Sackers

Finance & investment briefing

December 2022

Sackers finance & investment group takes a look at current issues of interest to pension scheme investors

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Abbreviations

AVCs: Additional Voluntary Contributions

CDC: Collective Defined Contribution

DB: Defined Benefit

DC: Defined Contribution

DWP: Department for Work and Pensions

ESG: Environmental, social and corporate governance

FCA: Financial Conduct Authority

GTAG: Green Technical Advisory Group

HMT: HM Treasury

IGC: Independent Governance Committee

IS: Implementation statement

LDI: Liability-driven investment

OTC: Over the counter

PRI: Principles for Responsible Investment

SDR: Sustainability Disclosure Requirements

SIP: Statement of Investment Principles

TCFD: Taskforce on Climate-related Financial Disclosures

TPR: The Pensions Regulator

UNEP FI: United Nations Environment Programme – Finance Initiative

WPC: Work and Pensions Select Committee

Finance & investment focus

"Welcome to our fourth and final finance & investment briefing for 2022. As we put an unseasonably warm autumn behind us we take stock of what 2022 has had to offer and what might be in store for 2023.

The last few months have, of course, been unusual not just for the weather. LDI markets caught a cold on the back of Liz Truss' ill-fated mini budget in September and many trustees and investment teams have had a busy time trying to keep pace with rapidly rising gilt yields. Whilst things appear to have stabilised for now, many schemes have had to liquidate large parts of their portfolios to keep their hedge ratios in place and may be heading into 2023 with quite different investment portfolios to the ones they started with this year.

2023 will also look different for many trustees on the legal and regulatory front. Trustees of schemes with assets between £1bn and £5bn will now be in scope of TCFD reporting requirements (see our Alert). In addition, new DWP guidance brings additional reporting obligations for ISs applicable to scheme years ending on or after 1 October 2022. In the vast majority of cases this will impact ISs included in trustee annual reports generated during the course of 2023. We look at some of the new requirements on page 3.

Coming down the track, we are also keeping an eye on the implementation of the Government's Greening Finance Roadmap, with a consultation recently launched by the FCA on new SDR for asset managers, as well as a new sustainability labelling and classification system. We provide an overview on page 4 and will be closely monitoring the potential implications for pension trustees as we head into 2023.

In the meantime, we wish you all a restful holiday period and look forward to seeing you in 2023."

Stuart O'Brien
Partner, finance & investment group

stuart.obrien@sackers.com

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New DWP Guidance on SIPs and ISs

In June 2022, the DWP published new guidance for trustees on the recommended content for SIPs and ISs.

The new guidance, "Reporting on Stewardship and Other Topics through the Statement of Investment Principles and the Implementation Statement: Statutory and Non-Statutory Guidance" (the "Guidance") contains both "statutory" and "non-statutory" provisions, focusing particularly on stewardship, voting and engagement.

The statutory element of the Guidance concerns the content of the annual IS, and trustees must have regard to the Guidance when preparing the IS.

The non-statutory part (primarily focused on the content of the SIP) is intended to encourage good practice, but trustees are not obliged to take it into account. The activities set out in the Guidance are therefore described as things trustees either "must", "should" or "could/may" do.

Voting behaviour

A key theme of the Guidance in relation to IS content is the link between a scheme's stewardship priorities and voting behaviour.

Most significant votes

Trustees must describe in the IS the voting behaviour by, or on behalf of, the trustees during the year. Trustees should include relevant statistics to help describe voting behaviours (which ideally would be broken down into types of issue, including ESG). In addition, the Guidance contains substantial details on "most significant votes", noting that what constitutes a most significant vote will vary from scheme to scheme, in the same way that stewardship priorities will differ. The Guidance states that it is likely and desirable that most significant votes are aligned with a scheme's stewardship priorities or themes, stressing that a thematic approach towards most significant votes allows trustees to consider the links between a scheme's stewardship priorities and voting behaviour.

The Guidance provides a list of suggested information that trustees should include in respect of "most significant votes" in the IS, including which stewardship priority the vote was linked to as well as why the trustees consider the vote to be most significant.

Expression of wish

The Guidance supports the idea of trustees providing their managers with a trustee "expression of wish" over voting policies. This was originally a recommendation of the Taskforce on Pension Scheme Voting Implementation (September 2021). The Guidance also cross refers to the UK Stewardship Code and indicates areas of potential alignment between the IS requirements and the Stewardship Code principles. It explains that trustees can use information in their Stewardship Code reports in the IS, providing that information meets the legal requirements.

Audience

The Guidance sets out DWP's view that TPR, as opposed to the scheme membership, is the primary audience of the SIP and the IS. However, trustees are encouraged to write both documents, as far as possible, in plain English such that a reasonably engaged and informed member could interpret and understand the disclosures. In addition, it is noted that if scheme-specific research indicates that members are more likely to engage with a different style of communication, trustees are encouraged to consider producing member-facing summary versions of the IS.

Timing

The Guidance concerns ISs that trustees are required to prepare in respect of any scheme year ending on or after 1 October 2022. In the vast majority of cases this will impact ISs included in annual reports generated during the course of 2023, however the precise timing of application of the Guidance will be specific to each scheme. Nevertheless, the detailed provisions included in the Guidance means early preparation is key. Trustees on the front foot when requesting the required information from their managers will be best placed when it comes to compiling annual reports.

Greening Finance Roadmap

In October 2021, HMT published a policy paper Greening Finance: A Roadmap to Sustainable Investing. The paper set out the Government's ambition "to green the financial system and align it with the UK's net zero commitments".

It builds upon the Government's Green Finance Strategy published in 2019. Developments in this area are likely to have an indirect impact on schemes via the companies and investment products in which a scheme invests. In time, the scope of these further direct reporting obligations may be expanded to include pension scheme trustees.

We highlight below some of the key areas to note.

New mandatory climate-related financial disclosures for UK companies and limited liability partnerships

In January 2022, new disclosure requirements were introduced under the Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022 and the Limited Liability Partnerships (Climate-related Financial Disclosure) Regulations 2022. The Government has also published guidance to accompany these new regulations. The regulations amend sections of the Companies Act 2006 and the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 to place requirements on certain publicly quoted companies, large private companies and certain LLPs to incorporate TCFD-aligned climate disclosures in their annual reports. The regulations apply to reporting for financial years starting on or after 6 April 2022.

In addition, the FCA has also published climate-related disclosure rules for listed companies.

New sustainability disclosure requirements and FCA climate-related disclosures for investment managers and investment products

The FCA is consulting on new SDR disclosures for asset managers, as well as a new sustainability labelling and classification system for funds and portfolio management arrangements (see UK Green Taxonomy below). The proposals "aim to build transparency and trust" and to ensure that "sustainability-related terms in the naming and marketing of products are proportionate to the sustainability profile of the product". The consultation closes on 25 January 2023. Final rules and guidance are expected in the first half of 2023, and the FCA will look to "expand and evolve" the requirements over time. This may include expanding the application of the disclosure requirements to include certain FCA-regulated asset owners, pension arrangements and other investment products.

The consultation follows the addition of the ESG Sourcebook to the Business Standards block within the FCA Handbook. The sourcebook contains rules and guidance for asset managers and certain FCA-regulated asset owners, including FCA-regulated pension providers, to make disclosures consistent with the TCFD recommendations. The rules require annual disclosure at both entity level and product or portfolio level, applying from 1 January 2022 for the largest in scope and 1 January 2023 for smaller firms above a £5 billion exemption threshold. The first public disclosures in line with the sourcebook requirements must be made by 30 June 2023.

UK Green Taxonomy

The Government is implementing a UK Green Taxonomy that will set out the criteria which specific economic activities must meet to be considered environmentally sustainable or taxonomy-aligned. The details of the Taxonomy are set out in the roadmap policy paper and draw on the EU approach pursuant to Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088, which the UK helped design as a former member state. Reporting against the UK Taxonomy will also form part of the SDR disclosures.

A GTAG has also been established by the Government to advise on the development of the UK Green Taxonomy. On 7 October 2022, GTAG published a report containing its advice to the Government. The report focuses on how to approach onshoring the EU framework, "do no significant harm" requirements, international interoperability and Taxonomy use cases. The report indicates that a consultation on the UK Green Taxonomy is anticipated.

Legal update

Changes in force from 1 October 2022

Several changes came into effect on 1 October 2022, including:

- climate reporting, introducing a new fourth "Paris alignment" metric to schemes in scope of the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021. See our Alert for details. TPR has also updated its guidance to reflect the reporting requirements
- statutory guidance for preparing SIPs and ISs, and
- the introduction of simpler annual benefit statements for DC schemes used for automatic enrolment.

Gilt market

On 28 September 2022, following a surge in gilt yields after the Government published the Growth Plan 2022, the Bank of England announced plans for temporary purchases of long-dated gilts to "restore orderly market conditions". The purchases took place up until 14 October 2022 with the intention that they will be unwound in a "smooth and orderly fashion once risks to market functioning are judged to have subsided". The Bank of England, TPR and the FCA are "closely monitoring the progress of LDI funds".

On 12 October 2022, TPR published a statement "Managing investment and liquidity in the current economic climate" that set out its expectations of pension scheme trustees in managing investments and liquidity risks "in the face of current market conditions". The statement highlighted the key actions trustees could take ahead of the end of the Bank of England's temporary programme to purchase long-dated government bonds on 14 October 2022.

Following these developments, on 24 October 2022, the WPC launched a new inquiry into DB schemes with LDI, following the rapid increases in gilt yields. The WPC has opened a call for evidence as part of the inquiry, looking at issues including the impact of the rise in gilt yields on DB schemes, the impact on members in both DB and DC arrangements, and whether the experience suggests other policy or governance changes are needed. The call for evidence closes on 15 November 2022. The WPC intends to follow this with a further inquiry in 2023 looking at DB schemes more widely, with issues "likely to include DB scheme funding requirements and arrangements to protect pension benefits when a scheme is wound up".

PRI report: UK: Integrating sustainability goals across the investment industry

On 11 October 2022, the PRI, in partnership with UNEP FI and the Generation Foundation, published a new paper "Legal Framework for Impact (United Kingdom): integrating sustainability goals across the investment industry". The paper releases new analysis on how investors address sustainability challenges, and how the UK's legal frameworks help or hinder such efforts. The paper includes several recommendations focusing on policy measures that would empower investors to consider sustainability factors and pursue sustainability impact goals. The three main recommendations include:

- clarifying when sustainability impact goals must be considered as part of fiduciary duties of loyalty, care and prudence
- clarifying that purpose-related requirements (duty to act in client's best interests) entail consideration of sustainability impact goals
- ensuring stewardship powers are used to achieve sustainability impact goals.

The recommendations "build on existing and planned UK regulations with the aim of accelerating the transition to a sustainable financial system".

DWP publishes consultation on broadening the investment opportunities of DC schemes

On 6 October 2022, the DWP published a consultation on draft regulations and statutory guidance intended to remove performance-based fees from the DC charge cap and to implement certain of the changes proposed in its March 2022 consultation. The proposals include:

- amending the default SIP requirements (and main SIP requirements for CDC schemes) to ensure that schemes which provide DC benefits (excluding schemes where the only DC benefits are AVCs) disclose and explain their policies on illiquid investments
- requiring DC and CDC schemes to publicly disclose and explain their default asset class allocation in their annual chair's statement
- excluding "well-designed" performance-based fees from the charge cap that applies to default arrangements in DC schemes used for automatic enrolment, and
- requiring trustees and managers to have regard to the DWP's proposed guidance in relation to the asset allocation disclosures, and when determining whether a performance-based fee falls within the new charge cap exemption.

The consultation closes on 10 November 2022 and the draft regulations are currently expected to come into force on 6 April 2023. See our Alert for further details.

Sackers

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees, employers and providers. Over sixty lawyers focus on pensions and its related areas, including Sackers finance and investment group, a team of lawyers who provide cutting-edge advice on all aspects of pension scheme finance and investment.

Paul Phillips
Partner
D +44 20 7615 9523
E paul.phillips@sackers.com

Key areas of expertise include: risk transfer transactions, LDI, longevity transactions, OTC derivatives and repurchase agreements, investment management, transition and custody arrangements.

Ian Cormican
Partner
D +44 20 7615 9501
E ian.cormican@sackers.com

Key areas of expertise include: longevity transactions, funding negotiations, risk transfer transactions, LDI, fiduciary management and governance.

Stuart O'Brien
Partner
D +44 20 7615 9539
E stuart.obrien@sackers.com

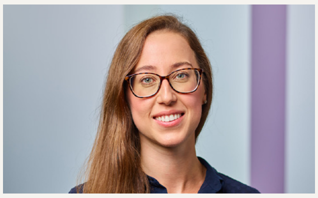
Key areas of expertise include: risk transfer transactions, LDI, investment management agreements, ESG issues including fiduciary duties, policy, stewardship, climate change risk, responsible and impact investing.

Jacqui Reid
Partner
D +44 20 7615 9550
E jacqui.reid@sackers.com

Key areas of expertise include: DC investment strategy, regulation and industry best practice for IGCs and providers, member engagement and value for money.

Ralph McClelland
Partner
D +44 20 7615 9532
E ralph.mcclelland@
sackers.com

Key areas of expertise include: risk transfer transactions including buy-ins and buy-outs, fiduciary management, custody arrangements, DB consolidators, all types of pooled investment products and ESG.



Paige Willis
Senior associate
D +44 20 7615 9540
E paige.willis@sackers.com

Key areas of expertise include: risk transfer transactions, pooled investment products and contingent assets.

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Sacker & Partners LLP
20 Gresham Street
London EC2V 7JE
T +44 20 7329 6699
E enquiries@sackers.com
www.sackers.com