THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

Trustees and Environmental, Social & Governance (ESG)

A practical guide to engaging with Asset Managers from the Society of Pension Professionals (SPP)

June 2024

Introduction

This guide provides a comprehensive outline of the various regulatory ESG disclosure requirements, ESG obligations for asset managers, a summary of the information that trustees need from their asset managers and a breakdown of the role of the investment consultant in ESG matters.

"This practical guide is a welcome addition to the available guidance on ESG for trustees, builds on our 2023 guidance on the same and is packed full of useful information in the form of checklists, summaries and case studies as well as more in-depth guidance.

There is still some uncertainty about obligations in this area so we hope this SPP guidance will play a useful role in raising awareness and understanding."

Sophia Singleton,
SPP President

Icons used in this doc: ©Rubem Hojo, Noun Project

Section 1: Key ESG related disclosure requirements

Trustees of occupational DB and DC pension schemes are subject to several disclosure obligations in respect of their investments, so it is important that they have the information they need from their investment managers to report effectively and in accordance with these requirements.

Further details were included in the SPP's updated 2023 ESG guide[1] but, in summary, the requirements for trustees fall under the Statement of Investment Principles, the Implementation Statement, and (for larger schemes) climate reporting requirements. All of these documents must be made publicly available online, free of charge.

Statement of Investment Principles

Trustees of occupational schemes with 100 or more members are required to maintain a Statement of Investment Principles (SIP) in relation to their scheme. Additional requirements apply to DC schemes requiring a statement specifically for any default arrangement.

The SIP must include the trustees' policies on:

> 'Financially material considerations' (including ESG considerations and climate change);

> Stewardship; and

> The extent (if at all) to which 'non-financial matters' (generally member views on ethical matters) are considered in the trustees' investment decision making.

Trustees must also include details of the trustees' arrangements with investment managers in the SIP. Among other things, this includes how asset managers are incentivised to:

> Align their investment strategy and decisions with the trustees' investment policies, including in relation to ESG matters.

> Make decisions based on the likely financial and non-financial performance of an issuer of debt or equity, and to engage with issuers to improve their performance.

Both requirements are likely to require a dialogue with the trustee's appointed managers.

Implementation Statement

Trustees are required to produce an annual 'implementation statement' setting out how they have acted on the policies set out in their SIP. The requirements vary between DB and DC arrangements.

For pure DB schemes, content is generally limited to a report on the engagement activities and votes exercised during the year. For DC schemes, including DB schemes which provide an element of DC benefits, requirements are more extensive, and trustees will need to report generally on the implementation of their ESG and other policies across the scheme (including in relation to any DC default fund) as well as their engagement activities and voting.

In June 2022, new guidance from the DWP set out recommendations for the content of SIPs and implementation statements. This includes both 'statutory' and 'non-statutory' guidance, focusing particularly on stewardship, voting and engagement.

One of the key themes of the new DWP statutory guidance is that trustees should consider the links between their scheme's stewardship priorities and the voting behaviour of the trustees' appointed managers. To do this, trustees need to identify their own stewardship priorities (e.g. climate change, biodiversity, human rights etc.), and ensure that their managers are providing the information they are required to report.

In broad terms, the content requirements with respect to fund level cover:

> Engagement objectives, details around related activities using case studies to substantiate..

> Information and statistics on the use of proxy voters, including commentary on alignment with trustee views on financially material topics included in SIP.

> Detailed reporting of significant votes as defined by the trustee in the SIP, if the vote was against management, whether the intention was communicated to the company ahead of the vote and whether further action is intended to escalate stewardship efforts.

1 SPP ESG Guide, 2023:
https://the-spp.co.uk/wp-content/uploads/SPP-ESG-Guide-2023.pdf

Climate reporting for larger schemes

Since 2022, trustees of pension schemes with assets over £1bn must comply with detailed legislation and statutory guidance in relation to climate issues.

As well as setting out how trustees should identify, assess, and manage climate-related risks and opportunities, the regulations and guidance require trustees to produce annual disclosure reports in line with the Taskforce for Climate-Related Disclosures (TCFD) framework[2].

A recent review by The Pensions Regulator (TPR), published in April 2024[3], found that most reports (60% of their sample) had some form of net zero goal with a target date of 2050 or earlier. This appears to be a positive development yet it also prompts questions of the remaining 40%. Although there is no requirement for trustees to set a net zero target, TPR state that such targets are "...consistent with sensible risk management."[4] The same review also concluded that trustees should, "...form and set out their own views on material climate-related risks and opportunities that affect the scheme even when relying on input from others. This assessment should be sufficiently broad, such as including funding and covenant where appropriate."[5]

It is also important to note the Department for Work & Pensions (DWP) statutory guidance includes a mandatory requirement for trustees of DB schemes to consider the impact of climate-relate risks and opportunities on the sponsoring employer's covenant.

Towards the end of 2022, the Government consulted on proposals to require Local Government Pension Scheme (LGPS) administering authorities in England and Wales to assess, manage and report on climate-related risks, in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). These proposals would see LGPS administering authorities having to calculate the 'carbon footprint' of their assets and assess how the value of each fund's assets or liabilities would be affected by different temperature rise scenarios, with administering authorities reporting on this annually. Although implementation has been delayed, these proposals provide a clear indication of the direction of travel.

2 TCFD Disclosure application guidance, December 2023: https://www.gov.uk/government/publications/tcfd-aligned-disclosure-application-guidance/task-force-on-climate-related-financial-disclosure-tcfd-aligned-disclosure-application-guidance
3 Review of climate-related disclosures by occupational pension schemes, April 2024: https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2024-press-releases/review-shows-how-pension-trustees-are-addressing-climate-risks-and-opportunities
4 Ibid
5 Ibid

Section 2: ESG disclosure obligations for asset managers

There are two key ESG disclosure frameworks which are relevant to asset managers in the UK:

1. FCA disclosure requirements aligned with the TCFD framework. These rules are included in the ESG Sourcebook, which is a new section of the FCA Handbook.
2. The FCA Sustainability Disclosure Requirements (SDR) regime , which is being phased in from 31 May 2024 onwards (see "Implementation" below).

The TCFD requirements apply to all FCA-regulated asset managers, unless they have less than £5 billion in relevant assets under management.

Likewise, SDR disclosure requirements will apply to those with over £5bn in relevant assets under management, although the FCA continues to encourage smaller firms with under £5 billion AUM to produce disclosures voluntarily. Furthermore, the FCA has stated it will consider reducing the threshold as part of its post-implementation review of climate-related disclosures.

The SDR regime includes an 'anti-greenwashing rule' which applies to all FCA-authorised firms who make any sustainability related claims about their products and services. The investment labels, disclosure and naming and marketing rules apply to UK asset managers.

For asset managers marketing funds into the EU, best practice standards are stipulated in the EU Sustainable Finance Disclosure Requirements , which impose similar reporting requirements to the FCA SDR regime.

TCFD disclosures

Asset managers are required to publish an annual 'entity-level' report consistent with the TCFD recommendations. The report must contain:

- information relating to delegation of functions and use of third parties;
- the firm's approach to climate-related scenario analysis;
- targets the firm has set to manage climate-related risks and opportunities; and
- a compliance statement signed by senior management.

Asset managers are also required to prepare 'product-level' public TCFD reports in relation to authorised funds and investment trusts, and provide on-demand TCFD product reports where clients need this to satisfy their own climate-related financial disclosure obligations.

Product reports must contain scope 1, 2 and 3 greenhouse gas emissions, total carbon emissions, total carbon footprint and weighted average carbon intensity, together with contextual information and historic annual calculations.

For larger firms with at least £50 billion of relevant assets under management, the earliest an on-demand client request can be made was 1 July 2023 (covering a period commencing on or after 1 January 2022). For other firms, the earliest a request can be made is 1 July 2024.

Entity-level SDR disclosures

These disclosures build on the TCFD entity-level disclosure requirements, covering how firms are managing sustainability-related risks and opportunities. The FCA is intending to develop its proposals over time to add specific disclosure requirements on other sustainability-related topics, consistent with future international reporting standards.

Consumer-facing product-level SDR disclosures

These disclosures will apply to firms marketing products to retail investors, to help them understand the key sustainability-related features of a product. Firms providing portfolio management services will not be required to produce the consumer-facing disclosures, but will instead be required to provide an index of the underlying products, linking to their label and consumer-facing disclosure, as applicable.

These disclosures must be published in a prominent place on a firm's main website and updated annually thereafter.

6 Sustainability Disclosure Requirements (SDR) and investment labels, November 2023: https://www.fca.org.uk/publication/policy/ps23-16.pdf

7 Sustainability related disclosures in the financial services sector: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088

Pre-contractual disclosures and sustainability product reports

In addition to the consumer facing disclosures, the FCA is introducing a further set of detailed disclosures for institutional investors, or for retail investors interested in receiving additional information.

Pre-contractual disclosures are applicable to products using a sustainability label, or where sustainability-related features are integral to the investment policy and strategy. These will cover the sustainability-related features of an investment product (e.g. its sustainability objective and investment policy and strategy) and are likely to be set out in the fund prospectus and updated annually thereafter.

A sustainability product report will be required by all firms using a sustainability label on their products, except firms providing portfolio management services and certain non-listed funds where "on-demand" information is instead provided. This report will set out ongoing sustainability-related performance information, including key sustainability-related performance indicators and metrics and be published annually on the firm's website.

Investment labels

The FCA is introducing an opt-in labelling regime to help consumers navigate the market for sustainable investment products. There will be four mutually exclusive sustainability labels:

- Sustainability focus – products that aim to invest in assets that are environmentally and/or socially sustainable.
- Sustainability impact – products that aim to invest in solutions to environmental or social problems.
- Sustainability improvers – products that aim to improve the environmental and/or social sustainability of assets over time.
- Sustainability mixed goals – products with a combination of the aims above.

Other requirements

The FCA will restrict the use of sustainability-related terms in the naming and marketing of products offered to retail investors that do not qualify for and use a sustainability investment label (this includes, for example, the terms 'ESG' and 'climate' and any other term which implies that a product has sustainability characteristics).

The FCA is also introducing an 'anti-greenwashing rule', requiring all FCA regulated firms to ensure that the naming and marketing of financial products and services in the UK is clear, fair, and not misleading, and consistent with the sustainability profile of the product or service.

Implementation

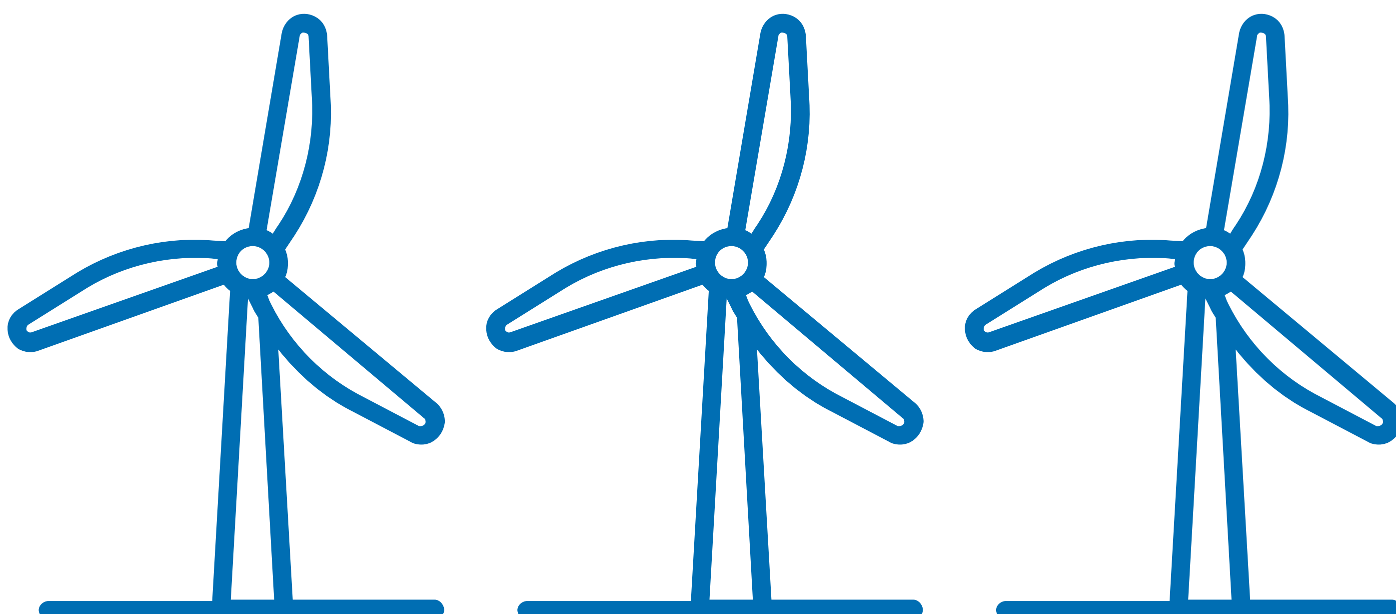
The timetable for implementation of the SDR regime is complex, but, broadly speaking, the relevant dates are as follows:

- anti-greenwashing rule: 31 May 2024
- labelling option and associated disclosure requirements: 31 July 2024
- naming and marketing rules: 2 December 2024
- entity-level and product-level disclosure rules: for firms with AUM of £50bn+, 2 December 2025; entity-level rules extended to firms with AUM of £5bn+ from 2 December 2026.

Section 3: Checklist of the information trustees need from their asset managers

TCFD requirements

<table>
<tr><th>Requirement for Trustees</th><th>Information needed from asset manager</th><th>Resources to support managers and trustees</th></tr>
<tr><td>Governance</td><td>Asset managers should:
> Provide information on stewardship activity e.g. UK Stewardship reporting, PRI Transparency reports that trustees and their advisers can source data from or request
> Demonstrate senior leadership oversight on responsible investment</td><td rowspan="3">TPR's General Code of Practice, especially "Stewardship" and "Climate change" modules
TPR's funding and investment guidance
Investment Association report, Insights and Suggested Actions on TCFD
PCRIG guidance, Aligning your pension scheme with the TCFD recommendations
PCRIG's 10 questions for asset managers
In addition to the above, managers should provide a narrative on the physical and transition risks that climate risks pose over the short, medium and long term for each asset class invested in as well as how these asset classes will fare under different climate scenarios</td></tr>
<tr><td>Strategy</td><td>Asset managers should:
> Describe the resilience of investment strategies for relevant asset classes using different climate scenarios</td></tr>
<tr><td>Risk Management</td><td>Asset managers should:
> Describe identification, management, and assessment of climate related risks posed to product and investment strategy</td></tr>
<tr><td>Metrics and targets</td><td>Asset managers must provide (at the product level):
> Two emissions-based metrics
> One portfolio alignment metric
> One additional climate related metric</td><td>Metrics and Targets - TCFD Knowledge Hub (tcfdhub.org)
ICSWG guidance, ESG metrics for asset managers</td></tr>
</table>



SIPs and Implementation Statement requirements

Requirement for Trustees	Information needed from asset manager	Resources to support managers and trustees
Voting information	**Must** have: > Voting activity and voting/investment stewardship policies > Voting decisions made (for, against, abstain) > Use of proxy voting advisers > Significant voting examples aligned to the investment manager's responsible investment/voting policy (or explain the rationale for choosing significant votes) and relevant to the fund.	PLSA Vote Reporting Template PLSA Stewardship and voting guidelines PLSA Implementation strategy guidance TSF guide, Considering social factors in pension scheme investments
Engagement information	**Should** explain: > Where information is missing > Engagement activity and policies > Number and examples of fund specific engagements aligned to a manager's responsible investment/ stewardship policy > Number of firm-level engagements > Themes engaged at a fund level and aligned to the investment manager's responsible investment policy	ICSWG Engagement Reporting Guide (ERG)

SIPs and Implementation Statements – optional additional items

Requirement for Trustees	Information needed from asset manager	Resources to support managers and trustees
Understanding whether the SIP has been followed over the year in terms of stewardship	**May** seek to understand the Responsible Investment (RI) motivations of an investment manager, at the point of selection and ongoing: **Ambition** – How clearly does an investment manager set out in their RI policies, their goals and commitments with respect to RI themes important to them, e.g.: climate change, nature loss, human rights etc **Action** – What kind of prioritisation and what level of transparency is offered around an investment manager's engagement and voting activities around the themes outlined in their RI policies? How well does this align to the manager's stated RI ambitions? **Note:** The trustee may take steps to ensure the manager is regularly appraised of trustee investment stewardship goals.	PRI Transparency Reports UK Stewardship Reports Annual sustainability reports PLSA and ICSWG guides Manager websites Public reporting/ assurance – CDP, SBTi, TPI, CA100+

Section 4: Engaging with asset managers on ESG

Managing ESG requirements across multiple investments

To achieve a coherent ESG strategy for a pension scheme that invests in many different asset classes and/or managers, it is key to have a set of responsible investment principles.

These principles should:

- Be consistent with the scheme's SIP. For example, a scheme with a shorter time horizon may not need to adopt Net Zero by 2050 targets.
- Express some or all the members' key priorities.
- Be sufficiently general to apply across the asset classes and investment strategies the scheme invests in. This may include active, passive and thematic equity strategies, income-focused strategies, the use of private assets, and investments in property.
- Cover the key areas of interest in the ESG space, and clearly state those areas that are not of interest.

It is common for schemes to adopt, or plan to adopt, emissions reduction targets. Responsible investment principles could also state commitments to environmental targets other than climate, or to enshrine commitments to human rights, biodiversity risk or transparent corporate governance.

Once responsible investment principles are set, these should then be used to design an responsible investment strategy for the scheme. The strategy should state how the scheme complies with its responsible investment principles and may lead to certain investment actions being taken.

Such actions might include:

Exclusions

These could be company-specific (exclude a particular company due to the use of thermal coal), sector-specific (exclude all companies that use thermal coal to generate electricity) or region specific (exclude all companies in a particular jurisdiction due to the level of thermal coal usage in the economy).

Engagement targets

These could include activity targets (e.g. number of contacts with companies), sustainability outcome targets (e.g. number of companies that set net-zero targets due to investment manager engagement) or sector-specific targets (e.g. lists of companies that use thermal coal for managers to engage with to change their behaviour).

Changes to performance benchmarks to exclude companies with poor ESG characteristics:

For example, exclude all companies that use thermal coal from the performance benchmark, so that a passive equity manager can replicate performance with low tracking errors.

Introduction of specific ESG metric-related performance targets

For example, setting a temperature alignment target for a particular investment manager.

Specific, standing voting instructions for managers

For example, stating an 'expression of wish' or instructing an investment manager to vote in favour of resolutions to reduce the use of thermal coal.

Different investment managers will have different approaches to achieving these, and it is important to ensure that these approaches are not contradictory or inconsistent with implied SIP requirements.

Aligning and comparing approaches

Ideally, investment managers should be assessed on their ability to integrate ESG considerations into their investment process prior to appointment. Nevertheless, most schemes will need to carry out an assessment of their investment managers and strategies to ensure that they are able to comply with a new set of responsible investment principles. Any actions with respect to changing investment managers or investment strategies should be taken with any prior ESG-related preferences expressed by members in mind.

If responsible investment principles are set at a sufficiently general level, it is likely that most investment managers would be able to comply with them, albeit by different methods. For example, if the responsible investment principles require the scheme not to invest in thermal coal-related activity, an active equity manager may choose to comply by means of exclusion, whereas a passive equity manager may require their performance index to be changed. In general, compliance via different approaches introduces complexity, and trustees may need to consider whether they are able to monitor, evaluate and compare the performance of investment managers in such circumstances.

One area where nearly all investment managers differ is corporate engagement. There is no consistent definition of engagement across the industry, and engagement can be measured in different ways. Trustees should consider measuring manager effectiveness using different metrics, as well as a qualitative overlay considering whether engagements have been for transparency only or for change.

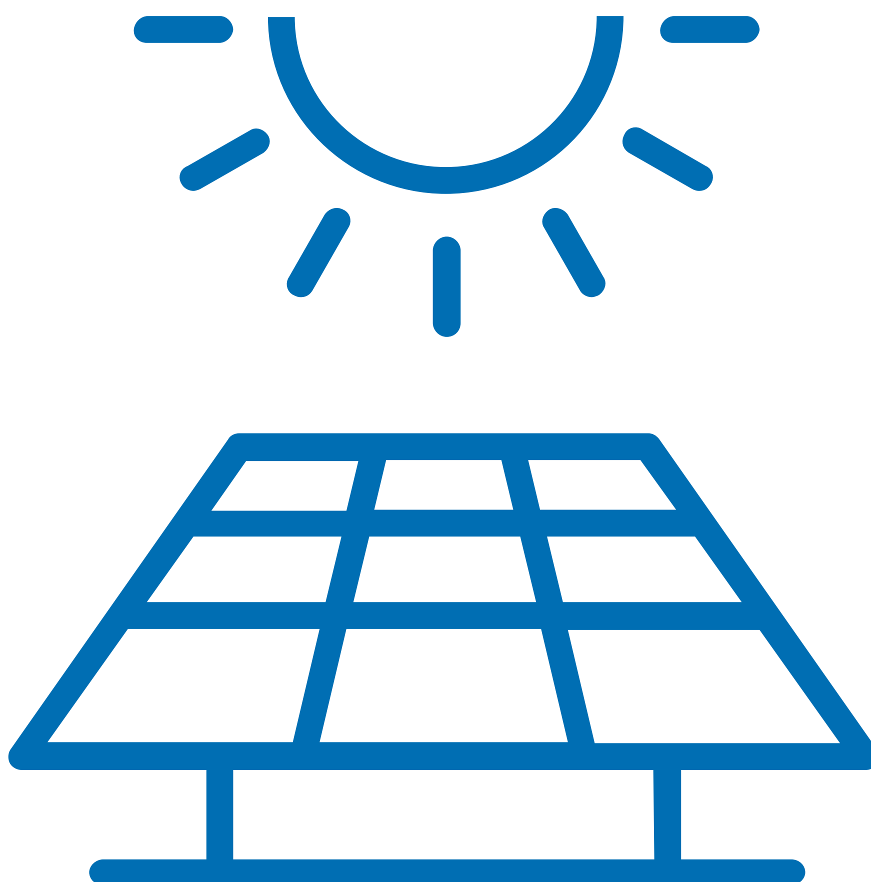
Voting information is more consistent and widely available across investment managers. The requirement to comply with the Shareholder Rights Directive II (EU legislation mirrored in UK legislation) means that many investment managers already disclose voting records, albeit across their entire assets under management rather than specific books of business.

Obtaining information from asset managers

Information sharing and reporting requirements should already be built into existing investment management agreements (IMAs) and service level agreements (SLAs). These should be reviewed to ensure that they cover new ESG-related information. If not, they need to be renegotiated.

As a minimum, trustees should expect investment managers to provide all information required for trustees to meet their regulatory obligations (e.g. under TCFD). There may be other information or metrics that are useful, but these are more likely to be provided on a best endeavours basis and may potentially not be comparable between investment managers.

Certain ESG-related metrics may not be available from investment managers on a total portfolio basis due to reasons of comparability or data coverage. In such instances, trustees may wish to source metrics from their investment consultants or advisors, who may be able to access data from external data providers.



23 SMF/Cushon, "Public attitudes on the pensions 'pot-for-life' proposal", April 2024: https://www.smf.co.uk/wp-content/uploads/2024/04/Up-for-grabs-April-2024.pdf
24 FCA, Financial Lives Survey 2022, published July 2023: https://www.fca.org.uk/financial-lives/financial-lives-2022-survey
25 Government response to DWP Select Committee inquiry, January 2023: https://publications.parliament.uk/pa/cm5803/cmselect/cmworpen/1057/report.html
26 DWP Official Statistics, Analysis of future pension incomes, published March 2023: https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes/analysis-of-future-pension-incomes

Section 5: Role of the investment consultant

Whilst the role of the investment consultant continues to rapidly evolve, the primary function is to facilitate alignment between asset owner clients and asset managers, in terms of purpose, investment strategy and culture.

Investment consultants will support clients by monitoring client investments, assessing and engaging with asset managers, focusing on evolving financial objectives and, increasingly, by promoting and underlining the importance of responsible investment . In doing so, risks and opportunities across various ESG issues can be considered, including, but not limited to, the risks and opportunities surrounding climate change.

Considering ESG criteria and stewardship credentials should ideally be a part of the manager research and fund recommendations provided by consultants. This includes reviewing manager voting and engagement policies, their resources, and their activity data. A consultant may also look at a manager's sustainability credentials across their research capabilities, integration of sustainability, stewardship credentials and exposure to both climate risks and opportunities. To raise industry standards, consultants may also provide feedback to managers on any areas that have scored poorly, and engage with managers in respect of specific client concerns or requirements.

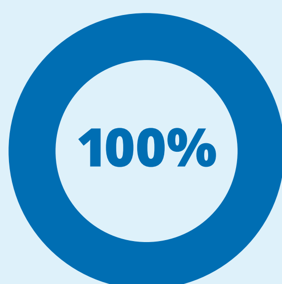
Consultants should also report on the ESG and stewardship credentials of clients' managers and strategy on a regular basis (likely annually). As part of this, information may be requested on PRI signatory status and reporting, Stewardship Code signatory status, Net Zero Asset Manager Initiative (NZAMI) membership, various ESG metrics (including carbon emissions data), and significant voting/engagement statistics, among other things. The consultant may also work with investment managers to enhance the data provided and emphasise the importance of stewardship on behalf of clients.

The outcome of these activities is that, in aggregate, clients (and the collective value of their assets) become more resilient to the evolving challenges of sustainability and stewardship and contribute to the economic challenges ahead. In addition, clients are better trained and have the knowledge to carry out their fiduciary duties, ensuring more robust governance going forwards.

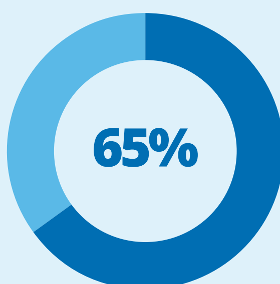
It is also worth noting that TPR expects trustees to be assessing and challenging the quality of the advice given, for example, via the annual review of CMA objectives.

Case study 1: Creation of an equity fund to support climate change

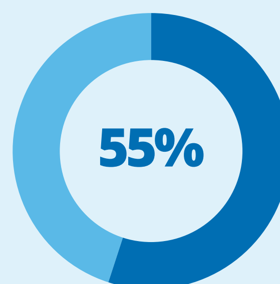
A £400m client has a focus on the transition to a world run on clean energy. It was keen to move its assets out of oil, coal and gas companies that it deemed were polluting the planet. The consultant was therefore tasked with helping to reduce the carbon exposure in the investment arrangements. This involved collaborating with an investment manager to create a passively-managed equity option, which the client seeded based on the reductions in the diagram.



Reduction to carbon reserves



Reduction to carbon intensity



Reduction to revenue from fossil fuels

Case study 2: Engaging with managers

The Pension Committee for a local authority pension fund needed help to engage their active and index-tracking equity managers about one of the companies held, and this was supported by their consultant.

A subsidiary of this company was involved in a social scandal in early 2021, which was misaligned with members' views. The Committee wrote to both equity managers asking how they were engaging with the company on this issue. The index-tracking equity manager shared a letter they had co-written with a group of investors and investment managers, asking for reassurance on how the situation would be resolved. The active equity manager stated that they believed the public apology issued by the company was "appropriate and proportional", and that they did not believe any further action was necessary. The Committee followed up with a call to the active equity manager to note their disappointment at the lack of engagement with the company on this issue and to suggest additional courses of action.

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About The Society of Pension Professionals

Founded in 1958 as the Society of Pension Consultants, today SPP is the representative body for a wide range of providers of pensions advice and services to schemes, trustees and employers. These include actuaries, accountants, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and pension specialists.

Thousands of individuals and pension funds use the services of one or more of the SPP's members, including the overwhelming majority of the 500 largest UK pension funds.

The SPP seeks to harness the expertise of its 85 corporate members - who collectively employ over 15,000 pension professionals - to deliver a positive impact for savers, the pensions industry and its stakeholders including policymakers and regulators.

Further information

If you have any queries or require any further information about this discussion paper, please contact SPP Head of Policy & PR, Phil Hall phil.hall@the-spp.co.uk or telephone 07392 310264

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