NORTON ROSE FULBRIGHT

UK Pensions Briefing

Where are we now on ESG and Climate Change?

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Introduction

In recent years, trustees and sponsors of UK occupational pension schemes have had to swiftly get to grips with ever more detailed requirements in relation to how their schemes account for and address climate change and Environmental, Social and Governance (ESG) considerations.

Since October 2019, schemes have grappled with the changes to pensions investment laws and regulations which have required them to revise their Statement of Investment Principles (SIP) to include their policy on how financially material considerations, including ESG factors, are taken into account in investment decisions and to draft and publish an Implementation Statement explaining how their actions follow the intent described in the SIP.

Although they are now through the first revised SIP and Implementation Statement cycles, trustees and sponsors are facing new and more detailed requirements in the climate change and ESG space.

The regulatory drive for action on climate change issues continues apace and this briefing summarises the key recent climate change and ESG developments and obligations applying to pension schemes as well as important upcoming developments. We have included a 'Roadmap of Key ESG Developments,' at the end of this briefing to help you keep an eye out for the key changes coming up.

Taskforce on Climate-Related Financial Disclosures (TCFD)

Published in 2017, the TCFD recommendations are intended to act as a clear and consistent disclosure framework in relation to the risks and opportunities associated with climate change. TCFD compliance is likely to be the most pressing climate and ESG issue on the agenda for many pension schemes in the near future.

Since October 1, 2021, new regulations and guidance have started to apply to the UK's largest pension schemes (those with over £5bn of assets and master trusts) under which in-scope schemes are subject to additional governance and reporting requirements aligned with the TCFD. For a summary of the key TCFD requirements, please see our March 2021 Briefing.

Compliance with the TCFD requirements will inevitably require significant engagement from trustees and whilst it is currently only the largest schemes in scope, those with assets of over £1bn will follow from October 1, 2022, with smaller schemes expected to follow in the coming years.

As an initial step trustees should take steps to understand when they may be in scope and engage with their legal and investment advisers to ensure they understand the impact of the new requirements on their schemes and are well positioned to tackle compliance.

Proposed new Statutory Guidance on the Implementation Statement

Most schemes will now have completed their first round of issuing an Implementation Statement. Although aimed more broadly at getting trustees to set out how they have put their SIP into practice, the Implementation Statement will need to include evidence of how the trustees have put their policies on ESG and climate change into action.

The DWP has expressed concerns about the levels of compliance and inconsistency of approach taken by trustees so has published draft statutory guidance for consultation. Feedback explaining the DWP's expectations is currently pending but it is anticipated that the new guidance will enter into force this year.

The proposed new (mandatory) Statutory Guidance is intended to help trustees understand what good practice reporting looks like and to ensure consistency across schemes.

The guidance, if enacted in its current form, would substantially increase the level of detail which trustees will be required to include. It is anticipated that many schemes would need to update their Implementation Statements significantly to meet the new standard.

A particular area which the draft guidance focuses on is in relation to stewardship and voting behaviour where trustees are urged to include significantly more details such as: rationale for their votes and how their stewardship policies are in members' best interests; the extent to which their chosen investment managers have aligned with the trustee's stewardship policies; and provide examples of the most significant votes exercised in the context of the trustee's stewardship priorities.

Trustees should keep an eye out for the final guidance and consider whether they will need to adopt a different approach for future Implementation Statements to ensure that their approach is in line with the new requirements.

Litigation Risk

The increased member awareness around ESG coupled with the requirement to publish the SIP, Implementation Statement and TCFD Report on a publicly available website generates an increased risk of climate-related litigation by pension scheme members. This could in turn lead to costs and reputational damage for the scheme, the trustees and possibly, by association, the employer.

The extent to which schemes are at risk from such claims will become clearer if / when cases are heard by the courts however the action currently facing the Universities Superannuation Scheme illustrates some of the accusations which trustees may face including:

- Failure to devise a credible plan to meet the scheme's net-zero goals.
- Failure to take into account the goals of the Paris Agreement.
- Failure to conduct a credible assessment of the financial risks posed by climate change.
- Failure to devise and implement a plan for disinvestment from fossil fuels.

Don't Forget the 'S' in ESG

Much of the discussion to date has concentrated on the Environmental and Governance aspects of ESG, with a particular focus on climate change and stewardship in recent years.

However, trustees should also take care to ensure that they have considered the Social risks and opportunities associated with the scheme's investments. This may involve considering factors such as diversity and working conditions. Potential actions which trustees could consider include working with investment managers to put in place a social scoring system to weigh up potential investment funds.

The Regulator's Single Code of Practice

Trustees will be aware that we continue to await a full response from The Pensions Regulator (TPR) on its proposals for a Single Code of Practice.

Under the proposals as currently drafted, climate change will be directly addressed within the Code as a new module, while ESG will also feature within a stewardship module. Additionally, trustees will also be required to consider climate change as part of the new 'Own Risk Assessment,' which they would be required to carry out under the proposals. These requirements will apply in addition to the TCFD requirements and to a wider range of schemes as the Code is not restricted to larger schemes in the same way as TCFD compliance.

Under the draft Single Code of Practice, trustees would be required to consider climate change and ESG in numerous ways including[1]:

Requirement	Relevant Code Module
Ensuring that the scheme's governing body (i.e. the trustees) considers environmental factors as part of its investment decision-making.	Climate change
Ensuring that the scheme's governing body talks to advisers and asset managers about how short and long term climate change risks and opportunities are factored into its recommendations.	Climate change
Considering the potential short, medium and long-term effects of climate change on the objectives of the scheme.	Climate change
Maintaining and documenting processes for identifying and assessing climate-related risks and opportunities and integrating these processes into the risk management and governance arrangements.	Climate change
Overseeing, assessing and managing climate-related risks and opportunities facing the scheme.	Climate change
Identifying and accounting for the systemic risk of climate change in decisions made about the scheme's investment and funding.	Stewardship
Considering engagement with investee companies (and co-operating with other institutional investors to do so), policymakers and industry initiatives, (either directly or through investment managers), to mitigate climate and ESG risks.	Stewardship
Covering how the scheme's governing body assesses investment risks relating to climate change, the use of resources and the environment as well as how it assesses social risks to the scheme's investments in the Own Risk Assessment.	Own risk assessment

Presently, we expect TPR to lay the new Code before Parliament in spring 2022 with it becoming effective around summer 2022. The first Own Risk Assessment is expected to be due within a year of the new Code coming into force.

Greening Finance Roadmap

Published in October 2021, the Greening Finance Roadmap sets out the UK Government's plans for aligning the financial system with its net-zero by 2050 commitment.

The Roadmap includes plans for Sustainability Disclosure Requirements (SDR) to be imposed requiring certain occupational pension schemes and asset managers to disclose how they take sustainability into account. The SDR are intended to prevent green-washing and assist trustees to integrate sustainability related risks and opportunities into their decisions.

The SDR will set similar expectations on schemes as TCFD in relation to governance, strategy, risk management and use of metrics and targets. It is therefore anticipated that SDR will build on and be combined with the existing TCFD reporting requirements currently being phased in.

Taskforce on Nature-Related Financial Disclosures (TNFD)

The TNFD was officially launched in June 2021. It aims to do for nature and biodiversity what the TCFD is trying to achieve for climate. The TNFD is expected to act as a risk management and disclosure framework for reporting on

[1] Note that some of these requirements will apply only to schemes with 100 members of more.

nature-related risks and encourage more nature-positive financial investments.

The initiative is currently at an early stage of development with a draft framework expected for consultation by 2023 and whilst there is currently no suggestion that TNFD disclosures will become mandatory for pension schemes in the immediate future, it is another area of potential change for trustees to consider in their investment planning discussions.

How to combat practical issues?

Trustees should also recognise and be aware of the practical issues which they may have to deal with in this area and potential solutions including:

Practical Issue	Potential Mitigation
Obtaining the necessary data	Consider a gap analysis highlighting the missing information. You can then sit down with your asset managers and make a plan for obtaining the necessary data or, if they cannot provide it, you will at least be able to explain why certain data cannot be obtained .
Recognising greenwashing	Follow industry guidance on how to recognise greenwashing such as the Environmental Social and Governance (ESG) Guide produced for trustees by the Society of Pension Professionals. Keep an eye out for progress on the UK Green Taxonomy which should assist trustees with scrutinising green labels and products.
Consideration of disinvestment	Consider in advance with your advisers at what point disinvestment might be necessary. Consider how disinvestment might fit into the scheme's wider engagement strategy with its investee companies.
Decisions around whether to commit to a net-zero target	Consider speaking to the scheme's sponsor to understand their stance on this and whether you could / should align the scheme with their goals.

We are here to help

Although the trustees will retain overall responsibility for compliance with the obligations set out in this briefing, you can look to your advisers, including both your legal and investment advisers for help in understanding and complying with your ESG-related duties. Sponsors should also consider discussing these issues and how they are being addressed (both at scheme and sponsor level) with the trustees.

You should consider whether training from your legal or investment advisers might be beneficial and what information and assurances you may need from each of your advisers on ESG.

Roadmap of Key ESG Developments

The key recent and upcoming developments to watch out for include:

Requirement	Expected timeframe
Schemes with GBP£5bn or more in assets at the end of their first scheme year falling on or after March 1, 2020, and authorised master trusts in-scope for TCFD Requirements	October 1, 2021
Consultations on UK Green Taxonomy	Expected Q1 2022
The Pensions Regulator's new single Code of Practice comes into force, including new module on climate change	Expected Summer 2022
Schemes with GBP£1bn or more in assets at the end of their first scheme year falling on or after March 1, 2021, in-scope for TCFD Requirements	October 1, 2022
Requirement to measure and report on alignment with Paris Agreement	October 1, 2022 – watch out for the final regulations expected shortly
New statutory guidance increasing the level of detail needed in the Implementation Statement	Expected to be finalised and enter into force in 2022

Consultation expected on the application of potential Sustainability Disclosure Requirements (SDR) to occupational pension schemes	2022
Taskforce on Nature-related Financial Disclosures (TNFD) framework expected to be available for adoption	2023
Smaller schemes potentially in-scope for TCFD Requirements	Potentially 2023 or 2024 following expected Government review in 2023

Contacts

Lesley Browning
Partner
Tel +44 20 7444 2448 | +44 77 1030 3311
lesley.browning@nortonrosefulbright.com

Shane O'Reilly
Partner
Tel +44 20 7444 3895
shane.o'reilly@nortonrosefulbright.com

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