UK Pensions Briefing - Trustee investment decisions and the role of ESG: A practical guide to the next steps

July 2020

Introduction

Environmental, Social and Governance (ESG) considerations have been on the radar of occupational pension scheme trustees for many years.

Following recent changes to the legislative framework for trust-based pension schemes, it is now clear that the incorporation of ESG factors and stewardship approaches (e.g. how trustees engage with their investments) should be a key component in the investment decision-making of trustees.

ESG factors are not static and encompass a wide range of considerations which trustees could take into account in their investment decisions. Some examples include

Environmental	Social	Governance
Climate change	Community relations	Board composition
Waste and recycling	Employee relations	Executive Remuneration
Supply chain management	Health and safety	Bribery and corruption
Carbon emissions	Human Rights	Shareholder rights
Energy usage	Gender and diversity	Audit committee structures

Despite the legislative changes, a February 2020 report by the UK Sustainable Finance and Investment Association (UKSIF) found that a change in attitudes may not yet have occurred amongst many pension scheme trustees and some schemes remain at the start of their ESG journey. The report found that many trust-based defined contribution schemes had ESG investment policies which were vague and non-committal and two-thirds of schemes had failed to comply with the minimum legal requirement to publish their Statement of Investment Principles (SIP). Such non-compliance places trustees at risk of breaching their fiduciary and regulatory duties.

The coronavirus pandemic is also likely to push ESG concerns further up the agenda of pension scheme trustees. In particular the Social, and Governance elements, which have to date received less attention than Environmental considerations may receive more prominence as the sustainability of companies with good structures in place to help them survive the fall-out from COVID-19 becomes more evident.

This briefing aims to set out the ESG-based requirements which are currently in place in order to assist trustees in assessing their compliance to date and to provide a practical guide to the next steps which trustees should be taking in preparation for the additional requirements which are coming in to force later this year and beyond.

Evolution of ESG in the SIP

The Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations) have long required trustees to include in their SIP their policy in relation to *"the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments".* However, due to historic confusion about the ability and extent to which trustees should take ESG into account in their investment decisions, ESG has traditionally been viewed by many pension scheme trustees as an 'optional extra' or a nice-to-have luxury.

To address this apparent inertia, the Government has commissioned various reports in the last few years to identify any legal obstacles which would prevent pension trustees from taking account of ESG type factors in their investment processes. In particular, it appeared that many trustees remained under a mistaken belief that the case of *Cowan v Scargill* [1985] meant that taking account of ESG factors and/or considering social impact investments would run contrary to the long-established principle that trustees must only invest in the best financial interests of members.

However, the Law Commission found that the key is to understand that ESG factors are financial factors in their own right as they can affect risks and returns in the investment strategy, both of which impact the financial interests of members. Accordingly, the Investment Regulations were amended in 2018 and 2019 to introduce revised obligations dealing with trustees' ESG policies and their stewardship and dealings with their asset managers.

Where are we now?

By October 1, 2019 trustees were required to include in their SIP their policies on:

- The duty to take into account financially material considerations over the appropriate time horizon. 'Financially material considerations' expressly include ESG issues including climate change. The 'appropriate time horizon' means the length of time which trustees consider is required for the funding of future benefits by the investments of the scheme.
- Their stewardship obligations – this encompasses how rights relating to scheme investments (including voting rights) are exercised.
- Their approach to non-financial matters – this means the extent to which (if at all) non-financial matters play a role when trustees are deciding whether to select, retain or realise scheme investments. 'Non-financial matters' include the ethical views of members and beneficiaries, their views in relation to social and environmental impacts and their views on the present and future quality of life of the members and beneficiaries of the scheme.

By October 1, 2020 trustees will need to include further detail in their SIPs on their stewardship policy and arrangements with asset managers. Prior to that date, the SIP must be expanded to cover:

- How their arrangements with their asset managers incentivise the manager to align its investment strategy and decisions with the trustees' investment policies.
- How their arrangements with the asset managers incentivise them to assess and make decisions based on the medium to long-term financial and non-financial performance of an issuer of debt and equity and to engage with the issuer to improve this medium-long term performance.
- How the method and time horizon of the evaluation of the asset manager's performance as well as the manager's remuneration is aligned with the trustees investment policies.
- An updated stewardship policy which deals with how they engage with and monitor investee companies in terms of their capital structure and how actual or potential conflicts of interest are managed.
- How they monitor the portfolio turnover costs incurred by the asset manager.
- The duration of their arrangement with the asset manager.

From October 2020 trustees who are required to produce a SIP will also need to produce an implementation statement - we discuss this in the second part of our briefing below.

Key ESG dates for your diary

A — By October 1, 2019

Trustees of DB and DC / Hybrid schemes[1] should have included in their SIP their policy on how financially mater ial considerations including, but not limited to, ESG factors are taken into account in trustee investment decisions; the extent (if at all) non-financial matters such as member views are taken into account in trustee investment decisions; and to reflect their stewardship policy (e.g. how rights relating to investments (including voting rights) are exercised)

DC / Hybrid schemes were also required to ensure the SIP for the default arrangements also covers the above matters

DC / Hybrid schemes must have published the scheme's SIP on a publicly available free to access website

B — By October 1, 2020

Trustees of DC / Hybrid schemes and DB schemes must update their SIP to include additional details on their arrangements with the scheme's asset managers

DB schemes must publish the scheme's SIP on a publicly available, free to access website

C — From October 1, 2020

Trustees of DC / Hybrid schemes and DB schemes must include an Implementation Statement in their first Annual Report published after October 1, 2020. This must also then be published online free of charge.

D — By October 1, 2021

DC / Hybrid Schemes must publish their first implementation statement online by this date at the latest

DB Schemes must publish their implementation statement free of charge on a website

1 Any reference to DC / Hybrid or DB Schemes throughout this briefing means such DC / Hybrid or DB occupational pension schemes which are required to produce a SIP under Section 35 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005 (which means most DB, DC or Hybrid schemes with 100+ members).

Implementation Statements – a practical guide

What is an Implementation Statement?

Alongside the obligation to formally formulate their policies on ESG integration, from October 2020 trustees will be required to include an implementation statement when they publish their scheme's annual report. The Pensions Regulator intends that this statement will be a way of ensuring that action follows intent as far as possible by requiring trustees to set out how they have followed and acted upon the investment principles and policies contained in their SIP during the scheme year. The fact that the implementation statement will be publicly available means trustees will have to focus on how their policies and arrangements have delivered against the agreed principles and rely on their asset managers and consultants to equip them with the relevant information to demonstrate compliance.

When will an Implementation Statement be required?

Trustees will need to include an implementation statement when they publish their first annual accounts after October 1, 2020. Each subsequent annual report will also need to include an implementation statement. The deadline for the first implementation statement will therefore depend on when trustees produce their annual report. This is subject to a final deadline of October 1, 2021 for the publication of the first implementation statement for both DC / Hybrid and DB schemes.

Although some schemes may still have some time before their first implementation statement is required there are a number of steps which trustees should be taking now to ensure they are prepared to comply with the implementation statement requirements when the time comes.

What goes in an Implementation Statement?

Although the exact information contained in the implementation statement will differ depending on whether your scheme is a DC / Hybrid scheme or a DB scheme and depending on the individual circumstances of your scheme there are some broad principles which the legislation requires trustees to cover as described in the table below.

It should be noted that if the scheme does provide both DB and DC benefits, the DC / Hybrid requirements apply to the whole scheme even if the DB and DC benefits are run as segregated sections. Hybrid schemes must therefore report on the implementation of their DB investment policies as well as their DC policies.

Non-compliance with the legislative requirements, is subject to discretionary penalties under s168 of the Pension Schemes Act 1993 and Regulation 5 of the Disclosure Regulations.

DC / Hybrid Schemes	DB Schemes
• Trustees should describe how and the extent to which in their opinion, they have followed the SIP during the scheme year. • Trustees should detail any changes made to the SIP during the scheme year and the reasons for these changes. • Trustees should describe any review of the SIP undertaken in compliance with Regulation 2(1) of the Investment Regulations and / or any other review of the SIP undertaken during the scheme year.[2] • Where no review has been carried out in accordance with Regulation 2(1) the trustees should include the last date that such a review took place. • Trustees are also required to include a description of voting behaviour by or on behalf of the trustees (including the most significant votes cast by or on behalf of the trustees).[3] • Trustees also need to state any use of a proxy voter during the scheme year.[4]	• Trustees should include a description of voting behaviour by or on behalf of the trustees (including the most significant votes cast by or on behalf of the trustees). • Trustees also need to state any use of a proxy voter during the scheme year. • Trustees will need to describe the extent to which they have followed the policies in their SIP on the exercise of rights attaching to investments (including voting rights). • Trustees will also need to describe the extent to which they have followed the policies in their SIP on undertaking engagement activities including monitoring and engaging with investment managers.

The Pensions Regulator's DC investment guidance has now been updated to provide some further ideas on what trustees may look to include in their implementation statements. The DB investment guidance has not yet been updated however the DC guidance may also be useful to trustees of DB schemes as an illustration of the Pensions Regulator's current thinking on implementation statements.

The DC guidance states that the implementation statement might include detail on the following:

- How trustees have developed their policies on voting and engagement, including the relevance of investment beliefs underpinning those policies and their investment time horizons.
- The time and resources trustees have dedicated to the process, including details of any relevant sub-committees and advice taken.
- How the trustees' policies have been implemented in practice (e.g. actions taken with investor coalitions, reviewing investment manager mandates and public policy work undertaken).

The February 2020 UKSIF report did recommend that the Pensions Regulator provides more detailed guidance on what should feature in the implementation statement however this is not expected at present.

PLSA guidance

In addition to the legislative requirements and minimal guidance from the Pensions Regulator set out above, on July 31, 2020, the Pensions and Lifetime Savings Association (PLSA) also released its Implementation Statement Guidance. The PLSA worked together with industry participants to devise this practical guidance which is designed to assist trustees in producing the new implementation statement and co-ordinate the necessary conversations with their asset managers and other professional advisers. This guidance follows on from the PLSA's 2019 guidance on the first phase of the changes and includes a step-by-step process in both planning and producing the implementation statement to assist trustees in identifying and actioning the key milestones on the journey to publication of the statement.

2 Regulation 2(1) requires trustees to review their SIP every 3 years or following a significant change in investment policy if earlier.
3 The requirement to include this information in the implementation statement has an extended final publication deadline of October 1, 2021.
4 The requirement to include this information in the implementation statement has an extended final publication deadline of October 1, 2021.

The PLSA recognises that implementation statements are new for both trustees and their advisers and this guidance is designed to help trustees get to grips with what the legislation requires and when. In addition, the PLSA sets out some high-level general principles on the content of the implementation statement and some more detailed questions for trustees to consider when deciding on the disclosures which will feature in the implementation statement. The guidance also contains specific consideration of how to deal with voting behaviour disclosures in the implementation statement and concludes with some more general tips on investment communication.

The PLSA intends that this guidance should assist trustees in getting the disclosures in the implementation statement correct so that they are meaningful, relevant and focus on significant, 'move the dial' information which has had a material impact on investment outcomes and decisions. The guidance is also intended to assist trustees in fully considering the time and resources needed to complete the first implementation statement in good time and will evolve over time as market practice develops.

Publishing the Implementation Statement

Defined contribution and hybrid pension schemes will be required to publish their first implementation statement online free of charge at the earlier of:

- The signing of their first annual report after October 1, 2020.
- By October 1, 2021.

Defined benefit schemes will also be required to publish their implementation statement online by October 1, 2021.

The requirement to publish the implementation statement means publishing it free of charge on a publicly searchable website. DC / Hybrid schemes are also required to include a link to the implementation statement in the annual benefit statements to members whilst defined benefit scheme trustees are required to notify the scheme members as to where the implementation statement is located.

What should Trustees be doing now?

Trustees should also ensure that they are familiar with the intentions and objectives contained in their SIP and what these commitments mean in practice so that they are able to evidence and explain these when writing their implementation statement.

In order to prepare, trustees should ensure that their managers are providing them with the information which they will need to complete the implementation statement. Although the majority of trustees will not have the experience, expertise or regulatory authorisation to take the necessary steps to integrate ESG into their portfolios, the legal responsibility to ensure that ESG and stewardship are properly integrated rests with the trustees – it is not sufficient for trustees to totally delegate these matters to their investment managers. Instead trustees should work together with their managers to ensure appropriate integration of ESG and stewardship matters. The PLSA recommends some key procedural steps which trustees should be embarking on to manage their new ESG responsibilities.

Key Tips for Trustees

- You should recognise that you will need to take a more active role in considering ESG as a factor in investment decisions and should carefully consider the responsibilities which you are delegating to asset managers.
- If you have not already done so, you should ensure you understand how ESG is already incorporated within your scheme's investment portfolio. You should ask your asset managers which ESG risks it considers financially material to your portfolio and why.
- You should ensure the Trustee Board undertakes some training on ESG investing and climate change.
- When delegating to an asset manager ensure, that you have asked questions around and considered their ESG capabilities and reporting framework.
- You should check the contents of any Investment Management Agreements to see if ESG requirements should be added to the mandate.
- If you have not yet done so, sit down with your asset managers to consider their ESG capabilities and how your investment beliefs can be realistically put into practice.
- You should also question your asset managers about their approach to ESG investing and the data and tools which they use to integrate ESG and meaningfully consider ESG factors including their voting approach and their ability to influence companies.

- You should be prepared to challenge advisers on how they will use trustee investment beliefs in how they incorporate and report ESG activity.
- You should discuss a reporting process on ESG with your asset managers to ensure that you are able to communicate on how ESG has been implemented and that regular meetings can be scheduled.
- Ensure that you keep up to date with industry best practice guidance and consultations.
- Consider engaging with your asset managers to periodically review your SIP to ensure that it matches your evolving investment beliefs and any changes in market practice.

What Next?

It is clear that the importance of ESG and stewardship considerations has grown considerably in recent years and that these factors should now be an important topic on a pension scheme's agenda. Many schemes remain near the beginning of their ESG journey and recent indications are that this journey still has a long way to go.

In addition to the enhanced statutory requirements which will apply from October 2020 which trustees will need to be prepared for, they should also be mindful that the Government's gaze appears firmly fixed on requiring pension scheme trustees to address climate change.

Pensions Minister Guy Opperman has expressed a commitment to ensuring that pension scheme trustees act on climate change and as well as consulting on requirements on all large asset owners (including pension schemes) to make disclosures in-line with recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) by 2022,[5] the Pension Schemes Bill currently progressing through parliament had an amendment tabled which, if included in the final legislation would give the Government broad reserved powers to introduce enhanced climate change governance responsibilities and reporting requirements for trustees as well as giving related enforcement powers to the Pensions Regulator.

It is therefore clear that the regulatory direction of travel for ESG and climate change related issues is moving towards increased governance and forcing stakeholders such as pension scheme trustees to take steps to adopt an ESG-integrated mindset.

As trustees start to focus on putting together their first implementation statements, this momentum will only accelerate and push ESG considerations higher up the agenda. What is undeniably clear is that trustees are at the beginning of a new regulatory regime, which will likely need a mindset shift and detailed support from their investment managers, consultants and legal advisers to navigate the challenges ahead.

We have put together the brief skeleton checklist below for trustees to use as a final takeaway reminder of the key dates for their ESG / Stewardship diary.

5 This stems from the Government's 'Green finance strategy' which can be found here and the 'Aligning your pension scheme with the TCFD recommendations' consultation document which can be found here.

ESG Checklist

Requirement	Deadline	Scheme Type	Completed?
Update SIP with ESG and Stewardship policies	October 1, 2019	DB and DC / Hybrid Schemes	
Publish SIP on a freely available website	October 1, 2019	DC / Hybrid Schemes	
Update SIP to include policies on arrangements with asset managers	October 1, 2020	DB and DC / Hybrid Schemes	
Publish SIP on freely available website	October 1, 2020	DB Schemes	
Implementation Statement must be included in next annual report setting out how the SIP has been followed during the scheme year. Publish this on a freely available website	First annual report from October 1, 2020. No later than October 1, 2021	DC / Hybrid Schemes	
Published Implementation Statement must also now include a description of the voting behaviour by or on behalf of the trustees including the use of proxies.	October 1, 2021	DC / Hybrid Schemes	
Implementation Statement containing information on Stewardship policy and trustee voting behaviour must be included in next annual report and must be published on a freely available website	First annual report from October 1, 2020. No later than October 1, 2021	DB Schemes	

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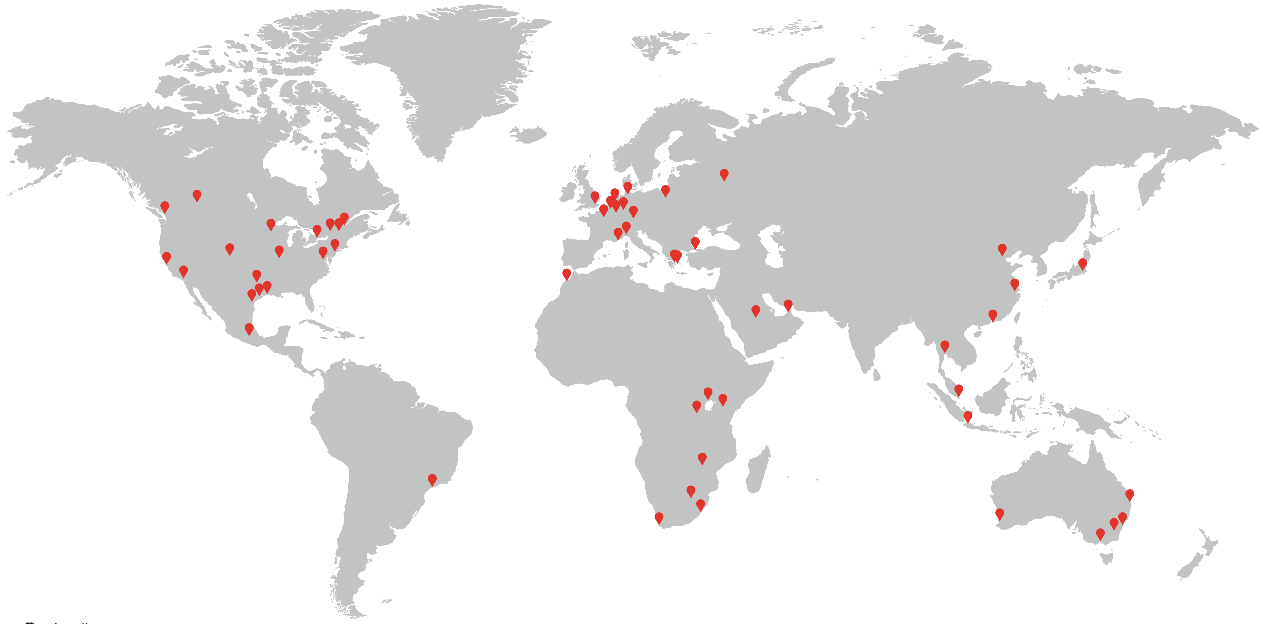

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