Sackers

ESG beyond climate

What else is on the agenda?

2024

Introduction

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Download our previous ESG guides from our website.

"*When sorrows come, they come not single spies but in battalions.*" So says Claudius in Shakespeare's Hamlet. This is not, as a less kind reader might suggest, a reference to our ESG Guides – now in their eighth year – but the sentiment might resonate with trustees labouring under the increasing weight of ESG-related expectations for pension schemes.

Over the last few years, most trustees will have been focused on climate-related issues. We are now over two years into climate-related governance and reporting obligations applying to larger schemes. Nearly all schemes to which the Climate Change Governance Regulations apply will have published at least one TCFD report, with many setting voluntary net zero ambitions in addition. But ESG is not all about climate and, in this year's Sackers guide, we are casting the net a little wider, also looking at other aspects of ESG which are becoming increasingly relevant to pension trustees.

We consider how the latest recommendations of the TNFD might apply to trustees getting to grips with nature-related risks and on pages 6-8 what crossover for trust-based schemes might come from the new SDR for FCA regulated entities. In the rest of the guide, we cover the draft guidance from the TSF, the DWP's Guidance on SIPs and implementation statements and TPR's General Code, as well as briefly revisiting the broader issue of trustee fiduciary duties, which we have examined in some of our previous guides.

We hope you enjoy reading this latest guide and that it helps you to banish any sorrowful thoughts when tackling these latest developments.

Abbreviations

Climate Change Governance Regulations: the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021
DWP: Department for Work and Pensions
DWP Guidance: guidance published by the DWP in June 2022 in relation to SIPs and implementation statements
ESG: Environmental, social and corporate governance
ESOG: Effective system of governance
FCA: Financial Conduct Authority
FMLC: Financial Markets Law Committee
GBF: Global Biodiversity Framework
GRI: Global Reporting Initiative
IGC: Independent governance committee
IORP II: Directive (EU) 2016/2341
ISSB: International Sustainability Standards Board
LDI: Liability-driven investment
PCRIG: Pensions Climate Risk Industry Group
SDR: Sustainability Disclosure Requirements
SIP: Statement of investment principles
TCFD: Task Force on Climate-related Financial Disclosures
The Code: TPR's general code of practice
The Recommendations: the final framework and recommendations of the TNFD
TNFD: Taskforce on Nature-related Financial Disclosures
TPR: The Pensions Regulator
TSF: Taskforce on Social Factors

Contents

TNFD

"The science is clear. Nature is deteriorating globally, and biodiversity is declining faster than at any time in human history."

The Recommendations

Download the guide

The Task Force on Nature-related Financial Disclosures ("TNFD") was launched in June 2021 to develop a voluntary risk management and disclosure framework for organisations to report and act on nature-related risks, with the aim of supporting better risk mitigation and management. The framework is intended to be used by organisations of all sizes and across all jurisdictions to "identify, assess, manage and, where appropriate, disclose nature-related issues".

The framework can be applied by a company in relation to its own activities or by asset owners (including pension schemes) to better understand the nature-related risks impacting the organisations they invest in.

The TNFD released for consultation several iterations of the draft framework during 2022 and 2023. The final framework was published on 19 September 2023 and contains 14 disclosure recommendations (the "Recommendations") to help organisations build on their reporting and provide decision-useful information to investors and other providers.

The TNFD mirrors, and sits alongside, the TCFD and its own related disclosure and reporting requirements. In addition, the Recommendations are consistent with the International Financial Reporting Standards developed by the ISSB, the GRI's Sustainability Reporting Standards (a set of standards for sustainability reporting to enable corporations to measure and understand their impacts on the environment, society and economy), the European Financial Reporting Advisory Group and the UN Kumming-Montreal Global Biodiversity Framework ("GBF").[1] The TNFD specifically refers to the relevant GBF targets, where applicable.

Nature-related issues

The Recommendations are intended to help organisations meet the challenge of assessing and managing the impact of nature on society, the economy and financial systems, and to report on nature-related dependencies, impacts, risks and opportunities. These four concepts are collectively referred to as nature-related issues.

"It is essential to evaluate dependencies and impacts on nature to assess the risks and opportunities to an organisation."

The Recommendations

Occur when organisations avoid, reduce, mitigate or manage nature-related risks, and/or through strategic transformation of business models, products, services, markets and investments that actively work to reverse the loss of nature

Aspects of environmental assets and ecosystem services that an organisation relies on to function

Potential threats that "arise from its and wider society's dependencies and impacts on nature"

The Recommendations

Changes in the state of nature, which may result in changes to the capacity of nature to provide social and economic functions. Impacts can be positive or negative, direct, indirect or cumulative

1 The GBF includes targets for countries that are party to it to ensure that large and transnational companies and financial institutions regularly monitor, assess and transparently disclose their risks, dependencies and impacts on biodiversity, including along their operations, supply and value chains and portfolios

How might TNFD apply to pension schemes?

As of the date of writing, pensions schemes are not yet required to make nature-related disclosures in line with the Recommendations. Consequently, it is arguably still too early for pension schemes to put in place any detailed approach to identify and address nature-related issues. However, given the direction of travel on ESG and recent public statements by the Government, disclosures in line with the Recommendations may become a statutory requirement in the future. The Government announced in its Green Finance Strategy that it will explore how best the Recommendations should be incorporated in the UK.

Some organisations have already signed up publicly to the Recommendations. On 16 January 2024, the TNFD published a list of inaugural early adopters who have signalled their intent to start adopting the Recommendations.

> Trustees who want to get ahead of the curve may wish to engage with investment managers and advisers to understand how nature-related issues are being considered in their decision-making, and whether they may be financially material. Trustees could also consider what information, if any, is available now and in the near future.

The future of nature-related disclosures for trustees

The framework aims to be consistent and align with the existing TCFD framework and reporting, and the ISSB in terms of approach, structure and language. The intention is to move towards integrated sustainability disclosures over time.

The Recommendations and accompanying additional guidance provide a basis for organisations to identify, assess and disclose their nature-related dependencies, impacts, risks and opportunities consistent with the ISSB and GRI standards. They are intended to provide a practical basis for organisations to get started and to increase the scope and ambition of their disclosures in coming years.

From TCFD to TNFD: potential challenges for trustees

? What do we need to consider?

In many ways, the Recommendations are similar to those now well established under the TCFD. The framework is based on the same four pillars of governance, strategy, risk and metrics and targets, with each pillar accompanied by a set of recommended disclosures. The TFND has also carried over all the TCFD recommended disclosures, as well as adding three new ones. Trustees might, therefore, be forgiven for thinking that if they are already complying with the Climate Change Governance Regulations (which were based heavily on the TCFD) then it ought not to be too much of a stretch to bolt on TNFD to their TCFD governance processes and reporting.

However, although the frameworks are indeed very similar, the detail of TNFD, when compared with TCFD, is likely to pose some significant early challenges for all but the most committed (and well resourced) pension trustee boards.

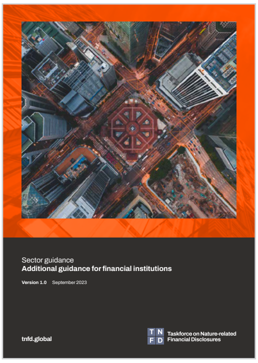
Metrics

The most obvious challenge to trustees looking at the Recommendations is what to measure and how to go about it. The Climate Change Governance Regulations specified a limited number of climate-related metrics which trustees were expected to measure and disclose against (including carbon footprint and most recently a portfolio alignment metric). Although data availability and quality has posed some challenges (and there are variations in methodologies), at least the DWP were clear on what trustees were expected to monitor and report.

Nature-related metrics are more nascent and multi-faceted, and we anticipate will be much harder for pension trustees as asset owners to get to grips with. As nature-related issues are so complex there are many more things that can be measured and at a potentially very granular level. Across certain industry sectors such specific metrics may be useful indicators of risk (and opportunity) relating to particular investee companies. For example, concentrations of key pollutants in wastewater discharged may be a very pertinent metric for certain industries but it may not be a meaningful statistic to report for a pension scheme.

For most pension schemes this level of analysis will be too detailed. What we anticipate is that trustees will need to be more discerning in their approach to such metrics. We expect that those trustees who are first to embark on a TNFD journey will have to start by building confidence in the ability of their appointed managers to obtain, interpret and act upon such detailed metrics (and more particularly those managers' specialist research teams) rather than the trustees carrying out this role themselves.

To a certain extent, the TNFD has anticipated that the lot of an asset owner will not be an easy one when it comes to nature. As such, the Recommendations are supplemented by draft specific industry guidance for various industry sectors, together with discussion papers aimed at financial institutions, focusing on the landscape of biodiversity and approaches to advanced scenario analysis. The guidance and discussion papers set out specific guidance for banks, insurers, asset managers and asset owners, recommending some higher-level metrics for those organisations to measure and report against. These include the portfolio's exposure to sectors or companies with material dependencies on nature. These may make more sense for a pension scheme but there is still some way to go before such metrics coalesce into anything as uniform as some of the more established metrics for climate.



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Targeting nature-positive impacts

Another way TNFD differs from TCFD for pension trustees is in its greater focus on nature-related "impacts" as well as risks. In other words, those looking to adopt the Recommendations should be seeking to identify, assess and manage not only the risks that nature-related issues might pose to them but also the external impacts that they might have on nature. This raises a fairly fundamental point for trustees.

It is well understood that trustees can act on any matters that go to financial risk and returns for their investment portfolios, and that these can include environmental risks (both climate and nature-related). To that extent, the Recommendations on monitoring and managing nature-related risks will chime with how trustees have approached climate-related risks under the TCFD. Where there is portfolio exposure to sectors with material dependencies on nature, and these in turn create a financial risk to the portfolio, trustees will want to understand such risks in the same way as they should consider those parts of their asset portfolio with high exposure to climate transition risks. However, care is needed when looking at the external impacts that investee companies have on society and their environments. Where there is no direct financial impact on a scheme's portfolio, trustees might quickly find they face challenges as to whether this falls within their fiduciary duties, particularly if they wish to start setting impact targets. For further discussion of fiduciary duty, see page 9.

In practice, asset owners subject to fiduciary duties will usually seek to square the circle by acting on an investment belief that companies that "do good" ought also to "do well" as a financial proposition. But this needs to be evidence-based, and it will be particularly important that trustees take care and advice to ensure that they are acting consistently with their legal duties when approaching this particular aspect of the Recommendations. None of this should be a reason not to engage with the issues, but a realistic approach as to what is achievable is likely to be required from any early-mover trustee boards.

SDR and investment labels

"...to improve trust and transparency to the market for sustainable investment products."

Policy Statement

On 28 November 2023, the FCA published a Policy Statement on Sustainability Disclosure Requirements ("SDR") and investment labels. The Policy Statement is intended to support the Government's commitment to a net-zero economy, and to build on announcements made by the Government in July 2021 and a consultation published by the FCA on 25 October 2022.

The Policy Statement sets out the FCA's final rules and guidance to help consumers navigate the market for sustainable investment products, and requires sustainability-related terms to be used in the naming and marketing of investment products to be proportionate to the sustainability profile of the product.

Applying predominantly to FCA regulated entities and investment products, the final package of measures include:

- an anti-greenwashing rule for all FCA authorised firms
- four labels to help consumers navigate the investment product landscape
- naming and marketing rules for investment products, to ensure the use of sustainability-related terms is accurate
- consumer-facing information to provide consumers with better, more accessible information to help them understand key sustainable features of products
- detailed information in pre-contractual, ongoing product-level, and entity level disclosures, targeted at institutional investors and consumers seeking more information, and
- requirements for distributors to ensure that product-level information is made available to consumers.

The FCA will supervise the regime using its existing supervisory and enforcement powers.

What is proposed?

Anti-greenwashing rule

A new general "anti-greenwashing rule" has been introduced to clarify that all FCA regulated firms must ensure that the naming and marketing of financial products and services in the UK are "clear, fair and not misleading, and consistent with the sustainability profile of the product or service". This is intended to help address the risk of misleading sustainability claims in relation to products which do not use an investment label. A consultation on proposed guidance for anti-greenwashing has been published and closed to responses on 26 January 2024. The guidance will come into force on 31 May 2024.

Classification and labelling of sustainable investment products

A fundamental component of the regime is the classification and labelling of sustainable investment products. The intention is for firms to provide transparency on the types of assets their products will or will not invest in to assist consumers in distinguishing between different types of products and investments in line with the Consumer Duty.[2]

Naming and marketing rules: firms will not be able to use certain sustainability-related terms (such as "ESG", "green" and "sustainable") in product names and marketing materials unless the product uses one of the standardised sustainable investment product labels.

2 The FCA Consumer Duty sets high standards of consumer protection across financial services. In general terms, it is a duty to ensure consumers get communications they can understand, products that meet their needs and offer fair value, and customer support they need

Sustainable investment product labels ("labels"): the four labels represent different sustainability objectives and include different approaches to pursue those objectives depending on whether the product aims to invest:

1. in assets that are environmentally and/or socially sustainable ("sustainability focus")
2. to improve the environmental/ social sustainability of assets over time, including through stewardship ("sustainability improvers")
3. in solutions to environmental or social problems ("sustainability impact")
4. in a combination of all the labels ("sustainability mixed goals")

Firms can choose whether or not to use the labels but must do so in order to use the restricted sustainability-related terms in names and marketing. If the labels are used, firms must meet certain qualifying criteria and ensure the criteria is met on an ongoing basis (ie that the product must have an explicit environmental and/or social sustainability objective, and the firm must have an investment policy and strategy for the product aligned with its sustainability objective).

Disclosure requirements

The FCA has introduced new disclosure requirements that must be produced for UK (FCA regulated) products with or without a sustainable investment label (the FCA recognises that disclosures will "inherently be more limited" for products that do not have a label).

Proposed disclosures are:

- consumer-facing product-level disclosures – intended to help consumers understand the sustainability-related features of an investment product (including details of the product's sustainability objective, investment approach and performance against the objective)
- detailed product-level disclosures – aimed at institutional and retail investors, and
- entity-level disclosures – consistent with TCFD, firms must disclose their governance, strategy, risk management, metrics and targets relating to their sustainability risks and opportunities.

All firms with over £5 billion of assets under management must make these disclosures annually in the sustainability entity report.

What does this mean for pension trustees?

The labelling and disclosure requirements will initially apply to FCA regulated asset managers and their UK-based fund products and portfolio management services. This means that trustees of occupational schemes won't be directly affected. However, there may be an indirect effect via the investment funds which trustees invest in. For DB schemes, the labelling and disclosure requirements may be useful, albeit limited only to UK investment products.

The FCA has stated that "in the medium term, we will consider extending the regime to pension products, as we recognise that the potential harm we are seeking to address with this regime may also arise with these products." The intention is for the FCA to develop proposals for pension products by working with the DWP and TPR. This will add to, and sit alongside, existing climate governance and reporting obligations (which apply to FCA regulated schemes as well as occupational schemes).

Although no direct action is required of pension schemes at the time of writing, this is a developing area to watch. Trustees should be aware of the proposed SDR and labelling regime and how it may impact their scheme in the future.

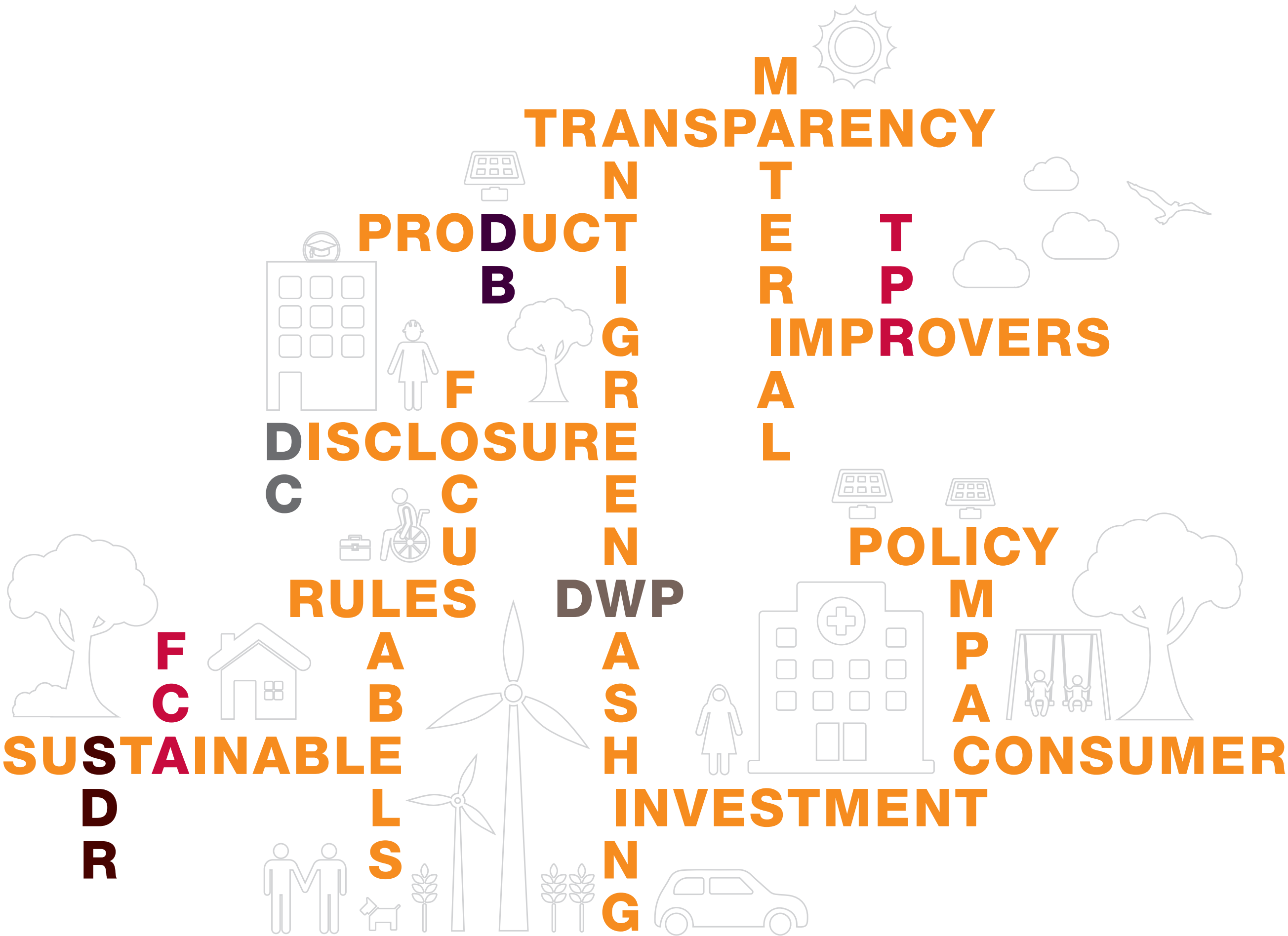
The future of SDR for trustees

It remains to be seen exactly how the new fund labelling, disclosure and anti-greenwashing rules will flow through to occupational and trust-based pension schemes. Although not currently within the FCA's remit, the DWP may in the future introduce regulations for occupational and trust-based schemes that dovetail with the new FCA rules.

DC master trusts may want to promote funds with a "sustainability focus".

As long as the requirements apply only to FCA regulated entities then, whilst those managers and fund providers will have to take great care with their fund descriptions, disclosures and labelling, there will be no required flow-through to the end-user who is a member of a trust-based DC scheme (and where the trustees of that scheme are not subject to the same rules). It is possible that trustees of DC schemes will wish to voluntarily adopt the labelling of the underlying FCA regulated funds in which the scheme invests. We predict that for DC master trusts this could well become a differentiator amongst providers keen to promote their DC default as being invested in funds with a "sustainability focus". It may also help trustees to more clearly label self-select funds, particularly where members want investment choice to choose funds with "sustainability impact". For DC master trusts tied to a particular provider, and where that provider's products are already subject to the new disclosures and labelling requirements, we expect that master trust trustees will choose to pass those disclosures through to their members.

For trustees of DB schemes, it is less obvious that there will be any pass through of any underlying fund labelling, although the enhanced provider disclosures may assist trustees in their scrutiny of the scheme's investments and member reporting in implementation statements and TCFD reporting.

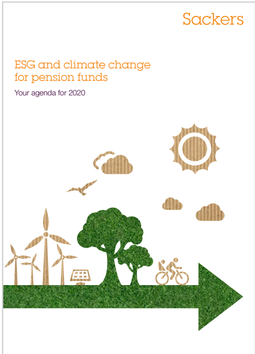


Fiduciary duty

As discussed in our previous guides, pension scheme trustees are subject to various trusts law and fiduciary duties that they owe to their scheme beneficiaries.

These duties require trustees to:

Exercise their investment powers for their "proper purposes", namely the provision of members' pensions	Take account of factors which are relevant to that purpose, this will usually mean those that are financially material (this may be consideration of risks as well as returns)	Do so in accordance with the "prudent person" test. Broadly this is the 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"



Download the guide

There has been, and continues to be, considerable debate amongst lawyers and other industry professionals as to how these duties might apply in practice to emerging ESG themes. The duty is frequently oversimplified to a duty of "maximising returns" based on wording in the 1984 case of *Cowan v Scargill*. However, context is everything. The backdrop against which the trustees in that case were exercising their investment powers, and the timing, were highly relevant to the judgment, and it must be understood in context.

In our view, the case remains 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). Put simply, when considering an ESG related issue, trustees may find it illustrative to check their motives for taking the matter into account in the investment decision-making. For further detail, see our 2020 Guide.

Financially material

Trustees should always take into account any relevant matters that are financially material to their investment decision-making. These might include factors that are likely to contribute positively or negatively to anticipated returns. Equally, relevant matters may relate to whether a factor increases or reduces risk. The idea that the physical risks of climate change and society's transition to a lower carbon future might pose a significant financial risk to pension schemes is now well established. Where financially material to a scheme, this should be considered by trustees in their investment decision-making, consistent with their trusts law and fiduciary duties.

A more difficult question arises when considering whether trustees can, or should, take other, potentially wider, issues into account, such as systemic market risks and beneficiary quality of life. Or, whether it is legitimate for them to pursue a strategy designed to deliver other objectives such as net zero or alternative outcomes providing a positive environmental or social impact for society. In practice, the pensions industry has tended to fudge the issue by drawing a link between these objectives and a direct positive financial return (or reduction of risks) for the pension scheme, but pursuing those objectives for their own ends can quickly get trustees into legal difficulties. This is a particularly complex and difficult legal area and requires all trustees, and lawyers, to think more deeply about trustee duties going forward.

FMLC paper

On 6 February 2024, the FMLC published a paper entitled "Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change". As discussed above, the developing legal, regulatory and political landscape in relation to sustainability and climate change has given rise to renewed uncertainty over trustees' fiduciary duties and how these should be applied in such context. The paper is intended to provide "a very general explanation of the legal position and the uncertainties and difficulties that exist" in respect of these duties owed by trustees and "help trustees in their discussions with advisors". Although the paper does not change the legal interpretation of fiduciary duty, it does give pause for thought on how seriously trustees are considering the issue. In addition, we understand that the Work and Pensions Committee is set to review the position of fiduciary duty. There is no doubt that this is likely to continue to be a topic of considerable debate and development in the years to come.

Social factors: the "S" in ESG

"The "S" of ESG is one area in which the risk management of pension schemes can be strengthened."[3]

History and regulation

2019 was arguably a turning point for a cascade of regulation in respect of ESG and climate change for pension scheme trustees. Changes to the Occupational Pension Schemes (Investment) Regulations 2005 imposed new requirements on trustees to set out their policies in their SIPs in relation to "financially material considerations" (defined to include ESG considerations and climate change) and stewardship. By October 2020, additional changes to the regulations (implementing elements of the Shareholders Rights Directive II) required trustees to also include details in relation to arrangements with asset managers.

As noted on page 12, trustees also have defined regulatory obligations to articulate and report their policies on voting, engagement and stewardship, bolstered by the new DWP Guidance published in 2022 in relation to SIPs and implementation statements.

What are social factors?

"Social factors include a wide range of topics from payment terms for suppliers, anti-microbial resistance, links to armed conflict, and vaccine fairness and to just transition, health impacts on consumers and communities (mental and physical) and inequality."

TSF

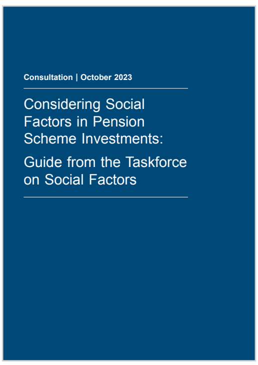
Taskforce on Social Factors

In July 2022, the Government published its response to a call for evidence (launched in March 2021) on the consideration of social factors by pension schemes.

The call for evidence sought to encourage a more proactive approach to embedding social factors within pension schemes' investment decisions, separating out the "S" in trustee ESG and stewardship policies, and suggesting themes that trustees might look at (eg specific policies on human rights within the context of business practices, including modern slavery as well as a more focused approach to workforce conditions, supply chains, community engagement and consumer protection). The Government also announced a new minister-led taskforce to support pension scheme trustees and the wider pensions industry with some of the challenges around managing social factors, such as the identification of reliable data and metrics. A Taskforce on Social Factors ("TSF") was subsequently launched on 28 February 2023 with the support of the DWP.

The TSF is made up of a wide variety of industry practitioners from pension funds, asset managers, insurers, relevant non-government organisations with a range of regulators and government departments as observers. The key aim of the TSF is to raise awareness and develop a common understanding of social risks and opportunities which pension scheme trustees, industry and policymakers can address.

Under current plans, the taskforce will operate for one year and deliver guidance and recommendations to the pensions and investment industry.


Consultation | October 2023

Considering Social Factors in Pension Scheme Investments:

Guide from the Taskforce on Social Factors

Download the guide

Considering Social Factors in Pension Scheme Investments

On 19 October 2023, the TSF published a consultation on a draft guide on incorporating social factors into investment and stewardship decision-making.

The draft guide sets out how pension trustees can "better consider and incorporate social factors into their investment and stewardship decision-making, by developing a common understanding and assessment of financially material social risks and opportunities".

3 Consultation outcome: Government response: Consideration of social risks and opportunities by occupational pension schemes July 2022

Recommendations for pension trustees include:

The guide makes over 30 recommendations for different stakeholders in the pensions sector.

- Having a good understanding of the way their investment consultants approach social factors (and wider ESG factors) and to set objectives in relation to the same
- Ensuring their asset managers consider social factors and integrate them into their investment strategy and stewardship
- Ensuring their asset managers have a strong engagement track record, appropriate exclusion policies and display responsible behaviour as businesses. Also ensuring that proxy voting policies of asset managers align with the trustees' policies and investment beliefs and setting clear expectations of managers on social factors, with focus on desired outcomes
- Considering social impact investment opportunities where financial outcomes align with desired social outcomes
- Considering their own practices in relation to social considerations
- Improving their understanding of key areas of social factors

The consultation closed on 1 December 2023 and final guidance is expected to follow in due course.

Sackers view

The draft guide from the TSF provides a helpful focus on social issues, with the appendices in particular providing useful suggestions on how trustees might provide oversight of both stewardship and use of data on social factors by managers and service providers, including investment consultants. Trustees would be well advised to read the guide's suggestions on what good reporting from a manager looks like and may find some of the suggested approaches to manager questioning useful.

The draft guide suggests that trustees should "understand and consider incorporating the preferences of beneficiaries into [their] decision-making". Our view is that this should be addressed with considerable caution. The law is restrictive on the extent to which trustees can base their investment decisions on member views as well as there being obvious practical difficulties of doing so on complex matters. Whilst it may be helpful for trustees to have a general understanding of the interests of their members in order to improve their reporting of ESG issues, trustees should proceed carefully and take legal advice before embarking on member surveys or similar approaches aimed at garnering member views.

Stewardship: voting and engagement

Stewardship and voting

Pensions and Lifetime Savings Association

"Voting activity should not be considered in isolation from what should be an investor's ongoing dialogue with companies and its broader stewardship strategy."[4]

Regulatory requirements

From 1 October 2020 new requirements under the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 required trustees of schemes in scope to produce an annual "implementation statement" setting out how they have acted on policies in the SIP in the previous year. More recent guidance published by the DWP in June 2022 contains both "statutory" and "non-statutory" provisions, focusing particularly on voting and engagement. The statutory element of the DWP Guidance concerns the content of the annual implementation statement, and trustees must have regard to the DWP Guidance when preparing this document. 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 DWP Guidance are consequently described as things trustees "must", "should" or "could/may" do.

Trustees should now be well accustomed to these requirements and how they apply to their specific schemes. However, this is not an area for complacency. A blog by TPR in May 2023 (The ESG elephant is now in the room) confirmed that the regulator will be conducting a review of schemes' SIPs and implementation statements in the Autumn of 2023. The review is expected to focus on the extent to which the DWP Guidance has been adopted by trustees (and at the time of writing has not yet been published).

4 Pensions and Lifetime Savings Association: Stewardship & Voting Guidelines 2023 (March 2023)

Vote reporting

The predominant theme of the DWP Guidance is the link between a scheme's stewardship priorities and voting behaviour, particularly in relation to the implementation statement.

Most significant votes

Trustees must describe in their implementation statement the voting behaviour by, or on behalf of, the trustees during the year. Trustees should include relevant statistics to help describe voting behaviours (ideally broken down into types of issue, including ESG). In addition, the DWP 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 DWP 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 DWP Guidance provides a list of suggested information that trustees should include in respect of "most significant votes" in the implementation statement, 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

As part of the global response to climate change and other sustainability issues, trustees are being increasingly required and encouraged to improve their stewardship activities and this is certainly an area to watch. Reports in recent years by both the Taskforce on Pension Scheme Voting Implementation and the Investment Association have focused on giving pension savers a voice, and embedding the relationship between investment managers and pension schemes.

The DWP 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 DWP Guidance also cross refers to the UK Stewardship Code and indicates areas of potential alignment between the implementation statement requirements and the UK Stewardship Code principles. It explains that trustees can use the information in their Stewardship Code reports in their implementation statements provided that information meets the legal requirements.

What does this mean for pension trustees?

The DWP Guidance concerns implementation statements that trustees are required to prepare in respect of any scheme year ending on or after October 2022. In the vast majority of cases this will have impacted implementation statements included in annual reports generated during 2023, with many schemes now on their way to preparing their next statement. In any event, early preparation of implementation statements is key. Trustees on the front foot for these statements will be best placed to compile annual reports.

It is clear in the DWP Guidance that the Government considers TPR as the prime audience of the SIP and implementation statement, as opposed to the scheme membership itself. Nevertheless trustees are encouraged to write both documents in plain English, such that a reasonably engaged and informed member could interpret and understand the disclosures. Indeed, trustees are encouraged to consider producing member-facing summary versions.

General code

On 10 January 2024, TPR published its long-awaited new general code of practice (the "Code") and consultation response. Previously known as the "single code" and first announced in 2019, a draft version of the Code was consulted on in early 2021, with an interim response from TPR following later that year.

The Code is expected to come into force on 27 March 2024. It brings together 10 of TPR's 16 current codes of practice into new "modules" which are intended to be clearer and more accessible. For the most part, the standards it sets out are not new. We have set out below a summary of some of the key aspects of the Code that relate to ESG.

Effective system of governance ("ESOG")

In 2019, regulations to implement parts of the second European Pensions Directive (better known as "IORP II") introduced the requirement for trustees to establish and operate an ESOG, which must be proportionate to the size, nature, scale and complexity of the scheme. The Code explains that an ESOG should include consideration of ESG matters relating to scheme investments.

Stewardship

The Code provides the following expectations that trustees should follow in relation to stewardship:

- identify their rights (including voting rights) attached to investments and consider their approach to voting and engagement on relevant matters, including on ESG
- ensure they are familiar with their investment managers' own stewardship policies
- consider investment managers' stewardship policies as selection criteria and seek to influence them as appropriate
- monitor and regularly review investment managers' stewardship practices
- take into account the potential long-term positive and negative impacts of investment decisions on member outcomes
- consider following, where appropriate, the principles set out in the Financial Reporting Council's UK Stewardship Code
- seek to establish engagement approaches with investee companies and collaborative industry initiatives, whether directly or via investment managers, with a view to mitigating risks to long-term investment goals, and
- consider co-operation with other institutional investors in engaging with investee companies, for example on ESG issues.

Climate change

The Code acknowledges that "all pension schemes face some degree of material risk from climate change". An ESOG is expected to ensure that consideration of environmental factors is part of a scheme's investment decision-making. The Code states that trustees should:

- talk to their advisers and asset managers about how short and long-term climate change risks and opportunities are built into their recommendations, and
- understand what measures are being taken to reflect climate change risk within investment portfolios.

Trustees are also required to establish and operate adequate internal controls for their scheme and as part of this should assess the risks and opportunities associated with climate change in their risk assessment. These requirements dovetail with the obligations already in place under the Climate Change Governance Regulations (for schemes with assets over £1bn and DC master trusts) and the Code sets out that trustees of all schemes should:

- consider the possible short, medium, and long-term effects of climate change on the scheme's objectives and its operations
- maintain and document processes for identifying and assessing climate-related risks and opportunities
- integrate these processes into their risk management and governance arrangements, and
- oversee, assess, and manage climate-related risks and opportunities relating to the scheme.

How we can help

Sackers is the UK's leading commercial law firm for pension scheme trustees, employers and providers. Over 70 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.

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 disclosures. 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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