Factoring ESG into risk settlement decision making

New regulations from the Department for Work and Pensions require a more active approach from trustees when taking into account Environmental, Social and Governance (ESG) risks. Trustees will need to take steps to understand the issues, engage and report on an ongoing basis. These actions are meant to have a real impact and not to be a tick box affair.

Trustees of defined benefit schemes are required to set out in the Statement of Investment Principles (SIP) their policies on ESG, particularly climate change, and stewardship, including voting and engagement. They are also required to prepare an Engagement Policy Implementation Statement (EPIS) to document how and the extent to which they have followed their engagement policy over the scheme year.

Furthermore, there are additional (voluntary) codes and guidelines. For example, the UK Stewardship Code requires ESG reporting across asset classes, covering both activities and outcomes, and with a renewed focus on purpose and governance.

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ESG and risk settlement

Risk settlement products such as annuity policies and longevity swaps are purchased for long-term risk protection. We believe that evidence of a strong ESG policy is an increasingly important factor to consider when choosing between providers before purchasing such a product.

The best-in-class approach requires ESG integration, engagement and collaboration to address sustainability issues completely. A suitable culture is also needed within an organisation and its portfolio management teams for high levels of ESG integration to be credible.

Provider approaches

UK bulk annuity providers are noticeably placing more focus on demonstrating their ESG credentials. The majority of providers are signatories to the UN Principles of Responsible Investment (UN PRI), and several now carry out specific annual reporting of their ESG policies and progress.

However, there is still a broad range of approaches from UK bulk annuity providers when it comes to their credentials and how well-integrated ESG is in their operations.

Environmental issues, especially climate change, are currently receiving particular attention. The Prudential Regulation Authority has charged all UK insurers with integrating climate change considerations into their business, across both assets and liabilities, and disclosures. In July 2021 the Association of British Insurers (ABI), a trade association across the insurance and long-term savings industry of which seven of the eight UK bulk annuity providers are members, published their ‘Climate Change Roadmap’ in order to facilitate collaboration and collective action across the insurance and long-term savings sector towards achieving net-zero targets. The ABI’s initiative arose part way through a wave of actions from insurers, so has been timely with some insurers already leading the way and others quickly responding in line with the ABI suggestions.

Certain providers have set clear carbon-reduction policies for their asset portfolios, with some aiming for net-zero emissions as early as 2040, whereas others are yet to commit to such targets.

Beyond environmental issues and initiatives, providers’ policies generally cover social and governance aspects too. For example, in the area of Diversity, Equity, and Inclusion we see a wide-ranging set of targets, with numerous inclusive initiatives now set-up across the industry. With public reporting on gender pay gaps now mandatory, there are some clear leaders in this area.

Key considerations for trustees implementing a risk settlement transaction

Given the statements made for regulatory and scheme specific beliefs on ESG, it means that – as a minimum – the approach to insurer selection and due diligence should align with the ESG statements in the scheme's SIP. In addition, following a risk settlement transaction and pre-buyout, trustees need to refer to the transaction in their SIP, and it is good practice for schemes to include details of the insurance arrangement and the selection process within the EPIS.

Integrating ESG into your decisions

Aon has developed an ESG rating system for UK risk settlement providers, which is designed to assess whether, and how well, ESG considerations are integrated into their investment decision-making process. It is based on a variety of qualitative factors, starting with a proprietary due diligence questionnaire, which is completed by the UK risk settlement provider.

We also conduct a review of the provider's ESG policy and other Responsible Investment policies and procedures (where they apply) and examples of real-time application of these policies. The ESG assessment process is consistent with the Investment Manager reporting framework of the UN PRI.

The ratings sit alongside our existing administration due diligence ratings and financial strength commentary and are designed to provide an added dimension of analysis.

For further information please register to receive access to our new ESG and Provider Selection whitepaper, where you can also learn more about our ESG rating system.

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