Summary
- The BP Deepwater Horizon oil spill in 2010 is an example of an unforeseen environmental disaster that was extremely costly for pension fund schemes invested in the oil company.
- Investors are increasingly aware of ESG issues, but their views on what constitutes a risk can be subjective – what is viewed as a governance risk by some members, might not be by others, so it is the job of trustees to weigh up which is financially material to the scheme.
- Exposure to certain regions, such as emerging markets, can leave pension schemes vulnerable to ESG controversies, through direct and indirect investments, requiring more thorough due diligence and reporting.
- Voting and engagement policies are a way for pension fund investors to take action to minimise exposure to unexpected ESG events.

How to prepare for the unexpected

ESG disasters or events are more scrutinised than ever, but can't always be foreseen, as pension fund investors know all too well

In pensions, as in life, unforeseen events or circumstances are not only a nasty shock, but the financial consequences can be far-reaching and reputationally damaging.

Historically, pension fund investors have been exposed to several environmental, social and governance (ESG) scandals or incidents, including the BP Deepwater Horizon oil spill in 2010. In the immediate aftermath, BP's market value more than halved, while clean-up costs faced by the oil giant ran into the 10s of billions of US dollars.

At the time, UK pension schemes invested in BP were encouraged and eventually able to pursue recovery of losses suffered as a result of the disaster but, by this stage, the damage was already done.

Closer to home, the cladding scandal affecting high-rise residential developments, which came to light following the Grenfell Tower fire in London, has left many trustees footing the bill for repairs that have dragged on for years.

"One of the challenges of investment is ensuring that the risk of being exposed to unforeseen events, such as the BP Deepwater Horizon disaster, is minimised, given the potential impact on returns that can arise through making reparations for the losses incurred and the associated reputational impact," says Hymans Robertson head of responsible

investment, Simon Jones.

While it is impossible to prepare for every eventuality in life, thorough due diligence on behalf of pension fund members can mitigate some of the most extreme and costly consequences of unexpected ESG-related events.

Monitoring, managing, mitigating

Barnett Waddingham partner, Chris Binns, says: "By their very definition, 'unexpected consequences' are hard to predict and, therefore, monitoring, managing and mitigating the risks of 'unexpected consequences' can be very difficult."

He adds: "This has been highlighted by unexpected consequences linked to key recent events – including Covid-19, the war in Ukraine and extreme weather events, to name a few – whereby externalities have been internalised, and investors have been required to view risks holistically."

One of the biggest challenges for pension fund investors is understanding not only where they are directly exposed through their investments, but also where they are indirectly exposed to ESG risks.

As Binns points out, this is complicated by the intricacy of global supply chains, the complex structure of companies, and even the reliance on emerging markets, which "tend to be more exposed to ESG and controversy risks".

He also points to differing public views and perceptions on what constitutes ESG and sustainability issues.

Indeed, there is general agreement that alignment with ESG initiatives, such as the UN's Sustainable Development Goals, will help reduce exposure to potentially catastrophic events. But, in reality, investing on behalf of so many investors will mean taking positions in companies that some might consider more of an ESG risk, and therefore be less comfortable with, than others.

Independent Trustee Services director, Tegs Harding, explains: "There are thousands of positions in a large pension scheme portfolio, and it simply isn't possible for trustee boards to get under the bonnet of every single one."

"Even if you could, these issues are subjective and it's difficult to know which issues could prove to be a financial risk, and whether any mitigating steps a company is taking are sufficient."

She adds that what makes it hard to apply any policy or approach consistently is the fact that many schemes invest globally, "and there are significant cultural differences in social issues".

Responsible stewardship

More than ever, there is growing scrutiny of pension funds' holdings, often because

"Trustees need to ensure that sufficient information is available to effectively assess potential risks and to exercise stewardship through engagement with organisations"

of media coverage of the fallout from events. This, in turn, has helped investors become more aware of the wider impact of their investments. That impact might be the cost to the environment, or the financial cost, but it can also take the form of the human or social toll of an event.

Ndapt managing director, Marcus Hurd, is under no illusion that pension scheme trustees are asset owners.

"Although they hold the scheme assets for the benefit of others, namely scheme members, they are responsible for the stewardship and consequences of the assets they hold," he says.

"It behoves trustees to act as responsible investors. Delivering sound financial returns is important, but so is acting as a responsible steward."

However, he acknowledges there is a balance to be struck between "sensible" financial investment and what he calls "ESG evangelism".

"Trustees must remember that their duty is to act on behalf of the pension scheme members they represent. Scheme assets are not personal wealth, where decisions can be made purely on philanthropic grounds," adds Hurd. "Rather, a trustee must – to the extent their asset holding permits – balance making sound financial investments with the responsibility of being an asset owner."

Taking action

Fortunately, trustees can ensure they are investing in a way that best represents their members' ESG principles without compromising on financial returns.

Doing it is one thing, but demonstrating it is another, as recent research published by XPS Pensions Group found.

The research revealed that 81 per cent of fund managers now have a net-zero commitment in place, up from 41 per cent in the previous year. However, less than a quarter (22 per cent) could demonstrate a credible plan within specific funds to meet their firm-level commitment.

In addition, 31 per cent of fund managers could not provide any examples of how they integrated ESG into their funds, according to XPS.

The key, then, is transparency and provision of information.

Jones says: "In conjunction with their investment managers, trustees need to ensure that sufficient information is available to effectively assess potential risks and to exercise stewardship through engagement with organisations."

"This serves as both a primary risk control, but also a means for understanding the rectifications that can be put in place should an event occur. The process of stewardship can, therefore, serve to improve behaviours by ensuring companies are challenged to meet best practice, both in what they do and what they disclose."

Importantly, Jones adds that where the direct consideration of savers' views may differ to those issues which trustees have identified as financially material, there is currently no legal requirement for trustees to consider them.

"However, it's important for trustees to understand what their stakeholders think, so they are better equipped to communicate effectively on the actions they are taking," he says.

Jones suggests that trustees can use members' views on the "real-world impacts arising from social and environmental issues" as both a tool for further engagement, but also as the basis to demonstrate the positive outcomes that pension savings can create.

Harding agrees that trustees can take some useful action on social issues in their voting and engagement policy.

"This means making sure the asset manager that invests on their behalf is voting in a way that is consistent with their ESG policy and engaging with them, and taking action if it isn't," she says.

Robust due diligence

Even with the best intentions, pension scheme trustees and their members will inevitably be caught unawares at some point by an event or accident that could simply not have been expected.

Despite this, ongoing monitoring of fund holdings and interaction with investee companies to ensure they are being held to account for their actions will help minimise the financial and reputational fallout.

Binns says that investors delegating day-to-day investment decisions to asset managers should feel comfortable that the due diligence and research undertaken by their managers is robust, "allowing them to quantify such risks".

He adds: "Investors should also have confidence that their asset managers' investment processes allow them to integrate and react to such risks, as appropriate."