Putting stewardship into practice

Stewardship can be a tricky issue in pensions. Scheme investment chains are sophisticated, globalised and highly intermediated. On top of this, the law is widely framed, leaving trustees with a lot of flexibility, but arguably little specific direction, over what to do. This can make it hard to know where, or even whether, to start. In this article we explore the legal rationale for pension scheme stewardship, some challenges, and some pointers for putting it into practice.

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Introducing stewardship

Why should trustees be proactive about stewardship? A definition helps us to answer this question. The Financial Reporting Council's UK Stewardship Code 2020 describes stewardship as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, environment and society". For trustees, two key points emerge from this:

- Stewardship's purpose is to create or preserve "long-term value" within an investment portfolio. This value-driven objective is well aligned with trustees' core 'mission', which is to invest scheme assets in order to provide members with their retirement benefits.
- Stewardship is not limited to environmental, social and governance ("ESG") matters. Considerations such as investee capital structures or financial performance are also valid stewardship themes, as investment legislation makes clear.

There are other legal prompts to look at stewardship too. *Reporting on Stewardship and Other Topics through the Statement of Investment Principles and the Implementation Statement* (2022) is Government statutory and non-statutory guidance for occupational pension schemes. There isn't space to summarise it here but it promotes detailed public disclosures around stewardship and, in effect, calls on trustees to publicly justify their approach. It is genuinely ambitious and wide-ranging. Indeed, the industry may not have fully appreciated its significance yet. Separately, schemes in scope for mandatory climate reporting are likely to need to cover climate-related stewardship activity in their annual climate governance reports.

In our view, this means stewardship is a legitimate part of the trustee investment toolkit and an important component of trustee legal duties.

Getting started

The 2020 UK Stewardship Code also gives practical examples of stewardship actions including: investment decision-making, actively monitoring service providers, engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights.

However, it's important to note that there is no requirement for trustees to practise stewardship across all issues at all times. Instead, a variety of sources recommend two key steps:

- Identify priority stewardship themes that are expected to have the greatest impact for the scheme's portfolio. As noted above, this could be financial topics such as investee leverage ratios or management incentivisation, but could also be climate change or modern slavery, for example.
- Develop clear processes for implementing stewardship. This will include both reporting packs from investment managers and an 'escalation strategy' of pre-agreed issues and triggers for different levels of stewardship intervention. These interventions can range from informal conversations and expressions of wishes from the trustees, to much stronger steps such exercising legal rights attaching to assets or, in extremis, disinvestment or termination of an appointment.

We acknowledge that stewardship experiences can vary between asset classes at present. In equities there is already a fairly well-developed reporting and voting ecosystem, though there is a lot of sectoral variation. In 2023, the Church of England Pension Fund disinvested from certain carbon-intensive equities, but only after a period of prior engagement with the companies around their climate transition. This is a real-life example of climate change as a stewardship theme and a connected escalation strategy being implemented gradually over time. Another example is NEST's climate change risk policy from December 2022, which details their climate stewardship and escalation approach.

Stewardship is possible outside equities but it will look and feel slightly different, as the box below outlines.

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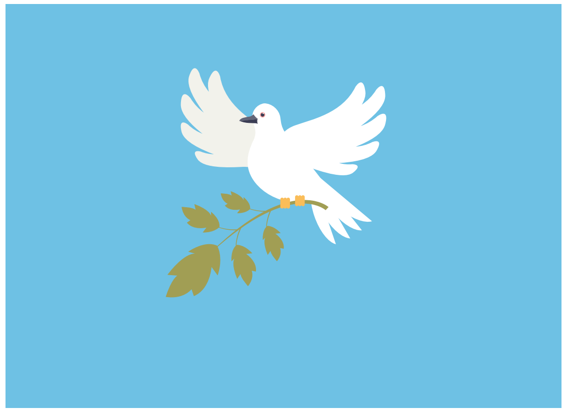
Approaches to fixed income assets stewardship

The fixed income market has grown in importance, particularly as defined benefit schemes have shifted allocations away from equities in line with market trends and regulation. The market is evolving, and while fixed income investors are not the ultimate owners of companies, they nevertheless provide substantial amounts of capital and can therefore play an important role in promoting effective stewardship.

However, unlike equities, investors in fixed income assets do not automatically have a right to vote. Historically this has driven a slower uptake in effective stewardship in fixed income. This is now changing. Here are some different approaches that we have seen pension schemes use in this space:

i. *Only permitting investment in bonds which have a ESG score[1] among the top 80% of the respective sector;*
ii. *Sending annual letters to key issuers in the industry to highlight their investment approach and flag the relevant issuer's current ESG score;*
iii. *Reducing investable limits in a single issuer where the issuer has a poor ESG score;*
iv. *Declining to participate in a primary issuance where their credit analysis showed that the pricing of the new bond did not adequately compensate investors for the current ESG risks and broader credit risk;*
v. *Raising concerns in an initial engagement meeting and then providing feedback to the issuer where there has been insufficient progress on those matters to warrant further investment; and*
vi. *Including the above (as applicable) in investment documents to ensure that investment managers are contractually bound to comply with the relevant steps on behalf of the trustees.*

[1] ESG scores are a measure of how a company addresses ESG issues in its day-to-day operations. Key ratings agencies include Bloomberg and S&P, which use various criteria to evaluate whether a company is effectively managing ESG risks.



Working with managers

Whatever the asset class, it is often necessary to leverage investment manager services and experience in order to deliver stewardship activity on the ground. In this context, it's important for trustees to reflect upon their commercial relationship as the manager's client, and the environment the managers operate within, since these will influence the art of the possible. As always, the starting point is to ask questions.

In the UK, managers are required to publicly explain their commitment, if any, to the 2020 Stewardship Code. This may help may inform trustees of the stewardship exercised by their managers. Another sensible step is to scrutinise how effectively existing managers are plugged into their asset class(es) ecosystem for stewardship and how active they are within it. Case studies are helpful, but a consistent run of quantitative data is even better. The Association of Member Nominated Trustees voting red lines is one example of free template industry voting guidance that could be used for benchmarking, but others are available too. Specific to carbon-emissions related data, most UK managers are required to either make public disclosures or provide disclosures on investor request on climate-related matters under the framework of the Task Force on Climate-Related Financial Disclosures.

In an international context, access to information may be more challenging. There are some mandatory frameworks that require disclosures about stewardship, such as the EU Shareholders' Right Directive (specific to listed equities). But not all international asset managers are subject to requirements to provide information about stewardship, leaving this instead to a commercial negotiation between the trustee and the manager. Voluntary disclosures, such as where the manager is a signatory to the UN-supported Principles for Responsible Investment, may help. But early conversations are likely to be important to ascertain an asset manager's specific commitments and reporting, which in turn can help trustees when negotiating terms for a specific investment, including to set stewardship requirements.

Planning for accountability

Stewardship activities are publicly disclosable in various pension scheme documents including the annual implementation statement. This can create new accountability risks for trustees, including media repercussions for the scheme and potentially its sponsoring employers and a developing risk of member legal claims (sometimes backed by NGOs or activists). There are cost and reputation considerations even if such litigation ultimately fails, and this is a trend we are watching closely together with many schemes. In our view it makes sense to develop stewardship policies with trustee accountability in mind right from the outset.

Conclusions

Pension scheme stewardship is supported by law, strongly encouraged by guidance, and feasible in practice if planned thoughtfully and collaboratively. Above all, it's important to work actively, being realistic about what a scheme will do and when. Success depends on making sure trustees, advisers and managers are on the same page and committed to ensuring that planned activity is delivered.