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What's been happening and what's on the horizon in the world of pensions

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In this edition of Pensions Watch we look at the S, the social, in Environmental, Social and Governance (ESG) and why, despite perceptions to the contrary, it shouldn't be the almost silent consonant or the poor relation to the E and the G.

The almost silent S in ESG

The financial implications of Environmental, Social and Governance (ESG) risk factors are becoming increasingly important considerations in pension schemes' investment decisions. Not least as these issues become more pressing, as a result of a broader societal focus, increased regulation and their management becoming ever more critical to the success of scheme outcomes.

Indeed, since 1 October 2019, trustees of UK occupational pension schemes have had to set out how they take account of all financially material risks. Crucially, these include material ESG risk factors.[1] However, despite accounting for nine of the UN's 17 Sustainable Development Goals (SDGs),[2] many schemes, having successfully incorporated the environmental, notably climate, and corporate governance aspects of ESG into their investment processes, continue to struggle with explicitly analysing, managing and embedding social factors into investment strategies. This is partly a consequence of social factors being seemingly difficult to define and quantify.

What are social risks?

Social risks, although wide ranging, principally relate to people, starting with individuals' basic human rights. These comprise how people work, whether they suffer unfair or unsafe working conditions, whether they're allowed to associate with who they like and are free from bonded labour. In recent years, numerous suppliers to equally numerous high-profile companies have been called out for blatantly compromising these basic principles. Not only have the reputations of the latter been compromised, so have the integrity and sustainability of the latter's operations. As such, social issues are intrinsically linked to corporate governance issues. Likewise environmental issues. For example, the considerable spend required on education, training and reskilling if at or near to full employment is to be maintained in a just transition to a net zero emissions economy.

Then there's social inequality – a term which typically crops up when speaking about the world's less well developed economies but which equally applies to the rich OECD nations, such as the UK. Social inequality defines the extent to which differences exist between distinct groups in society. Resulting in an unequal distribution of income and wealth,[3] life chances, health, morbidity (healthy life expectancy) and life expectancy, factors such as gender, age, ethnicity, education and training, economic empowerment,[4] location, housing, communities and access to medicine all play their part.[5] In short, if you can solve inequality, you solve core social issues. Indeed, at a macro level, if left unaddressed, deeply engrained social inequalities and regional

[1] The greater focus on ESG risk factors follows from the recommendation of the Law Commission in 2017 that trustees should be required to state their scheme's policies on evaluating long-term investment risks and on the scheme's approach to stewardship. The UK government subsequently consulted on changes to the disclosure requirements relating to ESG issues, which led to an effective widening of trustee fiduciary duty to include material ESG risk factors. Indeed, since 1 October 2019, all trust-based schemes must include within their Statement of Investment Principles (SIP), details of how all financially material considerations are taken into account in the selection, retention and realisation of investments. Moreover, since 1 October 2020 and 2021 respectively, DC and DB trust-based schemes have been required to include an implementation statement in the scheme's annual report on how and the extent to which the SIP has been followed in the scheme year.

[2] These SDGs comprise: 1. No poverty; 2. Zero hunger; 3. Good health and wellbeing; 4. Quality education; 5. Gender equality; 8. Decent work and economic growth; 10. Reduced inequalities; 11. Sustainable cities and communities, and 16. Peace, justice and strong institutions.

[3] Social inequalities can be quantified by the magnitude of the Gini co-efficient (the statistical dispersion) applied to a nation's distribution of income and/or wealth.

[4] Economic empowerment defines the extent to which people are in control of their own economic destiny.

[5] There are also the unintended consequences of economic progress on inequality, resulting from ever-increasing automation and digitisation, on jobs within certain industries.

disparities will inevitably hold back economic development, productivity and ultimately economic growth – a point recognised by the UK government in seeking to implement a widescale, and much publicised, levelling up policy.[6]

Levelling up will, of course, require the deployment of significant public sector resources and know how to address marked regional, gender, cultural and intergenerational disparities that exist across the UK's towns, cities, rural and coastal areas. However, such an ambitious agenda can only be achieved with the added monetary clout of private sector, principally institutional asset owner – including pension fund – money, and only if the returns are sufficiently attractive and the risks acceptable.

Notable areas of investment, for which pension funds are ideally placed to invest, typically via pooled funds,[7] include social bonds, affordable housing and much improved social (and economic) infrastructure, especially in the more deprived areas of the UK. Indeed, each prospectively offers pension schemes the financial rewards they seek from asset ownership, without the social risks inherent in many traditional investments, while targeting well defined social impacts, or outcomes. Crucially, in each case, the preconception that one needs to sacrifice financial returns in order to achieve positive social outcomes simply doesn't hold.

Social bonds

Social bonds, as distinct from other "specific use of proceeds" bonds, such as green and sustainable bonds, are defined by the International Capital Markets Association (ICMA) as, "use of proceeds bonds that raise funds for new and existing projects with positive social outcomes." Helpfully, the ICMA's Social Bond Principles, published in June 2017, provide guidance to issuers on the process of issuing social bonds, including the types of projects that qualify as social projects and the level of disclosure that should be provided to investors.[8]

Social bonds really came into their own during the global pandemic, with governments, supranational entities and corporates across the world raising funds through this mechanism, in order to exclusively channel the proceeds to pre-identified projects with defined social outcomes aimed at alleviating the pandemic. These included health care support, education and job preservation, with issuers including the World Bank, African Development Bank, Inter-American Development Bank and Council of Europe Development Bank. Indeed, the speed and volume at which the social bond market responded at this time of need was remarkable, proving that it was not only standing ready to respond to a social crisis, it was also capable of addressing the ramifications of the global pandemic.[9]

Now with such a strong foundation, the rapidly expanding social bond market is well positioned to provide the requisite support to yet another global imperative – achieving a just transition to a net zero emissions economy by 2050 – even though social considerations are not explicitly embedded in net zero analysis – through the financing of the necessary education, training and reskilling to maintain economic activity at or near full employment. Not that social bonds are all about financing the response to crises. Indeed, they have long been the go-to method of financing a whole host of initiatives with defined and measurable social outcomes.

Typically accessed by pension schemes through pooled investment funds that scrutinise and target both the financials and social impact credentials of issuers and issuance, social bond strategies' track records prove that one can do well by doing good by successfully achieving both a financial return and positive societal impact. In addition, typically being short-dated, social bonds can provide a social impact dimension to, increasingly popular, cash-flow driven investment policies.

Affordable housing

A key aspect of levelling up across the UK is the more widespread provision of quality, affordable private rented housing for low to middle income groups, not least key workers. This, so-called, Build to Rent housing, currently accounts for just 2% of the 4.4m homes that comprise the, unregulated and underserved, private rented sector. The latter, in turn, sits between the highly regulated and government-subsidised social housing sector, comprising 4m homes, and the UK's owner-occupied sector, which totals 15.5m homes.[10]

[6] Although the idea of "levelling up every part of the UK" was central to the government's 2019 election manifesto, the intervention of the global pandemic meant that implementation has been slower than anticipated. Indeed, it wasn't until October 2021, that the government revealed the successful bids for the first round of its £4.8bn Levelling-Up Fund, while the plan to achieve the targeted levelling up by 2030 wasn't unveiled until February 2022. See: Levelling up in the United Kingdom. The Department for Levelling Up, Housing and Communities (DLUHC). 2 February 2022. See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1052046/Executive_Summary.pdf
To quote from p.1 of this publication: "It is vital that we preserve and enhance the economic, academic and cultural success stories of the UK's most productive counties, towns and cities. But it is equally critical that we improve productivity, boost economic growth, encourage innovation, create good jobs, enhance educational attainment and renovate the social and cultural fabric of those parts of the UK that have stalled and not – so far – shared equally in our nation's success." p.3. continues with: "Levelling up is not about making every part of the UK the same, or pitting one part of the country against another. Nor does it mean dampening down the success of more prosperous areas… [Levelling up] will make the economy stronger, more equal and more resilient, and lengthen and improve people's lives. The economic prize from levelling up is potentially enormous. If underperforming places were levelled up towards the UK average, unlocking their potential, this could boost aggregate UK GDP by tens of billions of pounds each year. Levelling up skills, health, education and wellbeing would deliver similarly-sized benefits. Accumulated over time, those gains could easily surpass annual UK GDP." pp.4-5 identifies the six key "capital" drivers to achieving levelling up as being: 1. Physical capital – infrastructure, machines and housing; 2. Human capital – the skills, health and experience of the workforce; 3. Intangible capital – innovation, ideas and patents; 4. Financial capital – resources supporting the financing of companies; 5. Social capital – the strength of communities, relationships and trust, and 6. Institutional capital – local leadership, capacity and capability."

[7] EU, as opposed to UK, regulated pooled funds with a defined social impact are designated as either SFDR Article 8 or Article 9 Funds. The EU Sustainable Finance Disclosure Regulation (SFDR) is a set of EU rules, which came into force on 10 March 2021, that aim to make the sustainability profile of investment funds more transparent, comparable and better understood by end-investors. A so-called Article 8 (light green) Fund under SFDR is defined as "a Fund which promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices", while an Article 9 (dark green) Fund is defined as "a Fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective." In addition, an Article 9 Fund is required to assess the Fund's portfolio against the principle of "do no significant harm" by considering the principal adverse sustainability impacts (PASIs) of its investee companies. Based on preliminary data, Morningstar estimates that, as of March 2021, funds classified as Article 8 represent 18% of total European fund assets, while Article 9 account for 3.6%. See: Finding ESG Funds just got easier. Morningstar Research. 6 April 2021.

[8] See: Social bonds: The darlings of the post-pandemic world? Simon Bond. The DC Future Book: In association with Columbia Threadneedle Investments. The Pensions Policy Institute. 6th edition. September 2020. pp.53-54 and The Social Bond Principles. Voluntary Process Guidelines for Issuing Social Bonds. ICMA. June 2021.

[9] See: Simon Bond (September 2020). op.cit.

[10] Source: English Housing Survey 2020–2121; Savills Residential Property Forecast, Winter 2021.

Consisting of quality, energy-efficient, new-build apartments and houses, and offering a dynamic mix of permanently discounted and mid-market rents aligned to local average incomes,[11] with rent increases limited to inflation, the much-needed development of Build to Rent accommodation is evidenced by the sheer number of households effectively trapped in the private rented sector. For instance, 80% of private renters aged between 24 and 34 cannot afford either the deposit or repayments for a mortgage on the average house in their region. With average UK annual rental growth of 8.3%, buoyant house prices and rising mortgage rates, this isn't likely to get any easier any time soon.[12]

Although 70K Build to Rent units have been delivered to date, this number is overwhelmed by, and indeed fails to accommodate, even the 193K households who entered the private rented sector in 2020-21. As such, there remains considerable scope to accelerate Build to Rent developments to meet this untapped demand.

The principal means by which these developments and their subsequent operation are funded is via housing associations working with real estate asset managers. With the asset manager securing the funding and the packaging up of multiple developments into an evergreen pooled investment fund and working with the housing association to ensure the units are professionally managed, such investments appeal to those institutional asset owners seeking both a sustainable, long-term indexed-linked income stream and strong social impact credentials. Indeed, in addressing the growing demand for good quality, affordable, fit-for-purpose rental homes, targeting the UK's low to middle income working households, such funds reduce social inequality through a sustainable community-focused strategy.

Social infrastructure

Whereas infrastructure describes those facilities, structures and services that act as a foundation for economic activity, social infrastructure comprises those foundational services and structures that support a nation's social development and quality of life. Think schools, hospitals, universities, student accommodation, libraries, community recreation and leisure facilities and transport solutions – all of which have the potential to address social inequality, ultimately improving the nation's quality of life.[13] While in many countries, social infrastructure is almost exclusively provided by a central or local government, or related entities such as regional health boards and universities, in the UK, since the early 1990s, the development and provision of social infrastructure has been successfully delivered by Public-Private Partnerships (PPP). This, in turn, has opened up myriad investment opportunities for institutional asset owners, not least pension funds.

Of course, the overriding imperative for asset owners is ultimately to be rewarded financially for asset ownership. Once again, adopting a focus on those assets with strong social impact credentials shouldn't compromise the financials. And so it is with social infrastructure. In addition to offering very different return drivers to publicly traded assets, thereby acting as a genuine diversifier of equity and credit risk, many social infrastructure assets offer secure long-term cash flows, often with an implicit or explicit/contractual inflation linkage – a characteristic increasingly valued when faced with high single digit inflation. However, tapping into this opportunity set typically requires nimble investment governance if the associated risk premia are to be captured in a timely manner.

Why does this matter?

The almost silent S in ESG has recently been propelled into the spotlight, largely as a consequence of and the requisite responses to the global pandemic. Indeed, although we are only beginning to learn which long-term trends will emerge as a result of the pandemic, the heightened sensitivity towards social issues seems likely to stay. Consequently, this has led to social increasingly earning its rightful place in mainstream investing, alongside protecting the environment, capturing climate opportunities and employing robust stewardship to hold companies to account. In fact, the E, the S and the G are inexorably linked.

One misconception frequently aimed at the social, which is easily dispelled, is that which suggests the need to sacrifice financial returns in order to achieve positive social outcomes. This simply doesn't hold. Moreover, aside from many social impact investments offering very different return drivers to publicly traded assets, most offer secure long-term cash flows, often with an implicit or explicit/contractual inflation linkage. Of course, if left unchecked, social factors can not only introduce unwelcome financial risks into a scheme's assets but also significant reputational risk for the scheme and, quite possibly, its sponsor.

In other words, taking this risk and the return point together, it's readily apparent that social can no longer be the almost silent consonant or the missing part of the ESG jigsaw.

[11] Despite not attracting a government subsidy, rent levels target a household burden rate of less than 35% of gross household income.
[12] Sources: Office for National Statistics - Household disposable income and inequality in the UK: financial year ending 2021. 28 March 2022 and BMO Housing Strategies. BMO Real Estate Partners. June 2022.
[13] By contrast, economic infrastructure supports economic activity and is often characterised by 'user-pays' or demand-based revenue streams, such as tolls on toll roads.

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