XPS Investment

FM ESG Integration

Progression of the UK fiduciary managers' approach to ESG integration

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Contents

Overview and key findings

Our Fiduciary Management ('FM') Oversight team have surveyed the UK fiduciary management market to assess the progress of incorporating environmental, social and governance ('ESG') and sustainable investment practices into the management of portfolios for UK pension schemes. The survey covers over 90% of the FM market, representing 12 fiduciary managers who manage over £190bn of pension scheme assets.

The focus on ESG and sustainable investment practices is only likely to increase. Whilst fiduciary managers continue to up their approach and capability in this space the bar will only continue to rise, and whilst there are still areas that fiduciary managers need to do more, as highlighted in our key findings space, the levels at which they are assessed will also become more stringent.

Under a FM arrangement the day-to-day investment decisions are delegated to the fiduciary manager, and we expect this to include ensuring that ESG is incorporated within a scheme's portfolio, as well as reporting this to the trustee on a regular basis. It is important that the fiduciary manager does not concentrate solely on environmental factors, such as climate change, but also focusses on social and governance issues.

1. **10% of fiduciary managers** do not currently have the capability to report their carbon footprint, despite commitments to the Net Zero Asset Managers Initiative.
2. **33% of fiduciary managers** do not exclude underlying managers who have been assigned their lowest ESG rating.
3. **All fiduciary managers** now monitor the voting and engagement activity of underlying managers. This has increased from last year.
4. **The majority of standard client reporting** provides little information against other environmental, social and governance factors. This excludes climate change which tends to be covered in more detail.
5. **17% of fiduciary managers** are not yet able to provide reporting at a strategy level to support investors specifically with the upcoming TCFD reporting requirements.

When looking at a pension scheme's investments through an ESG lens, in many cases the fiduciary manager's preferred approach may not align with the views of the sponsor, trustees and members. It is important that the integration of ESG meets the scheme's objectives and is done at the pace of the trustees and not at the pace of the fiduciary manager.

Andre Kerr, Head of Fiduciary Management Oversight

Trustee checklist

1	**Discuss and understand** your fiduciary manager's approach to ESG integration.
2	**Capture your beliefs** to outline and set clear priorities to your fiduciary manager.
3	**Scrutinise the extent of integration** of ESG practices into your FM solution and challenge accordingly.
4	**Assess the alignment** between your ESG beliefs and what is being implemented.
5	**Ensure a structured plan is in place** with your fiduciary manager to set out how your scheme will meet TCFD reporting requirements (as applicable).
6	**Apply oversight** to monitor continued development, integration and application of ESG practices.

Engagement with companies is critical for risk management and to improve outcomes, so it's important fiduciary managers monitor this and hold their underlying fund managers to account.

Alex Quant,
Head of ESG Research

Introduction

When trustees set the investment strategy for a fiduciary manager to implement, they do so with set criteria, such as target return, risk tolerance, asset class restrictions, level of liability hedging, time to a funding target, for example. All fiduciary managers should provide this service for pension schemes irrespective of size or fee constraints.

When trustees are setting sustainable investing strategy, such as a pathway to net zero, the approach and ability of the fiduciary manager may be at odds with this. For example, for pensions schemes with assets below £200m, a lot of FM approaches are aimed at meeting the needs of the average scheme, with a focus on making the solution efficient and scalable to ensure fees are controlled and minimised. This can result in the fiduciary manager setting a sustainable investing strategy with little ability for change and this could result in a mismatch between the views of the trustees, members and sponsor, and that of the fiduciary manager.

Our survey focussed on five key areas of assessment; philosophy, integration, climate change, stewardship and reporting, further details of which are provided in the Appendix. Overall, we have seen a continued improvement in the extent to which ESG and sustainability practices are incorporated into UK FM solutions. However, the industry standards for doing this are also continuously rising and fiduciary managers are having to work harder to prove their credentials in this space. By the same token, XPS' research has also evolved and, for 2022, just two UK fiduciary managers are rated as Green for their overall ESG approach, compared to three in 2021.

The two areas of our ratings analysis that have seen the greatest changes are those relating to climate change and reporting. When it comes to climate change, the UK FM market has developed at a rapid pace, particularly regarding climate-related scenario analysis and stress testing. 25% of fiduciary managers are now rated Green compared to 0% last year. When assessing reporting, we have increased the requirements for fiduciary managers to achieve a Green rating, in response to ESG reporting. This has meant that just 33% of fiduciary managers achieved a Green rating compared to 79% last year.

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

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

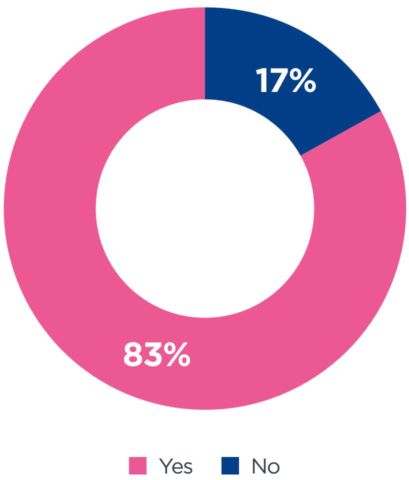
	Overall		Philosophy		Integration		Climate change		Stewardship		Reporting	
	2022	2021	2022	2021	2022	2021	2022	2021	2022	2021	2022	2021
Green	17%	16%	42%	37%	17%	32%	25%	—	25%	32%	33%	79%
Amber	83%	84%	58%	63%	83%	68%	67%	84%	75%	68%	58%	16%
Red	—	—	—	—	—	—	8%	16%	—	—	8%	5%

Philosophy and integration

At the foundation of a fiduciary manager's approach to ESG and sustainable investment practices is the overall commitment of the firm and its dedicated resource.

All fiduciary managers across the UK market now have in place full time sustainable/responsible investment professionals with a focus on combining ESG practices into investment processes and solutions for clients. However, sizes and experience of teams vary greatly, along with the structure of teams; whether they are integrated within existing investment teams or separated entirely. Whilst there is no single best arrangement, incohesive structures will impact on the ability of fiduciary managers to integrate ESG into their solutions and, at a minimum, we would expect ESG integration to be within a fiduciary manager's investment policy documentation.

Chart 1: Does your investment policy documentation refer to your ESG integration practices?

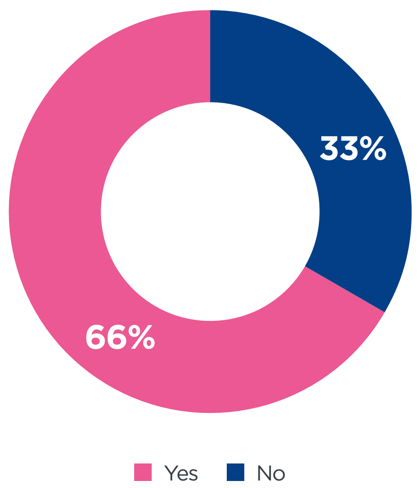


Alongside a fiduciary manager's ability to integrate ESG and sustainable investment practices within a scheme's portfolio, firms themselves are increasingly exhibiting behaviours consistent with ESG considerations. Encouragingly, social factors are progressively being addressed, such as diversity and inclusion, as well as governance factors such as board composition and structure. Unsurprisingly, targeting net zero carbon emissions for business operations is the most highlighted aspect across the industry, with some firms having already achieved net zero.

Despite the many net zero commitments however, some firms have not yet developed the capability to report their carbon footprint. With there being increasing scrutiny from trustees on the extent to which managers are taking ESG considerations into account when making investment decisions, such matters will naturally be factored into the selection or re-appointment of their fiduciary managers.

> Capability to obtain and report scope 3 emissions data is still very much in a development phase. However, the firms that are unable to report at least scope 1 and 2 emissions data are behind what is becoming standard reporting practice.
>
> **Fraser Weir**
> Investment Consultant

Chart 2: Do you exclude underlying managers who have been assigned your lowest ESG rating?



When it comes to the integration of ESG considerations into solutions, more fiduciary managers now give an ESG rating to underlying managers and funds within client's portfolios, however underlying managers with the lowest ESG ratings are still being included in many fiduciary managers' portfolios. Whilst there has been an 11% decrease in instances of this happening since last year's survey, the change has been minimal, meaning many pension schemes can still be exposed to ESG risks that may not be appropriate, and trustees should understand the reasons why a fund with the lowest ESG rating can be included in their portfolios.

Whether or not these ESG risks are appropriate depends on the risk tolerance of trustees and one of the best ways of establishing this is through setting ESG beliefs. We are supportive that, when initially engaging with trustees, fiduciary managers consider ESG beliefs which then form part of the scheme's investment objectives. However, the extent to which these are integrated in portfolios and then measured against varies greatly due to the different structures of fiduciary management solutions and reporting capability. If trustees have a very strong set of ESG beliefs this can make alignment difficult.

Climate change and stewardship

With an increased focus in the lead up to COP26 at the end of 2021, climate change is at the top of the agenda for many organisations and trustees are committed to incorporate this within a pension scheme's investment strategy.

Fiduciary managers are also responding quickly to its importance and there have been large advances in the capability of their solutions. 92% of fiduciary managers now have the capability to carry out climate related stress testing and scenario analysis compared to only 30% last year. Having this capability aligns with the TCFD requirements and should allow trustees to assess how their portfolios may be impacted by different climate scenarios. It should also provide them with a means of tracking their pathway to net zero.

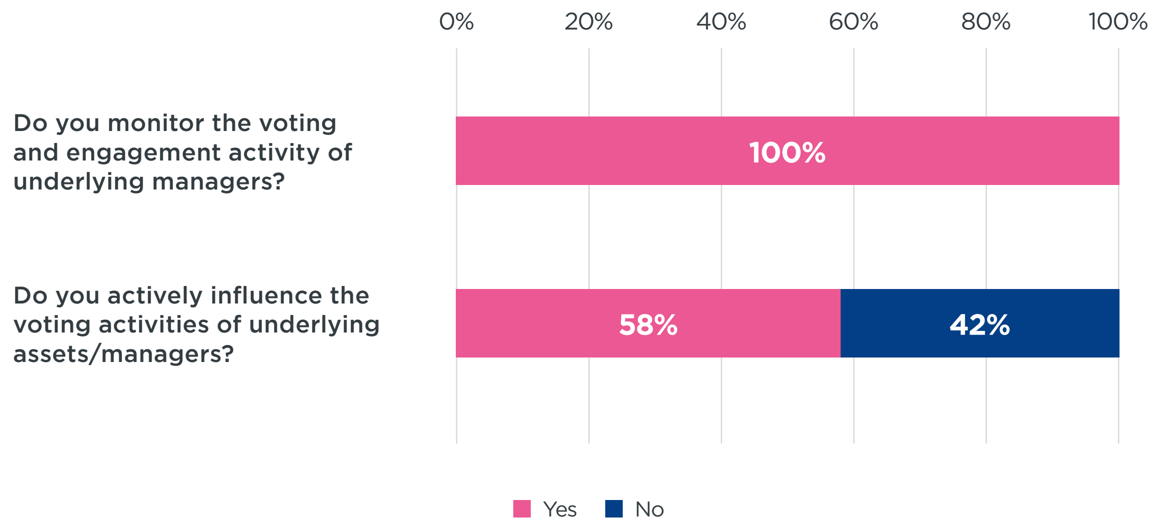
> There are many different internal and external tools that fiduciary managers use to undertake climate change analysis and trustees should assess whether these provide the analysis and details required.
>
> **André Kerr**
> Partner

The UK Stewardship Code is now seen as the standard for asset managers and service providers to evidence the calibre of their stewardship approaches. Such is the importance of the UK Stewardship Code, we now require that fiduciary managers must be signatories in order to receive a Green rating for ESG. At the time of our survey, 33% of fiduciary managers were not signatories. Stewardship is one of the most influential tools investors have to bring about positive change and increasingly fiduciary managers are citing a preference to use engagement as an approach to bring about sustainability.

Signatory of: STEWARDSHIP CODE | 2021

Encouragingly, all fiduciary managers now monitor the voting and engagement activity of underlying managers and most actively influence the underlying managers by setting out expectations on voting practices and frequently engage around voting approaches. Whilst monitoring this activity may meet the minimum requirements for most, this may not be enough for those trustees who expect their fiduciary managers to do more and ensure alignment of their ESG beliefs.

Chart 3: XPS FM ESG survey response



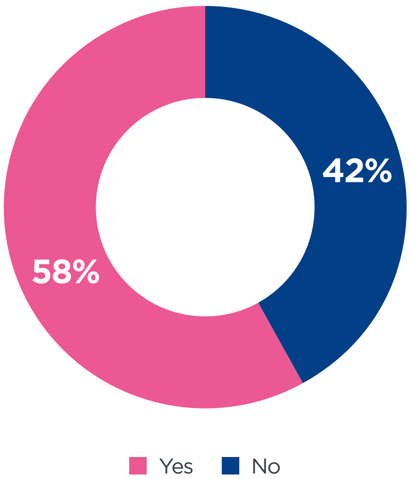
Such is the importance of the UK Stewardship Code, we now require that fiduciary managers must be signatories in order to receive a Green rating for ESG.

Reporting

The level of reporting for ESG and sustainable investment practices is improving across the industry and all fiduciary managers now include a section on ESG within their standard client investment reporting provided to trustees.

Whilst reporting on ESG should be a matter of course, and we support its inclusion in standard client investment reports, the level of reporting varies significantly. For example, not all include a section on stewardship specific to the scheme's portfolio, leaving this to the annual Engagement Policy Implementation Statement. This may be appropriate for some trustees, however for those who are increasingly placing stewardship as a higher priority on their governance agendas, more voting and engagement information will likely be required.

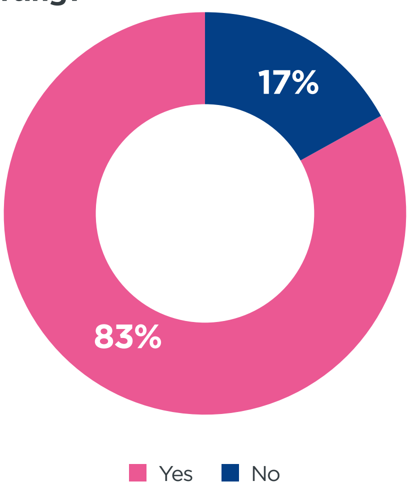
Chart 4: Does your standard client investment reporting include a section on stewardship specific to the portfolio?



Climate change again dominates the ESG subject matter within reports, with the majority of fiduciary managers providing carbon and green-house gas emissions data for their portfolios and even for the underlying investment managers within their solutions. However, there is relatively very little reporting against any other ESG factors. Trustees should expect and challenge their fiduciary managers to make sure they are reporting across the ESG spectrum.

Trustees should note that not all fiduciary managers are yet able to provide reporting at a strategy level to support investors specifically with the upcoming TCFD reporting being placed on pension schemes specifically. Trustees preparing for this requirement will be reliant on support from their fiduciary managers and whilst this year sees only schemes with assets under management of more than £1bn being affected by the requirement, it will quickly come around for the majority of others.

Chart 5: Are you able to provide reporting to support investors specifically with their TCFD reporting?



> Climate change is a pressing issue and it is no surprise that this has the most attention when it comes to reporting. But ESG is a broad subject with many important and interlinked factors which should not be forgotten.
>
> **Fraser Weir**
> Investment Consultant

Summary

The last twelve months have brought about significant changes to investment markets, and the approaches fiduciary managers use to incorporate ESG and sustainability practices into scheme's portfolios is no exception.

There have been huge developments regarding capabilities to assess climate change-related risks for UK pension schemes and the formalising of ESG integration into investment policy documentation.

The pace of change regarding approaches to ESG incorporation shows no signs of slowing, with the Pensions Regulator setting the pace for trustees along with their appointed fiduciary managers. Upcoming reporting requirements (TCFD) and increasing scrutiny on ESG incorporation and sustainability practices leaves nowhere to hide and fiduciary managers must continually evolve their solutions to meet investor demands.

For trustees, they must continue to push their fiduciary manager to assist them in meeting their ESG requirements and to help them assess whether their ESG beliefs are, or continue to be, aligned.

About us

XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 968,000 members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 51 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £140bn of assets under advice.

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Appendix

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

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

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