

No longer on the sidelines – ESG in defined contribution

It may not be immediately apparent, but there has been a sea change in UK defined contribution (DC) pensions when it comes to environmental, social and governance (ESG) investing. Just five years ago, DC schemes had no requirement to even consider ESG.

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Product innovation accelerates

The regulatory push – first with disclosing the approach to ESG in the statement of investment principles, then having to produce implementation statements, and finally, a Pension Schemes Act putting climate disclosures into law in 2021 – have prompted pension funds to articulate top-level investment beliefs, show what they have done in accordance with them, and understand what the implications of ESG investment are.

This has created demand for products to help put into practice the newly articulated strategies, and asset managers have responded with product innovation to support the implementation of trustees’ beliefs.

“Those products probably weren't there if you go back to 2018-19, so I would say the industry's evolved together, both at the trustee and asset manager level. ESG has gone from being a peripheral requirement to a significant driver of investment products and investment propositions for members,” says Tim Hodgson, Head of DC Platforms and Retirement Solutions at BlackRock. “It's unquestionably accelerated and continues to do so.”

This ongoing change means DC trustee boards have not just had to look at the underlying building blocks of investment strategies, they have also evolved in the way they adapt and incorporate their ESG objectives and have started to formulate top-level objectives for the portfolio, such as carbon reduction targets.

ESG was long on the sidelines in DC, stowed away in the self-select range – at some schemes it still is – often attracting little by way of member funds, as inertia means more than nine in 10 DC members stay with their fund's default option. However, a growing number of schemes are making ESG part of the default.

“We've definitely seen a massive uptick in the proportion of default funds that take ESG into account,” notes Hodgson.

Master trusts lead the way

Not all DC schemes will take ESG into account in the same way or to the same extent, however.

Master trusts – which is where many DC members now have assets – tend to have higher levels of adoption, believes Hodgson, not least because as commercial entities, they operate in a competitive environment.

A number of master trusts have net zero commitments. For example, Nest aims to be net zero by 2050 and halve emissions by 2030¹, as does Now Pensions². Both the Legal & General WorkSave Mastertrust³ and the People's Pension have committed to net zero by 2050⁴, while Cushon's unique selling point is that it offers a pension option which is net zero now.⁵

“There are varying degrees of commitment to the net zero journey,” observes Hodgson. “Some of those commitments have led to product innovation from asset managers like us.”

Managers can also help master trusts map out their net zero journey further into the future, where not all master trusts might have defined their actions as clearly yet.

“At BlackRock, we partner with master trusts to identify not only what the short-term carbon reduction can look like but also how we can help the trusts continue on their journey to net zero,” he explains.

Ultimately, the choice about how to address ESG is with the master trust or pension fund. BlackRock aims to understand client objectives and offers a range of products and strategies to meet these. Many investors ask for products with sustainability

or transition-focused objectives – they can select not just the products they want to use but also decide on the type and level of portfolio construction, analytics, and stewardship they would prefer.

Member engagement must be part of the ESG journey

While such commitments are set as goals to work towards for the trust, they also send a signal to the wider market and its membership. Much of recent climate regulation has focussed on disclosure, with reports having to be publicly available so that members can find them easily. While there has been some debate over the extent to which documents that are in effect compliance reports are readable by scheme members, Hodgson believes regulatory requirements have resulted in more member engagement.

“You've definitely seen an uptick in engagement from members on what their pensions are invested in,” he says.

This greater member engagement also means the Pensions Regulator is watching the space closely.

“What we are seeing is an increased focus now from the regulator on how you help your clients meet their investing goals, how you help their members to understand the implications of that [net zero] transition,” he says.

“I think there is a genuine sense that the first piece of legislation [PSA 2021] worked. I'd be surprised if they were too heavy-handed going forward, but it's now about reporting and helping people understand what ESG is and why it's in their pension pots.”

The need to support people in learning about how their pension assets are invested, and why, means “there's a huge onus on us to deliver that transparency to trustees and to trustee boards and therefore to their members”, he adds.

What about S and G?

While the focus in ESG – both from a regulatory and an investor perspective – has long been on the environment, there is now growing interest in social and governance factors, based on the realisation that many of the E issues are inextricably linked with S and G.

The approach to integrating these factors into investments might however need to be adapted from the one that has brought E into the picture.

“The perception of the marketplace and the trustees broadly is that what got us here won't get us there,” says Hodgson.

As with climate some years ago, more trustees are now looking to set top-level objectives for the S and G of ESG – even though it can seem even more difficult.

“It's harder in some senses to come up with a statistic for S and G in the same way – a score, for example – as it is a climate objective. And I think that's why it's a bit slower,” notes Hodgson.

This is perhaps unsurprising as policymakers have not created urgency around the issue. The EU has developed a green taxonomy, and there are several ways to measure carbon emissions in a portfolio, but an attempt to expand the taxonomy to include social issues was reportedly shelved last year.

In the UK, there has been some initial effort in this area. A one-year taskforce on social factors was set up earlier this year to identify reliable data and metrics, monitor and report on developments around international standards and find out how schemes can better engage with social factors, coming up with guidance for trustees around modern slavery and supply chain issues.

Data is already becoming more available and richer all the time, says Hodgson – BlackRock looks at about 2,500 key performance indicators (KPIs) from external sources across E, S and G, which are condensed down to 150 KPIs that are then weighted.⁶

“It is about identifying those factors. And what those data points are is continually scrutinised,” he explains.

Trustee boards are at different stages of their ESG journey and have varying degrees of commitment. While some are already thinking about S and G, others are still very focussed on climate. For Hodgson, the key is that they have data to help them understand what factors might be material to an investment. They also require choice in investment strategies to implement their views.

While S and G are not universally integrated across DC schemes, some master trusts are now evolving their climate commitments towards a more holistic ESG solution, potentially a harbinger for the direction the industry is moving.

“Whether or not regulation is required to drive that – I'd be slightly surprised if they felt the need at the moment, because the market does feel like it's heading in that direction anyway,” says Hodgson.

Stewardship is part of responsible asset management

As investors seek to find a path on these issues, they also make use of their rights as owners of listed assets by voting and engaging with companies.

Stewardship is seen by many pension funds as a cornerstone of responsible investing.

Hodgson says it is an important part of DC schemes' ESG journey because it allows individual trustee boards to have their voice heard by the organisations they are investing in on behalf of their members.

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In 2022, BlackRock became one of two managers leading the way on investor voting in pooled funds, rolling out the ability for institutional clients, representing 7 million UK pension savers, to participate more directly in proxy voting. In 2021, the government-initiated Taskforce for Pension Scheme Voting Implementation recommended that all asset managers should offer investors the opportunity to set an expression of wish. BlackRock's tool is only the second on the market, after institutional platform the Asset Management Exchange and asset manager DWS, working in partnership with Northern Trust and Minerva Analytics, launched one in February 2021.

"Stewardship is an incredibly important tool in DC. We've definitely seen member engagement in our stewardship activity and I think we have excellent relationships with organisations which are reflecting their views and their trustees' views into these propositions and products," says Hodgson.

"We look after our clients' best interests, that's our responsibility. Voting on their behalf is integral to this."

1. Nest Pensions, July 2020
2. Now Pensions, October 2022
3. Legal and General, November 2022
4. The Peoples Pension, September 2022
5. Cushon, July 2021
6. BlackRock, as of 28 February 2023

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