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Responsible Investment:

A guide for Defined Benefit trustees

In 2018, the UK Government introduced new Investment Regulations for trust based defined benefit (DB) and defined contribution (DC) schemes.

What the regulations require

The 2018 Regulations require that, with effect from 1 October 2019, trustees must set out in their Statement of Investment Principles, their policy on:

1. How they take account of 'financially material considerations' which include, but are not limited to ESG factors, including climate change;
2. Their approach to stewardship activities for the assets held; and
3. The extent to which any non-financial matters are taken into account.

In addressing these requirements, trustees need to consider and set out how their approach is appropriate for determining both the strategic allocation and its implementation.

Reference is made to an "appropriate time horizon", defined as the length of time that the trustees consider is needed for the funding of benefits by the scheme's investments. The intention is that trustees consider longer-term risks within their investment arrangements.

Stewardship policies should cover voting, engagement and monitoring. This should include how trustees engage with companies and investment managers on matters such as "performance, strategy, risks, social and environmental impact, and corporate governance". It should also include the exercise of any rights (such as voting rights) that come with particular investments.

Where trustees rely on their investment managers to act or to mitigate risks, they will need to explain how their approach is implemented and monitored. Trustees should also consider how they monitor adherence to their own policies and how they would demonstrate compliance, if asked.

Glossary

ESG is used to collectively describe a series of different risk factors arising from **Environmental** (resource scarcity, waste management, pollution, energy efficiency), **Social** (health & safety, workforce diversity, working conditions, data protection) and **Governance** (board structure, business ethics, shareholder rights, executive compensation) issues.

Responsible investment refers to investment practices that integrate the consideration of environmental, social and governance (ESG) factors into investment management processes and ownership practices, recognising that these factors can have a material impact on financial performance.

Stewardship describes the activities of investors in exercising the rights and responsibilities that come with asset ownership. These practices can include voting on shares and engaging with company management but should also include the oversight by trustees of those to whom they delegate responsibility for such activities.

Trustees need to understand Responsible Investment across the investment process

The Regulations encourage trustees to take greater ownership and be aware of the consequences of their responsible investment policies, rather than adopting a "box ticking" approach.

Where trustees' approach has historically been somewhat manager centric, greater emphasis is now placed on the consideration of financially material factors beyond implementation and there is a broader requirement for trustees to consider responsible investment issues at each stage of the investment process. Trustees should pose themselves, and seek to answer, a number of questions about their current approach in developing their policy:

Objective setting

- To what extent are RI factors relevant given the trustees' timeframe?
- Has consideration been given to setting investment beliefs or specific RI objectives?
- Do the trustees have strong views that they want to reflect in their strategy?

Asset allocation

- Do modelling assumptions make explicit or implicit allowance for ESG factors?
- Could ESG focused mandates be included for consideration and do they affect risk/return expectations?
- Do the trustees have strong views that they want to reflect in their strategy?

Implementation

- How relevant is RI for the mandates in the strategy?
- Are manager RI policies explicitly considered in manager selection?
- How good are managers at integrating the consideration of ESG risks into their approach?
- Should RI be a differentiator in picking managers?
- Do the trustees have strong views that they want to reflect in their strategy?

Monitoring

- Do the trustees receive any information (e.g. metrics, case studies) relating to the ESG characteristics of their mandates in reporting?
- Do the trustees review manager reporting on ESG issues and challenge manager activity?
- Do the trustees actively question managers on their stewardship activity?

Trustees can continue to delegate much of the implementation of their RI policy to their investment managers. However, the onus remains on trustees to both understand the approach taken by their managers and to effectively challenge those to whom they delegate this responsibility.

The special case of climate change

Climate change is singled out as an issue within the Regulations. Climate change is a systemic risk that has the potential to affect economies, financial returns and demographics although its future impact is uncertain. Other bodies such as the Pensions Regulator and the Institute and Faculty of Actuaries have also highlighted climate change as a potential risk factor to be considered by both advisors and trustees alike.

As long-term investors, there are potential implications for pension schemes although it is also worth noting that climate change cannot be regarded as a wholly long-term risk, with policy action that could affect pension schemes highly likely in the short term. There are several actions that trustees can take to better understand, and begin to address, the potential risks to DB pension schemes arising from climate change. These include:

- Undertaking regular training to understand climate risk, regulatory changes and market developments;
- Developing investment beliefs relating to climate risk and/or acknowledging climate as a contributing risk factor to financial and demographic considerations on the scheme's risk register;
- Considering the extent to which climate risks arise in investment mandates, particularly passive mandates, and reviewing benchmarks where appropriate;
- Discussing climate risk with investment managers and understanding how they reflect this in their decision-making processes;
- Understanding how managers vote and engage with companies on climate risk issues and challenging managers as to how they encourage best practice, such as compliance with the recommendations of the Taskforce for Climate Related Financial Disclosures.

It is inevitable that regulation and best practice regarding the consideration of climate risk will evolve. We therefore encourage trustees to ensure that they stay up do date with emerging legislation.

Consider what sort of Responsible Investor you want to be

Our "Core-Active-Leader" framework encourages trustees to consider "what sort of responsible investor they want to be". By recognising that there is a spectrum of positions that they could take, trustees can determine an approach to RI that is right for them, recognising this should be both proportionate and scheme specific.

The factors that inform trustees' approach should include their investment beliefs, the complexity of the investment arrangements and their governance budget. Trustees should not however feel constrained in their approach and, where they believe it appropriate, should strive to demonstrate higher standards of behaviour. The behaviours and actions of a "Core" responsible investor are set out below; trustees demonstrating and documenting these behaviours will be compliant with regulations.

RI Criteria	Behaviours and Actions of a "Core" responsible investor:
Beliefs	• Trustees have developed investment beliefs and RI-related issues are clearly represented. • RI-related risks (e.g. climate risk) are included where appropriate in the risk register.
Training/Education	• Trustees have a solid understanding of RI, its financial significance and the potential impact on different investments. • Training is received periodically on RI matters from advisers and/or managers. • RI is a consideration in annual business planning.
Strategy/structure	• Where there is an appropriate investment horizon, trustees will consider the potential impact of ESG factors on risk and return from each asset class/strategy. • Trustees recognise the influence of benchmarks on the selection of assets by investment managers, particularly in passive arrangements where different indices are considered. • Trustees consider alternative approaches for investment in some asset classes such as equity and infrastructure where ESG factors are more prominent.
Implementation	• RI criteria are included as a consideration in manager selection processes. This may be through reference to manager ratings or some other evaluation criteria. • Trustees understand the extent to which their managers take account of ESG issues in their investment processes.
Reporting	• Trustees request RI factors are included in reporting by advisers/managers and will agree what information it would be helpful to receive. • Trustees receive and review periodic reporting on stewardship activities from their managers. • Trustees include high level RI information in their own reporting to members, particularly where members have demonstrated an interest.
Monitoring	• Managers RI credentials and changes to house policies are reviewed annually. • Managers' adherence to policies is considered and questioned in meetings and managers are challenged on decision making. • Trustees question managers on topical RI issues.
Policy adherence	• Trustees undertake an annual review of their RI policies and practices and consider ways to improve practices.

For many trustees, the changes required to evolve their policies and practices may be relatively small. Discussion on RI practices with investment managers can be incorporated into existing meeting arrangements; reporting can be extended to include additional information, and questions can be asked during strategy discussions. This should be founded on a proper understanding of RI and its relevance to each scheme's investment arrangements. Training therefore remains paramount.

Non-financially material factors

A significant change within the 2018 Regulations is that the consideration of ethical issues, social impact and members views are all now captured under the heading of "non-financially material factors". There is no obligation on trustees to develop a policy on their approach to such factors, although they can do so if they wish.

The Law Commission's 2014 report on the ability of trustees to take account of non-financially material factors was clear. Trustees can do so if their decision meets the dual criteria of:

- a belief that a majority of members would share the views being expressed, and
- the decision is unlikely to be of significant financial detriment.

Case study: pooled investors can have an impact

Many trustees often claim that, because they invest through pooled funds, they are unable to influence the decisions of investment managers. Whilst this may be correct, this does not mean that trustees cannot hold their investment manager to account and challenge their decisions.

A client with significant pooled equity exposure and subject to member scrutiny put in place a formal voting and engagement policy, defining the expectations of their investment manager. This led to them receiving greater information from their manager, and their manager subsequently improved the levels of disclosure on their pooled funds.

The trustees are also reviewing individual voting decisions on particular issues and increasing their challenge on the manager. The manager is being required to justify their decisions and has sought to meet with the trustees.

Such increased scrutiny ensures that managers cannot simply hide behind their policies and limit their level of disclosures to their underlying clients. Changing practices by investors will ensure that more asset managers and asset owners become accountable for decisions. You should consider the extent to which you challenge your managers in developing your own policy.

What do trustees need to do next?

Trustees need to ensure that their Statement of Investment Principles is updated by 1 October 2019. This is just the start. Policies define the behaviours and practices that trustees intend to demonstrate going forward and we suggest that, as a minimum, trustees focus on the following activities:

- Ensure that investment beliefs are defined and documented;
- Schedule responsible investment training into the ongoing trustee education programme;
- Confirm that your managers properly integrate the consideration of material ESG factors into their investment processes and if not, understand why not. Your investment consultant could help with this, for example, by providing RI ratings;
- Ask investment managers to include suitable RI information in their periodic updates and ensure that managers are challenged to explain their actions. You could discuss with your investment consultant what information it would be useful to receive; and
- Include an annual "Responsible Investment" review as part of the trustee governance programme.

Please speak to your regular Hymans Robertson consultant to discuss further how we can help you.

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