Government Actuary's Department

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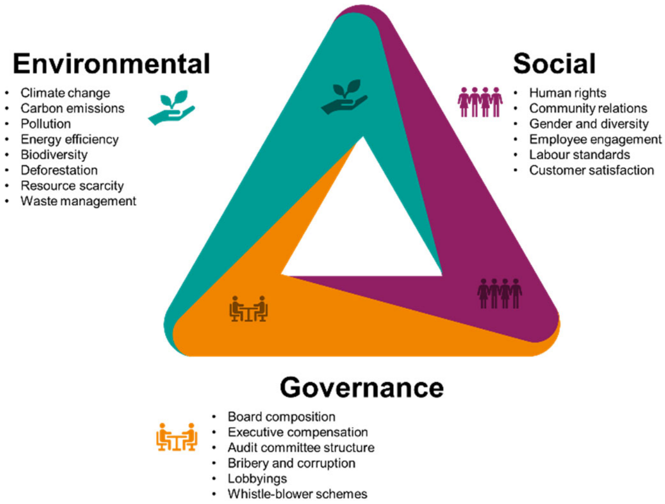
Investment Bulletin

In the second article of a series on risk management for defined benefit pension schemes, we discuss the increasing requirement for schemes to consider Environmental, Social and Governance factors.

What are ESG criteria?

With an increasing focus on sustainability, **Environmental, Social and Governance (ESG)** factors are becoming increasingly important considerations for investors in terms of both evaluating investments opportunties but also influencing corporate decisions as shareholders. **Environmental criteria** consist of looking at a company's performance as a steward of nature, the environmental risks they face and how these are managed. **Social criteria** are used to examine how a company manages relationships and its impact on communities whilst **governance** deals with issues such as executive pay, audits and shareholders' rights. Examples falling under each of the criteria are shown to the right.



Requirement for pension schemes to consider ESG factors.

It is becoming increasingly common for investors to consider ESG factors and pension scheme investment is no exception. The Department for Work and Pensions has proposed that from October 2019, trust-based pension schemes will need to say how they account for financially material ESG considerations, including climate change, and outline their policy on engaging with companies they have invested. Previously schemes have only been advised to consider these. Schemes will also need to acknowledge and consider their members' views on ESG risks and be allowed to account for non-financially material ESG considerations where there is general member agreement.

What does this mean for scheme investment returns?

As the UK is a world leader in ESG fund management, UK pension schemes already benefit from having access to a wide range of approaches and opportunities. There are many that argue that consideration of, and allowance for, ESG factors in a pension scheme's strategy should not reduce investment performance and may even result in better performance. For example, more sustainable companies are likely to be more robust and resilient to any necessary changes arising in the future from climate change issues which increases their profits and returns over the long run. Alternatively, companies with better governance are more likely to be better at identifying, managing and mitigating financial risks relating to such factors. The increased requirement to consider ESG factors may require further consideration and oversight for pension schemes. It's argued that it is beneficial for consideration of ESG to become part of the usual investment process that should pay off in the long run as schemes should see greater and more stable returns for more sustainable companies.

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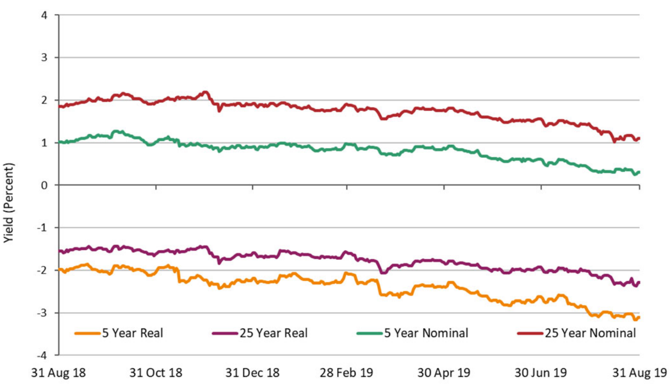
This month in brief

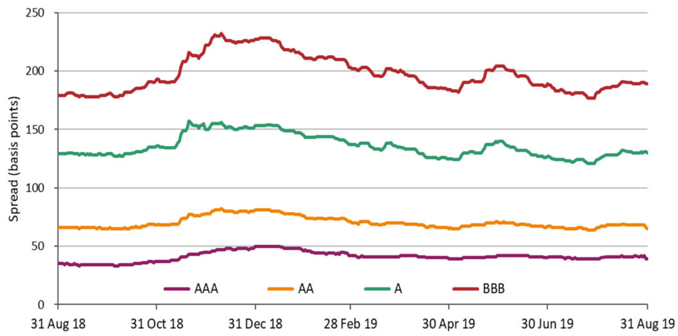
The pound rose slightly against the euro over August, the exchange rate being €1.10 at the end of August. This follows a month of instability for the pound, with the exchange over the month being largely dependent on the ongoing discussion of a deal. The relative strength of the pound at month end is attributed to the discussion of a deal by the German Chancellor, Angela Merkel. House prices fell in August as consumer confidence dropped amidst the Brexit related uncertainty. The drop in consumer confidence was reflected in other industries, such as retail.

Inflation dropped to its' lowest level in 2 and a half years at 1.7%, well below the Bank of England target of 2%. This follows a drop in the price of recreational goods, including games and sea fares. This is good news for savers as it means there are more savings accounts available with interest rates above the rate of inflation.

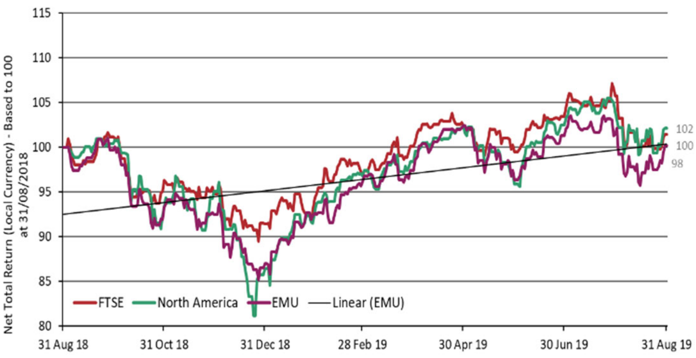
Real and nominal yields on short term bonds dropped slightly over the month.



Credit spreads of lower rated bonds rose over the month.



Equity markets fell over the month.



Real and nominal yields are slightly lower than last month.