Sackers

ESG and climate change for pension funds

Your agenda for 2020

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Introduction

Download our previous ESG guides from our website.

Welcome to our latest guide for pension trustees on ESG investment and climate change.

Nothing stands still in the world of ESG and, as we look forward into 2020, pension trustees are faced with more changes. These include a new October 2020 deadline for a second round of SIP updates following SRD II, as well as a new requirement for trustees to publish annual implementation statements setting out how trustee ESG and stewardship policies have been followed during the year. The regulatory developments run in parallel with the ever-pressing need for trustees to consider the potential impact of the climate crisis on their investments. Contract-based pension fund providers don't escape either this year, with new requirements for IGCs taking effect from April 2020.

In this, our fourth guide to ESG and climate change, we consider how trustees should respond to the latest regulatory requirements. We look back at some of the key ESG milestones since the Paris accord and summarise the latest regulatory requirements, including a timetable for trustee compliance with the latest round of changes. Trustees will need to consider carefully how the legislation applies to their schemes, as it applies in different ways (and with different deadlines) depending on the scheme in question.

Against the backdrop of regulatory change, climate change is increasingly under the spotlight. Last year was the second hottest on record, and 2020 has begun with a series of natural disasters that appear to be linked to hotter temperatures. Where do pension trustee duties fit into this and how should trustees react to emerging government policy likely to mandate climate-related risk reporting by pension funds? We look again at climate change risk and the trustee fiduciary duty and report on the consultation on cross-industry guidance, which was launched in March 2020, and is something Sackers is proud to have been involved in.

We also focus on stewardship in light of updates to the FRC's Stewardship Code and how ESG and climate change issues should be considered in DC schemes, including by master trusts and IGCs. Finally, we set out an action plan for pension schemes. This looks at what trustees might do to better integrate ESG factors into their decision making, both for trustees who are just getting started and for those who want to go further.

We hope you enjoy reading this guide. If you would like to discuss how your scheme can best formulate, document and implement its approach to ESG, climate change and stewardship, please speak to any member of the Sackers team.

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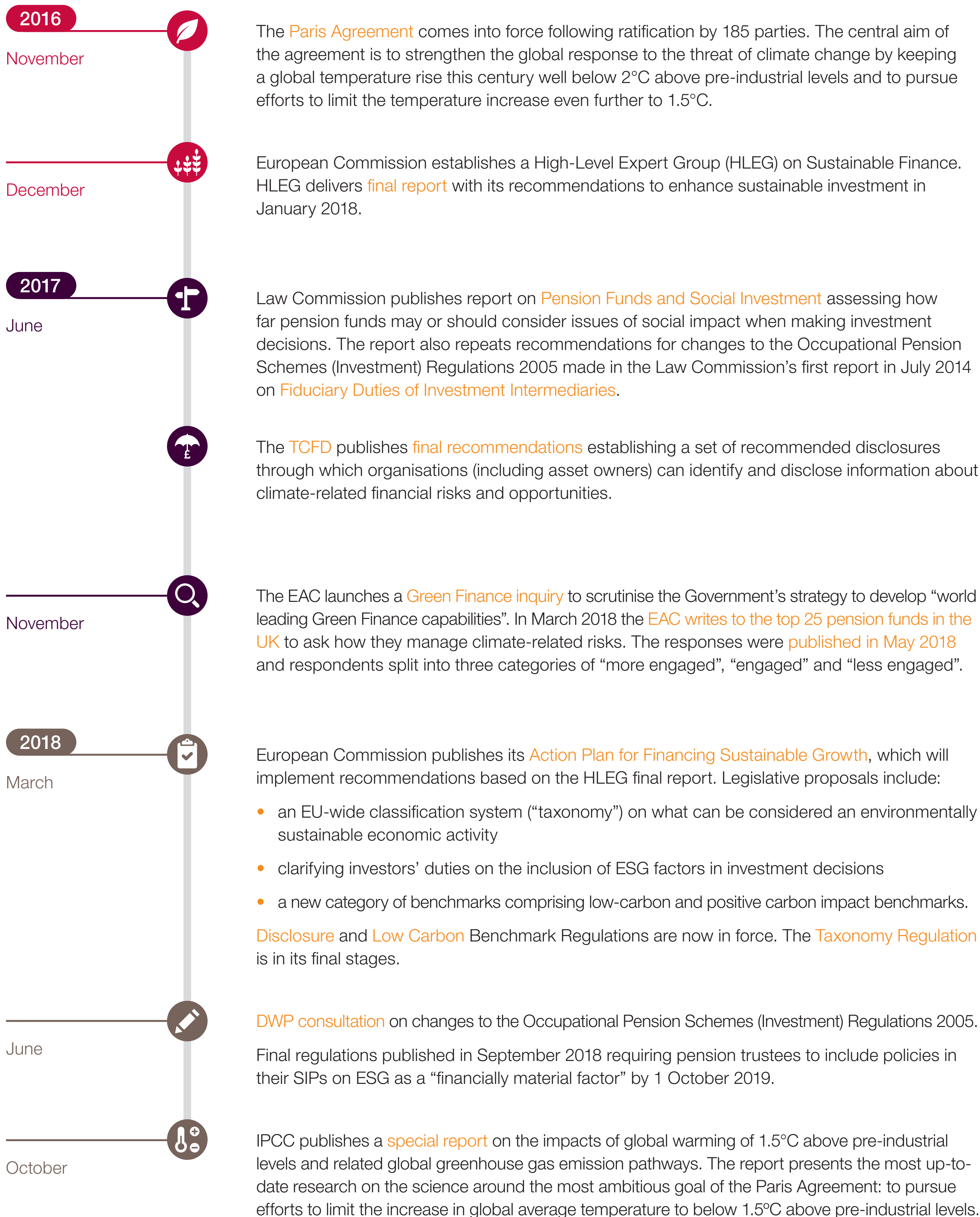
Key developments since Paris



The Paris Agreement comes into force following ratification by 185 parties. The central aim of the agreement is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5°C.

European Commission establishes a High-Level Expert Group (HLEG) on Sustainable Finance. HLEG delivers final report with its recommendations to enhance sustainable investment in January 2018.

Law Commission publishes report on Pension Funds and Social Investment assessing how far pension funds may or should consider issues of social impact when making investment decisions. The report also repeats recommendations for changes to the Occupational Pension Schemes (Investment) Regulations 2005 made in the Law Commission's first report in July 2014 on Fiduciary Duties of Investment Intermediaries.

The TCFD publishes final recommendations establishing a set of recommended disclosures through which organisations (including asset owners) can identify and disclose information about climate-related financial risks and opportunities.

The EAC launches a Green Finance inquiry to scrutinise the Government's strategy to develop "world leading Green Finance capabilities". In March 2018 the EAC writes to the top 25 pension funds in the UK to ask how they manage climate-related risks. The responses were published in May 2018 and respondents split into three categories of "more engaged", "engaged" and "less engaged".

European Commission publishes its Action Plan for Financing Sustainable Growth, which will implement recommendations based on the HLEG final report. Legislative proposals include:

- an EU-wide classification system ("taxonomy") on what can be considered an environmentally sustainable economic activity
- clarifying investors' duties on the inclusion of ESG factors in investment decisions
- a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks.

Disclosure and Low Carbon Benchmark Regulations are now in force. The Taxonomy Regulation is in its final stages.

DWP consultation on changes to the Occupational Pension Schemes (Investment) Regulations 2005.

Final regulations published in September 2018 requiring pension trustees to include policies in their SIPs on ESG as a "financially material factor" by 1 October 2019.

IPCC publishes a special report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways. The report presents the most up-to-date research on the science around the most ambitious goal of the Paris Agreement: to pursue efforts to limit the increase in global average temperature to below 1.5ºC above pre-industrial levels.

2019

January

The Occupational Pension Schemes (Governance) (Amendment) Regulations 2018 come into force. Designed to implement aspects of IORP II, they update the Pensions Act 2004 with a new requirement for the establishment and operation of "an effective system of governance".

TPR is required to set out the details in a code of practice including how trustees' systems of governance should consider ESG factors and assess new or emerging risks (including climate change). A consultation on the new code is expected in 2020.

April

FCA launches consultation on extending the remit of IGCs. Final rules published in December 2019 include a new duty for IGCs to consider and report on their firm's policies on ESG issues, member concerns, and stewardship, for the products that IGCs oversee.

June

Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations published. They are intended to implement aspects of SRD II relating to workplace pension scheme stewardship and governance, and significantly expand the requirements for SIPs and trustees' investment disclosure obligations. SIPs will have to be updated before 1 October 2020.

Updated DC Investment Guidance published by TPR.

July

Government publishes its Green Finance Strategy – Transforming Finance for a Greener Future report. It sets out the Government's expectation that all listed companies and "large asset owners" should be reporting climate-related risks in line with the TCFD recommendations by 2022.

September

Updated DB Investment Guidance published by TPR.

PRI launches Inevitable Policy Response project with the publication of a series of major research papers. The PRI recommends that investors should be braced for governments "to act forcefully but in an uncoordinated fashion on climate change within the next five years".

October

Pensions minister asks 50 of the UK's largest pension schemes for copies of ESG statements.

"Revised and strengthened" UK Stewardship Code published by the FRC. The new Code took effect on 1 January 2020 setting new expectations about how stewardship is integrated in investments, including ESG issues.

December

ShareAction publishes a review of UK master trusts' ESG policies.

2020

February

UKSIF publishes a report on pension scheme compliance with the new SIP requirements. The report finds that most pension scheme trustees have adopted "thin and non-committal" policies to manage environmental risks, and many have not complied with minimum legal obligations.

Amendments proposed to the Pensions Bill to give a regulatory-making power to require that pension schemes provide public climate-related risk reporting.

SIPs and implementation statements – where to start?

Since October 2019 trustees have needed a clear policy on ESG, climate change and stewardship. This is not just about finding the "right" words to put in a SIP. Trustees must think carefully about how policies are integrated into their portfolios and risk assessment. On pages 8-9 we set out a timetable for DB and DC schemes.

Recap on SIP requirements – October 2019

Trustees were required to update or prepare their SIP, before 1 October 2019, to set out their policies in relation to "financially material considerations" (defined to include ESG considerations and climate change), and their engagement activities in respect of investments (stewardship). SIPs also had to be updated to set out the extent (if at all) to which "non-financial matters" (generally member views on ethical matters) are taken into account. Trustees of DC schemes must also publish their SIP on a publicly available website.

SIP requirements – October 2020

Further changes to the Investment Regulations[1] were made in 2019 to implement aspects of SRD II in the UK. These require trustees to make further changes to their SIPs by 1 October 2020, setting out the following in relation to their arrangements with their asset managers (or explaining why they are not set out):

- how asset managers are incentivised to align their investment strategy and decisions with the trustees' investment policies, including in relation to ESG matters
- how asset managers are incentivised to make decisions based on assessments about medium-to-long-term financial and non-financial performance of an issuer of debt or equity and to engage with issuers of debt or equity in order to improve their performance in the medium-to-long-term
- how the method (and time horizon) of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with the trustees' investment policies
- how the trustees monitor portfolio turnover costs incurred by asset managers, and how they define and monitor targeted portfolio turnover or turnover range, and
- the duration of the arrangement with the asset manager.

Trustees must also set out the methods by which they monitor and engage with investee companies and other stakeholders in relation to their capital structure and the management of conflicts of interest.

Tips for updating your SIP

1

Allocate time within a trustee or investment sub-committee meeting to consider the trustees' overall approach. What policies can realistically be adopted based on overall investment strategy and governance budget as well as the nature of the scheme's investments?

1 The Occupational Pension Schemes (Investment) Regulations 2005

Implementation statements

From 1 October 2020, trustees will also be required to produce an implementation statement setting out how they acted on the principles set out in the SIP. Trustees should take advice on this from their usual advisers as the precise timing and content will vary for each scheme. Here are the key points.

All schemes must prepare their implementation statement for inclusion in their first annual report and accounts produced after 1 October 2020. As trustees are required to prepare this within seven months of the end of each scheme year, a scheme with a 31 December scheme year-end will have until July 2021 to prepare their first implementation statement. Schemes with a 31 March scheme year-end will have a choice of producing their first implementation statement in October 2020 (if they use the full seven months to prepare their annual report and accounts for the 2019-2020 scheme year), or waiting until October 2021 if they complete this year's report and accounts within six months (ie before 1 October 2020). Trustees should ensure that they take advice on how the deadlines will apply to their scheme.

The requirements in relation to the content of the annual report and accounts are included in the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013. For pure DB schemes the content is generally limited to a report on the engagement activities and votes exercised during the year. For DC schemes (and schemes which provide both DB and DC benefits), the content requirements are more extensive and trustees will need to report generally on the implementation of their ESG and other policies across the scheme (including in relation to any DC default fund) as well as their engagement activities and voting.

A public document means public scrutiny

The requirement for SIPs and implementation statements to be made available online will, for many schemes, increase the likelihood of public scrutiny. In December 2019, ShareAction used publicly available SIPs to publish a review of UK master trusts' ESG policies, grading each master trust on its performance (see page 19 for details). In February 2020, UKSIF published their report on pension scheme compliance with the new SIP requirements. Trustees should assume these documents will be read not just by their members but by other organisations which may seek to hold trustees accountable for their actions (or inaction).

2

Where ESG issues and stewardship are delegated, ensure manager policies and mandates are consistent with the trustee policies stated in the SIP. In the context of segregated mandates, consider whether to request any change to investment objectives, restrictions and reporting requirements to reflect policies stated in the SIP.

3

Consider whether a standalone Responsible Investment Policy may be a better approach than seeking to put everything in the SIP. This can be a helpful tool to explain the trustees' approach to members in a more accessible format and can be a useful way of keeping the SIP in shorter-form.

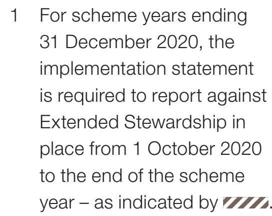
4

Prepare for implementation statements. Consider in advance how the implementation of stated policies will be described. Remember that certain aspects of the SIP and implementation statement have to be included in the scheme's report and accounts.

Your timetable for 2020 and beyond

This timeline is based on a scheme year of 1 January to 31 December

Schemes with a different scheme year to the above will require a specifically tailored timeline – please speak to your usual Sackers contact to discuss further.



1 For scheme years ending 31 December 2020, the implementation statement is required to report against Extended Stewardship in place from 1 October 2020 to the end of the scheme year – as indicated by ▨.

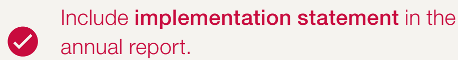
To the extent that schemes have adopted Extended Stewardship ahead of 1 October 2020, schemes should report on such policies in the implementation statement for the period from adoption to the end of the scheme year.

2 Timing currently unclear but trustees will have at least 24 months from the date of publication of the relevant code of practice.

31 December 2020

Produce an **implementation statement**:

- explaining how and the extent to which policies on exercising rights and undertaking engagement in respect of the scheme's investments have been followed during the preceding scheme year[1]
- describing voting behaviours by and on behalf of trustees, including most significant votes cast by trustees or on their behalf during the preceding scheme year.



Include **implementation statement** in the annual report.

NB: This will require relevant information to be gathered during 2020

31 July 2021

(deadline for annual report)

Produce an **implementation statement**:

- setting out how the principles set out in the SIP have been followed during the preceding scheme year[1]
- describing any review undertaken during the preceding scheme year and explaining any changes made and the reasons for them
- describing voting behaviours by and on behalf of trustees, including most significant votes cast by trustees or on their behalf during the preceding scheme year.

Include **implementation statement** in the annual report

Publish **implementation statement** on website and inform members of its availability via annual benefit statement

Publish **implementation statement** on website

Final date for publication of certain elements of the implementation statement.

Carry out and document an "**own risk assessment**" (ORA)

Where ESG factors are considered in investment decisions this must address how trustees assess new or emerging risks including:

- those related to climate change, the use of resources and the environment
- social risks
- risks relating to the depreciation of assets as a result of regulatory change.

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- those related to climate change, the use of resources and the environment
- social risks
- risks relating to the depreciation of assets as a result of regulatory change.

A fiduciary duty to consider climate-related risks

In previous guides, we have explained why pension trustees' fiduciary duty is best articulated as a duty to exercise a scheme's investment powers for "proper purposes" in accordance with a "prudent person" test.

Here, we look at why trustee duties are a key component of responsible investment and, in particular, the consideration of climate-related risk issues.

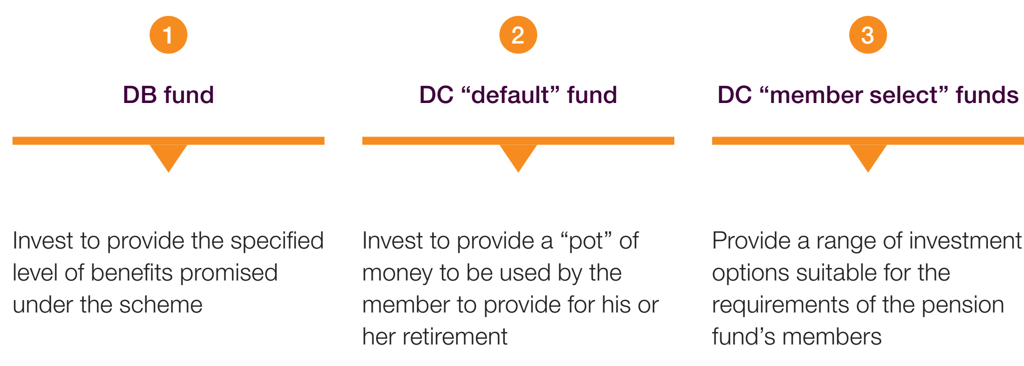
Exercising investment powers for proper purposes

Many commentators still seek to define trustee investment duties as being about "maximising returns". However, this may not always be the best way to look at things, even when considered over the long term and balanced against the need to control risks. Trustees do not invest according to a mathematical growth formula. They exercise their investment discretion in the context and circumstances of their scheme at the time. DB pension trustees should have an integrated approach to investment, funding and sponsor covenant.

Testing any investment approach against a perceived fixed duty to "maximise returns" will frequently miss the point. It is also a misinterpretation of the law (see our analysis of Cowan v Scargill on the next page).

In a DB scheme, investment powers should be exercised for the purpose of providing a defined level of benefits. When considering a particular ESG factor or approach, trustees should ask themselves whether they consider it will contribute positively towards that objective. This may well be about whether a particular ESG approach provides an improved "risk-adjusted return". But it may just as equally be about whether taking account of an ESG factor removes or mitigates an insufficiently rewarded risk, or a risk that does not need to be tolerated, in order to provide the promised benefits.

In a DC scheme, the purpose of the investment power is different. In relation to a scheme's default fund, it is to provide a "pot" of money to be used by the member to provide for his or her retirement. And for those members who do not wish to invest in that default fund, the purpose of the trustees' investment power is to provide a range of alternative investment options that are suitable for the needs of the membership. Again, the objective will not always be about "maximising returns". Other factors may come into play, such as avoiding volatility at inopportune moments for the member, improving member engagement, and operating within costs and charges constraints.



Cowan v Scargill still applies, but context is vital

It is hard to cover trustee fiduciary duties without mentioning Cowan v Scargill, the 1984 case concerning the politically motivated decision by some of the trustees of the Mineworkers' Pension Scheme (MPS) to avoid investments competing with the British Coal industry. The wording of the judgment that pension trustees' power to invest "must be exercised so as to yield the best return for beneficiaries judged in relation to the risk of the investments in question" is still frequently quoted as the basis of a perceived fiduciary duty to "maximise returns".

But, context is everything and the backdrop against which the MPS trustees were exercising their investment power must also be considered. In the MPS, investment returns paid for discretionary increases to pensions which protected members from inflation. The case predated any statutory indexation of pensions. Consequently, the statement that investment powers must be exercised to yield the best returns for the beneficiaries would make complete sense in that context, where the fortunes of the trustees' investment strategy were directly linked to the level of pension that members would receive. However, the wording translates less well to an integrated risk management approach pursued by most DB trustees, where trustees are usually investing simply to provide a promised level of benefits.

This is not to say that Cowan v Scargill is bad law. In our view, Cowan v Scargill is still good authority for the legal proposition that trustees must exercise their investment powers for their proper purposes (namely, to provide members' pensions and not for politically motivated reasons), but it is wrong to understand the case as binding trustees to an absolute duty of return maximisation.

Exercising investment powers in accordance with a prudent person test

There is a long-established principle that trustee investment powers must be exercised with the "care, skill and diligence" a prudent person would exercise, when dealing with investments for someone else for whom they feel "morally bound to provide".[2] This requirement for fiduciaries to invest in accordance with a prudent person test is legislated for in both IORP Directives.[3]

Prudence will always be context specific, based in DB schemes on funding levels and on sponsor covenant. It must also be applied to an investment portfolio as a whole rather than in relation to individual assets (the so-called "modern portfolio theory").

Prudence has always been an evolving concept depending on the economic and financial conditions at the time. Trust investments used to be limited, for reasons of prudence, to certain jurisdictions and government or government-sponsored securities, as well as to stocks of local authorities and certain railways and utilities. It wasn't until the 1960s that legislation was relaxed to permit the sort of equity investments routinely invested in today.

ESG is a fast-growing regulatory concern and our knowledge of the financial risks of climate change continues to improve. Against this regulatory backdrop, we are now at the point where a prudent investor must consider the financial implications of climate change and other ESG factors. The requirement to do so is borne not out of a duty to maximise returns or a regulatory requirement to state a policy, but out of a requirement to act prudently.

2 Re Whiteley (1896) 33 Ch D 347 at 355

3 See Art.18 of IORP, now Art.19 of IORP II

Understanding climate change as a financial risk

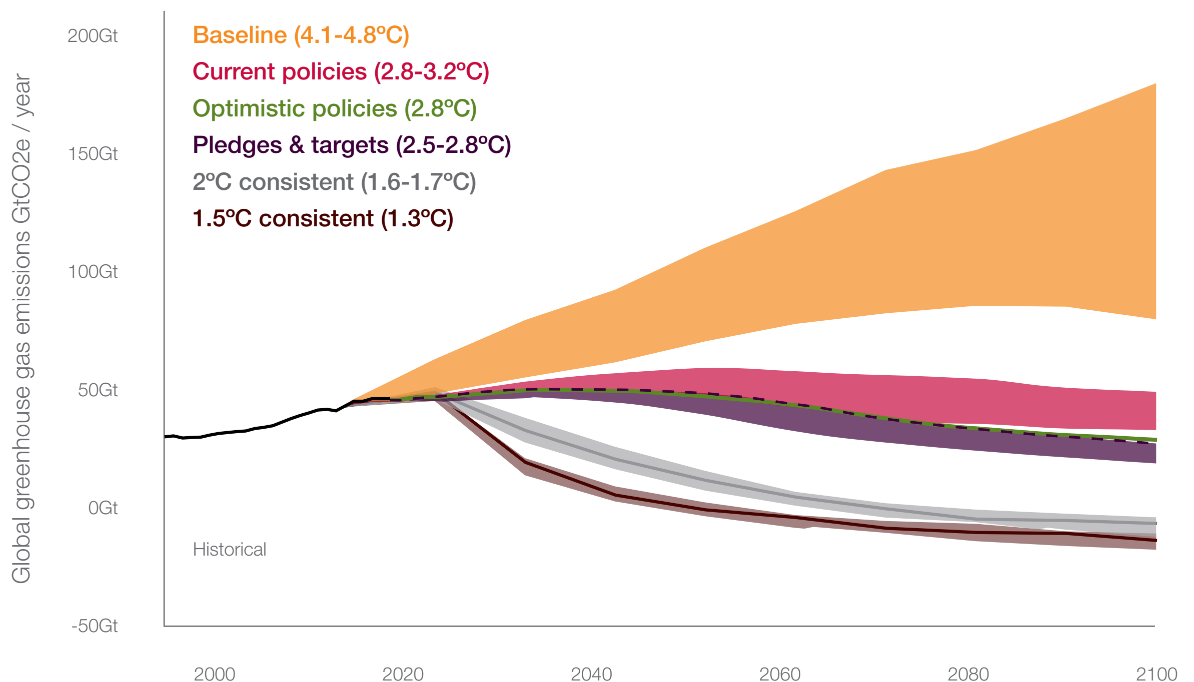
In the absence of policies to reduce emissions of greenhouse gases, global warming is expected to reach 4.1°C – 4.8°C above pre-industrial levels by the end of the century (the "baseline scenario"). Current policies presently in place around the world are projected to reduce baseline emissions and result in about 3.0°C warming.[4] Temperature rises at any of these scales, however, would have large and detrimental impacts on global economies, society and investment portfolios.

Keeping temperature rises to well below 2°C above pre-industrial levels in line with the Paris Agreement (and the pursuit of efforts to limit even further to 1.5°C) requires a rapid reduction in greenhouse gas emissions in the coming years, and to net-zero around mid-century. This will require a significant change in the fundamental structure of the global economy.

All pension schemes are exposed to financial risk from these issues, whether investment strategies are active or passive, pooled or segregated, growth or matching, long or short time horizons. DB schemes may also be supported by employers or sponsors whose financial positions and prospects for growth are dependent on current and future developments in relation to climate change.

When considering the financial implications of climate change, a distinction can be drawn between **transition risks** and **physical risks**. The former relate to the risks (and opportunities) from the realignment of the economic system towards low-carbon, climate-resilient or carbon-positive solutions (eg via regulations or market forces). The latter relate to the physical impacts of climate change (eg rising temperatures, rising sea levels, and increased frequency and severity of extreme weather events).

2100 Emissions and Warming Projections



Source: Climate Action Tracker, Dec 2019 update

4 Climate Action Tracker

The inevitable policy response

The longer the delay in climate policy action, the more forceful, urgent and disorderly any regulatory policy intervention will inevitably need to be in order to limit global average temperature increases to well below 2°C. This is likely to have a more severe impact on companies and pension schemes as investors.

The PRI refer to this as the "Inevitable Policy Response":

Government action to tackle climate change has so far been highly insufficient to achieve the commitments made under the Paris Agreement, and the market's default assumption appears to be that no further climate-related policies are coming in the near-term. Yet as the realities of climate change become increasingly apparent, it is inevitable that governments will be forced to act more decisively than they have so far.

The question for investors now is not if governments will act, but when they will do so, what policies they will use and where the impact will be felt.

There are few signals that governments will act forcefully on climate change in the next two years. But this situation is not sustainable – and 2023-25 is the critical period. [T]he Paris Agreement 'ratchet mechanism' – starting with the Global Stocktake 2023 and leading to the third round of climate pledges in 2025 – increases the likelihood that policy announcements to tackle climate change will accelerate within this period.

Considering climate-related risk as a financial factor

Trustees should always take into account any relevant matters which are financially material to their investment decision making. These are frequently referred to as "financial factors".[5] This may well be about whether a particular factor is likely to contribute positively or negatively to anticipated returns. But, it may equally be about whether a factor will increase or reduce risk.

That climate change might pose a significant financial risk to pension schemes is becoming increasingly apparent and, where financially material to a scheme, it should be taken into account by trustees in their investment decision making.[6]

Trustees should consider the financial implications of both transition risks and physical risks across a range of climate scenarios and determine the extent to which they are financially material to:

- **in a DB scheme:** the scheme's assets, liabilities and the covenant of the sponsoring employer(s)
- **in a DC scheme:** the investment risk and returns of the default fund (and other relevant self-select funds).

Where appropriate, trustees should take action and implement processes to build climate resilience across pension scheme assets.

5 See the Law Commission's report on the Fiduciary Duties of Investment Intermediaries (July 2014)

6 Keith Bryant QC and James Rickards, The legal duties of pension fund trustees in relation to climate change (November 2016)

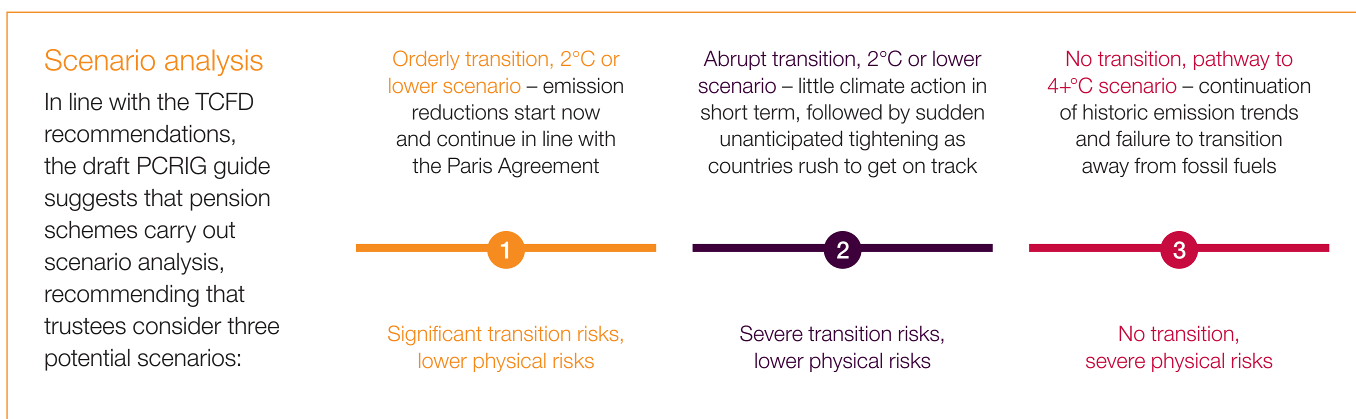
Integrating the consideration of climate-related risks into trustee decision making

On 12 March 2020, the Pensions Climate Risk Industry Group (PCRIG) launched a public consultation on draft climate risk guidance for pension trustees.[7] Sackers is proud to have played a key part in the formulation of this guidance, with Partner Stuart O'Brien chairing the group. Details on how to respond to the consultation can be found on the Government website.

The draft guidance provides suggestions on how to integrate the consideration of climate-related risks within trustee governance and risk management processes as well as making recommendations as to how pension trustees might approach scenario analysis (ie how resilient the pension fund might be to different future climate scenarios). The consultation also looks at what metrics trustees might usefully measure and monitor as part of a strategy to integrate climate risk considerations into their investment decision making.

The TCFD recommendations

The draft PCRIG guidance builds on the disclosures recommended by the TCFD. Published in 2017, the TCFD's recommendations[8] establish a set of eleven clear, comparable and consistent disclosures through which exposure to climate-related financial risks and opportunities can be identified, assessed, managed and disclosed. Applying the TCFD recommendations is intended to lead to better informed decision making on climate risks, as well as improved transparency/accountability by reporting entities.



Climate risk reporting and government policy

The Government set out its expectation for all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022 as part of its Green Finance Strategy in July 2019.[9] At the time of writing, amendments to the Pensions Bill have been tabled by the Government creating a regulation-making power that can be used to mandate such reporting by pension schemes. The DWP have said that they will consult extensively on both the content and timing of regulations before laying secondary legislation.[10] However, recent comments of the Pensions Minister would suggest that mandatory reporting for larger schemes should be expected.

7 PCRIG was established in 2019 by the DWP, TPR and other government departments including the Department for Business, Energy and Industrial Strategy

8 See further reading on page 23 for details of TCFD Report and materials, including the TCFD Knowledge Hub

9 Download the Green Finance Strategy report (July 2019)

10 Pension Schemes Bill: Supplementary Memorandum from the DWP to the Delegated Powers and Regulatory Reform Committee

Setting your stewardship policy

The trustee obligation to report on their voting and engagement policy has existed in some form for many years, but recent legislative intervention has underscored the growing importance of this area.

The first raft of changes, which trustees will have implemented in October 2019, replaced previously equivocal provisions with an unqualified obligation to articulate a policy on rights (including voting rights) attached to investments, including engagement with issuers of both debt and equity.

The changes this year build upon this obligation. In an attempt to pressure schemes to act on the policies they are now required to have, trustees will need to report on how their stewardship and engagement policies have been implemented on an annual basis (see pages 6-7 for further details). The Government's clear intention is to shine a light on trustee voting and engagement activities.

This policy may prove effective. Civil society groups are already making use of online access to scheme SIPs to publish a review of those documents. The implications are clear. **Trustees will shortly be required to give a public account of their voting and engagement activities and they should not expect any leeway from those interrogating their work**.

Timing

The implementation statements for both DB and DC schemes will need to be ready for the first annual report prepared after 1 October 2020. Trustees need to act now to ensure they are ready to report their engagement and voting activities.

A key focus for trustees will be working with their managers to ensure that they have sufficient information to prepare the implementation statements. As these statements will be retrospective, **trustees cannot wait until the date of the first annual report after 1 October 2020 to act**.

Trustees should speak to their managers now to ensure that they will receive the information they need relevant to their own specific reporting period and their own specific mandates.

Trustees should be wary of the glossy brochure from a manager which does not align with the trustees' own reporting period and possibly not even the trustees' particular mandate with their manager.

Putting it into practice

As regulations require trustees to both have and report back on their policy on stewardship, trustee activity will be governed by the art of the possible. The options open for multi-billion pound schemes will differ widely from those of a mature scheme with less than £500m in assets. For many, the nature of their strategic asset allocation and/or the use of pooled funds will impact on the levers available to implement policy. This may be a particular issue for DB schemes.

For many schemes, the most obvious option will be to delegate stewardship responsibility to their managers. However, a number of significant commentators have queried whether this is adequate without proper trustee oversight and scrutiny. Amongst them, UKSIF's SIP Review has the following to say:

Trustees have, by and large, simply left issues to their investment managers, applying varying degrees of scrutiny to how their investment managers approach these issues. This is precisely what the Pensions Minister said he did not want trustees to do. Trustees who have developed advanced policies are the exception, not the rule.[11]

For trustees wishing to go further, we see four broad options in practice.

Monitor

Actively monitoring managers' engagement and voting activities is likely to be the most practical option for many smaller schemes. Trustees should make their reporting expectations clear to managers and seek to get behind manager marketing spin

Outsource

Specialist providers are available to assist trustees in developing and/or implementing a bespoke scheme's policy on their behalf (and at their expense)

Adopt

Smaller schemes may wish to look to adopt industry-wide voting policies prepared by organisations like the AMNT's Red Line voting initiative and work with their managers to implement them where possible

DIY

Some trustees may be in a position to develop and implement their own policies on voting and engagement in-house. This implies resource and expertise, which is likely to be found only in the largest schemes

11 Pg 14 of UKSIF SIP Review January 2020. See also AMNT review into fund managers' voting policies and practices (May 2019): "[Trustees] will no longer be able to simply state in their SIP that "we have delegated stewardship to our fund managers"

For many schemes, some of these options will remain aspirational given constraints on internal resource and expertise. There may also be significant constraints within the asset management industry, as pointed out by the AMNT in a report[12] based on a survey of pooled asset managers. The AMNT suggests "substantial opposition within the fund management industry" to trustee voting initiatives. It concludes that:

> **The response from most fund managers amounts to a failure to recognise and respond to the new regulatory environment to enable pension scheme trustees to fulfil their new responsibilities.**

If the Government's intention was to create tension between increasing regulation on the one hand and constraints arising from both industry factors and trustee resource on the other, they may well have succeeded. For those trying to understand what constitutes an adequate response in the current circumstances, there are few bright line tests. What is clear, however, is that we are in a transitional period in which stewardship cannot be treated as a "business as usual" topic.

Updates to the FRC UK Stewardship Code

Trustees should be aware that the Code has been significantly updated with important implications for signatories.

In particular, all signatories will be required to make public disclosures about their stewardship activities and assess how effectively they have achieved their objectives. Signatories are:

- expected to take ESG factors, including climate change, into account and ensure investment decisions are aligned with the needs of their clients
- expected to explain how they have exercised stewardship across asset classes beyond listed equity, and in investments outside the UK
- required to explain their organisation's purpose, investment beliefs, strategy and culture and how these enable them to practice stewardship.

Organisations wanting to become signatories to the Code will be required to produce a "Policy and Practice Statement" (required on signing) and an annual "Activities and Outcomes Report" explaining how they have applied the Code in the previous 12 months.

Schemes should review their compliance if they wish to remain signatories. To be included in the first list of signatories, organisations must submit a final report by 31 March 2021.

12 AMNT review into fund managers' voting policies and practices (May 2019)

DC schemes

For DB schemes, the job of the trustees is to invest scheme assets appropriately to pay the scheme's promised benefits. In a DC scheme, the objectives are more subtle and may best be thought of as having two key components:

1. To establish a default fund appropriate to the needs of the membership, keeping this under review and updating as necessary

2. To ensure an appropriate choice of investment arrangements for those members who do not wish to invest in the default arrangement

The pitfall

The classic trap for a DC scheme to fall into is to focus on ESG as part of the second component, but largely ignore it as part of the first. When challenged, trustees will often say, "but people worried about that sort of thing can choose to invest in our ethical fund". Unfortunately, addressing ESG in this way makes two fundamental errors. First, it confuses the non-financial factor of ethical investment with ESG as a financial factor. Second, it ignores the fact that most members are likely to be invested in the default fund and the trustees' duty is to act prudently in those members' best financial interests.

How to approach ESG and climate-related risks in the default fund

It is estimated that more than ten million savers[13] have now been auto-enrolled into a workplace pension scheme. Over 90% of those in a scheme "elect" to stay within the default fund.

In its guidance on investment governance, TPR comments that, "many members of DC schemes will be invested for a long time and will be exposed to longer-term financial risks… When setting investment strategies, we expect trustee boards to take account of risks affecting the long-term financial sustainability of the investments".

DC default funds will almost certainly be held in a pooled fund or a combination of pooled funds, and may be accessed through an insurer platform structure. In practice, therefore, addressing ESG is likely to be a case of:

- selecting a fund (or component funds) for the default strategy, the objectives of which take account of the ESG factors which the trustees have identified as financially material, including climate-related risks
- monitoring those funds against the trustees' ESG policies.

As with DB benefits, ESG does not stop at portfolio design and manager monitoring. Trustees should also consider how stewardship will be approached in the default fund and whether the stewardship policies, practices and reporting of the selected pooled fund managers are appropriate. The new requirement is to report annually on the implementation of ESG and stewardship practices.

13 Automatic enrolment commentary and analysis: April 2018-March 2019

Members' views

For DC trustees, the primary focus should be on constructing a default fund that they judge to be in the best financial interests of the members invested in it. This should include a consideration of ESG and climate change issues as financial factors. Members' views might be an additional pertinent factor for some schemes, such as those attached to a charity or religious organisation, but should be approached with caution as the law is restrictive on when they can be taken into account.

However, trustees may wish to get a better understanding of what their members want, to ensure they provide an appropriate range of alternative funds (potentially including some which are ethically based, or which pursue specific social impact objectives).

Master trusts

In December 2019, ShareAction published "Is regulation enough? A review of UK master trusts' ESG policies". Its key findings were:

- low-scoring master trusts are over-reliant on other market players (their sponsoring group / asset manager / investment consultant) for direction on responsible investment issues
- master trusts are largely over-delegating stewardship to their asset manager without sufficient oversight
- master trusts show low levels of engagement with policymakers on the low-carbon transition
- an increase in take-up of ESG / climate funds into master trusts' default asset allocation
- high-scoring master trusts show signs of acknowledging the impact of investments on society and the environment.

ShareAction considers that positive progress has been made but states that we now need to see action. Hopefully, schemes' forthcoming implementation statements will show that words are being translated into deeds.

Contract-based schemes

On 17 December 2019, the FCA published final rules extending the remit of IGCs. With effect from 6 April 2020, they will be required to consider and report on the "adequacy and quality" of a firm's policies on ESG matters, member concerns and stewardship. The accompanying guidance makes clear that IGCs should consider whether the firm's policies do enough to address all relevant and significant risks and opportunities and whether the firm's policies are sufficiently robust to achieve good consumer outcomes. To comply, IGCs may need to upskill their existing members, or recruit individuals with the requisite expertise.

In the year after their first reports on the policies, IGCs will be required to report on their implementation. Such reports can be made earlier if appropriate.

A plan for ESG and climate change integration – from behind the curve to getting ahead

Action plan	Behind the curve Unlikely to stand up to any serious scrutiny	Getting compliant Putting ESG on the agenda
Your action plan		
1 Set investment beliefs	Trustee board relies on its investment consultants to tell them what to believe. Sets nothing out in writing.	Trustee board receives a brief training session before minuting that ESG and climate change are considered material financial factors.
2 Review existing managers	No engagement with existing managers.	Takes stock of existing managers and uses investment consultant scoring framework to rate current managers on their ESG credentials. However, scores are only used as a differentiator where there are other reasons to review a manager.
3 Set a DB investment strategy	Existing strategy not reviewed.	Trustees keep existing strategy under review as ESG experience develops.
4 Consider DC benefits	Does not consider ESG in default fund. Falls into the DC "trap" considering the provision of an "ethical fund" as a self-select option to be sufficient.	Reviews default fund. Manager expected to demonstrate ESG credentials. For passive funds, this may be limited to more active stewardship.
5 Document a policy	Added generic wording to SIP in 2019 at suggestion of the investment consultant in the belief that this will make the trustee "compliant". Will do the same in 2020. Trustees do not consider wording or how it will be implemented in practice.	Trustees considered wording in the SIP in 2019 reflecting the circumstances of the scheme and existing manager mandates. Intend to do a fuller review in 2020. Trustees agree how wording is implemented in practice with their investment consultants.
Further considerations		
Monitor manager	Reports on quarterly past performance figures only. No forward looking consideration of manager ESG attributes or exposure of mandates to climate change risk in the longer term.	Expects active managers to demonstrate how ESG criteria are being used in stock selection and de-selection.
Appointing new managers	Mentions ESG only as an afterthought in tender invitations and gives it no weight in selection criteria.	ESG is identified in tenders as an important issue on which potential new managers will be expected to demonstrate competency.
Stewardship and engagement	Not considered relevant. Justified based on an incorrect assumption that the scheme's investments are all pooled and therefore "stewardship is impossible".	Trustees expect managers to report on how they have exercised voting rights attached to shares (including across passive equity mandates). Managers are expected to be signatories to the FRC UK Stewardship Code.
Climate scenario analysis	None.	Obtains broad estimates from consultants as to the potential significance of climate change on the scheme's portfolio.
Reporting	Sends stock wording to any members "causing a nuisance". Will worry about implementation statements when required.	Some commentary provided to scheme members in annual report. Actively considering implementation statement content now.
Industry involvement	None.	Relies on advisers to provide updates on significant developments, requiring action and training as needed.

On the front foot Embedding ESG into trustee governance	Getting ahead Making ESG and climate change a key strategic issue
Trustee board spends time on training before discussing and agreeing a responsible investment beliefs statement, including a position on climate change risk.	Trustee board discusses ESG beliefs at least annually. Where applicable, trustees seek to align beliefs with sponsor views. Considers alignment of strategy with UN Sustainable Development Goals.
Full consideration of each manager's ESG capabilities (including qualifications) with specialist input from investment consultants – includes being alive to "green-washing". Managers which require most attention identified and engaged with. Where no improvement is forthcoming, or possible within current mandates, these will be reviewed.	Expects all managers to demonstrate deep ESG integration. Integrates corporate environmental data in manager investment processes.
For active mandates: considers diversification across sources of climate risk as well as traditional asset classes. Sustainability and low-carbon indices considered for passive allocations.	Positive allocation to sustainable investment or investment in assets aligned with a below 2˚C pathway. Consider tilting portfolio away from lower scoring ESG assets or sectors such as high carbon emitters.
Reviews composition of DC default to manage ESG risks and align with trustees' ESG beliefs. Regularly reports to members on how default fund is responding to climate change.	Uses ESG leaders or factor-based funds as default. Self-select fund choices include "impact" investment funds with ESG goals. Considers seeking member views to ensure an appropriate fund range.
Trustees develop a stand-alone responsible investment policy which supplements the SIP. This may start with existing manager mandates but will progress to deeper integration of ESG factors over time. The policy identifies priority ESG themes and is periodically reviewed.	Extensive responsible investment policy with detailed consideration of ESG in each asset class, detailed climate change policy and stewardship policies. Climate change risk embedded across other trustee governance and internal control frameworks and considered as part of an integrated risk management framework (including any climate change risks pertinent to the scheme sponsor covenant).
Develops a robust monitoring process – reporting qualitatively and quantitively against each manager. Managers expected to demonstrate integration of ESG in investment processes rather than the existence of separate "advisory" ESG analysts.	Managers expected to provide frequent concrete examples of deep ESG integration and active behaviours with investee companies. Measures alignment of listed equity and corporate bond portfolios across 2˚ transition sectors and technologies.
ESG credentials key in tender process. Investment management agreements negotiated to include specific ESG requirements.	Responsible investment requirements included across all asset classes eg side letter terms in private equity funds.
Expects managers to report in detail on their engagement policies and how these have been implemented. This should include examples of engagement changing corporate behaviours and voting against the board on ESG-related issues. Managers with a poor engagement record will be downgraded. Considers adoption of an off-the-shelf voting policy eg AMNT Red Lines.	Large schemes: takes an active and direct role engaging with investee companies across all asset classes. Considers joining other investors in filing climate-related shareholder resolutions where companies are underperforming on adaptation or disclosure. Scheme is an FRC UK Stewardship Code signatory. Small schemes: appoints proxy voting and engagement service reflecting trustees' ESG beliefs and position on climate risk.
Makes use of freely available tools such as PACTA and / or PRA stress test data.	All-portfolio risk assessment (including all real asset holdings) to identify exposure to transition risks and potential physical damage risk under different climate scenarios.
Considers TCFD reporting framework as a structure for internal governance. Plans for public reporting in the near future. Sees implementation statements as an opportunity for member engagement.	Reports publicly against TCFD. Has an annual responsible investment update report for members.
Trustees keep abreast of industry discussions and attend events to improve knowledge and observe best practice. Considers becoming a signatory to the PRI.	Joins investor groups such as IIGCC. Engages with policy makers to improve practice across the industry.

How we can help

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. 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 to trustees, employers and providers on all aspects of pension scheme finance and investment.

We advise on the development and implementation of ESG strategies consistent with trustee fiduciary duties and the development of trustee ESG and engagement policies, including how to document trustee responsible investment policies and related wording for a scheme's SIP. We also provide ESG training for trustees and pension scheme providers.

For further information and advice on ESG and climate change considerations for UK pension schemes, contact any of the contributors to this guide using the details below, or your usual Sackers contact.

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Key areas of expertise include: ESG issues including fiduciary duties, policy, stewardship, responsible and impact investing. Also advises on derisking strategies including buy-ins and buy-outs.

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Abbreviations

AMNT: Association of Member Nominated Trustees

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

EAC: Environmental Audit Committee

FCA: Financial Conduct Authority

FRC: Financial Reporting Council

IGC: Independent governance committee

IIGCC: Institutional Investors Group on Climate Change

IORP: Directive 2003/41/EC

IORP II: Directive (EU) 2016/2341

IPCC: UN Intergovernmental Panel on Climate Change

LDI: Liability-driven investment

PCRIG: Pensions Climate Risk Industry Group

PLSA: Pensions and Lifetime Savings Association

PRI: Principles of Responsible Investment

SIP: Statement of investment principles

SRD II: Directive (EU) 2017/828 (which amended the Shareholder Rights Directive)

TCFD: Task Force on Climate-related Financial Disclosures

TPR: The Pensions Regulator

UKSIF: United Kingdom Sustainable Investment and Finance Association

Further reading

Law Commission Guidance on Fiduciary Duties: “Is it always about the money?” (July 2014)

TCFD Final Report: Recommendations of the TCFD (June 2017). See also the TCFD Knowledge Hub

PRI: Preparing investors for the Inevitable Policy Response to climate change (September 2019)

IIGCC: Addressing climate-related risks and opportunities in the investment process: a practical guide for trustees and boards of asset owner organisations (November 2018)

The Transition Pathway Initiative (TPI): How can investors use the TPI? (January 2017)

Mercer: Investing in a Time of Climate Change – The Sequel (2019)

House of Commons EAC: Greening Finance: embedding sustainability in financial decision making: Seventh Report of Session 2017-2019 (May 2018)

PLSA: ESG & Stewardship: A Practical Guide to Trustee Duties (June 2019)

The Pensions Policy Institute: ESG: past, present and future (October 2018)

UKSIF: A Checklist for Pension Trustees

PCRIG consultation: Aligning your pension scheme with the TCFD recommendations: a guide for trustees (March 2020)

Nothing stated in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. Action should not be taken on the basis of this document alone. For specific advice on any particular aspect you should speak to your usual Sackers contact. © Sacker & Partners LLP March 2020

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