth in UK pension savings, ESG will increasingly become fully integrated into default investment strategies where the bulk of assets lie. For cost and charge cap reasons, these assets will be almost exclusively invested in pooled and passive ESG tilted funds (with minor, less liquid allocations within blended fund structures). In these cases, social factors are considered alongside E and G factors in the tilts and exclusions folded into them. For self-select funds, there's likely to be further choice for members in various ESG approaches supported by improved communication to allow members to align their pension saving choices with their personal values on ESG matters. To the extent that take up is greater for funds minimising risks related to social matters, this will see greater emphasis from trustees. It is likely, however, climate matters will be more popular given the dominance the subject enjoys in the media and from government.

The truth is, for many companies, shortfalls in performance on social factors will have less bearing on long term asset performance than other investment performance drivers, so trustees must be proportionate in the way they allocate their investment time and resources. Thus, as is so often the case, trustees taking a balanced approach to ESG will likely lead to best member outcomes.

For defined benefit (DB) schemes, there is more work to do in terms of available funds and reporting to determine which funds are performing well, and for trustees to benchmark where they are relative to other schemes. We are aware of one large consultancy undertaking some benchmark work across several hundred clients. If others can follow and this can be shared into a combined universe, it would benefit all trustees and the industry.

PSGS has recently responded to the consultation on The Pensions Regulator's single code of governance. We note there is a clear intent to crystalise ESG and climate change considerations on trustees, which is positive. However, the new requirements do, on the face of it, seem to weight things in the direction of the E. We think this could be rebalanced easily through better wording to make it clearer to trustees that E, S and G are all interrelated and carry equal importance.

In addition, smaller sponsors, those under financial duress or trustee boards without professional trustees may struggle to either have the skills or time available on agendas to consider these issues properly.

Lastly, the Pensions Policy Institute commented in April 2021 that broader appreciation of ESG needs to be demonstrated, but also points out societal matters have come to the fore during 2020, mainly through the global covid19 pandemic and black lives matter protests. While some of the data and benchmarks may lag the E, awareness in the S has caught up and our experience as trustees is that E, S and G are valued equally.

1: Trustees' legal duties

1. Does your pension scheme, or do schemes you advise, have a policy on financially material social factors? In this policy, are social factors discussed separately to ESG factors in general?

Social factors are integrated into the sustainable investing agenda which reflects the trustees' beliefs that E, S and G are all financially material factors. It is not practical to split out these factors when selecting investments. It is practical, however, to select managers with an awareness of whether their funds incorporate approaches to voting on management pay, diversity, community engagement and supply chain matters in addition to governance and climate priorities.

The reporting on social matters available from investment managers is not always consistent and sometimes sparse - it feels like a developing area. Some investment managers are better equipped to report on ESG generally than others. This makes the trustees' job of looking specifically at the S on a more regular basis against benchmarks and take decisions based on S 'performance' difficult.

Some schemes are starting to consider the ESG policy of their sponsor and this may require further efforts to define what policy objectives may look like. Again, this is an evolving area.

2. Does your scheme, or do schemes you advise, have (a) a stewardship policy and/or (b) a voting policy that specify covering social factors?

Some do, but most not specifically. However, managers conducting engagement activities and voting on shareholder resolutions incorporate social matters in the issues they seek to address.

The current position feeds back to question 1, where more sponsors and companies are only really now starting to think about greater focus on the S and discussing with their investment advisers how that works in practice with the funds the pension scheme is invested in.

Some but not all schemes meet with core fund managers on a rotational basis. This brings a greater emphasis on discussing ESG directly with the trustees (together with their advisers), including specifically how they select funds and consider things such as supply chains and labour practices and are putting in contracts a requirement on events deemed to be contrary to generally understood ESG values.

2: Social factors and financial materiality

3. On which social factors do your scheme's investment and stewardship policies focus? What was the rationale for deciding to focus on these particular social factors? Do you refer to any international standards, such as those relating to human rights or labour rights?

We do not focus on specific social factors. We are pensions schemes investing in the interest of members. Adhering to sound social practices is core to good corporate governance and companies that stray outside such good practices will be called out during corporate engagement activities. We typically have exclusions for UN global compact violators that screen out companies that expose members to most risk in this area. It is not the job of pension scheme trustees to be involving themselves in the details of how individual companies run their businesses or to determine where diversity might be a key failing versus sloppy supply chain management. Member outcome detriment will simply not be large enough to justify this. It is for asset managers (with suitable encouragement from their trustee clients) to determine, prioritise and manage these elements appropriately.

Greater availability of tangible statistics and setting some universal benchmarks (eg adherence and reporting against the UN global compact and UK stewardship code for fund managers) would help. These measures, together with investment and fund/asset managers regularly reporting on what activities they undertake on monitoring and evolving their ESG policies and objectives as part of the standard regular performance updates to trustees will help focus the conversation.

We have seen in a minority of schemes the sponsor influencing the trustees, for example they will not invest in funds that have links to weapons manufacturing or brown investments, such as mining, and have requested the trustees follow suit. Alignment to measures such as the UN global compact becomes more relevant for asset/fund managers.

4. Which resources have you found useful when seeking to understand and evaluate social factors either for your scheme or a scheme you advise? Do you feel that you have sufficient understanding of how companies perform on social issues?

It is rare for trustees to have good visibility of how companies within scheme pooled funds behave on social issues. In general, they rely on good stories told by asset managers about how they have called out bad behaviour or engaged with management to address failings and promote good behaviour. This doesn't equip trustees to judge how effective these actions are and portfolio-wide metrics are hard to come with respect to these social factors.

There are some measures of what could reasonably fall into social factors (as mentioned in question 3 above) but these are items which firms sign up to rather than are required to adhere too, which leads to an inconsistent position amongst asset/fund managers and trustees. The MSCI ESG framework does act as an index but the data behind this is likely to be patchy at best, as does the number of asset/fund managers using this.

3: How trustees can take social factors into account

5. What approach do you, or the trustees you advise, take to managing the (a) risks and (b) opportunities associated with social factors? Why have you chosen this approach?

We encourage asset managers to believe they will win incremental lucrative business if they can demonstrate the active steps they are taking in this area. This has resulted in proactive managers like BlackRock taking huge strides on all areas of ESG in the past 12 months and they are seeing the fruits of this work in new business flows. This supports further investment in these actions and products with positive knock on effects on competitors such as Vanguard who find they are being left behind.

We have been using the growing area of diversity and inclusion in pensions to consider social matters with our co-trustees and investment advisers and whether, for investments, more could or should be done in the ESG arena more widely – a collective sense of making things better for members, so everyone benefits from targeted investments. As a large professional trustee, we use our leverage to ask the investment advisers what they are doing on ESG across the piece and challenge them to be more effective and, in turn, challenge the asset managers that sit on their buy lists.

Like the topic itself, our approach reflects the financial and non-financial reasons for wanting more emphasis on ESG and, particularly, social factors.

6. If this is delegated to asset managers, how do you ensure and monitor that they manage the risks and opportunities associated with social factors?

Social factors are an integral part of the ESG agenda for pension schemes. It may not be as noisy a topic as climate change but, in the case of many schemes (such as DC master trusts which have a commercial imperative to integrate ESG into their default and self-select ranges), the social elements are very much part of the engagement and voting priorities of the managers they appoint. This consultation assumes social factors are being ignored in favour of climate – they simply aren't in our experience.

The DB landscape is bit more complex to segregate in clearly labelled choices for trustees and members. There are a small number of 'green' funds. Less visible are 'social impact' funds, though these are starting to appear. Moreover, there is growing emphasis on how asset managers conduct their business through the ESG criteria used to select and monitor the companies/investments they allocate investors' monies. We are seeing this coming through those schemes where asset/fund managers meet with the trustees.

7. (a) Have the trustees of your scheme, or a scheme you advise, undertaken stewardship (engagement or voting) with an investee company on a social factor in the past 5 years, whether directly or through an asset manager? (b) If yes, please provide details including why you felt this was necessary, what was done and the impact of your intervention. (c) If no, then please provide details including what disincentives and barriers you faced in undertaking stewardship activities (engagement or voting) with an investee company?

The question misunderstands how most schemes operate. Unless a large DB scheme is appointing a manager to a highly concentrated ESG segregated mandate, the trustees have no business getting involved in the detailed activities of investee companies and, even in this case, it is questionable. Trustees appoint asset managers or select funds based on how they are managed – increasingly with ESG integration as a criterion. It is then for the asset manager to exercise stewardship on their behalf. It is likely the managers, in meetings with trustees, will showcase examples of where they have encouraged management of investee companies to improve their social, governance or environmental practices. This occurs even in passive funds (and those with ESG tilts) where managers use their aggregated voting power to lobby and vote for change when such a need is identified.

In a minority of cases, we have seen a fund being removed as it is clearly related to an area misaligned with ESG (eg mining) in favour of a fund with a direct ESG outcome. In the DB space that tends to mean an environmental impact rather than a social impact – noting the former can improve the latter indirectly.

We are still in the first full year of implementation statements and the variety of data and information across fund managers reflects the lack of standard reference points in this area. However, evidence in the voting decisions provided suggests all aspects of ESG are looked at, not just the 'E' (albeit, we recognise this is a specific selection for clients).

4: Social factors as opportunities

8. What opportunities are there for trustees to invest, directly or indirectly, in companies solving social issues in developing or emerging markets? How attractive are these investments?

If you call China an emerging market, ESG doesn't even register yet as a corporate priority so it's early days there. In less developed markets, the same is largely the case (even the US investment and corporate markets are only just waking up on ESG). That doesn't mean there are no opportunities and there are managers of Asian funds who have sustainability as an objective. This has yet to reach pension scheme portfolios in any meaningful degree, although actively managed self-select funds in DC master trusts are beginning to get selective exposure in these markets.

ESG impact funds are relatively rare on the DB side as mentioned previously, but there are signs of more funds developing on the DC side of trusts and master trusts. Sharia funds, for example, meet a wider societal objective to encourage savings provision amongst Muslims and have been relatively commonplace with the larger providers for several years. We note recent UK data indicates these funds could be marketed more effectively to increase take up.

DB has a way to catch up but there are signs these types of focused funds will start to appear in greater number, as trustees' probing and growing legislation increasingly demand.

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