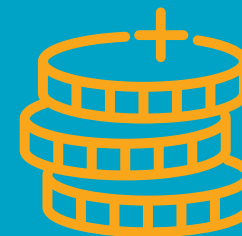


# Responsible investment in DB schemes

*Responsible investment has become a mainstream consideration for pension scheme trustees. This guide sets out the key things you need to know, including an overview of your responsibilities and some suggestions for putting responsible investment into practice.*

December 2019



## Introduction

It is now generally accepted that responsible investment (RI) is part of good practice for all pension schemes since environmental, social and governance (ESG) factors can affect the performance of assets, both individually and collectively, over both the short- and long-term. In addition, members often want and expect trustees to invest responsibly. The Pensions Regulator (TPR) has set out clear expectations for trustees in relation to ESG factors and stewardship and trustees are required to state their RI policies in their Statement of Investment Principles (SIP).



## What is responsible investment?

RI incorporates ESG factors into investment decisions and adopts stewardship (active ownership) practices such as voting and engagement, with the aim of achieving long-term sustainable returns.

RI has at times been confused with ethical investing, which in the past sometimes meant accepting lower returns by screening out certain investments that fail to meet ethical considerations (eg avoiding tobacco shares). However, RI focuses on ESG factors that are financially relevant and have the potential to improve risk management as well as help generate sustainable, long-term returns. We believe in taking a pragmatic approach to RI that aims to enhance the long-term risk-return profile of a scheme's assets.

## What do trustees need to document in their SIP?

In summary, trustees must state their policy on:

- Taking account of financially material considerations, including ESG factors, including climate change, over the appropriate time horizon of the investments.
- Taking account of non-financial matters, such as members' ethical views (if the trustees have such a policy).
- Exercising rights (eg voting rights) that are attached to investments.
- Undertaking engagement activities in respect of their scheme's investments.

*Click here to access the latest guidance from the Pensions Regulator*

## What else are trustees expected to do?

The [Law Commission's guidance](#) clarifies trustees' legal obligations in relation to ESG factors:

- You should take into account factors which are financially material to investment performance.
- You may take into account financial factors that are not financially material to the scheme.
- Where you think ESG factors or certain ethical issues are financially material, you should take these into account.
- While the pursuit of a financial return should be your main concern, the law is sufficiently flexible to allow you to take other, non-financial factors into account if you have good reason to think scheme members share your view and there is no risk of material financial detriment to the fund.

In addition, trustees are expected to follow TPR's investment guidance. This says that trustees will want to assess the financial materiality of ESG factors and allow for them accordingly in the development and implementation of their investment strategy. Where pooled funds are used, care is required to understand the ESG approach of the available funds, including in the selection criteria for new funds, and when monitoring how managers take account of ESG factors in practice.

TPR also says it is up to the trustees to exercise stewardship and ensure, as far as they are able, that this is done through the whole length of the investment chain. It notes this is particularly relevant for the management of macro-economic, systemic risks such as climate change, which cannot be sufficiently hedged through portfolio construction and asset allocation alone.

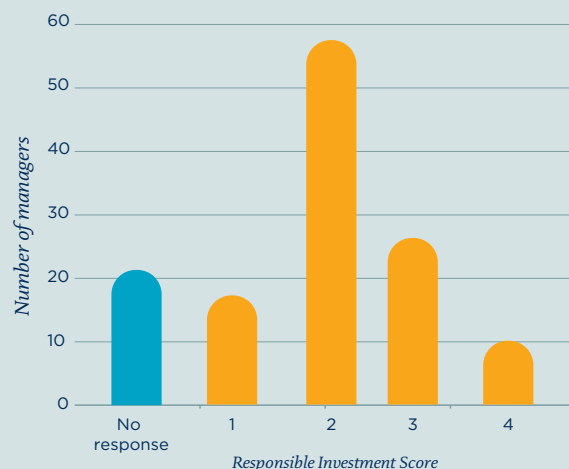


## What are your investment managers doing on your behalf?

The day-to-day implementation of trustees' RI policies is typically carried out by their investment managers. Many managers will say they take account of ESG factors and exercise stewardship, but they do this in different ways and with varying effectiveness. Therefore, trustees should oversee what their managers are doing on their behalf.

Our manager research programme incorporates RI as part of the due diligence process, so we have a wealth of in-depth information on investment managers' RI approaches and credentials. We can use this information to help you understand how your managers measure up on RI and support you in your discussions with them.

The chart below shows the headline scores from [our latest RI survey](#) where 1 is weak and 4 is strong.



## Should trustees do something different on climate change?

The amended SIP requirements specifically reference climate change in the definition of financially material considerations. There is a trend towards trustees having a specific policy on climate change, in addition to a more general ESG policy. The reasons include:

- strong evidence that climate change will be financially material, supported by scientific and public policy consensus.
- climate change is an issue that affects all sectors of the economy and poses risks to the stability of the financial system as a whole.
- expectations set by regulators, eg climate change and management of it as a systematic, macroeconomic risk features prominently in TPR's guidance.
- expectations set by policymakers; eg when the MPs' Environmental Audit Committee reviewed the climate practices of the largest 25 UK pension schemes in the first half of 2018.
- increasing availability of credible investment products that seek to protect against climate-related risks and/or invest in climate-related opportunities.

## Should trustees have a policy on non-financial matters?

Trustees are not required to take account of non-financial matters, but the Law Commission has said they can do so if two tests are met:

- you have good reason to think scheme members share your view; and
- there is no risk of material financial detriment to the fund.

Examples include:

- a scheme not investing in controversial weapon manufacturers, in line with social norms.
- a scheme sponsored by a health charity excluding shares of tobacco manufacturers on ethical grounds.
- a scheme sponsored by a religious organisation applying a broad range of ethical screens.

## Putting responsible investment into practice

Best practice is to embed RI throughout your investment and wider risk management processes. Here are some suggested actions.

### Here are some suggested actions.

<b>Governance</b>	<ul style="list-style-type: none"> <li>• Make RI a standing item at investment committee / trustee meetings.</li> <li>• Undertake trustee training on RI at least annually, to stay abreast of developments in this fast-moving area.</li> </ul>
<b>Integrated risk management</b>	<ul style="list-style-type: none"> <li>• Understand your exposure to ESG risks through your investments and sponsor covenant, and any links between them.</li> <li>• Seek ways to mitigate these risks (see below for investment options). Take account of remaining ESG risks when making funding decisions and contingency plans.</li> </ul>
<b>Investment beliefs</b>	<ul style="list-style-type: none"> <li>• Develop a consensus set of beliefs about how ESG factors and stewardship affect investment performance. For example: <ul style="list-style-type: none"> <li>• do market prices fully reflect ESG factors? If not, can investment managers add value by taking account of ESG factors?</li> <li>• should trustees should consider long-term environmental, social and economic sustainability when making investment decisions?</li> </ul> </li> <li>• Document your beliefs and use them to inform your RI policies.</li> </ul>
<b>Investment strategy</b>	<ul style="list-style-type: none"> <li>• Consider how investment options vary in their exposure to ESG factors and investigate whether there are suitable options that have lower exposure to ESG risks and/or higher exposure to ESG opportunities. For example: <ul style="list-style-type: none"> <li>• passively managed funds that track an index that is tilted towards companies with lower exposure to climate risks and vice versa; or</li> <li>• actively managed funds that specifically seek to invest in companies that are aligned with long-term social and environmental sustainability.</li> </ul> </li> </ul>
<b>Manager selection</b>	<ul style="list-style-type: none"> <li>• When selecting a new investment manager: <ul style="list-style-type: none"> <li>• consider setting minimum RI standards (eg must be a signatory to the Principles for Responsible Investment);</li> <li>• ask RI questions at the beauty parade (eg can the portfolio managers give good examples of how ESG factors affect their investment decisions?); and</li> <li>• make RI one of your criteria for ranking managers.</li> </ul> </li> </ul>
<b>Manager monitoring</b>	<ul style="list-style-type: none"> <li>• Understand how your investment managers are implementing RI on your behalf (see box on p2) and ensure their approach is consistent with your RI beliefs.</li> <li>• Review managers' voting and engagement reports regularly, eg each quarter.</li> <li>• Identify any areas of weakness and encourage your managers to address them.</li> </ul>
<b>Communication</b>	<ul style="list-style-type: none"> <li>• Document your policies on ESG considerations, climate change, voting and engagement in your SIP , as required by the regulations.</li> <li>• Tell members about your RI activities. Seek to engage them on pensions through demonstrating the links between real-world issues and the scheme's investments.</li> </ul>
<b>RI leadership</b>	<ul style="list-style-type: none"> <li>• Sign up to the <a href="#">Principles for Responsible Investment</a>, <a href="#">UK Stewardship Code</a> and <a href="#">Task Force on Climate-related Financial Disclosures (TCFD)</a> recommendations .</li> <li>• Join investor collaborations that encourage companies, regulators and policymakers to adopt good ESG practices that enhance long-term investment returns.</li> </ul>

## Three simple steps for you to get started

- 1** Undertake training to find out more about ESG factors and stewardship, how they can affect your scheme's investment performance, and how you can implement RI in practice.
- 2** Develop and document your consensus view about how ESG factors and stewardship affect investment performance.
- 3** Find out how your investment managers are implementing RI on your behalf by reviewing their responses to LCP's RI survey and engaging in dialogue with them.

*Learn more by visiting our  
responsible investment hub*

## Want to find out more?

If you would like more information, please contact your usual LCP adviser or one of our specialists below.



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