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Considering the 'S' in ESG – the DWP's response

While environmental (including climate change) and governance factors are subject to a great deal of trustee scrutiny, the government is concerned that the third strand of ESG – social considerations - receives less attention.

The DWP has published its response to a call for evidence on the consideration of social risks and opportunities by occupational pension schemes.

The main outcome is the establishment of a Minister-led taskforce to identify reliable data and metrics and "seize the opportunities of the 'social' element in ESG investing".

Background

The need for a policy on financially material social factors

Most occupational pension schemes with at least 100 members must prepare a statement of investment principles (SIP). A SIP must also be prepared by trustees of schemes with more than one member offering money purchase benefits within a default arrangement.

SIPs must include trustees' policies on financially material considerations including ESG factors. Trustees of schemes offering money purchase benefits are required to prepare and publish an implementation statement reporting on how, and the extent to which, the SIP has been followed during the year. DB schemes must also issue an implementation statement, but only in respect of voting and engagement matters.

The need for a policy on non-financially material social factors

Trustees are also required to set out "the extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments". These are defined as the views of the members and beneficiaries including, their ethical views, their views in relation to social and environmental impact and in relation to present and future quality of life.

In contrast to financially material social factors, trustees are not required to take account of these non-financial matters when making investment decisions.

Trustees' legal duties

The DWP agreed with respondents that social risks and opportunities can have a financially material impact on the value of schemes' financial assets and the long-term performance of investments. Whilst it agreed that an integrated approach to ESG is perfectly reasonable, separating out ESG risks and opportunities is also acceptable.

It also strongly agreed that social factors are often closely linked to governance factors and environmental factors, including climate change. Being aware of the links would help trustees manage financially material risks and opportunities in an effective way.

Having quality data and metrics on climate-related risk has been helpful and the Taskforce on Climate-Related Financial Disclosures has advanced financial risk data developed over several decades.

A taskforce led by the Minister for Pensions has been established in order to support pension scheme trustees in meeting the challenges around managing social factors. The aim is to identify reliable data and metrics.

In the meantime, to help trustees and their advisers, the DWP has included a list of resources to identify, assess and manage social risks and opportunities.

Social factors and financial materiality

Social factors are wide-ranging and will mean different things to different people. Nevertheless, trustees need to consider which of these factors are financially material. Some of the social factors investors may wish to consider are shown below. These factors may involve financially material risks or opportunities to the pension scheme:

Area	Social factors/themes
Practices within a company and its supply chain	• Health and safety in supply chains • Working conditions • Remuneration practices • Modern slavery • Employee engagement, diversity and inclusion
Company products and selling practices	• Product quality and safety, including public health • Selling practices and product labelling • Customer privacy and data security (Digital rights) • Consumer protection
Companies in the community	• Management of human rights and treatment of indigenous peoples • Community engagement • Impact on local businesses • Use of local workforces

The DWP's response acknowledges that the volume of social issues makes it difficult for trustees to know where to start. It sets out some questions that pension scheme trustees can ask to help them identify which specific social issues might be financially material and therefore relevant to the scheme.

- Are there any links between the scheme's climate change policies and social risks and opportunities?
- If available, what high level insights on social risks and opportunities do the scheme's managers or service providers have? For example, what were the top ESG trends for the previous year or what are they likely to be for the following year?
- Are there any regulatory changes (e.g. changes to legislation) affecting companies, that cut across social risks and opportunities, for instance the Modern Slavery Act 2015?

How trustees can take social factors into account

For trustees to act in the best interests of members, pension schemes need to invest in a way that will provide an appropriate return over the long-term, not just the highest possible returns available today. Research by the Pensions Policy Institute in 2019 found that an individual with DC pension savings could increase their pension pot by around 2% at State Pension age by investing in assets with good ESG credentials.

There is no single "right" way to consider social factors but there are several distinct approaches available, including screening (exclusion), tilted funds, social impact investing, voting and engagement.

The DWP's response confirms that it is fully supportive of active ownership – engagement with companies and others in the investment chain as part of a stewardship strategy. The DWP would like to see a more detailed and transparent approach from asset managers so that trustees can monitor social factors better. The response is clear on the importance of stewardship and the DWP's expectation that trustees should be improving this – even for pooled funds.

Social factors as opportunities

The DWP's response acknowledges the limited or high-risk opportunities of investing in companies solving social issues in developing or emerging markets. However, it is keen that trustees look at the growing opportunities as well as objective outcomes. Guy Opperman, Minister for Pensions, says "in my view, trustees who do not factor in financially material social factors are at risk of not fulfilling their fiduciary duty".

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