FM ESG Integration

Progression of the UK fiduciary managers' approach to ESG integration

September 2023

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Overview and key findings

Our Fiduciary Management ('FM') Oversight team have surveyed the UK fiduciary management market to assess the progress of incorporating environmental, social and governance ('ESG') and sustainable investment practices into the management of portfolios for UK pension schemes. The survey covers over 90% of the FM market, representing 15 fiduciary managers.

1. **27%** of fiduciary manager's solutions have been rated **Green for ESG** by XPS.
2. For the second year, the biggest improvement for fiduciary management solutions has been for **climate change**, one of our five key areas of assessment.
3. **26%** of fiduciary managers **do not have a net zero target** for their FM solutions.
4. **53%** of fiduciary managers **do not have minimum explicit climate related requirements** for underlying funds.
5. **53%** of fiduciary managers are able to **report a scheme's portfolio alignment to the goal of limiting the increase in global average temperatures** to 1.5 degrees Celsius above pre-industrial levels.

Fiduciary managers continue to develop their capability for integrating ESG into their FM solutions and in tandem we have continued to develop our survey to capture the evolving landscape and so trustees can keep informed for their schemes.

André Kerr
Partner

Trustee checklist

1	**Capture your beliefs** to outline and set clear priorities to your fiduciary manager.
2	**Discuss and understand** your fiduciary manager's approach to ESG integration.
3	**Assess the alignment** between your ESG beliefs and what is being implemented.
4	**Scrutinise the extent of integration** of ESG practices into your FM solution and challenge accordingly.
5	**Apply oversight** to monitor continued development, integration and application of ESG practices.

> Consideration of ESG factors into the investment process is a critical part of good investment – from both a risk and opportunities perspective.

Alex Quant
Head of ESG Research

Introduction

The practice of incorporating ESG investment decisions and sustainable investment practices is continually evolving to meet reporting requirements and investor demands. Increased availability of data, its transparency and enhanced models for portfolio analysis are increasing the confidence of all in the development of integrating ESG and sustainability considerations into practice whether they be asset owners, auditors or investment managers.

When considering the UK's fiduciary managers of DB pension schemes, they too continue to progress in the development of their solutions especially when considering their capability to support trustees with reporting requirements (e.g. TCFD) and formally integrating ESG into their investment policies. Likewise, we have developed our survey to capture the evolving solutions assessing the FMs in their capability to incorporate increasingly important ESG factors such as biodiversity.

Our ratings reflect the development of fiduciary manager's solutions, with now 27% of those surveyed being rated Green overall, our highest ever allocation. When considering our five key areas in isolation, climate change saw the largest improvement in ratings for the second year in a row as fiduciary managers continued to demonstrate increased capability in this area, particularly regarding the development of stress-testing and scenario analysis. However, proportionately less fiduciary managers were rated Green for philosophy and reporting compared to 2022 as we too have raised the bar of our survey to reflect the increasing standards on ESG integration and sustainable investment practices.

Table 1: Breakdown of fiduciary manager XPS Pensions Group ESG rating

Percentage of fiduciary managers rated Green, Amber or Red against key areas

	Overall			Philosophy			Integration			Climate change			Stewardship			Reporting		
	2023	2022	2021	2023	2022	2021	2023	2022	2021	2023	2022	2021	2023	2022	2021	2023	2022	2021
	27% (4)	17% (2)	16% (3)	34% (5)	42% (5)	37% (7)	20% (3)	17% (2)	32% (6)	40% (6)	25% (3)	–	27% (4)	25% (3)	32% (6)	20% (3)	33% (4)	79% (14)
	67% (10)	83% (10)	84% (16)	60% (9)	58% (7)	63% (12)	67% (10)	83% (10)	68% (13)	54% (8)	67% (8)	84% (16)	73% (11)	75% (9)	68% (13)	67% (10)	58% (7)	16% (4)
	6% (1)	–	–	6% (1)	–	–	13% (2)	–	–	6% (1)	8% (1)	16% (3)	–	–	–	13% (2)	8% (1)	5% (1)

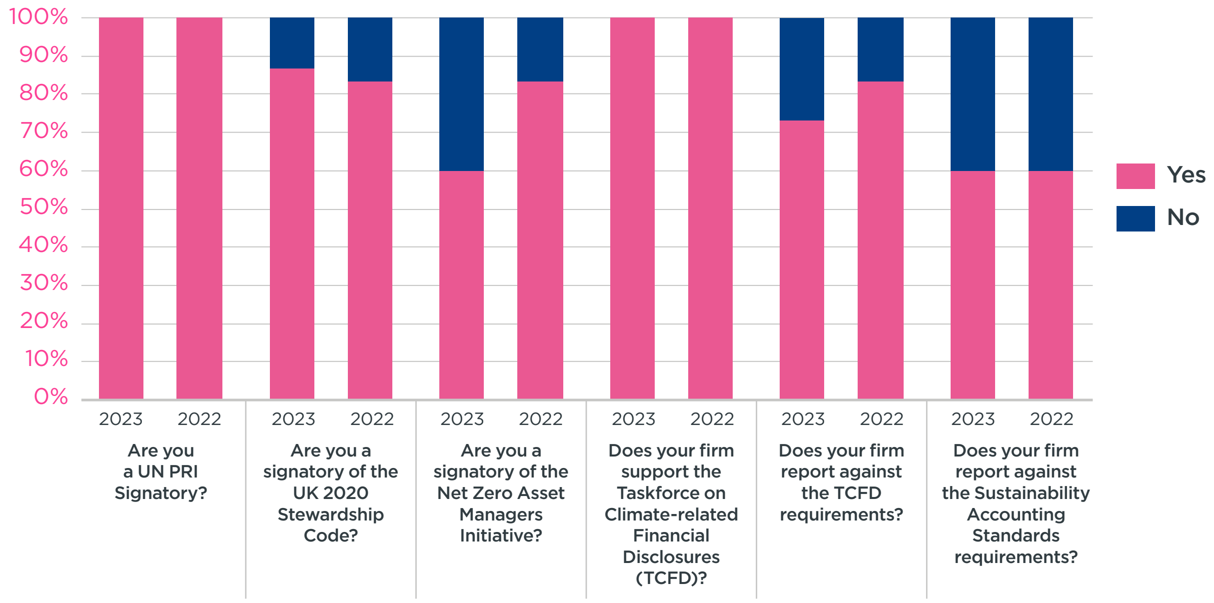
Note: Numbers in brackets represent number of fiduciary managers.

Philosophy and integration

At the foundation of any successful integration of ESG and sustainability considerations into a scheme's investment portfolio is the commitment, policies and behavioural standards set by the fiduciary managers themselves.

Most fiduciary managers are part of the networks, following the standards, or are members of the initiatives that we consider to be the most important within the area of sustainable investment as shown in chart 1. Whilst it appears less fiduciary managers are signatories to the Net Zero Asset Managers Initiative and as firms report against the TCFD requirements, this is due to the new participants of this year's survey. More specifically, such is the value we place on following the standards of the UK Stewardship Code, we do not rate any fiduciary managers as Green, unless they are signatories of the Code.

Chart 1



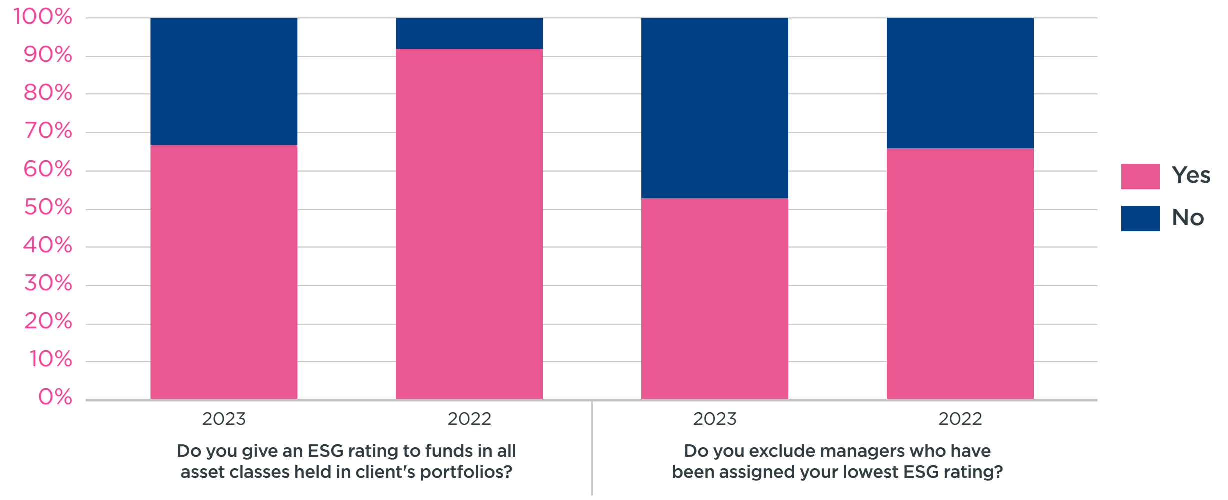
With the many commitments and following of standards, it is clear ESG is now considered as an integral part of investment management and this is further supported by the 93% of fiduciary managers that have investment policy documentation which refers to ESG integration practices. Most trustees can therefore be comfortable that their appointed fiduciary manager is committed to integrating ESG and sustainable investment practices into their fiduciary management approach.

However when it comes to the integration of these practices, fiduciary managers can have very different approaches. Whilst many use underlying funds to build their solutions via an open architecture approach, not all are given ESG ratings. Furthermore, some underlying funds and/or managers who have the lowest ESG ratings assigned by that fiduciary manager, can still be included within a scheme's portfolio.

Jargon explanation

Open architecture approaches are when fiduciary managers use a combination of in-house and external funds as part of their fiduciary management solutions.

Chart 2



With the exception of one, all fiduciary managers consider trustees' ESG beliefs as part of the initial engagement with pension schemes. We are fully supportive of this as capturing and documenting a trustees' ESG beliefs is a key factor to the continued development of ESG and sustainable investment practices. However, a challenge remains within the fiduciary management model as to how well trustees' investment beliefs can be aligned to their fiduciary manager's investment approach.

For larger schemes with more bespoke portfolios, or for schemes with not particularly strong ESG preferences this may be suitable for now. However, if regulation pushes schemes towards stronger requirements and evidencing of ESG preferences, this may prove challenging.

There are a few fiduciary managers who standout from their peers by not only ensuring to capture trustees' investment beliefs but also demonstrate how that has been aligned within their investment portfolio.

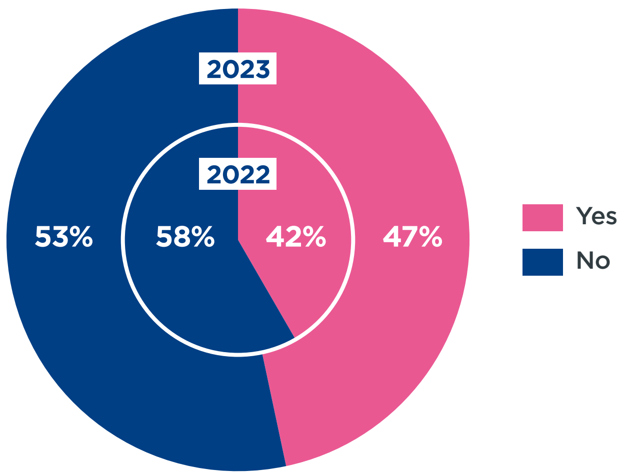
Fraser Weir
Investment Consultant

Climate change

A clear example of where ESG beliefs may not be aligned is with regard to climate change. Many pension schemes are now establishing clear climate change objectives with regards to their portfolios.

These can be reduction targets for carbon emissions or risk management through scenario analysis. It may therefore be surprising that 27% of fiduciary managers do not have a net zero target for their fiduciary management solutions and this could be resulting in a situation whereby a scheme has a net zero target but it isn't achievable because of the fiduciary management arrangement they are in. Trustees with schemes in fiduciary management arrangements that do have a net zero target should also be aware how effectively their fiduciary manager is progressing their portfolio to a net zero target especially when underlying managers are being utilised within the solution which we see most typically through an open architecture approach. With over 50% of fiduciary managers not having minimum explicit climate related requirements for underlying funds, fiduciary management solutions may not be as effective trustees may think.

Chart 3: Do you have any minimum explicit climate related requirements for the underlying funds you invest in?



Fiduciary management as a governance arrangement can be suitable for many schemes however aligning specific objectives, particularly when attempting to represent ESG beliefs, can be difficult.

Fraser Weir
Investment Consultant

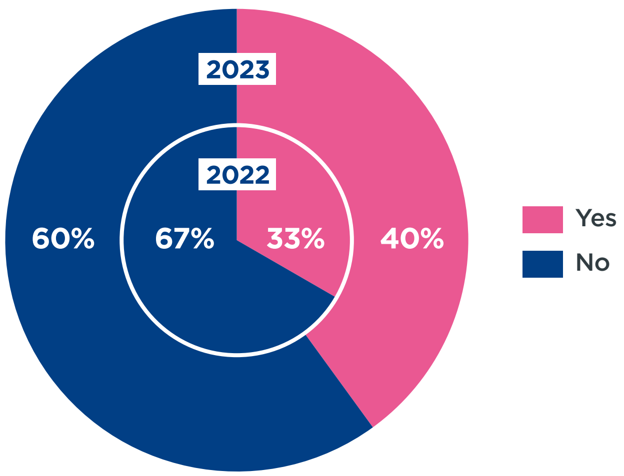
Stewardship

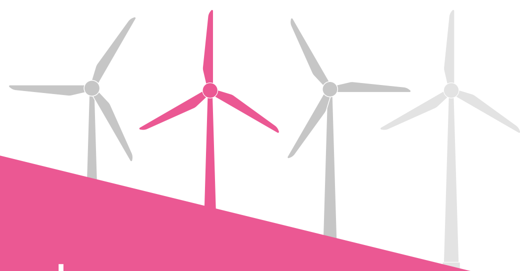
Stewardship is one of the most powerful tools trustees have to effect positive change.

However, trustees must be aware that, just like the delegation of investment decisions, stewardship is delegated to underlying managers. There are some fiduciary managers that retain power of attorney but in most cases voting and engagement activity will be led by the underlying managers. It is essential that fiduciary managers at least monitor the voting and engagement of underlying managers and all fiduciary managers do this.

Given the importance of stewardship and the ability to effect positive change, we approve of fiduciary managers who actively influence voting activities of underlying managers. Trustees must understand the approaches and action their fiduciary managers are taking to engage with underlying managers.

Chart 4: Do you actively influence voting activities of underlying assets/managers?





Trustee checklist:

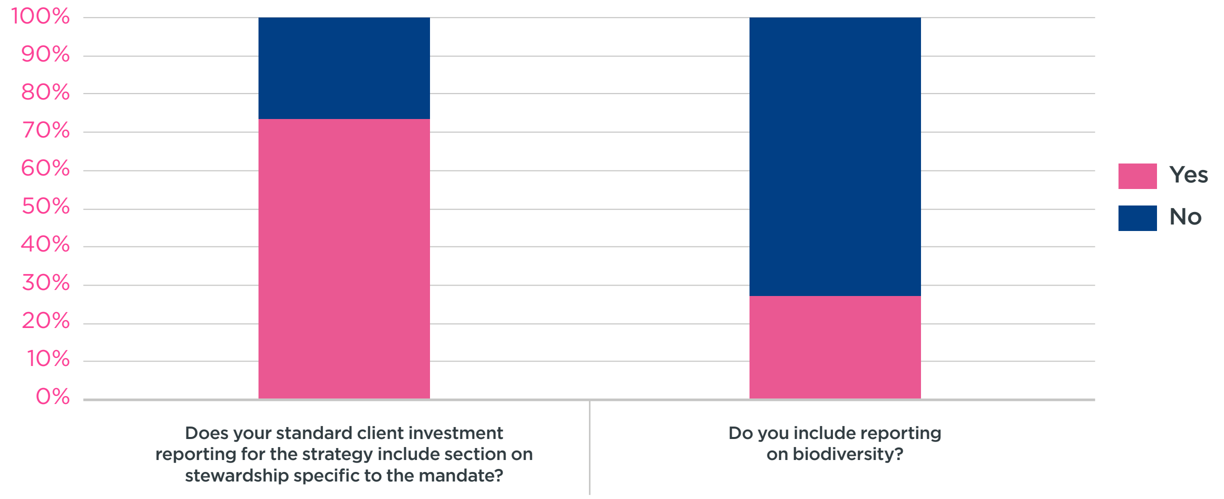
1. Capture your beliefs
2. Discuss and understand your FM's approach
3. Assess the alignment
4. Scrutinise the extent of integration
5. Apply oversight

Reporting

As well as understanding the integration of ESG considerations into investment decisions, trustees want to know the ESG exposures of their scheme's assets at a portfolio level.

Whilst all fiduciary managers continue to include a section on ESG within their standard client reporting, the capability of fiduciary managers and information they report varies widely. It would be fair to say climate change risk is the predominant ESG factor for many trustees and the availability of data has vastly improved over recent years, yet only 53% of fiduciary managers are able to report a scheme's portfolio alignment to the goal of limiting the increase in global average temperatures to 1.5 degrees Celsius above pre-industrial levels.

Chart 5



Regulatory requirements however are pushing the fiduciary managers to improve their capabilities in specific areas. The introduction of mandatory Engagement Policy Implementation Statements is an example of this. Whilst still a standalone requirement for all schemes, fiduciary managers are increasingly including sections on stewardship specific to a scheme's mandate within standard client reporting with now 74% doing so compared to 58% last year.

Following a pressing focus on climate change, unsurprisingly, biodiversity is now gaining increased attention as an ESG factor with the World Economic Forum indicating that biodiversity loss is the third most severe global risk in the next ten years. However we have identified many fiduciary managers need to improve their capability with only 27% being able to include reporting on biodiversity for schemes. Given the Taskforce on Nature-related Financial Disclosures are developing a framework for managing and disclosing risks related to nature, we anticipate fiduciary managers to develop their capabilities in this area quickly given it can be expected that pension schemes will be expected to report along these lines in the future.

We are seeing an increasing demand from trustees for ESG data at a portfolio level. However, many fiduciary managers are unable to report against a wide range of ESG metrics to their clients.

Fraser Weir
Investment Consultant

Summary

The governance model of delegating investment decisions via a fiduciary management arrangement represents a large proportion of DB UK pension scheme assets and this has increased over recent years.

Yet, it should be noted that the choosing of fiduciary management as a preferred governance approach has been done against a backdrop of increasing pressures regarding policies for ESG and stewardship practices. Fiduciary managers are continually developing their solutions and capability to support trustees especially with respect to climate change scenario analysis and stress testing models. However, against this backdrop trustees need to understand how their fiduciary management solution is able to align with their ESG beliefs and preferences as solutions vary between fiduciary managers.

ESG integration and sustainability investment practices will continue to evolve at a fast pace of change. For areas, such as biodiversity and diversity and inclusion, like climate change in recent years, we will see drastic changes in the volume of data, its transparency and validity and trustees will become more confident with how their ESG views are being incorporated within the stewardship of their assets. Increasing regulation too will place further demands on trustees and whilst investment decisions may be delegated, responsibility cannot, and trustees must keep abreast of their investment portfolio and how ESG risks are being managed within their fiduciary management arrangement.

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Appendix

Five key areas that we consider to be fundamental when assessing ESG practices:

1	**Philosophy** Firm-level philosophy relating to ESG, stewardship and broader sustainability issues.
2	**Integration** Implementation of the firm's ESG philosophy within research and portfolio construction.
3	**Climate change** Explicit climate change considerations within the investment and stewardship processes.
4	**Stewardship** Approach to voting and engagement to drive positive change in invested companies and underlying managers.
5	**Reporting** Transparent communication of activity to stakeholders.

About us

XPS Pensions Group is a leading independent pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over one million members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 81 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £96bn of assets under advice.

Professional Pensions UK Pensions Awards 2023 – WINNER – Fiduciary Evaluator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2022 – 25 Anniversary – WINNER – Investment Consultancy of the Year – XPS Pensions Group

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Culture and Sustainability