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Consideration of social risks and opportunities by occupational pension schemes

A call for evidence

16 June 2021

About our response

In this document, Cardano Risk Management Limited (“Cardano” or “we”) respond to the consultation on “Consideration of social risks and opportunities by occupational pension schemes” as published by the Department for Work and Pensions (“DWP”) in March 2021.

Founded in 2000, the Cardano Group is a privately-owned, purpose-built risk and investment specialist. We are widely recognised as a market leader in the provision of specialised services to private-sector and collective pension schemes in the United Kingdom and the Netherlands. Our c. 350 professionals strive to deliver better and more secure financial outcomes: stability in an uncertain world.

For Cardano, sustainability areas of particular focus are:

- The climate crisis, including net zero carbon emissions by 2050, global emissions reduction of 50% by 2030. This informs our decarbonisation targets
- Fairer society, including respect and support for human rights and to fight against human rights abuses
- Sustainable development in emerging markets

Cardano has prepared our response in conjunction with NOW: Pensions (“NOW”) and Lincoln Pensions, both part of the Cardano Group.

For questions or comment, email Will Martindale, Group Head of Sustainability at: w.martindale@cardano.com.

Background to Cardano's beliefs

Cardano welcomes the consultation.

Social purpose is at the heart of who we are and what we do. Pensions enable working people to save for their retirement. The consideration of social risks and opportunities in pension provision is core to how we understand and run our business.

We approach sustainability from first principles. We are sustainable investors because it is the right thing to do.

Cardano's clients are overwhelmingly pension schemes. Their members and beneficiaries represent a broad swathe of society in the UK and Europe across industries, income levels, age groups and cultural and ethnic backgrounds. The youngest members of these schemes may be over 50 years away from retirement.

Many of them will have families who will live into the next century. We believe that our clients' members and their dependents should enjoy a quality of life similar to or better than that possible at present. This should be in a sustainable and less polluted environment within a fairer society where they can enjoy financial security.

In recent years, the DWP, TPR and industry groups, such as IIGCC, have developed practical investment frameworks that allow us to understand the risks associated with climate change – and to invest in a way consistent with the UK's commitment to net zero carbon emissions by 2050. For example, we note the growth of the green bond market, as well as the success of industry initiatives, such as Climate Action 100+[1].

To date, there has been less regulatory attention to social risks and opportunities. In our experience, it is not common practice for pension schemes to have a standalone policy on social factors, indeed, nor for most pension schemes to specifically mention social issues (other than within the context of ESG factors more broadly).

Rather, most pension schemes have focused their sustainability efforts on climate change first. This is, perhaps in part, because social risks and opportunities are more difficult, and in some cases impossible, to quantify. When it comes to social issues, there is not the same political urgency; nor is there the same consensus on the problems we're trying to solve. Social issues are often context specific.

This, however, doesn't lessen their importance.

[1] https://www.climateaction100.org/

Cardano welcomes regulation on integrating financially material social risks and opportunities in investment decision-making.

We favour regulation because terminology, implementation and disclosures are fast-evolving, and, in our experience, often incomplete. This leads to inefficiencies. We are unable to consider social risks and opportunities to their fullest extent. Effective regulation can help resolve this.

Regulation also rewards first-movers, levels the playing field and – most importantly – raises minimum standards. By implementing their commitments to social risks and opportunities with sufficient scale and depth, UK pension funds can accelerate the attention to social issues through the investment chain – here in the UK, and indeed, in the international markets in which we invest.

The "TCFD" for social risks

We believe the DWP should introduce similar regulatory structures to those used for climate change. For example:

- We believe the DWP should clarify governance requirements on social risks and opportunities, including investment policies, trustee skills, integration and disclosure. In doing so, we would welcome further TPR guidance.
- We also believe the DWP should set out key metrics requirements on social risks and opportunities, with reliable information flows: The TCFD for social risks, if you will.

We would encourage the DWP to base its regulatory requirements on the best available international frameworks. This includes, but is not limited to:

- The International Labour Organisation
- The OECD Multinational Enterprise Guidelines on Business and Human Rights
- The UN Guiding Principles
- The UN Global Compact

We would also encourage review of the EU's Sustainable Finance Disclosure Regulation, and in particular, Principle Adverse Impact disclosure requirements.

The social risks and opportunities we are prioritising include:

- Human rights
- Modern slavery
- Child labour
- Diversity and inclusion, including, but not limited to gender

- Working conditions
- Employee relations

We will also look at social factors particularly relevant to pensions. We provide further details in our response below.

Rooted in the SDGs

We believe the UN Sustainable Development Goals (SDGs) provide the best-available set of indicators we have for understanding social risks and opportunities. For example, SDG 5: Gender Equality, includes indicator 5.5, which states, "ensure women's full and effective participation and equal opportunities for leadership at all levels of decision-making in political life". Disclosure against this indicator would help advance gender equality in the UK.

We believe gender inequality represents a material financial risk. The SDGs provide a framework for which we can measure and manage social risks and opportunities.

Further attention to social risks and opportunities

Finally, we believe there are three important additions to the DWP's consultation:

1. There is no mention of the need for trustees of DB pension schemes to also understand the potential impact of social risks on the employer covenant provided by the sponsoring company. The employer covenant is likely to be a DB pension scheme's most material single asset and brings significant idiosyncratic risks to every scheme (including in relation to social risks). We believe that it is essential that the exercise of understanding an in-scope DB pension scheme's social risks and opportunities are extended to also cover the impact of social risks on the employer covenant[2].
2. We encourage the DWP to work with FCA, BEIS and others to support corporate disclosure requirements on social risks and opportunities. We want harmonized (standardised, comparable and audited) information flows (downstream and upstream) through the intermediation chain on social risks and opportunities. We recommend disclosures include a look through to supply chains: the scope 3 'equivalent' of social risks.
3. We encourage the DWP to work with investment groups (such as the UN PRI or Walk Free[3]) to facilitate a "Net Zero" pledge equivalent on social risks and a "Climate Action 100+" initiative equivalent on social risks, where UK pension funds can collaborate to engage companies with the largest social risks and opportunities.

[2] See Lincoln Pensions response to the consultation for more details

[3] https://www.walkfree.org/reports/beyond-compliance-in-the-finance-sector/

The topics raised in this consultation are close to our heart. We make ourselves available to the DWP and the minister. We congratulate the DWP on issuing this consultation – we hope the DWP takes the steps necessary to ensure social risks and opportunities are given the attention they deserve.

Responses to the questions

In addition to the comments above, we provide further details in response to the questions asked in the consultation. We recommend the DWP review both the comments above and the answers to the questions in conjunction. We have grouped questions to avoid duplication.

1. Does your pension scheme, or do schemes you advise, have a policy on financially material social factors? In this policy, are social factors discussed separately to ESG factors in general?

No. In our experience, it is not common practice for pension schemes to have a standalone policy on social factors, indeed, nor for most pension schemes to specifically mention social issues (other than within the context of ESG factors more broadly).

Rather, most pension schemes have focused their sustainability efforts on climate change first. This is because there are more comprehensive data sets, choice of investment products and clarity on the methodologies to measure social factors. This is not the case for social issues. There is not the same political urgency; nor is there the same consensus on the problems we're trying to solve. In addition, social issues are often context specific.

At Cardano, we do not have a standalone policy, but we do discuss social factors within our sustainable investment policy.

For example, the social issues we have prioritised are:

- Promoting a Fairer Society: We support the ideals of western liberal democracies. We respect and support human rights globally and seek to fight against human rights abuses. We will look for ways to improve societal outcomes in the UK and the Netherlands, promoting diversity and inclusion and enhancing the wellbeing and financial security of our clients' beneficiaries and their families.
- Sustainable Development of Emerging Markets: We support the sustainable development of nations in the emerging world, who are most vulnerable to the effects of climate change transition and where impactful change can be most meaningful, in close alignment with the objectives of Cardano Development.

2. Does your scheme, or do schemes you advise, have (a) a stewardship policy and/or (b) a voting policy that specify covering social factors?

No. For the reasons covered above, social issues are often context specific and asset-class specific.

At Cardano we review the stewardship and voting policies of investment managers as part of the manager engagement process. We set out our approach to manager engagement in response to question 6, below.

3. On which social factors do your scheme's investment and stewardship policies focus? What was the rationale for deciding to focus on these particular social factors? Do you refer to any international standards, such as those relating to human rights or labour rights?

We focus our resources where we are passionate, knowledgeable and can have an impact. The social risks and opportunities we are prioritising include:

- Human rights
- Modern slavery
- Child labour
- Diversity and inclusion, including, but not limited to gender
- Working conditions
- Employee relations

We are also looking into the social areas closely tied to pension provision, including but not limited to: social housing, financial inclusion, provision of older age care, health care, including health science, wellness, and mental health. These are new topics to us (and the investment industry more broadly) but they are topics where we believe we can practically make a difference.

We refer to international standards in our sustainable investment policy and activities. We believe the DWP should review (and incorporate):

- ILO standards
- OECD Multinational Enterprise Guidelines
- UN Guiding Principles on Business and Human Rights
- UN Global Compact
- EU SFDR Principal Adverse Impacts

In addition, we participate in the Diversity Project, which undertakes action to accelerate progress towards an inclusive culture within the investment and savings profession. If not already, the DWP should review the Diversity Project's activities and resources.

4. Which resources have you found useful when seeking to understand and evaluate social factors either for your scheme or a scheme you advise? Do you feel that you have sufficient understanding of how companies perform on social issues?

We highlight the following research reviewed by our staff:

- Why and how investors should act on human rights, PRI, 2020[4]
- Finance Against Slavery and Trafficking (FAST), Liechtenstein Initiative, 2019[5]
- Beyond compliance in the finance sector, Walk Free, 2021[6]
- The Truth About Modern Slavery, Kenway, 2021
- Just Business: Multinational Corporations and Human Rights, Ruggie, 2013

As well as, of course, NOW: Pensions' research on the Underpensioned. While this relates to pension provision, many of the themes identified are relevant to investment:

- Underpensioned, NOW, 2020

We incorporate MSCI ESG data in our investment decision-making, which includes a range of social indicators.

5. What approach do you, or the trustees you advise, take to managing the (a) risks and (b) opportunities associated with social factors? Why have you chosen this approach?

We discuss ESG issues in our trustee meetings, through trustee training and supporting our clients with their annual implementation statements. To date, this has tended to focus on climate change.

We assess our third-party managers on policies, integration, engagement and reporting on ESG issues. We set out our approach to manager engagement in response to question 6, below.

Focus on the SDGs:

In our sustainable investment policy we also set out our approach to the SDGs and human rights. We believe the SDGs provide the best available framework for understanding real-world impact. We see clear overlap between the integration of ESG risks and opportunities and the SDGs.

We distinguish between the two as follows:

- ESG issues are associated with risk management. ESG issues capture the way in which companies and funds are responding to the sustainability transition. The focus is from the outside world to the investment decision: How the sustainability transition affects risk and return

[4] https://www.unpri.org/human-rights-and-labour-standards/why-and-how-investors-should-act-on-human-rights/6636.article
[5] https://www.fastinitiative.org/
[6] https://www.walkfree.org/reports/beyond-compliance-in-the-finance-sector/

- The SDGs are associated with real-world impact. The SDGs set the global goals for society and all its stakeholders – including investors. The focus is from the investment decision to the outside world: How the investment decision contributes to, or hinders, sustainability goals

We encourage our managers to use the SDGs as a framework for their investment activities, and to disclose to us on how their investments support the aims of the SDGs.

Focus on human rights:

There is a growing visibility and urgency around human rights issues, and the role required from businesses, including their investors. Human rights have been at the forefront of policy reform in the UK, Netherlands and Europe.

We support and respect human rights, and fight against human rights abuses, as such, we:

- Commit to UN Global Compact principles
- Adopt minimum safeguards in our investment activities, including (but not limited to) UN Guiding Principles on Business and Human Rights and OECD Multinational Enterprise Guidelines
- Prioritise diversity and inclusion including, but not limited to, targets on gender
- Undertake a modern slavery assessment, taking mitigating action where necessary

Business and human rights frameworks distinguish between the type of investment activity and use the following terminology:

- “has caused”
- “has contributed to” or
- “is directly linked to” human rights issues

“Has caused” would relate to our own business activities, and we expect this would be low probability for Cardano. “Has contributed to” would relate to a direct investment (for example, through our LDI or strategy investment). Again, we would expect this would be low probability.

“Is directly linked to” would relate to an external investment, and we think this has the potential to be higher probability, across equity, fixed income, private equity, infrastructure and property funds. As such, we prioritise our human rights activities on our third-party manager research and oversight.

We use OECD Multinational Enterprise Guidelines, UN Global Compact and UN Guiding Principles on Business and Human Rights, as well as guidance from the UK Equality and Human Rights Commission and the EU’s do no significant harm and minimum safeguards frameworks.

6. If this is delegated to asset managers, how do you ensure and monitor that they manage the risks and opportunities associated with social factors?

Our approach encompasses all investment strategies. However, we recognise that ESG issues, and social factors in particular, have a greater impact on some investment strategies than others and that some managers are able to exert a higher degree of influence and engagement than others.

For example, managers investing directly in single name equities and credit will have greater focus than managers investing synthetically through derivative instruments. That said, minimum standards will apply to all managers. We therefore divide investment strategies into high and low focus as follows:

Focus	Example Strategies
High	• Equity and credit strategies • Private equity • Property
Low	• Derivatives-based strategies/LDI • Highly diversified strategies • Systematic trading strategies

Next, we assess managers across four areas:

- Policy – does the manager have a sustainable investment (or equivalent) policy in place, what's included in the policy and how is it implemented
- Integration – does the manager integrate ESG issues in investment decisions, are ESG issues integrated throughout the investment life-cycle, and is the manager prepared to exit an investment if the asset does not meet ESG-related expectations
- Engagement – does the manager engage the investee companies on ESG issues, is the manager a signatory to a stewardship code (or equivalent), and how has the manager voted on ESG issues?
- Reporting – does the manager report on ESG issues, does the manager report on climate-related metrics, such as greenhouse gas emissions, and does the manager disclose (or intend to disclose) against the TCFD recommendations?

Based on our assessment we score the manager:

- Strong
- Good
- Standard
- Weak

Finally, we assess the progress a manager is making, adding a momentum score:

Momentum	Definition
+	Manager is making changes to enhance their ESG capabilities
=	Manager is not taking action to materially improve their ESG capabilities

We would be happy to discuss our framework, questionnaire and ratings with the DWP.

7. (a) Have the trustees of your scheme, or a scheme you advise, undertaken stewardship (engagement or voting) with an investee company on a social factor in the past 5 years, whether directly or through an asset manager?
(b) If yes, please provide details including why you felt this was necessary, what was done and the impact of your intervention.
(c) If no, then please provide details including what disincentives and barriers you faced in undertaking stewardship activities (engagement or voting) with an investee company?

Following the introduction of the UK Stewardship Code, we believe stewardship is increasingly well understood and practised within the UK. Further work is however necessary, and in particular, we welcome the DWP's Occupational Pensions Stewardship Council.

Here are a few examples of the way in which social factors informed the stewardship and investment activity of a selection of our third-party managers. We would be happy to discuss these (and other) examples in further detail with the DWP.

Region	**Issue**	**Action**
US	A US distributor of prescriptions was implicated in the opioid crisis, where it was alleged that pharmacy companies expanded the opioid pain relief market through aggressive marketing.	The position was sold
US	A US investment manager considered the following social factors in both the evaluation of companies: • Employs sound product safety and quality standards to protect end-users • Follows health and safety practices that protect employees	The list of factors informed company engagement activities

	• Has limited involvement in labour conflicts • Proactively prepares for changes in labour regulation • Minimizes/maximizes negative/positive social externalities (ex. educational opportunities, job creation, CSR) • Is positioned to take advantage of opportunities in economic development (ex. the middle income transition)	
US	Safety performance of a company providing services for electrical transformers was identified as a risk, with high lost work days and a fatality.	The frequency of safety reporting was improved, safety was discussed at quarterly board of directors meetings, and the company improved its safety culture, decreasing safety incidents by almost 90%.
UK	Tenant well-being was identified as a priority in design and specification of retail facilities.	Improvements included, cycle racks, lockers and showers, as well as enhancements to the buildings features to improve air quality and, in light of the Covid-19 pandemic, "touchless" travel.
US	A research project was undertaken on the implications of social issues to inform macro decision-making – this included, inequality, populism and social cohesion.	The results of the research were incorporate into investment decision-making systems.

Finally, we thought it useful to share our stewardship preferences. Good stewardship can be subjective. We encourage the DWP to review:

- PRI's Active Ownership 2.0, 2020[7].

We set out our preferences as follows.

- Quality over quantity – we're interested in a few meaningful quality engagements, with strong reporting (rather than, being interested in the quantity of votes). We want managers to prioritise the highest sustainability impacts in their portfolios

[7] https://www.unpri.org/download?ac=9721

- Long-term – we encourage managers to form long-term relationships with companies. Successful stewardship can take many months, maybe even years
- Real world impact – we're interested in engagement on topics that contribute to positive real-world sustainability impact (such as, reduction in absolute carbon emissions)
- Honesty – some engagement, perhaps even most engagement, will be unsuccessful. We're realistic, and we'd prefer honesty from managers
- Collaboration – engagement is more efficient when managers collaborate – not just for the managers, but for the companies too (who will field fewer, but higher conviction, engagements from their investors). We encourage managers to participate in collaborative initiatives, such as Climate Action 100+
- Innovation – we welcome innovation, for example, third-party tools to assess a company's conviction on sustainability topics
- Integrated – we're interested in how (if at all) stewardship contributes to the investment thesis and whether managers link their stewardship to other engagement activity (for example, policy engagement)

We also find useful the UN asset owner alliance net zero tool for climate-related proxy voting and would encourage the development of a similar guide for social risks and opportunities[8].

8. What opportunities are there for trustees to invest, directly or indirectly, in companies solving social issues in developing or emerging markets? How attractive are these investments?

There are less opportunities for investment in social issues, than green or environmental equivalents.

We believe there are two sets of considerations for the DWP to consider:

- First, attention to the social risks and opportunities in developing or emerging markets in the supply chains of the companies in which we invest.

Here we recommend the DWP review the Impact Management Project (IMP) framework. The framework explains impacts fall into three categories:

1. Acting to avoid negative externalities
2. Contributing a benefit to stakeholders
3. Contributing to solutions

UK pension funds should consider the reducing the negative – as well as maximising the positive.

[8] https://www.unepfi.org/news/industries/investment/net-zero-asset-owner-alliances-new-tool-for-asset-manager-engagement-on-climate-related-proxy-voting/

- Second, direct investable opportunities in developing and emerging markets. This, for us, is still work in progress, which we believe is typical for the UK pension fund market.

Cardano has a programme of work underway with its foundation, Cardano Development[9], to develop an impact framework, which we expect to use to guide further investments in social opportunities. We would be happy to share with the DWP once complete.

Finally, we are interested in further investments in social bonds and will follow this market closely.

[9] https://www.cardanodevelopment.com/