## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>3</td>
</tr>
<tr>
<td>The pension landscape</td>
<td>4</td>
</tr>
<tr>
<td>The UK regulatory landscape and fiduciary duty</td>
<td>7</td>
</tr>
<tr>
<td>Top tips for sponsors</td>
<td>9</td>
</tr>
</tbody>
</table>
INTRODUCTION

Just as more and more companies are embedding social and environmental risk and opportunity into strategy and decision making, it is vital that their pension schemes follow suit. The impact that climate change and other environmental, social and governance (ESG) risks can have on value and returns is driving changes across the market, including by regulators. Employees are not only asking their employers what actions they are taking to build a sustainable business, they are starting to ask questions of their pension schemes. Campaigns like Make My Money Matter, which aims to empower individuals to call for pensions that they can be proud of – ones which build a better world without compromising on returns – are set to increase this demand.

CFOs and their teams are often at the heart of the decision-making process, frequently involved in the governance arrangements around their organization’s pension scheme, and in regular dialogue with pension scheme trustees. As the sponsor, there are a number of reasons to ensure that ESG is part of the conversation:

- Pensions are a part of an employer’s value proposition to its employees
- Conversations about environmental and social issues can support employee engagement
- Embedding environmental and social risks into investment can enhance value and returns
- Sustainability as a mutual interest can strengthen trustee relationships

This top tips guidance is written for pension scheme sponsors, setting out why the sponsor should engage with their pension scheme on sustainable investing, summarizing the regulatory landscape and providing some practical steps for engagement. The context setting, top tips, examples given and references will support you in working with your pension schemes and engaging with your employees on their pensions.

We would like to thank members of our CFO Leadership Network and Asset Owners Network for their contributions to this guidance.

This edition focuses on the UK market, timed to support the launch of the Make My Money Matter campaign. Much of the content will be relevant for CFOs and teams in other countries, although differing legal and regulatory frameworks will need to be taken into consideration.
The importance of sustainable investing continues to grow in the UK pensions landscape. Regulatory policy has acknowledged the financially material impacts of environmental, social and governance (ESG) factors on investment decisions; defined benefit (DB) and defined contribution (DC) pension scheme consolidation is changing the size and shape of assets under management; and there is some evidence of a growing demand from members, enabled by increased reporting and online technology (dashboards, apps, etc), for investments to reflect their values.

In spite of the shock that the COVID-19 pandemic has delivered to the global economy, with both pension schemes and sponsors adjusting to the crisis, the focus on sustainable investing has not dissipated. The pandemic highlighted the fragility of the financial assumptions on which we rely to invest and secure our employees’ wellbeing in retirement, reinforcing the need for effective risk management, governance and a long-term outlook.

The pandemic has demonstrated just how rapidly nature can impact society and the economy. For many this has reinforced the urgency of the response needed to avert the climate crisis, an even greater existential threat that needs to be addressed if individuals – your employees – are going to retire into a thriving society on a healthy planet. In managing this threat, we must take on board the lessons learnt from COVID-19 on preparedness and long-term planning.

Pension schemes are both highly exposed to the risks of an unsustainable future and in a strong position to influence a more sustainable outcome. Embedding ESG factors into the investment process of a pension scheme is, similar to a business, essential for effective risk management, innovation and return on investment. It speaks to the heart of fiduciary duty and it also helps address the diverse demands of beneficiaries which, in turn, can lead to better engagement with their pension and also their employer.¹

What do we mean by sustainable investing?

There is a range of different investment approaches referred to as ‘sustainable investing’. Pension fund trustees have a duty to consider an appropriate financial return including all environmental, social and governance (ESG) risks which have an impact on those returns, or the level of associated risks. Some pension schemes do this through integration – embedding ESG considerations into the strategy and processes of fund selection and management.

Others may opt to aim to generate competitive returns while also considering the impact of ESG, or to exclude from portfolio companies and industries that do not reflect their members’ or their values. Different legal duties apply here, and sponsors or trustees should seek legal advice before they take this approach.

Our focus in this top tips guidance is on the integration of ESG risks and opportunities into the way that the pension fund is governed, strategy set and investment decisions made, across the whole portfolio of assets.

¹ Is your generation the greenest?, LGIM (https://update.lgim.com/dc-esg)
The role of the sponsor
Sponsors of DB and/or DC pension schemes cannot afford to ignore the argument for sustainable investing and aligning the values and sustainable business objectives of the sponsor with that of their pension schemes. Many are not. Working with their pension scheme or provider, executive teams of sponsoring organizations are recognizing the value of this approach.

“From press coverage of our fund in 2003, the realization that our pension’s investment strategy was not aligned to the values of the Environment Agency was a game changer for us. This started a process to embed ESG within the investment strategy, asset allocation, fund manager selection and performance monitoring of our pension fund. Working with our trustees, this has not only resulted in a pension investment strategy that we are all proud of – with a strong focus on responsible and sustainable investment, alongside strong annual investment returns – but has meant that we have developed a three way dialogue between the Fund and our employees and pension members which ensures the investments we do on their behalf continue to align with their values. The approach has delivered in all areas. As well as being environmentally beneficial, the fund has achieved good value whilst delivering 9.7% average annual investment returns over the last five years. We are also very well funded, with a funding ratio of 103% in March 2019.”

Emma Howard Boyd, Chair of the Environment Agency

- Pensions are part of an employer’s value to its employees
How an employer engages with their employees (past, present and future) around their pension could affect how the employee perceives the employer. Recent LGIM inter-generational research found that people of all ages report that they would engage more with their pensions if they were rewarding or encouraging companies to have a positive impact, and over half would feel more positive about their employer if their pension fund was making a positive social impact. The latest Edelman Trust Barometer also identified that 73% of employees expect prospective employers to join them in shaping the future of society, with ethical drivers being three times more important to company trust than competence.
Taking action to embed ESG considerations into pension fund arrangements can deliver positive benefits for the sponsor by increasing employee retention and workplace productivity, as well as promoting the organization as an attractive place to work. With millennials feeling even more strongly about these issues, and due to make up two thirds of the global workforce by 2025, it is vital that employers remain relevant and attractive to them.

- ESG discussions can broker a two-way engagement with employees
ESG means something different to different people and whether it is climate change, human rights or fair pay that is of interest, this provides a good opportunity to understand their priorities around their pension and strengthen the relationship. With public-facing campaigns, such as Make My Money Matter, driving awareness that pension fund investments are one of the most powerful tools that beneficiaries can possess to tackle climate change, drive societal change or improve how businesses are governed, providing opportunities for your employees to discuss what this means to them will deepen your relationship with them.

2 2020 intergenerational research by LGIM (https://update.lgim.com/do-esp)
3 2020 Edelman Trust Barometer (https://www.edelman.com/trustbarometer)
Sustainable investing can enhance investment performance

Evidence shows that sustainable investing can increase long-term investment performance by reducing volatility, increasing risk-adjusted returns and enhancing opportunities for asset diversification. This has been shown in both favourable market conditions and during times of crisis, such as those currently being faced as a result of the COVID-19 pandemic, with data across asset classes showing a strong positive relationship between a company’s relative market performance and its ESG rating.\(^5,6,7\)

For DB schemes, a stable, sustainable and long-term approach can provide more certainty for CFOs on the capital required and more predictability for trustees to plan their scheme’s investment strategy and cashflow. For DC schemes, it can strengthen trustee fulfilment of their fiduciary duty by offering members access to a wider choice of more sustainable investment funds aligned with employee values.

ESG as a mutual interest can strengthen trustee relationships

Developing a mutual interest in ESG can bring pension trustees and sponsors together and foster a collaborative and productive relationship between the scheme and its sponsor.

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\(^{5}\) Investing in firms with better record on social issues pays, study finds, the Guardian, May 2020 (https://www.theguardian.com/business/2020/may/18/investing-in-firms-with-better-record-on-social-issues-pays-study-finds)


THE UK REGULATORY LANDSCAPE AND FIDUCIARY DUTY

Fiduciary duty is the obligation for pension trustees to act on the best interest of the beneficiary. Historically that has been interpreted to mean a narrow focus on short-term financial return and thus has often been cited as the reason trustees cannot incorporate sustainability factors into investment decisions.

Specifically, the challenges faced have been:

- A long-held view that fiduciary duty means solely maximizing financial return to pay member benefits, coupled with the perception that ESG investing necessitates accepting lower investment returns.
- Uncertainty as to how trustees can work with employers without breaching their fiduciary duty and independence from a governance perspective.
- Ensuring transparency while limiting the complexity of information communicated.
- Understanding and acting on the varied priorities of large memberships.

Reviews of the legal concept of fiduciary duty have led to global regulatory changes reflecting a broader understanding of members’ best interests and acknowledging the financially material impact of ESG factors in investment decisions.

A modern fiduciary duty
A report by UNEP Finance Initiative and PRI¹ highlights two key aspects of fiduciary duty that emerge from global definitions:

- Loyalty – fiduciaries should: act honestly and in good faith in the interests of their beneficiaries; impartially balance the conflicting interests of different beneficiaries; avoid conflicts of interest; and, not act for the benefit of themselves or a third party.
- Prudence – fiduciaries should act with due care, skill and diligence, conducting activities such as investing as a ‘prudent person’ would.

As an increasingly urgent regulatory concern and financial risk, ESG affects the ability of investors to provide either loyalty or prudence and, therefore, in order to fulfil fiduciary duty, trustees should consider the financial implications of ESG risks and determine the extent to which they are financially material in:

- DB scheme: the scheme’s assets, liabilities and the covenant of the sponsoring employer(s)
- DC scheme: the investment risk and returns of the default fund (and other relevant self-select funds)

An aid to establishing beneficiaries’ best interests can be member engagement. Sponsors and trustees should work together to gather and share knowledge, and agree mutual investment beliefs. They might also carry out two-way engagement with members, collecting their views and raising awareness on ESG issues.


In order to fulfil fiduciary duty, trustees should consider the financial implications of ESG risks and determine the extent to which they are financially material.

There is no legal or regulatory barrier preventing the sponsor and trustees working together in this way.
The Department for Work and Pensions (DWP) made changes to the Occupational Pension Schemes (Investment) Regulations 2005 which require trustees to disclose how they have considered ESG, stewardship, and engagement in their investment approaches.

Guidance published by The Pensions Regulator (TPR) mandates trustees to document their approaches to ESG in their Statement of Investment Principles (SIP), with DC schemes required to publish this online.

Consultation opened on non-statutory guidance for occupational pensions on assessing, managing and reporting climate-related risks in line with the recommendations of the Task Force for Climate-related Financial Disclosures (TCFD).

DB schemes will be required to publish their SIPs online.

DC scheme trustees will be required to publish ‘implementation statements’ explaining how they have implemented their SIP policies, including on ESG and stewardship, as well as provide further information on their asset manager and investor engagements.

The Pensions Climate Risk Industry Group, which includes DWP¹, will publish guidance for pension schemes to adopt the TCFD recommendations within their schemes.

DB schemes will be required to report annually on the implementation of their policies around voting and stewardship.

TOP TIPS FOR SPONSORS

Whether large or small, with a DB or DC scheme, in the private or public sector, sponsors of pension schemes can take practical steps to align their scheme’s investment strategies with their organizational values and sustainability objectives. The following top tips provide examples of how this can be done with references and examples of sponsors already doing so. It is not meant to be all encompassing nor will all the suggestions be applicable to all sponsors, but we hope that they provide some ideas and help you to take action.

1. Understand the evidence base and invest in training

2. Understand what is important to your pension’s members

3. Support pension trustees through the investment process and decision making

4. Align and streamline processes with your trustees
1. UNDERSTAND THE EVIDENCE BASE AND INVEST IN TRAINING

The nuances of engagement between sponsors and their pensions vary from scheme to scheme, but conversations on long-term horizons and sustainability can be effective if the method of engagement is tailored. Examples could include:

**Setting up knowledge-sharing platforms with your trustees and the scheme’s Chief Investment Officer**

Engage on the business case for sustainable investing and capture what best practice looks like through formal or informal platforms with your pension. For example, the Church of England Pension Board has an Ethical Investment Advisory Group to support their investing bodies; while Unilever’s Chief Investment Officer and Head of Trustee Services provide oversight across the whole of the pension fund to ensure that the right strategic focus is being given to the various risks and opportunities, including those relating to climate change.

**Including trustees in corporate training on the company’s sustainability policies/business case for sustainability**

Most trustees do not have expert knowledge in this area and often lean on others to provide the necessary expertise. Training will increase trustee confidence to embed ESG risks into strategy and investment decisions, including asking the right questions of asset managers and consultants, and feeling in a better position to challenge responses given, as appropriate. For example, Unilever’s inhouse investment team runs ESG and climate change training sessions for all pension trustees.

**Sharing your company’s tried and tested processes**

Where relevant, share your experience around established processes with your scheme to enhance alignment and reduce duplication of effort, for example, where ESG considerations have been built into strategic planning and risk management processes, or how ESG considerations have been integrated into Board decision making.

**Attending training to understand better how trustees run their schemes**

Understanding the principles guiding trustees will enable you, your finance team and the investment team to engage and work effectively with trustees on sustainable investment.

“Integrating sustainability issues into pension fund management is not straightforward – it requires good knowledge of the subject matter combined with an understanding of the consequences that different choices will have on the pension fund and the companies in which they invest. To do this well requires close collaboration between the sponsoring company and the pension Board of Trustees as well as a good understanding of the trustees’ legal responsibilities. In Unilever we have been working collaboratively for many years and have found that this dialogue not only provides benefits to the pension fund, but also to the sponsoring company, enhancing the understanding of how sustainability issues and opportunities are reshaping the world around us.”

Lysanne Gray, EVP Financial Control, Pensions & Risk Management, Unilever
2. UNDERSTAND WHAT IS IMPORTANT TO YOUR PENSION’S MEMBERS

Understanding what is important to your employees with regards to their pension enables you to shape a meaningful conversation with them and, in turn, strengthen their opinion of and loyalty to your company. Ways to do this include:

**Members surveys and workshops**

Members can provide useful data across generations and gender. Utilize communication experts to frame questions effectively, use digital platforms to communicate, and follow up with appropriate responses to the survey results. Tesco plc recently spoke to 1,500 of its employees to understand where they would like their pension to be invested and is now updating its investment and stewardship strategies to reflect better its members’ preferences.

“For me, it is essential that Tesco plc works with our pension trustees together in engaging with members on ESG so that the values of plc and pension are reflected as one.”

*Alan Stewart, Chief Financial Officer, Tesco plc*

**Three-way engagement**

Engagement between members, employer and pension scheme, using formal or informal platforms, will allow you to understand better members’ views on investments and seek input from all sides on what sustainable investment could look like in the pension scheme. In addition to member webinars, the Environment Agency Pension Fund will be holding focus groups, after a survey showed nearly 600 members wanted to discuss responsible investment in more detail. The outcomes from the focus groups will be shared with trustees, to inform their discussions on the Fund’s investment approach.

**Member Nominated Trustees (MNTs)**

MNTs bring true member representation to pension scheme boards. Ask those employees who are MNTs to represent the employee view on ESG and act as a conduit between the pension scheme and its members to test and feedback on ESG sentiment.

**Online pension scheme portals**

Online pension scheme portals and apps such as Tumelo will make it easier for employees to engage with their fund and have a voice on what they want their money to be invested in.

**Pension activity updates**

Whether you or your scheme use email bulletins, video interviews, online case studies or updates on your pension portal or app, these updates will help members learn how their pension and associated investment managers are working with investee companies to improve ESG outcomes. This can include details on investee sustainability practices and reporting on voting by asset managers or providers working on your scheme. This will help to demonstrate the meaningful action taken by your employees’ pension scheme or provider to contribute to tackling major environmental and societal challenges (such as climate change or the COVID-19 pandemic).
TIPS ON ENGAGING YOUR MEMBERS

1. **It is very much a two-way process**  
   If we raise expectations then we need to follow this up and do something with the answers that members give us.

2. **Go digital**  
   All our member engagement is now online which has allowed us to generate member surveys relatively easily, quickly and cheaply with a large part of our membership.

3. **Break the response data down**  
   Across different demographics and membership type to be able to tailor future correspondence accordingly.

4. **Use relatable language**  
   Break down ‘ESG’ into the language and issues your members are reading and talking about.

5. **Use communication experts to help frame and order questions**  
   As non-experts in this field it’s easy to set leading questions inadvertently.

6. **Plan for the responses**  
   Successful member engagement will generate interest and more queries so make sure you have enough resources in place to meet the demand.

7. **Bring members' money alive!**  
   Use case studies to show where members’ money is invested and the types of impact it is making.

8. **Signpost members to relevant information and education campaigns**  
   So members can learn more about these issues and what it might mean for their own financial planning.

Robert Gould, Chair of the Environment Agency Pension Fund
3. SUPPORT PENSION TRUSTEES THROUGH THE INVESTMENT PROCESS AND DECISION MAKING

For single employer schemes, whether DC or DB, there is scope for sponsors to influence directly decisions around the way pensions are managed. While sponsors using multi-employer schemes such as Master Trusts have less say, there are still opportunities to engage. Whatever the scheme format, approaches could include:

**Encouraging the appointment of investment managers who act as responsible investors**

Whether the sponsor has a direct influence in the recruitment process or not, the message is the same – use investment managers who can demonstrate their ability to analyse and integrate ESG factors into their investment decisions. To identify them, incorporate within the tendering process such questions as:

- How do they consider and measure the impact of ESG integration?
- How do they engage with boards of investee companies on ESG?
- What are their proxy voting guidelines?
- Do they use third-party services or proprietary analysis in their sustainable investing approach?

**Supporting trustees with long-term investment manager relationships**

Throughout the engagement lifecycle, trustees will need to communicate with their investment managers: setting and reviewing investment mandates; exchanging requirements, data or other information at regular intervals; monitoring and tracking procedures and performance; and incentivizing delivery of their core objectives. Sponsors have a role to play in supporting this engagement. This can include knowledge sharing, funding or cost sharing for professional service fees, or sharing of governance technology and know-how. For example, GSK's inhouse pensions investment team works closely with the Joint Investment Committee – which is responsible for making the investment decisions for GSK's pension plans and is made up of trustee directors from each of their plans and the GSK Group Treasurer – as well as the trustees’ advisor and underlying fund managers.

“"This structure allows us to have a very open dialogue with the trustees which assists with the smooth day-to-day running of the Plans and the alignment of longer-term journey planning.”

Sarah-Jane Hall, SVP Group Treasurer, Pension Investments & Insurance, GSK
Integrating sustainability criteria into the DC fund or outsourced provider selection process

Regardless of direct influence, the sponsor can support DC pension scheme trustees by communicating their preference for sustainability criteria to be built into one or more of the members’ fund choices. Or, if directly appointing an outsourced DC provider, sponsors can utilize their own supplier procurement processes to embed ESG criteria into the selection process.

Questions to ask DC trustees regarding their fund selection process include:

- How are ESG considerations integrated across the entire fund offering for DC members?
- Are trustees going beyond the incorporation of ESG self-select funds to consider a default fund with ESG or climate tilts?
- Can ESG be incorporated across all asset classes within the fund?

Questions to ask of outsourced DC providers could include:

- What are their ESG policies and how does ESG feature in their statements of investment principles?
- What is their approach to stewardship to influence their investee companies?
- To what extent have they integrated ESG into their investment decision-making process?
- From where do they get their ESG expertise and knowledge? Do they have inhouse experts?

Engaging with your DB scheme trustees on integrating ESG considerations into the scheme’s portfolio

Just as sponsors work with DB scheme trustees to facilitate liability-driven investment strategies, support derisking and build a flightpath to buyout, sponsors can also engage with DB trustees on embedding ESG considerations that pose a material risk into the scheme’s portfolio. Lower volatility, increased risk-adjusted return and better diversified assets can all be beneficial to the long-term solvency of a DB scheme. This is not only good for the scheme and its members but, in turn, helps CFOs to better forecast and manage their pensions balance sheet and cashflow risk.

Further to the trustees’ investment strategy, sponsors can also embed an analysis of their own ESG performance and credentials when communicating the strength of employer covenant to their pension scheme. The existence of positive corporate sustainability policies, ESG governance and associated reporting could strengthen the employer covenant in triennial valuation and recovery plan negotiations. This could, again, have the effect of reducing the calculated deficit and managing recovery plan funding requirements.
THE BENEFITS TO A SPONSOR

In 2015, the trustees of the HSBC Bank (UK) Pension Scheme took the decision to integrate better its climate change beliefs in the default strategy of the DC section. The LGIM Future World Fund was codeveloped with the HSBC Trustees and integrates climate risk management through tilts away from carbon reserves and emissions in favour of green revenues, plus benefits from better engagement with the world’s largest emitters through the LGIM Climate Impact Pledge.

Adopting this approach has benefited the Bank (the sponsor) meaningfully in a number of ways:

• The default option is expected to manage risk better and thereby generate better outcomes in retirement for its employees relative to a fund which does not consider climate-related risks.
• The investment process is consistent with the Bank’s support of a transition to a lower-carbon economy, with the aim of achieving the objectives of the Paris Agreement.
• By demonstrating leadership in this area the Bank and Trustees illustrated the need and potential for this approach, which helped to encourage other investment managers to develop funds thereby increasing choice and increasing the resources directed to climate-change research.
• Increased engagement from employees as they can see their pension savings being put towards an objective (ie managing the risk of climate change) that is increasingly important to them.

Russell Picot, Chair of the HSBC Bank (UK) Pension Scheme
4. ALIGN AND STREAMLINE PROCESSES WITH YOUR TRUSTEES

Align guidance and engagement across all trustee boards and combine efforts where relevant. This could include:

Agreeing with the trustees on a way forward with regards to the entire investment strategy, formalizing this through the documentation of investment beliefs and governance policies.

Avoiding duplication of work around reporting processes.

For example, share how you identify and disclose climate risks and opportunities in line with the recommendations of the Task Force for Climate-related Financial Disclosures (TCFD), and pool resources and data where applicable to help your pension fund to undertake their own TCFD reporting and incorporate it into the scheme’s annual report and accounts.

Funding the creation of a pensions office or secretariat to act as an inhouse administrative function to your pension scheme.

ESG governance and resources can be maintained and deployed through this secretariat.
ABOUT A4S

Our vision is a future where sustainable business is business as usual.

HRH The Prince of Wales established A4S in 2004 to work with the finance and accounting community to:

- **Inspire finance leaders** to adopt sustainable and resilient business models
- **Transform financial decision making** to reflect the opportunities and risks posed by the climate crisis and other environmental and social issues
- **Scale up action** to transition to a sustainable economy

A4S has three global networks:

- **Chief Financial Officers (CFO) Leadership Network** – CFOs from leading organizations seeking to transform finance and accounting.
- **Accounting Bodies Network (ABN)** – members comprise approximately two-thirds of the world’s accountants.
- **Asset Owners Network** – Pension Fund Chairs who integrate sustainability into investment decision making.

FURTHER GUIDANCE FROM A4S

**LEAD THE WAY**

- Developing a strategic response to macro sustainability trends
  - Managing Future Uncertainty
  - Engaging the Board and Executive Management*
  - Finance Culture
  - Incentivizing Action*

**TRANSFORM YOUR DECISIONS**

- Integrating material sustainability factors into decision making
  - Strategic Planning, Budgeting and Forecasting
  - Management Information
  - Capex

**MEASURE WHAT MATTERS**

- Developing measurement and valuation tools
  - Natural and Social Capital Accounting
  - Social and Human Capital Accounting
  - Embedding climate risk into valuations*

**ACCESS FINANCE**

- Engaging with finance providers on the drivers of sustainable value
  - Enhancing Investor Engagement
  - Debt Finance
  - Implementing the TCFD Recommendations
  - Implementing a Sustainable Finance Framework

*coming soon

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CONTRIBUTORS

A4S
Jessica Fries
Kerry Perkins
Dr. Emiko Caerlewy-Smith
Tilia Astell
Annabel Clark
James Ives
Jamie Stewart

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@PrincesA4S

The Prince’s Accounting for Sustainability Project (A4S)

info@a4s.org

www.accountingforsustainability.org