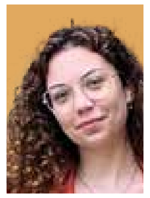
Governance gap in impact management

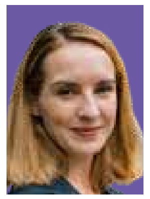
Implementing sustainable practices poses a challenge for organisations, and particularly pension funds with traditional business models and regulatory burdens. How can pension schemes adapt their governance and decision-making?

By Bruna Bauer



Evaluating sustainability requires examining businesses' long-term viability and anticipating shifts in politics and regulations. Additionally, managing pension funds involves acknowledging the capital belongs to pension savers, who increasingly seek investments aligned with their social and environmental values. Therefore, sustainable investment involves assessing a wide-range of risks over the long term, reflecting the inherent nature of pension investments.

Despite the growing discourse on the importance of sustainable investing, several barriers are preventing UK pension schemes from embracing sustainable investing. Richard Giles, Senior Director & Community Lead at *Pensions for Purpose*, hosted a discussion with James Alexander, Chief Executive of the *UK Sustainable Investment and Finance Association (UKSIF)*, and



Charlotte O'Leary, CEO of *Pensions for Purpose*. Some of the challenges they highlighted were:

Time and expertise of trustees and their adviser: trustees are being asked to consider ESG, climate and impact investing at already full meetings. Trustees require additional training in this area and are dependent on their adviser. Investment adviser experience in ESG is growing but still mixed, and how investment consultants prioritise these issues varies widely. For this reason, advisers in some cases are unable to provide effective challenge.

Rising regulatory landscape: the regulatory landscape is increasingly placing significant responsibility on trustees, making their role challenging. Investment consultants have growing influence over investment decisions, which can sometimes clash with trustees' sustainability objectives.

Complexity of aligning ESG issues and investment decisions: navigating ESG in investment decisions is complex, and identifying and prioritising relevant factors remains a challenge, especially given the nature of the data available and interpretation, as well as external factors like climate change and political dynamics.

The important but challenging role of trustees: to address these problems, trustees must enhance their expertise in ESG investing, while ensuring they have a good understanding of financial matters. There is also a need to increase the general awareness of pension members and savers, and educate them on ESG investment accordingly.

Empowering stakeholders: to move forward effectively, stakeholders, including investment consultants and asset managers, must be proactive in advising pension fund trustees. We shouldn't wait for perfect solutions but rather embrace systemic levers and best practices, such as the rigorous impact assessments conducted by B Corporations. It's imperative trustees demand accountability and transparency from their asset managers and consultants in integrating sustainability considerations into investment strategies.

Assessment: double materiality means considering the impact pension scheme investing has on the world as well as considering the impact the world has on a pension scheme's investments. Double materiality is crucial as real-world impact may bounce back to affect investments.

Task Force for Nature-related Financial Disclosures (TNFD): is vital for pension funds, although it isn't yet a regulatory requirement. TNFD is more relevant, it goes beyond traditional frameworks like Taskforce on Climate-Related Financial Disclosures (TCFD), by incorporating social and indigenous considerations, making the framework more comprehensive.

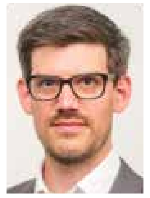
Avoid overly narrowing investment options: investing solely in B Corps or strictly adhering to the green taxonomy limits investment opportunities, often to under 1% of the market. A balance must be found to prevent excessive constraints on investment choices.

All-member event blog

Short-term gains versus long-term mindset: recently, funds underweighted in oil and gas have underperformed. Despite short-term gains in this sector due to scarcity, long-term perspectives are essential. Oil and gas have a high-systemic risk factor.

Consider the wider economy: as pension funds grow, their impact on the economy becomes significant. They need to consider investment to benefit the whole economy, rather than focusing on individual stock performance. Incentives often prioritise outperforming peers rather than contributing to overall market health.

ESG and impact investing language and terminology



James Alexander, Chief Executive of the *UKSIF*, mentioned the challenge posed by the varying, and often inconsistent, terminology used when discussing sustainable investment. To tackle this issue, the *CFA Institute*, the *Global Sustainable Investment Alliance* and the *Principles for Responsible Investment* collaborated on guidance to establish a common language for five key definitions related to the topic. Their objective is to assist investors in effectively communicating their practices:

Screening: employing defined criteria to determine the permissibility of an investment.

ESG integration: continuous consideration of ESG factors during investment analysis and the decision-making processes to enhance risk-adjusted returns.

Thematic investing: choosing assets based on specific trends or themes.

Stewardship: utilising investor rights and influence to safeguard and enhance long-term value for clients and beneficiaries, encompassing common economic, social and environmental assets crucial to their interests.

Impact investing: investing with the aim of producing a measurable, positive social and/or environmental impact in addition to financial returns.

According to James, the *Financial Conduct Authority (FCA)* recently confirmed a package to enhance trust and transparency in sustainable investment products and combat greenwashing. The measures include:

- Implementing an anti-greenwashing rule for all authorised firms to ensure fairness and clarity in sustainability-related claims.
- Introducing product labels outlining clear sustainability goals and criteria for investors' understanding.
- Enforcing marketing requirements to prevent misleading claims of positive sustainability impacts.

Although these regulations are primarily consumer-focused, James anticipates them being extended to institutional investors soon. The *FCA* aims to address greenwashing by establishing new sustainability' and 'impact' fund labels, restricting the use of these protected phrases unless funds meet specific criteria:

- 'Sustainable impact' focuses on impact investing, prioritising non-financial objectives over financial goals.
- 'Sustainable focus' targets assets already aligned with the fund's non-financial objectives, such as investing in renewable energy companies to reduce carbon emissions.
- 'Sustainable improvers' focuses on transitioning assets toward non-financial objectives through investor engagement over time.

James highlighted over 40% of the public desire investments that align with values like climate change, human rights, working conditions and biodiversity, indicating significant retail demand for these investments. It is anticipated asset managers will launch funds with sustainable labels from summer 2024. Meanwhile, efforts are underway to help asset managers align their funds to meet the required standards.

Fiduciary duty & sustainable investing

The misapplication of fiduciary duty is often used to justify actions or inactions based on trustees' personal preferences rather than their true fiduciary obligations. This misunderstanding stems partly from a lack of clarity in the definition of fiduciary duty. Ideally, a comprehensive definition should be standardised by the government and regulatory bodies, and include the ESG risk consideration and the impact of ESG factors, given negative impacts can eventually translate into risks. It's crucial to view fiduciary duty from a long-term perspective and act in the best interests of members over their entire pension savings journey.

According to Charlotte, it is essential for trustees to capture the shifting power dynamics resulting from industry consolidation, realising asset owners, through collaboration, have increased influence in shaping the investment landscape. This reframes the concept of fiduciary duty, emphasising the trustees' role as agents driving sustainable investment practices. By actively engaging with investment consultants and specifying sustainable investment preferences, trustees can shape new investment products.

Central to this is establishing robust governance structures capable of making strategic decisions and asking the right questions. The governance framework of pension funds must evolve to represent member views, considering the multi-generational nature of pension schemes and ensuring intergenerational fairness in sustainability decision-making. Neglecting sustainability considerations may disproportionately benefit older members at the expense of younger ones.

Insights from the audience:

- Trustees stressed the importance of sufficient time in meetings to discuss sustainability issues, recognising their responsibility in managing large investment portfolios.
- Concerns were raised about the lack of emphasis and limited attention given to sustainability in trustee meetings; these discussions need to be prioritised to ensure their continued relevance - audience members advocated collective action to address sustainability challenges, urging proactive engagement to influence regulatory frameworks.

Insights from the breakout sessions

Despite the rise in innovative sustainable funds from investment managers, **what holds schemes back from investing and how can they overcome these hurdles?** The audience explored this question from three angles:

Trustee's perspective: barriers include understanding complex language and jargon, assessing the importance of responsible investment and sustainability factors amid many other considerations. Impact funds are often new and smaller in scale, which pose challenges in making commitments and conducting thorough research. Encouraging consolidation can help address these problems. Common frameworks like the *FCA's* initiative and establishing a common language can offer benefits.

Investment consultants' view: scaling up sustainable investment practices across liquid and private assets is a challenge, alongside the need for greater education on the feasibility and benefits of integrating sustainability. Governance issues, such as budget allocation and time management, are also significant factors. Additionally, there's a need to address double materiality concerns and improve communication between in-house teams and trustees to align with the scheme's objectives and broader industry conversations.

Managers' perspective: the limited availability of sustainable investment options in the bond space is an issue – there is a need for product innovation. Managers must also clarify the role of sustainable strategies across asset classes and articulate clear objectives to support investors in portfolio allocation

PENSIONS FOR PURPOSE'S PERSPECTIVE

This event was open to all our members. If your organisation is not yet a member of *Pensions for Purpose* you may attend an event before deciding whether to join. If your firm would like more information on membership or you have colleagues who would like to sign up to attend an event, please email our Membership Manager, stephen.darlington@pensionsforpurpose.com.

decisions. Rapid changes in the sustainability landscape, clear future regulation and legislation are essential. Improved communication, using concise language and transparent reporting on sustainability factors and compromises, are necessary to enhance investor confidence and understanding.

Impact Lens

Our research includes published and commissioned reports. Through engagement with diverse stakeholders, from pension funds to their advisers and asset managers, we gather insights into the challenges of sustainable and impact investment. Impact Lens seeks to offer solutions and informed decisions on governance and investments. See our **Impact Lens** page.

More information

Interested in a conversation on this topic? Please e-mail Karen Shackleton.

Click to watch the video of the event.

● ***Bruna Bauer is an Intern at Pensions for Purpose and a graduate of the University of Glasgow***