



# Responsible Investment Framework



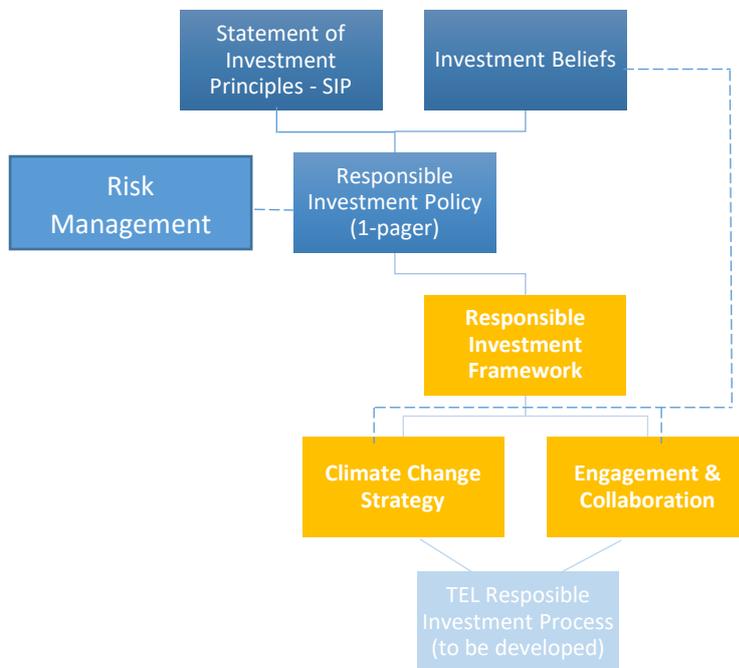
# NGUKPS Responsible Investment Framework

## 1. Introduction & Background

The National Grid UK Pension Scheme (NGUKPS) Trustee defines Responsible Investment (RI) as an approach to investing that incorporates Environmental, Social and Governance (ESG) factors into investment decisions. This view is founded on the increasing materiality of ESG factors that, in giving rise to reputational, operational and regulatory risks for the Scheme's investments, can materially impact the quality and sustainability of long-run investment returns, and therefore should be managed.

This framework expands on NGUKPS Trustee's Responsible Investment Policy and details the Scheme's approach to RI. It is based on the Trustee's views of the issues, on the UN-backed Principles for Responsible Investments (UNPRI), of which the Scheme is a signatory, and the practicalities of implementation. The framework, which captures these views and principles, was developed by the Trustee Executive Limited (TEL) and approved by the Trustee Board. The Lead Section Employer (LSE) was consulted regarding this framework and is fully supportive of the approach.

The diagram below presents how this framework fits in the context of other Scheme documents and processes.



## 2. Purpose & Scope

This framework sets out the Trustee's beliefs regarding RI, ESG factors, and more specifically about Climate Change and Engagement & Collaboration. It guides the implementation of such beliefs by TEL. The framework is comprised of the following four elements, each of which is covered in detail below:

- Governance
- ESG integration
- Climate change strategy
- Key ESG Themes and Engagement & Collaboration

TEL and external investment managers mandated to manage the Scheme's assets are expected to adhere to this framework. The Trustee, via TEL, will monitor compliance with this framework by external managers and TEL will also report to the Trustee on its own activities on a regular basis. Where external managers offer unsatisfactory levels of compliance, engagement and communication will be the

preferred approach, and termination used as a last resort. Similarly, for buy-in providers, TEL will regularly monitor the insurers' RI beliefs, policies and implementation, with a view to influence their approach and encourage alignment where appropriate.

This framework applies to the Scheme as a whole, and to all asset classes invested by the Scheme in all regions and markets and across all strategies. Not all asset classes are currently at the same stage of development on ESG considerations, so the Trustee and TEL will continue to monitor market developments, engage in discussions where appropriate, and update this framework as required.

This framework is relevant to all investment activities undertaken by the Scheme, directly or via external managers and buy-in providers, including asset allocation, risk management, manager selection, manager monitoring, voting and engagement.

### 3. Governance

RI and ESG governance should be as rigorous as other governance arrangements within the Scheme. Governance encourages accountability, which should make this framework an effective tool for incorporating RI and ESG considerations through the investment chain.

The Trustee is accountable for this framework and its approval. TEL is responsible for executing and implementing the framework in its investment decisions, supported by the Integrated Risk Management Committee (IRMC), which has oversight responsibilities. TEL is also responsible for monitoring its implementation by the Scheme's external investment managers in their investment decisions. TEL will engage in discussions with those managers about the implementation of this framework regularly.

Within TEL, RI-related objectives are included in most investment professionals' (including senior management) performance measurement and Learning & Development plans.

TEL will report to the Trustee on this framework's implementation annually, when RI-related objectives for the following year will be agreed. TEL will also monitor industry developments and suggest enhancements to this framework as appropriate. The Trustee, on an annual basis, reviews and approve key ESG themes and the Engagement & Collaboration agenda for the following period, according with the criteria detailed below.

### 4. ESG Integration

The Trustee's approach to ESG integration across its investment activities is set out below:

- a. **Asset allocation:** TEL considers ESG factors as part the investment process and its asset allocation decisions where these are relevant and financially material, and in the context of other relevant considerations. The focus of this exercise is not only on preserving capital, through the mitigation of ESG risks, but also on identifying better quality and more sustainable long-term investment returns. When considering alternative portfolio positioning, RI and ESG implications will be taken into account as well as other factors such as portfolio expected return and risk.
- b. **External Investment Manager Selection and Monitoring:** RI and ESG considerations are included in any manager selection exercise as part of the due diligence processes. The objective is to assess the extent to which ESG is integrated in the manager's philosophy and process (i.e. analysis, voting policy, engagement, and associated policies). Even though expectations will vary according to asset class and investment style, ESG is an integral component of manager assessment. RI and ESG will be incorporated on mandate design as and when appropriate.

RI and ESG are integrated in External Manager's Investment Management Agreements, where ESG objectives, ESG-related exclusions/restrictions, engagement plan and required ESG reporting are specified.

The Trustee expects that other investment service providers to be employed by the Scheme take into account ESG considerations to the extent that they are relevant and financially material, and

therefore they will also be assessed on their ESG policies and procedures as appropriate. This is also valid for buy-in providers.

- c. **Active Ownership, Engagement and Collaboration:** The Trustee believes that active ownership, in either equity or debt instruments, is the most appropriate channel to promote positive ESG practices. As all of the Scheme's assets are managed externally, the Trustee delegates voting to these external investment managers and expects each to vote on their portfolio holdings in line with their internal voting policies (reviewed by TEL periodically) and relevant recognised standards, such as the UK Stewardship Code. Any material exceptions should be reported back to TEL. Engagement is also encouraged in debt-related mandates such as corporate bonds. The Trustee expects external investment managers to engage with companies on ESG matters. Managers are well placed to do so, given their knowledge of the companies and access to company management. These managers are required to report on their RI and ESG integration processes and also on their proxy voting and engagement activities on a quarterly basis.

The Trustee, via TEL, will also seek to undertake direct engagement on themes and topics that are particularly relevant to the Scheme, as detailed in the Key ESG themes and Engagement & Collaboration framework included further in this document.

The Trustee backs industry-wide initiatives to encourage and advance RI and to that effect it is a signatory of the UNPRI. In addition, the Scheme may consider other collaborations with asset owners, investors, asset managers, advisers, and industry bodies on a case-by-case basis, which will be prioritised according to the framework included further in this document.

- d. **Risk Management:** The Trustee believes ESG should be integral to risk management. Understanding the portfolios' exposure and sensitivity to ESG factors is essential to determine the materiality of each specific factor and to inform investment decision making appropriately. When a material/key theme is identified (using the process described below in this document), the Trustee will look to mitigate it if/as appropriate.
- e. **Monitoring:** The Trustee aims to monitor the impact and progress of its RI activities. This monitoring will be undertaken by TEL, and reported to the Trustee on a regular basis. As a signatory of the UNPRI, the Scheme commits to report on its RI activities on an annual basis. The reporting framework enables comparison of RI performance versus industry peers, encourages strengthening of internal procedures, and summarises the activities for stakeholders.

## 5. Climate Change Strategy

### Beliefs and Objectives

The NGUKPS Trustee believes climate change presents a systemic and financially material risk to all asset classes. In alignment with its fiduciary duty to act in the best interests of the members, climate-related risks and opportunities should be mitigated and exploited by investment decisions where appropriate. In addition, the Trustee believes that climate change could have repercussions in the sections' funding level by affecting the employer covenant, long-term interest rates, inflation, and member life expectancy. An integrated risk-management approach is therefore required. Certain companies, sectors and industries are exposed to significant reputational and regulatory risk associated with climate change, which the Trustee must consider as an investor. Finally, the Trustee believes that its primary concern of safeguarding the payment of benefits of members in retirement is consistent with preserving and protecting the world they will retire into.

The Trustee's main objective is to ensure that the funding level is resilient to climate-related risks in the short, medium and long term. It aims to achieve this by incorporating climate-related thinking into its investment processes (including asset allocation where possible, manager selection and mandate specification) and liability hedging, longevity insurance and covenant monitoring considerations.

The Trustee seeks an investment strategy which aligns with and supports the Paris Agreement on Climate Change. The Trustee further believes that investor collaboration can help enabling the achievement of its ambitions and aims to collaborate on initiatives that support the achievement of the

Paris Agreement, even though it acknowledges the more significant role that government policy, companies and society in general have to play.

The Trustee believes that engagement is generally the most appropriate action to support and encourage the achievement of the Paris Agreement and to manage climate risk. However, in some cases engagement and collaboration with other investors may not be enough. When the perceived risk (either financial, reputational or regulatory) to certain companies, sectors, or industries is disproportionately large for the Trustee as an investor or where engagement can no longer serve a useful purpose, it will consider divestment and/or exclusions. With that in mind, the Trustee agreed to phase out from thermal coal related investment by 2022 or earlier.

## **Governance**

The Trustee is ultimately accountable for this strategy, but will assign clear responsibility and delegation to TEL to translate the strategy into action.

The IRMC is responsible for ensuring that the work of TEL on climate change conforms to the strategic parameters and risk framework, providing oversight and guidance to TEL and supporting the development of recommendations to the Trustee.

TEL is responsible for the strategy's implementation, monitoring and reporting to the IRMC/Trustee and advising the Trustee on ensuring that the strategy remains relevant and up-to-date. The strategy will be reviewed by TEL annually to ensure it is kept fit for purpose in light of continuously evolving climate change policies and regulations, technology, and best practices for companies and investors, with any proposed changes developed with support of the IRMC.

The Trustee commits to communicate on its position on climate change with key stakeholders, the membership base and externally, as and when appropriate.

## **Strategy**

At the core of the Paris Agreement is the mitigation of GHG emissions that drive temperature increase. The Trustee believes that investing in a way which is consistent with this necessary transition to a low-carbon economy is likely to lead to the best financial outcomes for our scheme and our members. In the portfolio context, this means seeking to gradually reducing the overall emissions contained in the portfolio and to holding the temperature increase well below 2°C, but actively aiming for 1.5°C. This will be achieved by investing in and engaging with companies which contribute to achieving emissions reduction in the real economy. The Trustee will aim to do so through investment decisions and engagement and collaboration as follows:

- **Investments:** The Trustee requires TEL to incorporate climate change considerations in its investment processes and when implementing the Sections' investment strategy. TEL will do so by considering asset allocation, asset classes and mandate specification that are together consistent with the more audacious decarbonisation aims of the Paris Agreement (i.e. target 1.5°C warming), without compromising the sections' main funding objectives, as follows:
  - **Asset allocation:** The Scheme's sections are somewhat constrained by the extent to which they can incorporate climate awareness in asset allocation due to their stage of maturity and the large proportion of Gilts held. The sections' achievement of the required temperature alignment is largely dependent on the UK Government achieving its own climate-related objective of becoming net-zero by 2050. Moreover, the treatment of buy-ins from a climate perspective is of significant relevance to the overall Scheme's approach to climate change. In that regard, the Trustee will maintain open dialogue with the buy-in providers to seek/maintain convergence in approaches to climate change, influencing and encouraging insurers where required.
  - **Manager Selection/Monitoring:** The Trustee considers climate change risks and opportunities alongside other relevant investment factors. It expects its managers to consider climate-related implications in their investment processes and to engage with companies on the Trustee's behalf to progress the climate change agenda, ultimately contributing to the ambitions of the Paris Agreement.

- **Mandate specification/Manager selection:** The main objective is to increase capital allocation to better climate-aligned assets and away from poorly climate-aligned assets, while maintaining other investment requirements such as appropriate diversification and risk/return characteristics.
- **Engagement & Collaboration:** The Trustee, via TEL, aims to collaborate with like-minded organisations in pursuing a low-carbon economy consistent with the objectives of the Paris Agreement, and collectively manage climate related risk in financial markets. The Trustee will support the Climate Action 100+ investor-led initiative. By focusing on engagement, the Trustee expects to assist, encourage and require portfolio companies to embark on decarbonisation pathways of a scale and pace consistent with the objective. Once these companies start to transition towards low-carbon business models, the portfolio will decarbonise as well. The Trustee should continue to encourage its asset managers to engage and collaborate but it should also encourage market participants to provide the required data, tools and products to underpin investors' climate change investment strategy implementation. Industry-wide collaboration initiatives, such as the Paris Aligned Investment Initiative<sup>1</sup>, to progress the methodological/technical landscape on climate change should also be supported proportionately.

## **Risk Management**

TEL, on behalf of the Trustee, will identify and document the processes used to assess and manage climate-related risk, allowing the Trustee to integrate these in its overall risk management framework.

The Trustee will receive scenario analysis as frequently as required to understand how different investment strategies could be impacted by the transition to a low-carbon economy and/or by the physical impacts of climate change and whether implementing an alternative strategy may enhance the likelihood of achieving the Trustee's objectives. The Trustee also seeks to understand the impact of climate change on the Scheme's liabilities and covenant strength.

TEL, on behalf of the Trustee, will review the portfolio's temperature alignment in order to inform decision making and monitor progress against the stated targets, and will report back to the Trustee on its findings. It will also monitor its asset managers to ensure that appropriate risk management is undertaken at the mandate level.

## **Metrics & Targets**

The Trustee will make regular measurements of the Sections' portfolio carbon metrics and will focus on those that can be used across asset classes and are comparable across investors, including temperature alignment analysis<sup>2</sup>.

The Trustee targets a net-zero carbon emissions portfolio by 2050 at the latest.

In the shorter-term, the Trustee seeks a 0.2-0.3°C portfolio temperature alignment improvement (excluding gilts and buy-ins) by 2022 or earlier, and a dynamic approach to target setting thereafter given the evolving nature of the topic for markets, companies and regulations.

## **6. Key ESG Themes and Engagement & Collaboration**

While all financially material ESG factors form part of the Scheme's risk assessment, the Trustee will, on an annual basis, identify key themes where the potential impact could spread across markets, countries, sectors and asset classes. In addition to the traditional definitions of ESG factors, the Trustee

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<sup>1</sup> IIGCC's Paris Aligned Investment Initiative was launched in May 2019, with the aim of exploring how investors can align their portfolios to the goals of the Paris Agreement. More than 70 IIGCC members, representing over USD 16 trillion in AUM have engaged in the initiative to date.

<sup>2</sup> Temperature alignment analysis is a nascent methodology. It aims to enable all industry participants to utilise a common, intuitive and consistent metric and allow investors to assess the status and ambition of companies and governments when building Paris-aligned portfolios.

may also consider the UN's Sustainable Development Goals<sup>3</sup> (SDGs) and other sources when defining key themes. These key themes, which will be based on relevance and financial materiality to the Scheme, will form the basis for setting the Trustee's engagement & collaboration agenda as set out below.

As described in the Trustee's Investment Beliefs, investment managers are best placed to engage with companies and manage sustainability risks. That said, direct engagement, either unilaterally or collaboratively, will occasionally be undertaken by TEL, particularly when the theme or topic is key for the Scheme, and where the additional effort could lead to better outcomes.

TEL will identify and prioritise themes based on certain criteria, including the following:

- Geography/markets or companies
- Materiality of the ESG factor in the future value of assets
- Correlation/overlap with the Trustee's strategic risks
- Exposure (holdings size), and overall exposure to the issue
- Response to ESG events that have occurred
- Consultation with stakeholders, including the LSE
- Breaches of international norms

In addition to the above, collaborative engagement activities will be prioritized based on the following criteria, among others:

- Potential to enhance knowledge of ESG issues through other investors
- Ability to have greater impact on ESG issues
- Ability to add value to a particular collaboration exercise

Strategic partners will also be consulted and views incorporated into the Trustee's identified themes where appropriate. The final list of key themes will then be circulated and discussed with investment managers to ensure they are aware of what is most important to the Trustee.

When an engagement opportunity becomes available, TEL will consider the intended and unintended consequences of such engagement, including the possibility of such engagement entering the public domain. To that end, before any material or views are shared externally, TEL will inform and seek feedback from the Chair of the Trustee and the Head of Pensions at National Grid. This is to ensure that any activity is not detrimental to the Scheme or to the LSE in any way. When a conflict of interest emerges, TEL will mediate discussions and consensus will be sought.

Engagement can occur in, and therefore this framework is relevant to, any asset class held in the portfolio including equities, fixed income or private investments. It could also be related to public and government policy.

The Trustee supports industry-wide initiatives and will leverage on organisations such as the PRI and Institutional Investor Group on Climate Change (IIGCC), of which the Trustee is a member, to enhance its RI practices.

The Trustee, either directly or via TEL commits to promote RI and ESG, aiming to:

- **Lead by example:** Investors and other stakeholders require companies to provide transparency on their exposure to ESG risk/climate change and explain their approaches to managing these exposures. The Trustee should aim to set an example by providing a similar level of transparency to members and other stakeholders.
- **Enhance trust and license to operate:** Communicating the Trustee's commitment to managing ESG and climate change risk fosters members' trust that their pension savings are being managed

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<sup>3</sup> The SDGs are an articulation of the world's most pressing sustainability issues and as such act as the globally agreed sustainability framework. The SDGs can support investors in understanding the sustainability trends relevant to investment activity and their fiduciary duties.

responsibly and prudently. External communications should aim to be as detailed and specific as possible to credibly convey the Trustee's approach.

- **Elevate the industry:** There are many benefits that accrue by supporting a more RI, ESG and climate-aware investment industry. Communicating the Trustee's RI approach, including on climate change, enables sharing of best practices, and some friendly competition that pushes the industry further.

The Trustee's engagement and collaboration activities will be reported to the Trustee Board at least on an annual basis, or more frequently if deemed appropriate.

## 7. Reporting

The Trustee will receive the following reporting on its RI activities on an annual basis, with some being disclosed externally as indicated below:

- Implementation of the RI Framework, and any proposed updates
- External Investment Manager RI Update
- Climate Change Strategy Update, including progress on targets and any proposed updates – to be disclosed externally
- Proposed ESG Key Themes for the following period
- Engagement & Collaboration Update, including activity in the previous year
- Regulatory reporting on RI such as the TCFD report and Voting & Engagement Implementation Statement – to be disclosed externally

In addition, the Trustee will receive, either directly or via the IRMC, RI-related portfolio information to facilitate appropriate oversight. The Trustee supports the Task Force on Climate-related Financial Disclosures (TCFD) and will report against its recommendations from 2021, and annually thereafter.