

# **TOP TIPS FOR CONSIDERING ESG RISKS AND OPPORTUNITIES IN THE EMPLOYER COVENANT PROCESS**



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## Top tips for considering ESG risks and opportunities in the employer covenant process

This ‘top tips’ guide is written primarily for trustees of defined benefit (DB) occupational pension schemes. Its aim is to provide trustees and their advisers with peer-tested, practical guidance on how to consider the impact of environmental, social and governance (ESG) risks, as well as potential opportunities when undertaking employer covenant assessments. It also lays out why this approach is compatible with the trustee’s fiduciary duty to act in the best interests of members.

This guide will also be of interest to the employers of defined benefit pension schemes (often called the ‘sponsor’). While the employer covenant evaluation process is unique to the UK pension market, the ‘top tips’ within this guide are also applicable to global asset owners who need to undertake due diligence and consider a sponsor’s future resilience.

### Disclaimer

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. We recommend that you obtain specific professional advice before acting or refraining from action on any of the contents of this publication. Neither Accounting for Sustainability (A4S) nor Employer Covenant Practitioners Association (ECPA) accepts any liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

### Defining sustainability

While there is no single definition of ‘sustainability’, for the purpose of this guide, references to sustainability will reflect the definition provided in the UK Government’s [‘Greening Finance: A Roadmap to Sustainable Investing’](#). This frames sustainability around three key factors – environment, social and governance.

- **Environment:** This covers how organizations impact and are impacted by climate change and broader environmental issues, like biodiversity.
- **Social:** This includes factors ranging from modern slavery to international development.
- **Governance:** Covers the means by which a company is controlled and directed, most usually through a Board of Directors.

# Foreword

**by Sarah Smart,  
Chair of The Pensions Regulator**

I welcome this short, practical guide developed by Accounting for Sustainability. It provides sensible, simple steps that trustees of defined benefit schemes of all sizes will be able to follow, to understand more fully the risks presented to the scheme's employer covenant.

I recall having discussions on the impact of environmental, social and governance (ESG) risks to pensions schemes when I first became a professional trustee back in 2005. At that time many of my peers in the (much smaller) professional trustee sphere had not even heard of terms like ESG or UNPRI (UN Principles for Responsible Investment). Roll forward 17 years and I am pleased that the risks presented to pension schemes by climate change and other ESG factors are widely acknowledged. A4S's role in enabling debate and discussion around these important challenges, and in providing useful tools to help trustees address them, has been fundamental to this change.

The Pensions Regulator (TPR) has a duty to protect people's savings in workplace pensions and we are focused on ensuring that the ESG risks to pension savings, including those related to climate change, are appropriately understood and mitigated. In this, we see the trustees of pension schemes as our 'first line of defence'. We appreciate that understanding and addressing the multi-faceted nature of ESG risks – particularly those presented by climate change – can be daunting for trustees. This guide provides an important first port of call to help trustees understand the ESG risks presented to the employer of the scheme. Building on this understanding, trustees will be better able to develop appropriate funding and investment strategies to manage or mitigate the potential impact of these risks on the employer covenant.

I look forward to a future where company reporting provides full transparency on all environmental, social and governance risks, including climate risks, faced by organizations. Until that time, the work of A4S provides invaluable support to trustees in improving understanding.



# Introduction

“The employer covenant is the extent of the employer’s legal obligation and financial ability to support the scheme now and in the future.”

**The UK’s Pensions Regulator (TPR)**

It is a requirement of a UK DB pension scheme’s actuarial valuation process to assess regularly the strength of the employer’s covenant. This is part of an integrated approach to risk management as a weaker employer covenant often results in the scheme liabilities being valued on a stronger basis, with a higher value being put on the liabilities to reflect the lower ability of the covenant to support the scheme and the liabilities. A scheme’s investment and funding decisions should reflect the ability of the employer to support it financially both now and in the future. While the employer covenant assessment and scheme valuation process is, in practice, a negotiation between a scheme and its sponsoring employer, it is also an opportunity for collaboration.

This process requires trustees to consider the sponsor’s ability to address a range of likely future scenarios. These include the impact of climate change, biodiversity threats, inequality and other challenges that may affect the financial ability of the sponsor to support the scheme today as well as in the future.

ESG-related risks may impact:

- The sponsor’s financial capacity to support the scheme, due either to the magnitude of ESG-related risks or the capacity of the sponsor to absorb that risk on an ongoing basis.
- The strength of the sponsor’s covenant over time and in particular, for the time horizon over which a sponsor might be needed to support the scheme. The impact of this will be specific to the scheme’s own time horizon.

## What are ESG-related risks?

ESG-related risks refer to risks arising from environmental, social or governance (ESG) factors. These risks may impact an employer’s ability to support the pension scheme financially in a number of ways:

- Environmental: physical risks from climate change (eg extreme weather, natural disasters, climate action failure), transition risk caused by moving to a net zero economy<sup>1</sup>, nature-related risks (eg biodiversity loss, pollution, water scarcity), and litigation risk.
- Social: changing demographics, inequality (including forced labour), consumer preferences.
- Governance: sponsor risk management processes, board composition.

## What are ESG-related opportunities?

ESG-related issues can also present significant opportunities for some organizations, which should be factored into the valuation process. The steel and cement industries, for example, can use technological innovation to change the pricing and attractiveness of their product, while blue economy practices<sup>2</sup> may yield new sources of clean energy and natural cooling systems in ocean-based industries, generating jobs and inclusive clean growth.

## Why consider ESG-related risks and opportunities when assessing the strength of the employer covenant?

Increased familiarity with ESG-related issues globally, and regulatory development in certain jurisdictions including the UK, means that most occupational pension scheme trustees will have already given some consideration to the

1. More details on the climate change risks to pension schemes can be found in A4S’s [‘Aligning to a Net Zero Pathway: Top Tips for Pension Scheme Trustees’](#)

2. The World Bank defines blue economy as the “sustainable use of ocean resources for economic growth, improved livelihoods, and jobs while preserving the health of ocean ecosystem”.

potential sustainability risks and opportunities in their investment strategies. Trustees, their investment advisers and asset managers are increasingly cognizant of the link between their ESG risk management and the financial performance of their investments. The process of identifying climate-related investment risks and opportunities is gaining further traction in the UK as a result of the integration and reporting requirements of the Task Force on Climate-related Financial Disclosures (TCFD). There are many tools out there to support this process, which can be found in our [ESG Toolkit for Pension Chairs and Trustees](#).

The UK Transition Plan Taskforce is building on this work for companies, and transition plans for pension funds are already being discussed by some industry leaders<sup>3</sup> together with the work of the [Task-Force for Nature-related Financial Disclosures \(TNFD\)](#) which covers aspects such as biodiversity loss and deforestation.

Schemes should also consider ESG risks and opportunities when assessing the strength of the employer covenant, particularly with regard to the sponsor's financial capability to support the scheme over time.

Should a sponsor face substantial ESG-related risks that threaten its viability or ability to provide financial support when needed, trustees should:

- Understand these risks from both an impact and likelihood perspective, as well as when and how these risks might materialize.
- Monitor both the evolution of the risk and how the sponsor is mitigating both the impact and the likelihood of being impacted, engaging with the sponsor accordingly on specific risks.
- Understand how they can use other tools at their disposal to protect their funding position and the underlying security of members' benefits.

Some, mainly larger, DB schemes have gone further by undertaking explicit analysis of different ESG scenarios on the sponsor's ability to make good any potential future funding shortfall. The Railways Pension Scheme (Railpen), for example, established

an in-house employer covenant team in 2010 and uses a similar approach and methodology for identifying the sustainability risks and opportunities impacting its sponsoring employers as it does for its investments. More details about how it does this can be found in our [Railpen case study](#).

“The Trustee also uses this covenant advice within its integrated risk and integrated funding decisions, ensuring that for each pension scheme, the investment strategy and funding strategy are compatible with the covenant strength supporting that scheme.”

**Paul Burnett, Head of Employer Covenant, RPMI Railpen**

## Regulatory guidance

Guidance published in December 2021 by the UK's pension regulator, TPR, advises that climate risks and opportunities within the employer covenant are considered by the scheme's advisers when preparing their advice, completing any scenario analysis and through sponsor engagement.<sup>4</sup> With regulators increasing their advice to the pension industry on considering ESG risks and opportunities within their investment and strategic decision making, we expect further guidance in 2022 to cover the impact of ESG risks and opportunities on employer covenant.

The results of the Bank of England's [2021 Climate Biennial Exploratory Scenario \(CBES\)](#) indicate that climate risks are 'likely to create a drag on the profitability of UK banks and insurers' with some climate costs ultimately being passed on to their customers. This will inform the Prudential Regulation Authority (PRA)'s supervisory policy and approach, and the Financial Policy Committee's (FPC) thinking around system-wide policy issues related to climate risk. We can therefore anticipate further policy developments having the potential to impact, directly or indirectly, on sponsoring employers.

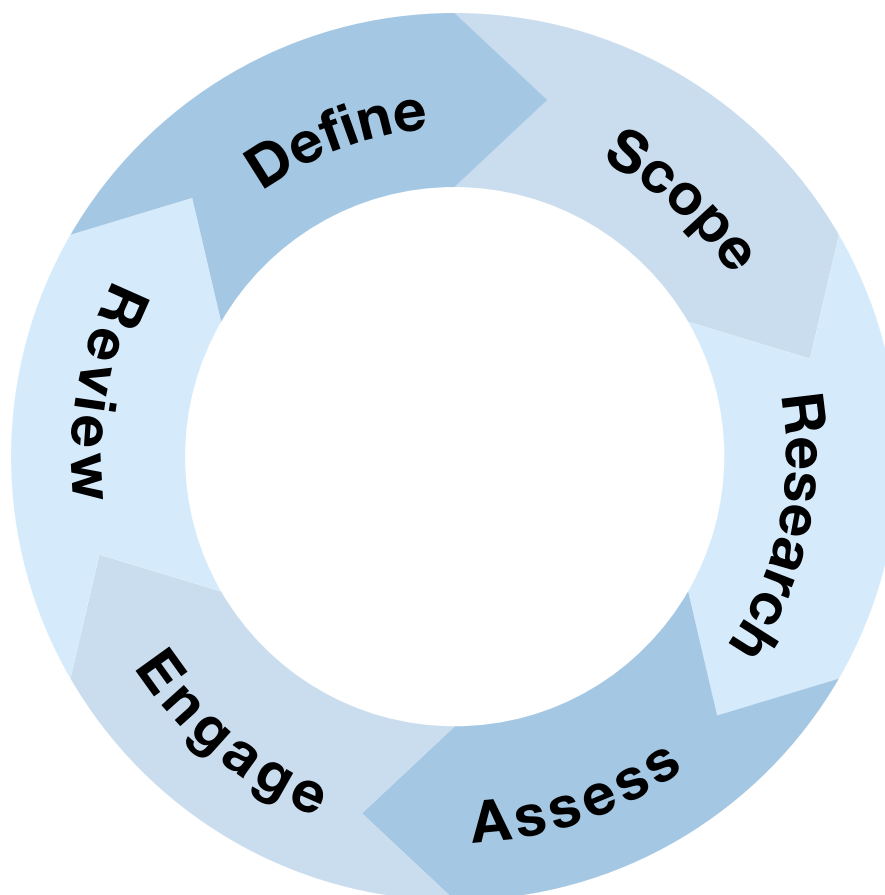
3. [The UK Transition Plan Taskforce](#)

4. TPR, [Governance and reporting of climate-related risks and opportunities](#)

# Top tips for embedding ESG considerations into the employer covenant process

The following section includes top tips that trustees can use when considering how ESG risks and opportunities impact the strength and longevity of the employer covenant.

1. **Define:** Identify the relevant time horizon
2. **Scope:** Broaden your understanding of sponsor-related ESG risks and opportunities
3. **Research:** Gather relevant data and information, and engage your sponsor and peers
4. **Assess:** Leverage expert advice to assess potential impact
5. **Engage:** Undertake evidence-based discussions with the sponsor
6. **Review:** Measure, monitor and reassess accordingly



# Top Tip One – Define: Identify the relevant time horizon

Whether a scheme may already understand its long-term time horizon, be it by targeting buyout or self-sufficiency, or is still working to define this, it is important that trustees have a timeframe front of mind to understand and assess the material ESG-related risks. Transitional risks to the energy industry, for example, may affect sponsors in that sector in the short term, whereas physical risks to the agricultural industry may take longer to materialize. Similarly, unintended consequences of both investment or divestment may not materialize in the short or even medium term. For example, the rewilding of agricultural land to sequester carbon and enhance biodiversity may have a detrimental effect on the local community in terms of jobs and food security.

As set out in the below table, these time horizons will influence the proportionate considerations to be made for each category of risk.

If longer-term journey planning has already involved discussion with the sponsor, this will aid the conversations around the relevant time horizons for considering ESG-related risks.

“Medium-term uncertainty around the impact of climate and sustainability on sponsors and the wider economy have reinforced the importance of clear longer-term funding objectives and comprehensive monitoring.”

**Ruston Smith, Chair, Tesco Pension Trustee Limited**

**[Table 1] Average time horizons for long-term planning journeys**

The types of support that a scheme is likely to need from the sponsor	Average time horizons
Cash support while the scheme is still subject to a recovery plan to meet a specific funding deficit	Recovery plans – average time horizon for deficits is six years <sup>3</sup>
Financial capacity to support downside risk in the scheme while investments perform to meet a long-term objective or self-sufficiency target	Long term funding objectives – commonly 10 - 15 years
Solvency support for the remaining duration of the scheme’s time horizon (which can be very long)	Solvency support – average life of a scheme ie c.30 - 40 years beyond the last retirement date

3. TPR, [Annual Funding Statement 2022](#)



**[Table 2] Examples of mapping relevant time horizons alongside the current view of sponsor covenant strength.**

<p><b>Scheme 1:</b></p> <ul style="list-style-type: none"> <li>• Well funded</li> <li>• Strong, financially capable sponsor</li> <li>• Short time horizon (eg targeting buy out in the next ten years)</li> </ul>	<p><b>Proportionate considerations:</b></p> <ul style="list-style-type: none"> <li>• Immediate sectoral adaptation challenges (eg diminishing and more costly raw materials)</li> <li>• Shorter-term sectoral regulation or restrictions on business goods and services</li> <li>• Short-term ESG-related risks to trading (eg rising fuel prices or consumer preference)</li> <li>• Impact of medium- and longer-term ESG-related risks on potential buy-out providers</li> </ul>
<p><b>Scheme 2:</b></p> <ul style="list-style-type: none"> <li>• Well funded</li> <li>• Strong, financially capable sponsor</li> <li>• Longer-term horizon to remain solvent for the life of the scheme</li> </ul>	<p><b>Proportionate considerations:</b></p> <ul style="list-style-type: none"> <li>• Medium- and longer-term ESG-related risks to employer’s financial stability</li> </ul>
<p><b>Scheme 3:</b></p> <ul style="list-style-type: none"> <li>• Less well funded</li> <li>• Weak, financially challenged sponsor</li> <li>• Longer-term horizon to remain solvent for the life of the scheme</li> </ul>	<p><b>Proportionate considerations:</b></p> <ul style="list-style-type: none"> <li>• ESG-related risks to employer’s financial stability over the short, medium and long term</li> </ul>

# Top Tip Two – Scope: Broaden your understanding of sponsor-related ESG risks and opportunities

## Start ‘macro’ by looking at some of the major trends within the sponsor’s sector and market region

### Using a sector lens

Different sectors and subsectors will face different risks and opportunities. For example, businesses in the energy sector or high energy consuming businesses are affected by the wholesale transition to greener energy in the short and medium term, where less significant energy consumers may still be affected by pricing, but may not need to pivot substantively their business.

### Avoiding ‘umbrella’ sector analysis

A recent paper by the Employer Covenant Practitioners Association (ECPA) and the Society for Pensions Professionals (SPP)<sup>4</sup> cautioned that ‘umbrella’ sector analysis can fail to identify the specific risks and opportunities to which sponsors may be exposed. For example, the impact of climate change on a vehicle tyre or body component manufacturer may be markedly different from the impact on a sponsor whose business is focused on components for internal combustion engines. Moreover, a market leader in transitional technology may have considerably better prospects than a sponsor whose business still relies heavily on ‘legacy’ technology.

Megatrends will also impact sectors in very different ways, creating new and emerging sustainability risks or opportunities. Automation and artificial intelligence (AI), for example, will provide a range of opportunities for the transport sector (eg self-driving cars) compared to maintenance, which is much harder to automate. Changing demographics will also have different impacts on different sectors: a smaller global workforce will be felt more keenly by those sectors unable to automate, while a growing global population will demand 35% more food by 2030<sup>5</sup> and increase demand for technological innovations in mobile health (mHealth).

Different sectors are subject to different regulatory bodies, public policy and consumer behaviour, which create different levels of risk and opportunity for different businesses. In the UK, for example, car makers must adjust to new government rules that ban the sale of new petrol and diesel-fuelled cars by 2030, while the authorities for the regulation of water (Ofwat) and energy (Ofgem) could impose targets or sanctions related to sustainability that will need to be considered when making decisions related to the scheme’s risk exposures.

“The published impact assessments around regulation can provide a helpful background to the climate-related drivers underpinning them.”

**ECPA and the Society for Pensions Professionals (SPP)<sup>5</sup>**

The availability of financing is also changing by sector. Increasingly, sustainability-related targets are embedded in debt pricing, with ratcheting interest rates if specific targets (potentially industry driven) are not achieved.

4. ECPA: [Reflecting climate change impacts and risks in employer covenant assessments](#)

5. National Intelligence Council, ‘[Global Trends 2030: Alternative Worlds](#)’

6. ECPA: [Reflecting climate change impacts and risks in employer covenant assessments](#)

### **Using a market regional lens**

There are regional differences that must be understood when evaluating ESG risks and opportunities. From economic development, cultural and historic factors to regulatory frameworks, understanding the wider geographical context of the sponsor's sphere of operations will be essential to make informed decisions about sustainability-related exposure.

Current global events highlight the importance of considering geopolitical and macroeconomic trends. Russia's invasion of Ukraine has been a catalyst for supply chain disruptions and trade shocks, with adverse effects on economic growth and inflation. Climate, nature and social risks have the potential to be significant drivers to geopolitical and macroeconomic instability, for example disagreements over use of land/water and boundaries in Ethiopia – further exacerbated by climate change – has led to inter-ethnic tensions, violence and political volatility. Schemes that need to secure cash flow for part, if not the rest, of the century, will need to be aware of how geopolitical risk can undermine functioning economies and severely disrupt access to capital.

### **Determine the sponsor-level exposure to identified risks and opportunities**

Include any key considerations that may distinguish your sponsor from their peers, such as culture, operations and governance. Additionally, identify any additional ESG risks and opportunities in other sectors or regions that might not appear to impact directly on the sponsor but might still have a significant impact on their supply chain.

Where possible, map the locations of offices, factories, key suppliers, consumers, and main tax jurisdictions to the findings from your sector and market region research, in order to assess the sponsor's wider sustainability risks and opportunities. It is important to understand all these risks and opportunities from both an impact and likelihood perspective.

Scoping the risk and opportunity environment at both a macro and company-specific level will provide a clearer idea of what data to gather.

# Top Tip Three – Research: Gather relevant data and information

Thorough research is essential to provide context for the scale and complexity of the sponsor's likely issues, and the amount of time and resources it may take for these to be properly managed. It will also allow an appropriate degree of challenge when discussing potential scenarios and impacts with the sponsor.

There are many publicly available sources to help understand how your sponsor is currently approaching ESG-related risk and opportunity management:

## From your sponsor

- Annual report (or similar) – many corporates have already started to incorporate sustainability information alongside, or integrated into, their financial reports. This could include emission disclosures, net zero targets and plans, board diversity, details on sustainability-linked financing or results of any scenario analysis undertaken. The amount and granularity of data can vary enormously from company to company so additional sources of information should also be considered.
- TCFD related reports – this could be as a stand-alone report (and we will see many more of these published in July 2022 onwards within the UK) or integrated into the company's annual report.

## Other

- Similar data can be found for competitors or industry peers, which can provide a helpful benchmark to identify potential gaps or areas where your sponsor may be either leading or lagging in their market.
- Sustainability ratings and industry group ratings from a range of providers including Sustainalytics, Trucost (Standard & Poors) and Refinitiv.

The forthcoming International Sustainability Standards Board (ISSB) reporting standards are expected to bring greater consistency to the way in which companies report on these issues, enhancing transparency and comparability. More detail on the rapidly evolving corporate reporting landscape can be found in A4S's [Navigating the Reporting Landscape guide](#).

# Top Tip Three (cont) – Research: Engage your sponsor and peers

## Sponsor engagement

It is impossible to assess the strength of an employer's covenant without access to the relevant data. Sponsors may be wary of providing such data – particularly where it is market sensitive – so early conversations and data agreements can help build an accurate picture of the sustainability risks and management practices of the sponsor.

“We are fortunate that our sponsor has been very open to sharing its own sustainability risks assessments and work with our scheme's trustees. This has included outputs from its climate scenario analysis and regular updates on sustainability and its progress to net zero.”

**Ruston Smith, Chair, Tesco Pension Trustee Limited**

## Ways to engage with your sponsor:

- Undergo a mapping exercise with your sponsor to understand the key risks and opportunities they have identified, and how these are integrated into business decision making. Use our maturity map as part of [A4S's Essential Guide to Managing Future Uncertainty](#) to provide a structure to this exercise.
- Ask the sponsor to brief you on their own TCFD or other sustainability disclosures such as an annual sustainability report.
- Sit down with the sponsor to analyse and discuss their publicly available sustainability score or rating by third party assessors such as Sustainalytics.
- Talk to your sponsor's investor relations teams to understand how they position the company's sustainability exposure, risk management and related opportunities to the market. Share [A4S's Essential Guide to Enhancing Investor Engagement](#) to provide clear guidance on practical steps and advice.

- Organize regular updates on sector and sponsor-related sustainability issues, across both the scheme and the employer.

## Peer collaboration

Reach out to pension schemes, as well as corporates operating within a similar space as your sponsor, to access relevant and up-to-date know how, best practice, top tips and practical experience of overcoming common challenges.

## Ways to engage with peers:

- Join industry working group discussions and leverage material from relevant associations such as the [Employer Covenant Practitioners Association](#).
- Use your membership of existing initiatives to ask for peer examples, such as the [Transition Pathway Initiative](#).
- Read case study examples that describe how pension schemes and corporates have navigated different aspects of the sustainability journey. [A4S's collection of case studies](#) provides valuable insights into the practical steps taken by pension schemes and corporates to embed sustainability into decision-making processes.
- Join collaborative platforms such as the [A4S Asset Owners Network](#) to share and learn from your peers in a confidential setting.

# Top Tip Four – Assess: Leverage expert advice to assess potential impact

While some schemes, such as Railpen, opt to have an in-house covenant team, it is more common for trustees to seek advice from external covenant specialists. These experts can provide an objective view and be used to review relevant scenarios, model the financial impact of various sustainability risks and opportunities, and then assess how these may impact the funding and security of the scheme. Covenant specialists can share their assessments with the scheme actuary, helping them to value the scheme's liabilities more accurately.

Whether or not you use an external adviser, some of the methods and approaches that can be used include:

## Risk identification in an integrated risk management (IRM) framework

As set out in guidance by TPR, adopting an integrated risk management approach enables you to consider the core funding, investment and covenant risks individually and then all together.<sup>6</sup> This approach provides a comprehensive picture of risk correlations and mitigations, as well as opportunities for the sponsor. Sustainability factors will make up some of these financial risk factors.

## Scenario planning and stress testing

Schemes that have used scenario analysis at the beginning of their 'TCFD journey' have been able to use their acquired understanding of their exposure to climate risks as a strong base on which to develop other aspects of their TCFD reporting. Similarly, scenario analysis can help with assessing the sponsor's covenant strength. Some sponsors such as financial services firms, are advised or even mandated to publish outputs from their own climate modelling, which is often a valuable data set for trustees.

When undertaking scenario modelling, it is important to:

1. **Identify the core risks** that apply to the scheme's appropriate time horizon, whether that is short, medium or longer term.
2. **Consider the nature of these risks.** Are they macroeconomic (inflation or interest rates), systemic, sectoral and / or sponsor specific?
3. **Assess the likelihood** of these risks occurring and their potential impact. Rank them according to the assessment of high-low likelihood and high-low impact.

"Simply get started on what you can. Don't get tied up in an overly complex analysis and go from there. It's not only the data that comes out of scenario analysis that is useful. For us, much of the value comes from the discussions with trustees, consultants and asset managers that have been sparked by the annual scenario analysis process and its results."

**James Duberly, Director, Pensions Investment, BBC Pension Trust**

## Modelling

The extent of appropriate sustainability risk modelling depends not only on the information available, but also on what is proportionate to the size and risk exposure of the scheme. Using company TCFD disclosures is a relatively straightforward and proportionate course of action for a smaller to medium-sized scheme. However, for larger schemes with experienced in-house resources or advisors, it would be more appropriate to undertake bespoke climate modelling. The trustees of HSBC Bank (UK) Pension Scheme, for example, as part of its climate modelling, have arranged for the analysis of the impact of climate risk on various longevity scenarios, as well as climate risk connections to investments and how these might influence the funding position of the Scheme and also the value of DC pension savings.

6. TPR, [Integrated risk management](#)

“The TCFD requirements provide a good opportunity for covenant and investment advisers to work together on an integrated workplan from the start, which considers both sponsor and investment climate change risks and how the different work that each adviser will perform will be collated so that the trustee gets an integrated view. This can then be developed for wider ESG risks.”

**Karina Brookes, Chair, ECPA**

“We ensure our covenant advisors are fully briefed on the results of the scenario analysis done by our investment advisors, so that the modelling and analysis from the investment side aligns with that of the covenant / liabilities side.”

**James Duberly, Director, Pensions Investments, BBC Pension Trust**

## **Working more closely with covenant specialists – an investment consultant’s perspective**

The advent of climate regulation on pension schemes has incentivized us, like other investment consultants, to engage more closely with specialist covenant advisers in order to determine whether our clients’ investment and funding strategies are resilient to the potential risks of climate change. In particular, to examine whether there are any ‘pinch points’ that could see a harmful drop in the funding level coinciding with a material deterioration in the strength of the covenant.

TCFD implementation has encouraged joined-up engagement between ourselves and these specialists, especially through the scenario analysis process that schemes must undertake. Specific areas of convergence have so far included:

- Agreeing the key temperature scenarios to use. While we will never be able to ensure perfect consistency, using the same temperature models enables a degree of alignment.
- Comparing and contrasting scenario results and identifying any scenarios that would threaten both the funding level and covenant.
- Planning to work together on analysing identified threats, as instructed by the trustees.

Furthermore, our clients’ covenant specialists have helped define the short-, medium- and long-term time horizons required as part of TCFD reporting, while also providing input into the drafting of the report itself, ensuring that what is written around scenario analysis accurately represents the covenant perspective.

**Jonathan Stoller, Director, Willis Towers Watson**

## Top Tip Five – Engage: Undertake evidence-based discussions with the sponsor and understand how material risks will be mitigated

Organize structured workshops and shared strategy sessions with the sponsor to agree how identified ESG-related risks and opportunities may impact the strength and longevity of the sponsor's covenant, the valuation of the scheme's liabilities and the funding requirements. These should be evidence-based and cover any risk-mitigation action plans for material risk, the importance of measuring progress and monitoring milestones.

“Our sponsor's willingness to share their own sustainability assessments has enabled us to consider – at least on a qualitative basis – how sustainability risks could impact both the sponsor and the scheme in the future.”

**Ruston Smith, Chair, Tesco Pension Trustee Limited**

These discussions should be forward-looking, focusing on the timeframes that are relevant for both the scheme and the sponsor. This should be valued as a mutually beneficial risk management exercise for both trustees and the sponsor's management team: enabling the latter to build out and enhance their internal analysis on corporate viability and ESG-related disclosure; and the former to understand material sponsor risks and associated actions needed as part of their risk management process.



## Top Tip Six – Review: Measure, monitor and reassess accordingly

ESG and wider sustainability-related risks and opportunities will vary in degree and duration of impact. This could range from singular events, such as the anticipated UK government restrictions to HFSS (high in fat, sugar and salt) advertising, to risks with no specific ‘tipping point’, but which instead exert an enduring impact over time, such as changing consumer preferences or demographic trends. Despite being slower to materialize, these creeping changes can have a significant financial impact on the sponsor, which may then impact funding capabilities.

Effective ongoing monitoring is essential to understand which risks remain relevant over time and the changing impact they may have on the sponsor’s financial strength, both now and in the future. This monitoring process should include:

- A proportionate number of **specific and measurable metrics**, which can be a mix of external data and sponsor-owned data.
  - **Sponsor cooperation** to facilitate access to relevant data and streamline the process, perhaps by leveraging the sponsor’s already established data-collecting processes. Ask the sponsor to send a regular headline progress report (eg every six months) on the risks flagged up in the covenant review.
  - **The frequency of the monitoring should be flexible** to account for the uncertainty around the risks and their subsequent impact on the financial strength of the sponsor. Timely monitoring is essential to allow trustees the opportunity to engage with management on potential mitigation strategies, as well as to develop their own responses before it is too late to take appropriate action.
- **Monitoring of investments and covenant strength should be parallel activities** so that risk interaction can be identified quickly to trigger appropriate action by trustees.
  - **Metrics should be reviewed regularly** to check their continued relevance and ensure risk triggers are set at appropriate levels. If the scheme’s time horizon changes for other reasons, such as demographics, liability management exercises, or transactions, then the process will also need to be reviewed.

“We are planning to embed some monitoring of the sponsor’s progress against its own sustainability targets into our ongoing covenant monitoring reports which will complement regular updates from our sponsor.”

**Ruston Smith, Chair, Tesco Pension Trustee Limited**

# About us

## The A4S ESG Toolkit for Pension Chairs and Trustees

A4S's [ESG toolkit for Pension Chairs and Trustees](#) contains resources designed specifically for pension trustees. It contains:

1. **An ESG maturity map** with suggested steps that trustees can take to progress on their ESG integration journey
2. **Practical examples** of pensions to bring 'what good looks like' to life
3. **Guidance material** to highlight practical steps, such as embedding ESG risks and opportunities into different asset classes

## 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

## About ECPA

The ECPA provides a forum for employer covenant advisors to:

- Discuss technical, legal and regulatory issues relevant to providing financial advice to clients – trustees or sponsoring employers – on matters connected with the employer covenant
- Participate in discussion around relevant matters such as the Pensions Regulator and Pension Protection Fund and, where appropriate, to promote the views of the Working Group with those bodies
- Act as a vehicle for raising the standards of, and promoting, the employer covenant financial advisory industry generally amongst the pensions community, including trade bodies, professional groups and potential clients

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## Get in touch and find out more



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