PENSIONS AND LIFETIME SAVINGS ASSOCIATION

RESPONSIBLE INVESTMENT QUALITY MARK:

CONSULTATION ON STANDARDS

JUNE 2021

CONTENTS

INTRODUCTION

In recent years responsible investing has been brought sharply into focus for the pension and investment industries, for policymakers and regulators and even for wider society too. This has been accelerated by a growing desire not only to tackle the climate crisis, but for pension scheme governing bodies to also encourage good corporate governance and fair workforce practices.

The PLSA has focussed for several years on supporting schemes in their endeavours to implement Responsible Investment principles and practices. Our latest initiative, the Responsible Investment Quality Mark, provides:

- a new standard to which schemes can aspire,
- the opportunity to share best practice among schemes, and
- a scheme member-focussed way to demonstrate activities in this area.

The details of the standards are set out in this paper and are now open for consultation until 3 September 2021. Please send your comments to info@pensionqualitymark.org.uk

In particular, we would welcome feedback on the following questions:

CONSULTATION QUESTIONS

- Q1. Do the proposed areas for assessment cover the core areas of responsible investing?
  - Please indicate what, if any, core responsibilities should be added or strengthened or amalgamated in the standards.
- Q2. Does the Quality Mark set sufficiently high expectations of effective responsible investment for all schemes and funds?
- Q3. Should all schemes and funds be expected to meet the criteria set out in the standards? Are there elements which would be less suitable for certain types or sizes of scheme? Are there additional elements that would be appropriate for 'Plus' applicants?
- Q4. What further supporting material or guidance could assist schemes or funds?
- Q5. Do you have any additional comments on the standards?

RESPONSIBLE INVESTMENT QUALITY MARK: A PRINCIPLES-BASED STANDARD

In our 'A Changing Climate: How Pension Funds can Invest for the Future' report, published in October 2020, we said we would consider whether to develop a new standard to recognise the good practice of many pension schemes regarding responsible investment (sometimes also known as sustainable investment or ESG approaches).

Working with the guidance of the independent Pensions Quality Mark Standards Committee, and drawing on the expertise of PLSA members, we have now completed the development of a new draft standard – The Responsible Investment Quality Mark (RIQM).

The RIQM is a principles-based standard, which will be open to all types of pension scheme. The standards, as proposed, recognise that schemes of differing scales and natures will have different approaches to the challenges of Responsible Investment that reflect their differing needs and investment approaches.

As with the Pensions Quality Mark, which recognises high quality DC pensions provision, our approach to assessments will be principles-based and respond intelligently and flexibly to the scale and resources of the relevant scheme. The RIQM standard covers the following areas:

- Focus on member interests
- Governance
- Investment strategy
- Oversight of stewardship
- Risk management
- Metrics and targets
- Communication and engagement

For schemes that are acting in ways that exceed best practice we are also proposing an RIQM Plus accreditation. This will be available to schemes where they are demonstrating industry-leading practice.

As with the Pension Quality Mark, compliance with the standards will be undertaken by a combination of internal PLSA staff and expert external assessors, with all decisions subject to potential review by the independent Pensions Quality Mark Standards Committee.

PRINCIPLES IN PRACTICE

For each of the seven areas for RIQM assessment, in simple language we set out the standard and a summary of best practice. We also outline our high-level expectation of the evidence our assessors will be seeking, and then a list of more detailed and specific elements that might be provided to fulfil this expectation.

Many larger and better resourced schemes are likely to be able to provide most, or all, of these individual elements of evidence – and indeed may be able to do so by highlighting existing commitments or qualifications (for example, being a UK Stewardship Code signatory as recognised by the Financial Reporting Council). However, other schemes with less resource will not be expected to deliver each individual element. Instead, provided our assessors can see clear evidence of best practice, such schemes will still be potentially eligible for the quality mark.

In particular, we recognise that those investing only through pooled funds may not be able to provide all the individual evidence elements. Expectations will also vary depending on the investment approach of the scheme, so that what is delivered by mature DB schemes may well be very different from that by growing DC schemes. In each case, we will seek to examine how the principles of the standards have been implemented in practice.

DEFINITIONS

The language used in this RIQM expectations guide also seeks to be inclusive, to encompass all forms of pension provision and savings vehicle. Our hope is that all forms of scheme will aspire to RIQM and our terminology reflects this.

Therefore, throughout we use the following terms, and intend them to be understood to capture generically a range of different scheme structures and circumstances:

- Governing bodies – to refer to trustee boards, IGCs, pension committees and so on, as relevant to the nature of the pension scheme or provider in question
- Scheme – to refer to any form of pension scheme, fund or equivalent savings vehicle
- Member – to refer to individual beneficiaries or members of a scheme

RESPONSIBLE INVESTMENT AND ESG

There are many different terms used for responsible investment, among them sustainable investment and ESG. We have chosen to use RI, or responsible investment, but our aim is to include all responses to the investment challenges arising from this set of issues that are material but have historically been neglected in investment because they have been seen as 'non-financial'. Our use of language is intended to be inclusive and not to exclude any one approach to these issues.

Many governing bodies will approach responsible investment through the lens of ESG, environmental, social and governance matters. This approach certainly makes sense at the investment asset level; the companies, properties and other assets that are the underlying investments. Pension funds and their fund managers will seek to understand how companies and other investment assets deliver appropriately against ESG expectations – and this is reflected particularly in the expectations on investment strategy and asset stewardship. Underlying assets should have strong and effective governance and oversight, and appropriately manage the social and environmental risks that they face, as well as rising to the social and environmental opportunities that arise.

However, the bulk of the RIQM standards are at the level of the governing body, its overall investment portfolio and its interactions with fund managers and other service providers (such as investment consultants). At this level, ESG is likely to mean:

- E: Environmental metrics across the portfolio as a whole – which in the climate change area are typically about carbon intensity and the CO_2 footprint – exist, though they are still subject to development. We encourage schemes to consider how they approach these issues in strategic ways and look to align their investment approach to address them, beyond the use of portfolio-wide metrics.
- S: Social metrics (and environmental metrics beyond the issues arising from climate change) are currently less well developed at the level of consideration across portfolios as a whole. We welcome the recent attention of the DWP to the 'S' in ESG and the PLSA has an active industry partnership with the CIPD, RPMI Railpen and the High Pay Centre to consider these issues further. As this work helps to inform best practice, we expect to reflect this in RIQM expectations.
- G: At this level, governance will refer to the way in which the governing body itself operates, and the process by which it holds its service providers accountable for delivery.

We look forward to seeing how this area of reporting develops over time, and will keep it under regular review.

ASSESSMENT AREAS: RESPONSIBLE INVESTMENT QUALITY MARK (RIQM)

1. Focus on member interests
2. Governance
3. Investment strategy
4. Oversight of stewardship
5. Risk management
6. Metrics and targets
7. Communication and engagement

Each of the assessment areas – and the relevant expectations in respect of each – is discussed in turn below.

AREA 1: FOCUS ON MEMBER INTERESTS

The standard

To deliver RIQM expectations, a pension scheme must:

- Clearly focus on member needs and interests
- Consider the time horizons over which investments are made on members' behalf, ensuring key risks and opportunities that arise over those time horizons are actively considered
- Ensure that information and data flow to the scheme and/or its advisers is sufficient to enable them to assess risk and opportunity over relevant time horizons and respond appropriately
- Understand and consider member expectations and opinions

Best practice rationale

Time horizon is crucial to effectively investing for members over the relevant period. This may mean additional factors need to be considered in investment strategies beyond short-term and/or purely financial issues.

Fiduciary duty requires that pension schemes must consider the needs and interests of members. However, historic approaches to fiduciary duty have tended to lead to a narrow, financially-focused understanding of those needs and interests. More recent clarifications and regulatory expectations mean that schemes and their advisers are now aware they need to consider financially material responsible investment (or ESG) issues that may previously have been neglected.

That makes sense because while some RI issues can be seen to have near-term impacts on asset values and investment performance, many such issues will only speak to value over the long-term investment time horizons that matter to pension schemes and to many of their individual members. A focus on member interests, and in particular the time horizon for investments on their behalf and the risks over such periods, should therefore assist in considering appropriate RI approaches.

Expected evidence

The underlying proof point for this requirement is that there is documented evidence that the pension scheme has:

- Sought an understanding of member demographics, and what time horizon for investment is relevant for its members
- Considered what the implications of this time horizon are for the RI approach
- Set in train a process to ensure that this time horizon and its implications for RI are reflected in investment practice

We recognise that DB schemes, where the member promise is more an employer's undertaking to make particular financial payments than a relationship reflecting member perspectives, face different pressures and needs. Our expectations will therefore be appropriately tailored to the nature of each RIQM scheme.

Specific evidence to support demonstrating delivery against this standard might include:

- Analysis of member demographics, likely investment time horizons and inferred opinions
- Work to develop an understanding of any specific RI issues that are of relevant concern to members (this might be delivered through a number of routes – though always with the understanding that there may be a self-selection bias in those members more likely to respond – such as: active discussion among member-nominated trustees or the equivalent; employer data and/or insights; invitation of input through regular newsletters or other member communications; polling at engagement events).
- A formal member survey, or other use of technology to source member input, again recognising the challenge of self-selection bias and the need to bolster engagement to overcome this (RIQM for DC schemes; RIQM Plus for DB)
- Processes that provide scope for less formal member feedback
- How any feedback received from members has been factored into trustee thinking

AREA 2: GOVERNANCE

The standard

To achieve RIQM, pension schemes must demonstrate that they have appropriate processes to consider relevant responsible investment issues and oversight to ensure that the expected RI approach is delivered in practice.

The way in which this is delivered will vary depending on the scale of the scheme, the nature of its governance structures, and its available resources.

Best practice rationale

In order to deliver RI effectively, a scheme must designate sufficient attention and resource to the issues involved. This must include ownership of the issue from the top of the organisation, including by the governing body.

In order for the governing body to deliver effectively, it needs to dedicate sufficient time and appropriate resource to RI, and to have sufficient skill – or access to relevant advice – to handle the issues involved. Schemes should see building RI into the structures and expectations for investment (fund manager assessments and dialogue, agreements with investment consultants, value for money assessments) as a normal part of their investment approach.

Expected evidence

The underlying proof point for this requirement is that there is documented evidence that the pension scheme has a regular and robust process for:

- Assessing its overall RI approach, including keeping it under review, and
- Delivery in practice against that approach

Schemes should also demonstrate that they have skills and/or training in place to ensure that the governing body has the capability to consider these issues appropriately. Alternatively, they should show how they have ensured that they have access to appropriately skilled advice in this area, which they challenge, test and hold to account.

Specific evidence to support demonstrating delivery against this standard might include:

- RI policies subject to governing body review from time to time
- That the asserted RI governance approach is actually delivered in practice in governing body decision-making and oversight
- RI consistently integrated across most governing body discussions and decision-making, or regular governing body time dedicated to RI considerations (at least quarterly)

- RI consistently integrated across governing body discussions and decision-making, or (where governance resources allow) as a standing agenda item at each meeting (RIQM Plus)
- Inclusion of RI in any mandate and objectives for investment consultant
- At least annual assessment of underlying fund managers on the effectiveness of their incorporation of RI issues according to policies (by governing body, or delegated to executive, consultant or other adviser)
- Members of the governing body benefit from RI knowledge and experience, either collectively or through having at least one member with specific expertise (RIQM Plus)
- Knowledge is maintained through regular training
- Pension scheme has set a net zero target (RIQM Plus)
- Any value for money assessment of investment services incorporates an understanding of the value derived from RI activities

AREA 3: INVESTMENT STRATEGY

The standard

Many aspects of responsible investment should be considered at an overarching level of investment, including as part of the scheme's statement of investment principles or beliefs (beyond a generic mention that simply reflects regulatory requirements). RIQM qualifying schemes are likely to be able to show not only that RI is included in this way but also that there was an in-depth discussion that led to its inclusion.

This high-level commitment must then be delivered in practice. It needs to be:

- Reflected in the approach to the asset classes in the overall scheme portfolio (though it is always possible to conclude that it is not relevant to a particular asset class or investment approach)
- Incorporated into RFPs and the terms of individual fund manager mandates

Best practice rationale

If RI is to mean anything it must be reflected in the top-level understanding of investment and the overarching approach. It then needs to be embedded into the details of the investment process, at SAA level and in relation to each asset class.

There is no expectation that RI will be the dominant or deciding factor in any decision, but incorporation into governing body debate and decision-making is expected – so that RI is reflected, to the extent appropriate, in relevant investment decisions.

Expected evidence

The underlying proof point for this requirement is that RI is fully incorporated into the SIP and/or investment beliefs, beyond a generic mention that simply reflects regulatory requirements. It also needs to be delivered operationally through:

- Consideration within the SAA;
- Inclusion in investment RFPs; and
- Incorporation into fund manager mandates.

Specific evidence to support demonstrating delivery against this standard might include:

- In-depth governing body discussion of the issues that led to inclusion of the RI approach in SIP and/or investment beliefs

- Ways in which RI is built into strategic asset allocation (SAA) and asset allocation decision-making processes, either in terms of RI risk or RI opportunities (or both)
- How considerations of the physical and transition risks of climate change help frame asset allocation
- How RFP processes are varied across asset classes and portfolio specifics to reflect particular RI expectations
- How fund manager mandates are varied across asset classes and portfolio specifics to reflect particular RI expectations
- How fund manager delivery against such the RI elements of such mandates is assessed
- How the scheme actively considers investment opportunities with positive RI impacts (RIQM Plus)
- How the scheme actively considers systemic risks and seeks to make concrete efforts to address them (RIQM Plus)
- Where relevant, that at least one specific fund choice with appropriate RI characteristics is made available to members (DC only)

AREA 4: OVERSIGHT OF STEWARDSHIP

The standard

RIQM pension schemes need to use the rights and powers that come as an investor in order to press for enhanced sustainability and ESG delivery by the assets in which they invest. This may be carried out directly, through individual fund managers, or through other agents and collective bodies.

Stewardship activity includes voting shares held in public companies, but extends far beyond this, including: active engagement with the boards of public and private company investments, dialogue with the general partners of private equity and other funds, and work to influence government policy and regulation.

Best practice rationale

Stewardship is a key area of RI: acting as a good long-term owner of the assets that are held is simply a reflection of the nature of the scheme's role as a fiduciary. The approach needs to be tailored to the scale of the resource available and the scope for influence given the level and nature of investment exposure, but there are multiple resources now available to assist schemes to build influence through collaboration, and to make the most of their available resources.

Expected evidence

The underlying proof point for this requirement is that stewardship is fully incorporated into the approach to investment through inclusion in the SIP or investment beliefs. Delivery is likely to be through requirements in fund manager mandates and reporting, or through some equivalent alternative stewardship-specific service. Any delivery through fund managers or other service provider needs in its turn to be subject to appropriate oversight and challenge. The level of what can be delivered and expected will reflect the nature of the investment approach, such as the use of pooled funds.

There must be some form of active reporting of delivery through stewardship activity to the governing body – what the Stewardship Code refers to as 'outcomes' (which needs to be more than simply reports on voting activity).

Specific evidence to support demonstrating delivery against this standard might include:

- Regular reporting of stewardship and ESG investment activity to the governing body, quarterly, biannually or annually as appropriate to scheme governance resources (covering stewardship broadly, not just voting on public equities)

- Appropriate stewardship and ESG investment are actively delivered across asset classes that form the majority of the overall investment portfolio
- Regular and robust challenge of stewardship and ESG investment delivery by fund managers or other service providers
- Service provider conflicts of interest in relation to stewardship matters are monitored and actively considered
- Active support of collective engagement (merely signing a collective investor statement or position paper is unlikely to fulfil this; the expectation would be for concrete actions to be delivered by the scheme, or by its service providers and overseen by the scheme)
- Scheme is signatory of the Stewardship Code (RIQM Plus)
- Scheme is an active participant in an industry body supporting collaborative engagement, as a member and scheme is an active participant in an industry body supporting collaborative engagement, as a member and contributor to engagement activity (RIQM Plus)
- Active work regarding public policy and systemic risk issues, or oversight of fund manager (or other service provider) delivery in this respect

AREA 5: RISK MANAGEMENT

The standard

Pension schemes qualifying for RIQM need to have active processes and oversight of the risks that may arise from key RI issues. This will be both from a top-down portfolio-wide perspective and from the bottom-up, considering ESG and other risk exposures at individual investments or funds and seeking to understand how those might aggregate.

Best practice rationale

Not least because RI risks are often systemic in their impacts and so may have correlated effects on investment portfolios, schemes need to consider RI risk at an overarching level, including considering if there are ways to make the portfolio more robust to possible shocks.

Expected evidence

The underlying proof point for this requirement is that the scheme has a regular broad process of horizon scanning to identify significant and emerging RI risks. The scheme needs regular reporting of RI risks as part of portfolio-wide risk management and also from individual fund managers.

Specific evidence to support demonstrating delivery against this standard might include:

- Quarterly reporting to governing body of RI risk issues at portfolio-wide level and at a more granular level
- At least annual consideration of horizon scanning for significant and emerging RI risks, using appropriate advisory inputs
- Regular assessments of fund managers incorporating portfolio assessments comparing ESG characteristics with a relevant benchmark
- Climate scenario analysis deployed as part of risk management tools (Plus for those for which not already compulsory)
- Active consideration of tools and approaches to assist the scheme to manage effectively social risks in the portfolio and in the investment supply chain

AREA 6: METRICS AND TARGETS

The standard

In order to qualify for RIQM, pension schemes will need to have in place a series of metrics that they can deploy to understand exposures to a range of RI issues, and set targets for how those exposures develop over time.

Best practice rationale

Like all management issues, there is a need to measure RI and to assess progress of those measurements over time. This is necessary to enable trustees to have confidence that issues are being considered, and, to the extent possible, addressed.

While metrics may at the moment be imperfect, having something to consider will play a part in driving more effective debate in the governing body. This should help enhance the quality of measurement over time.

Expected evidence

The underlying proof point for this requirement is that there is a mechanism for measuring RI exposures and for assessing progress over time. These must be considered regularly by the governing body, using appropriate advisory inputs.

Specific evidence to support demonstrating delivery against this standard might include:

- RI integrated in standard management information provided at each meeting of the governing body
- Agreed set of RI targets or ambitions for the metrics chosen
- Governing body-level discussion of progress of RI metrics against targets on at least an annual basis, using appropriate advisory inputs
- Identified relevant RI/ESG metrics for assessing the performance delivery in each investment mandate
- Regular assessment of climate footprint, weighted average carbon intensity or other relevant measure (such as science-based targets) of public equities and fixed income mandates and holdings; (RIQM Plus) for other asset classes also
- Consideration of appropriate social metrics across the investment portfolio (such as, perhaps, workers' rights and diversity, human rights and anti-bribery and corruption issues)

- Consideration of appropriate governance metrics across the investment portfolio (such as, perhaps, board independence and skills, pay structures and ratios, and auditor independence and effectiveness)
- Climate footprint of pension scheme operations (RIQM Plus)

AREA 7: COMMUNICATION AND ENGAGEMENT

The standard

To qualify for RIQM, a pension scheme will need to be communicating actively with its members – and to an extent publicly – about its work and delivery in responsible investment.

Often, RI is a way of making investment real for members: rather than talking just about numbers traded on markets, it is about the impacts that investment approaches and portfolios can have on the real world. Communications about RI are therefore an opportunity to deliver greater member engagement, especially if tailored to those issues that members especially care about. RIQM schemes take this opportunity to the extent relevant for their nature and the regulations they face.

Best practice rationale

RI matters to many members. As a further reflection of the way in which RI is closely associated with fiduciary duty and effective delivery for members over relevant time horizons, pension schemes should be transparent in their communications and reporting on RI activities.

Expected evidence

The underlying proof point for this requirement is that RI is a clear and integrated element of all key investment and benefits reporting to members. It should be used in a narrative way to communicate the story of investment and its real-world outcomes, as well as how it reflects the governing body's understanding of member interests. Where appropriate, this communication should invite further member engagement.

Specific evidence to support demonstrating delivery against this standard might include:

- RI policies (setting out how the intentions stated in the statement of investment principles or equivalent are put into practical effect) clearly articulated and set out in a separate document available to all members
- Framing of disclosure by in-depth discussion of two or three key areas of major concern to members; use of case studies as relevant
- Section of website dedicated to RI
- Active invitation of member feedback on reporting
- Public voting disclosure freely available on website (RIQM Plus)
- Standalone RI report (RIQM Plus)
- Inclusion of some real-world impact metrics (RIQM Plus)
- More informal communications to members through newsletters, or similar tools (RIQM Plus)

CONSULTATION RESPONSES

Please send us your comments and feedback on these proposed standards by 3 September 2021.

We are particularly interested in the following points:

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