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Pensions environmental, social and governance investing: An update

Sustainable Finance and Responsible Investment

September 2020

Introduction

Welcome to this update to our environmental, social and governance (ESG) investment guide for pension scheme trustees. The original guide was published in September 2019[1].

ESG continues to grow in prominence, both in the pensions sphere and across the wider investment world. As a result, it has never been more important for pension scheme trustees to understand the obligations on them in relation to ESG, as well as the limits on how far they can go when making their investment decisions.

In this update we take a look at the new obligations kicking in for trustees from 1 October 2020 as well as key further developments coming down the pipeline. We also have top tips on stewardship for trustees and an in-depth examination of when trustees can take non-financial factors into account when making investment decisions.

[1] cms.law/en/gbr/publication/pensions-environmental-social-and-governance-investing

The October 2020 changes

Pension scheme trustees had to disclose a range of new information on ESG investment starting from October 2019. However, further regulations will be coming into force with effect from 1 October 2020, increasing the disclosure requirements on trustees:

Updates to the SIP

— Going forward trustees of defined benefit and defined contribution schemes with 100 or more members will have to ensure that their Statement of Investment Principles (SIP) also includes:

- information about how their arrangements with their asset managers incentivise the appointed managers to align their investment strategies with the trustees' policies and to make investment decisions based on an assessment of the medium to long-term financial performance of investee companies;
- information about how the method and time horizon for evaluating asset managers' performance is in line with the trustees' policies;
- information about how they monitor portfolio turnover costs incurred by asset managers; and
- details about the duration of their arrangements with their asset managers.

— Trustees will also need to ensure that their policies on engagement are extended to cover the methods by which and circumstances in which they monitor and engage with investee companies, investment managers and other investors about matters concerning performance, capital structure, the management of conflicts of interest, risks, social and environmental impact and corporate governance. See page 11 for further information about stewardship activities.

Publishing the SIP

— Trustees of DB schemes will also have to publish their SIPs on a publicly available website by 1 October 2020 (in line with the current position for DC and hybrid schemes).

Annual report and implementation statement

— Annual investment reports produced from 1 October 2020 will need to include an implementation statement that sets out:

- how, and the extent to which, in the opinion of the trustees, their policies in relation to the exercise of voting rights and engagement activities have been followed during the year;
- a description of the voting behaviour by or on behalf of the trustees (including the most significant votes cast by or on behalf of the trustees) during the year, and any use of a proxy voting service during that year; and

— for schemes with DC benefits other than AVCs:

- a description of any review of the SIP, including an explanation of any changes. If the last review was not within the period covered by the report, the trustees must include the date of the last SIP review; and
- how, and the extent to which, in the opinion of the trustees, the SIP has been followed during the year.

- The implementation statement will need to be made publicly available online. There are specific timing requirements for this:
  - For schemes with DC benefits other than AVCs, the legislation is slightly ambiguous. Arguably this publication requirement will apply from 1 October 2020, but we think the better interpretation is that it will apply as soon as the annual report (including the investment report described above) has been produced after 1 October 2020 (and no later than 1 October 2021).
  - For DB schemes (with no DC benefits other than AVCs), this publication requirement needs to be complied with by 1 October 2021 – although it is open to trustees to make the implementation statement available online sooner, if they wish.
- All schemes must also include in their investment reports a statement of certain of the trustees' policies from the SIP, including those relating to how they take into account financial and non-financial factors when making investment decisions, how they exercise voting rights, and their arrangements with their asset managers.

What's in the pipeline?

Whilst there have been lots of new requirements in this area already, there are plenty more coming in the future. Here is a summary of what further developments are currently proposed.

Pension Schemes Bill

Bill may be passed in Autumn 2020. Unlikely to be in force until mid-to-late 2021.

This is expected to include regulation-making powers which will allow requirements to be imposed on trustees to ensure that pension scheme trustees explicitly consider climate change goals, including considering the range of risks in the Task Force on Climate-related Financial Disclosures' (TCFD) recommendations.

DWP Consultation on Climate Change Risk (Governance and Reporting)

Consultation closes on 7 October 2020. A second consultation is expected next year on the detail of the proposed regulations.

The DWP is currently consulting on proposals to require trustees of larger occupational pension schemes, authorised master trusts and collective money purchase schemes to have effective governance, strategy and risk management systems in place to assess and manage climate risks and to disclose these in line with the TCFD recommendations. Any regulations legislating for these proposals will be made under the powers currently being considered by Parliament in the Pension Schemes Bill.

Longstop for Implementation of Further UK Disclosure Requirements

1 October 2021.

Trustees of DB schemes will need to publish an implementation statement on a publicly available website, containing information on how the engagement policy in their SIP has been followed, and a description of their voting behaviour during the year, along with information relating to the additional policies included in the SIP from October 2020.

European Regulation on Sustainability-Related Disclosures in the Financial Services Sector

Most requirements effective from 10 March 2021.

This will introduce transparency obligations on how financial market participants (which include pension schemes) integrate ESG factors into their investment decisions and the impact on those investments. More detail is set out in the section on the Sustainability Regulation on page 10.

TPR report on climate change

December 2021.

TPR plans to produce a report on adapting to climate change for occupational pension schemes under the Department for Environment, Food and Rural Affairs' reporting regime by December 2021.

Pensions Climate Risk Industry Group

2022

The group has consulted on guidance for trustees on integrating climate-related risk assessment and providing a framework on reporting on climate risk in line with the TCFD's recommendations.

The government expects all large asset owners will disclose in line with the TCFD by 2022.

In-depth: When can trustees take into account financial and non-financial factors?

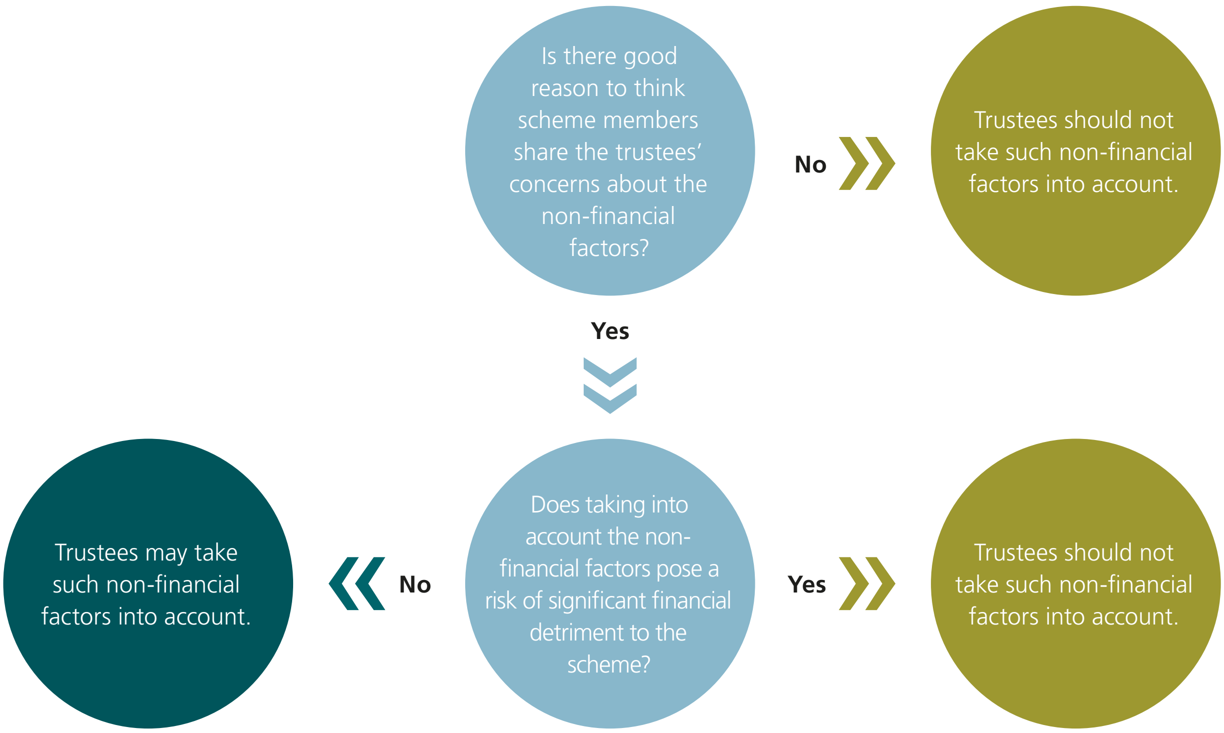
One of the key areas of concern for trustees considering ESG investments has been how to combine those considerations with their fiduciary duty to exercise their investment powers for their "proper purpose". In the context of pension schemes, this usually means acting in the beneficiaries' best financial interests.

For a DB scheme that is generally thought to mean investing to ensure that the scheme is able to meet its obligations to beneficiaries. For a DC scheme the position is slightly different with the goal being to provide the best possible pot of cash at retirement. In some cases, taking into account ESG factors may seem to be incompatible with these duties.

The question of when trustees can take ESG factors into account in making investment decisions is therefore a key one for pension scheme trustees. Reflecting this, it was considered by the Law Commission, which published a report on fiduciary duties in investment in 2014 (this was followed in 2017 by a supplementary report focusing on pension funds and social investment).

In its report, the Law Commission split investment considerations into financial and non-financial factors. Financial factors are factors which affect investment performance, while non-financial factors are not based on the financial performance of the investment. For example, in the context of ESG, the potential for higher taxes on carbon emissions leading to reduced dividends from oil producers would be a financial factor, while a belief that investing in fossil fuels was immoral would be a non-financial factor.

The Law Commission concluded that trustees should always take into account financial factors, but the position on non-financial factors was less clear. Its view on how trustees should consider non-financial ESG investment factors can be summarised in the following test:



While it is clear in law that financial factors should be taken into account, the position in relation to non-financial factors is less clear, with the Law Commission's test on non-financial factors generally considered to be a sensible approach. However, it was only an opinion and, until recently, was an approach which had limited legal basis to justify its adoption by trustees (and so trustees needed to approach non-financial factors with caution).

On the face of it, the recent Supreme Court judgment in *Palestine* has changed this. On first glance, it gives considerable additional weight to the Law Commission's test. In that judgment, Lord Carnwath said:

> *The Law Commission's report… may be seen as having settled a long-running debate as to the extent to which pension trustees could take account of non-financial factors…* ***There appears now to be general acceptance that the criteria proposed by the Law Commission are lawful and appropriate. I agree.*** *Thus administering authorities may take non-financial considerations into account… provided that doing so* ***would not involve significant risk of financial detriment to the scheme*** *and where they have good reason to think that scheme members would support their decision.*

It looked like the Supreme Court was adopting the Law Commission's test and so providing helpful certainty in this area. However, on a closer look, there is a difference between Lord Carnwath's wording and the Law Commission test:

Palestine: Non-financial factors can be taken into account if the decision would "*not involve* ***significant risk of*** *financial detriment*."

Law Commission: Non-financial factors can be taken into account if the decision would "*not involve a risk of* ***significant financial detriment***."

The wording in the *Palestine* judgment would seem to require there not to be significant risk of any financial detriment. In contrast, the Law Commission test requires there to be no risk of significant financial detriment – but could allow a significant risk of minor financial detriment.

The dissenters in the Supreme Court judgment also seemed to agree with the Law Commission, saying that trustees "*may only take non-financial factors into account if that can be done without any material financial detriment for scheme members*."

It is not clear whether the Supreme Court intended to introduce a different test to the Law Commission (Lord Carnwath's wording suggests not). However, it does introduce an element of doubt about what the correct test is for taking into account non-financial factors. Furthermore, the case was dealing with local government pension schemes, and so is arguably not directly applicable to "normal" occupational pension schemes.

The difference in wording between *Palestine* and the Law Commission is only going to be relevant in limited circumstances, but it seems clear that, unlike for financial factors, taking into account non-financial factors will continue to be a difficult area for pension scheme trustees.

Given the uncertainty, trustees will need to act carefully and take advice where they do wish to take into account non-financial factors to ensure that they continue to act in line with their investment obligations.

In-depth: EU Sustainability Regulation

While most trustees are aware of the impact on their schemes of the new requirements to update their SIPs and produce implementation statements, EU Regulation 2019/2088 (the "**Sustainability Regulation**") is less well known, but may also need to be complied with[2].

The Sustainability Regulation is part of the EU's Action Plan on Sustainable Finance and came into force in the UK on 29 December 2019, prior to Brexit. It requires detailed pre-contractual and ongoing disclosures on sustainability risks and factors, as summarised below. As its obligations have not yet taken effect, it is classified by the UK government as "in-flight" and the UK government is expected to bring in legislation to clarify some of its effects.

However, new ESG disclosure obligations will apply from **10 March 2021** for "financial market participants", which include occupational pension schemes. Trustees will therefore need to be aware of the Sustainability Regulation's requirements and be ready to comply with them.

The Sustainability Regulation's more detailed requirements are complex, requiring significant data collection, and additional information on compliance with them is likely to be issued, at both an EU and a UK level, before they come into force.

We have set out a summary of the Regulation's requirements below, but pension scheme trustees should get advice to ensure that they are fully compliant with the Sustainability Regulation when the initial obligations come into force in March.

From 10 March 2021, pension trustees will need to:

— Provide information on their policies on how they integrate "sustainability risks" into their investment decision-making process. In this context sustainability risks are ESG events or conditions that, if they occur, could cause an actual or a potential material negative impact on the value of an investment. An example of this might be the impact of rising sea levels on an investment in coastal property.

— Provide information on their due diligence policies in relation to the principal adverse impacts of their investment decisions on "sustainability factors", or if they do not consider those adverse impacts, clear reasons why not (including, if relevant, information on whether and when they will do so). For these purposes, sustainability factors mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

— Where a financial product "promotes environmental or social characteristics, or has sustainable investment as its objective", provide additional information. A pension scheme qualifies as a financial product under the Sustainability Regulation and so these obligations would be relevant to pension scheme trustees where, for example, they offered members the option of investing DC assets in a sustainable investment portfolio.

From 30 December 2022, pension trustees will need to provide a clear and reasoned explanation of whether (and, if so, how) they consider adverse impacts on sustainability factors (and a statement that more information is available in the pension fund's annual report).

Where these requirements apply, trustees would need to provide additional information on how the characteristics are met and how the objectives are to be obtained. Essentially, objective information needs to be provided to support any description of a pensions investment option as "sustainable" or having pro-ESG characteristics.

[2] This regulation extends beyond just pension schemes to other financial market participants such as insurers and investment firms. These industries have got into the habit of calling this EU Regulation the "disclosure regulation". However, the pension industry already has its own disclosure regulation, and so we continue to label this the sustainability regulation.

How must trustees provide these disclosures?

The Sustainability Regulation's provisions on what exactly must be disclosed and how are complicated, but in summary pension scheme trustees will be required to provide the above information in three ways:

Website
Pension scheme trustees will need to publish the required information on their websites.

Pre-contractual materials
Trustees will also need to include the information on all three areas in "pre-contractual materials". In the context of a pension scheme this will mean providing prospective members with them in advance of joining the scheme, or if they are auto-enrolled, immediately after joining the scheme. The information must also be available free of charge to members and other beneficiaries.

Periodic reporting
Trustees will additionally need to provide information on any financial products promoting ESG characteristics or with sustainable investment as their objective in their annual report. However, this requirement will not come into force until 1 January 2022.

Other requirements

While it may be less relevant to pension scheme trustees than to other financial market participants, trustees should also be aware that the Regulation requires them to ensure that their remuneration policies are consistent with the integration of sustainability risks and that any marketing material published is consistent with the Sustainability Regulation's requirements.

In-depth: Stewardship – Top tips for trustees

"Responsible" investing isn't just about climate change. Investors are now, more than ever, being encouraged to take all aspects of stewardship into account in their investment approaches.

What is "stewardship"?

Stewardship is the activity of investors engaging with the managers of underlying investments in order to promote the investments' long-term success. This has gained increasing prominence in recent times – following the implementation of the Shareholder Rights Directive into UK law, and the recent refresh of the UK Stewardship Code.

And, from 1 October this year, trustees will need to include information in their SIP about how they engage with investee companies and exercise voting rights. They will also need to disclose specific details about how their arrangements with asset managers facilitate effective stewardship of scheme assets.

Three top tips

1. Put in place a stewardship strategy

— The Pensions and Lifetime Savings Association has produced helpful guidance for trustees on developing an appropriate stewardship strategy.

— As a first step, it suggests working with advisers to develop and agree trustees' investment beliefs, and the role that stewardship should play within this framework.

— This will help trustees to identify the key strategic issues (i.e. the environment, social and corporate governance considerations) that are most material to the scheme.

2. Review arrangements with asset managers

— From 1 October this year, trustees will need to disclose how they incentivise their asset managers to make investment decisions in line with their scheme's stewardship policy, focusing on the medium to long-term performance of the underlying investments.

— Trustees should therefore think about setting appropriate expectations of their asset managers at the outset, when they are first appointed, and using the appointment process itself to assess whether a manager's attitude to stewardship is aligned with that of the scheme.

— In terms of existing arrangements, they may want to revisit appointment terms and investment management agreements, to make sure that their new expectations of their existing managers are clearly set out.

3. Develop a clear voting policy

— Trustees should consider developing a position on how they will vote on certain matters, so that they can clearly articulate their views on the full range of environmental, corporate governance and social issues.

Issues to be aware of

1. Managing conflicts of interest – securities lending arrangements

— Securities lending involves the temporary transfer of securities (and the voting rights attaching to those securities) to a borrower – and this has the potential to give rise to conflicts of interest.

— For example, a scheme may hold shares in an investee company, with the intention of exercising its voting rights in a way that encourages the long-term sustainable growth of that company. If the scheme's custodian or manager lends those securities to a market participant that has a financial interest in short term performance – possibly even wanting the investee company to fail – there's a clear conflict between the scheme's stewardship intentions and the motives of the other counterparty.

— So it's worth trustees thinking about the impact that this potential conflict could have on the effective stewardship of investments – and whether the scheme's existing securities lending arrangements need to be revisited.

2. Voting rights in pooled fund arrangements

— Under the new regime, trustees will need to disclose policies relating to the exercise of voting rights attaching to scheme investments.

— In this context, it's worth being aware that fund managers of pooled fund arrangements may be less willing to accept client-directed voting than other asset managers. This may make it hard for trustees who have all or mostly pooled investments to adopt any meaningful policy on voting rights.

Climate Change Consultation

On 26 August 2020, the DWP launched a consultation on proposals for requiring schemes to report on climate change risks and opportunities as provided for in the Pension Schemes Bill and in line with recommendations of the Task Force on Climate-related Financial Disclosures. The consultation closes on 7 October 2020.

The government's view is that it is appropriate for occupational pension schemes to move towards compulsory TCFD disclosure, starting with the largest schemes. This aligns with the government's Green Finance Strategy expectation for all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022.

There are four core elements to TCFD disclosures:

— **Governance:** The organisation's governance around climate-related risks and opportunities.

— **Strategy:** The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning.

— **Risk Management:** The processes used by the organisation to identify, assess and manage climate-related risks.

— **Metrics and Targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The broad proposal requires trustees of schemes with GBP 5bn or more in assets (and all authorised master trusts) to have effective governance, strategy, risk management, and accompanying metrics and targets for the assessment and management of climate risks and opportunities from October 2021 and to report on these in line with the TCFD's recommendations by the end of 2022. This will then be rolled out to schemes of GBP 1bn or more in assets one year later. The government estimates that about 100 schemes will come in the first (GBP 5bn) wave with a further 250 meeting the GBP 1bn threshold.

The proposals include schemes being required to calculate their "carbon footprint" and assess how the value of their assets and liabilities would be affected by different temperature rise scenarios. Trustees would need to produce an annual TCFD report which must be linked to from the scheme's annual report, made publicly available and notified to members. There would be a mandatory penalty for failure to publish a TCFD report.

The detailed requirements will be set out in regulations and supported by statutory guidance. The statutory guidance will not be mandatory but trustees would be expected to explain any deviation from it. It is also expected that the Pensions Climate Risk Industry Group (PCRIG) non-statutory guidance will be published by the end of 2020 (consultation on this closed on 2 July). The PCRIG guidance is supported by the government and will sit alongside the regulations and statutory guidance.

The proposed regulations are to be made using the powers given in the Pension Schemes Bill to make regulations imposing requirements on trustees "*with a view to securing that there is effective governance of the scheme with respect to the effects of climate change*" and requiring relevant information to be published. The consultation repeats comments made in the House of Lords that "*the measures will not, and cannot, be used to direct pension scheme investment*" and further states that "*trustees have primacy in investment decisions; it is not for the government to direct trustees to sell or buy certain assets and these proposals do not create any expectation that schemes must divest or invest in a given way*".

The government notes in the consultation document that some trustees are concerned that they might be under increased pressure to divest from high carbon sectors. The government's view is that holding such assets places trustees in an influential position to steward firms towards lower-carbon business practices, and it advocates collaboration with business, as opposed to divestment, as the most effective means of holding companies to account on climate change. It states that "*these measures are not intended to give any support to campaign groups calling for blanket divestment from certain assets*".

There will be a second consultation next year on the detail of the regulations. There will also be further consultation on reporting in line with the Paris Agreement on climate change.

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