STEPHENSON HARWOOD

pensions law group

CLEAR VIEWS

ESG considerations

A trustee guide

ESG is moving up the agenda

"This is no passing fad…given the long-term nature of pension schemes climate change will be a fundamental consideration. Trustees must take account of long-term risks and opportunities to deliver the pensions people will need in the future. And that may be in an environment very different from today's.

So, my advice to trustees? Build capacity in this area if you haven't already."

The Pensions Regulator blog
1 October 2020

We have already seen the law in this area change to recognise the impact that environmental, social and governance (**ESG**) factors can have on scheme investments and sponsor covenants, as well as savers' preferences. For example, trustees must produce a statement of investment principles (**SIP**) setting out their policies on financially material ESG considerations and stewardship. A new requirement to publish an implementation statement describing trustees' voting behaviour has also come into force.

Further developments in this area are on the horizon. In particular, the Pension Schemes Bill currently passing through Parliament and a DWP consultation suggest there will be additional disclosure and governance obligations for at least some schemes. If nothing else, the proposals in the pipeline show this area is being considered as increasingly important.

Pension scheme trustees need to ensure they fully understand their obligations in respect of ESG and are prepared for this to become a priority issue for schemes; both from a legal and member perspective.

Our specialist team

Overview

Our ESG team has advised on a number of issues in this area including advising:

- trustees on how to respond to ESG-based complaints from scheme members;
- on scheme compliance with ESG legal requirements; and
- on the ability of trustees to take into account non-financial ESG factors in a way that aligns with the views of the scheme employer and scheme members.

Our ESG team

Philip Goodchild
Partner

T: +44 20 7809 2166
E: Philip.Goodchild@shlegal.com

Stephen Richards
Partner

T: +44 20 7809 2350
E: Stephen.Richards@shlegal.com

Graham Wrightson
Partner

T: +44 20 7809 2557
E: Graham.Wrightson@shlegal.com

Mark Catchpole
Consultant

T: +44 20 7809 2059
E: Mark.Catchpole@shlegal.com

Julia Ward
Professional Support Lawyer

T: +44 20 7809 2028
E: Julia.Ward@shlegal.com

Further details of our pensions team, plus details of our wider specialists in pensions tax, investment and funds, covenant restructuring and insolvency and data protection, can be found at www.pensionshub.com.

What is ESG?

Environmental, social and governance factors

ESG investment takes into account environmental, social and governance factors when considering the risk-adjusted returns that investments can produce.

There are a wide range of factors that make up ESG considerations. The Pensions and Lifetime Savings Association (**PLSA**) has provided an example list[1]:

Environmental	**Social**	**Governance**
Climate risk	Community Relations	Board structure
Carbon emissions	Employee Relations	Executive remuneration
Energy usage	Health and safety	Bribery and corruption
Raw material sourcing	Human rights	CEO/Chair duality
Supply chain management	Product responsibility	Shareholder rights
Waste and recycling	Workforce diversity	Vision and business strategy
Water management		Voting procedures

Stewardship

Trustees will find that their legal obligation to consider ESG factors is increasingly also linked to an obligation concerning stewardship.

As pension scheme trustees invest money on behalf of their beneficiaries and must act in the best interests of those beneficiaries, they have a duty to act as good stewards and hold those in whom they invest to account. This involves monitoring assets and engaging with the issuers on a number of matters, including ESG, to ensure the long-term value of scheme assets.

[1] PLSA ESG & Stewardship: a practical guide to trustee duties

Aligning ESG with trustees' investment duties

There has long been confusion over trustees' need (or ability) to take account of ESG factors in their investment decisions. Are ESG factors financial in nature? If considered non-financial, to what extent could trustees take them into account?

Fiduciary investment duties of trustees

There are a number of common law fiduciary duties which are relevant to trustees' investment powers. The main fiduciary duties in this area could be described as the need to exercise investment powers for their 'proper purpose' and as a 'prudent person' would.

Investing for a proper purpose

In the often cited case of *Cowan v Scargill*, the court held that acting in the best interests of members in an investment context requires trustees to "…*yield the best return for the beneficiaries, judged in relation to the risks of the investment in question…"* and trustees' personal views should not influence matters when making investment decisions. This case has been cited as providing that, in the pensions context, trustees must act in a way that will maximise financial returns. However, doubt has been cast upon this interpretation of the case. It is now generally accepted that the case confirms that a trustee's investment powers should be exercised for their proper purpose and not for an ulterior motive (such as advancing a trustee's personal views). It is not quite right to say that a trustee must always 'maximise financial returns'.

Investing as a prudent person would

The case of *Re Whiteley* established that in an investment context, trustees must invest scheme assets with the care that an ordinary prudent man would take if he were investing for the benefit of other people for whom he felt morally bound to provide.

The Pensions Climate Risk Industry Group (**PCRIG**) has highlighted[2] that both the 'proper purpose' and 'prudent person' tests require trustees to consider how to take into account climate related risks and opportunities. It also notes that the consideration of likely future climate scenarios is something that trustees should undertake as part of their fiduciary obligations.

Guidance from the Law Commission

The Law Commission has provided that the primary investment duty of trustees involves balancing return against risks. It has produced guidance to trustees on how ESG factors should be taken into account when carrying out this balancing exercise[3].

[2] See Aligning your Pension Scheme with TCFD Recommendations March 2020

[3] For further guidance on this point see: "Is it always about the money?" Pension trustees' duties when setting an investment strategy: Guidance from the Law Commission and the Law Commission: Pension Funds and Social Investment 22 June 2017

Financial factors v non-financial factors

Trustees should always consider financially material considerations when setting their investment strategies. Can ESG factors be considered financially material in nature?

The Law Commission has highlighted that ESG factors can certainly amount to financially material considerations, in particular when looking at the 'risk' side of the investment balance. Similarly, in its investment guidance for trustees[4], the Pensions Regulator (**TPR**) highlights the need to consider ESG factors as allowing trustees to evaluate short and long-term financial risks and opportunities of the scheme's investments. This may be particularly pertinent when considering, for example, climate change.

There may of course also be ESG factors that are non-financial in nature. The Law Commission gives a non-financial ESG example as disinvesting in a particular industry in order to show ethical disapproval. Trustees can only take account of non-financial considerations when making investment decisions if two tests are met:

> "It would take a brave trustee…to conclude that absolutely none of these issues [ESG and stewardship] are material, or that they are all solely matters of personal ethics" Guy Opperman

1. trustees should have good reason to think that scheme members would share the concern; and
2. the decision should not involve a risk of significant financial detriment to the fund.

So should trustees take ESG factors into consideration when setting investment strategy?

The understanding of a trustee's investment duties has somewhat moved on from a belief it is purely about maximising investment returns. Trustees must take into account financially material considerations when making investment decisions, and a key part of that is considering risk as well as return. Many ESG factors will go to the 'risk' side of investments and must therefore be considered. Where factors are not considered financially material, trustees may still have regard to them if the above two conditions are satisfied. The initial question of "can or should trustees take ESG factors into consideration when setting investment strategy" seems to be more appropriately rephrased as "how can they not?"

[4] See The Pension Regulator's DB Investment Code and DC Investment Code, discussed further below.

Recent changes – ESG and stewardship in the SIP

Legislation introduced in 2018 and 2019 places obligations on trustees to consider ESG factors when preparing the statement of investment principles (**SIP**). Not only this, but SIPs now have to be made available on a publicly available website; the implication being that trustees can be held to account by members and beneficiaries scrutinising decisions made. The implementation statement also places additional requirements on trustees to comply or explain any deviation from the SIP during the year.

"It is now vital that trustees of all schemes understand and include ESG factors and stewardship approaches in their investment decision-making. A failure to do this puts trustees at significant risk of breaching their legal and regulatory duties." PLSA ESG and stewardship guidance

An overview of the changes introduced is set out below. For full details of all the requirements, including how these apply to your scheme, please contact your usual Stephenson Harwood contact.

Statement of investment principles

1 October 2019

The SIP must:

- state how financially material considerations are taken into account in the selection, retention and realisation of investments. Financially material considerations include ESG matters such as climate change;
- state the extent, if at all, to which non-financial matters are taken into account in the selection, retention and realisation of investments. Non-financial matters include ethical views and views in relation to social and environmental impact on members and beneficiaries;
- include a stewardship policy regarding the exercise of rights attaching to investments and the undertaking of engagement activities in respect of the investments. This includes methods by which, and circumstances under which, trustees would monitor and engage with respect to social and environmental impact; and
- for defined contribution schemes, be published on a publicly available website.

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October
2020

Statement of investment principles

The SIP must be expanded to include further information. This includes the trustees' policy in relation to any arrangement with an asset manager relating to:

- how the asset manager is incentivised to align its investment strategy with the trustees' investment policies;
- how the asset manager is incentivised to make a decision based on the medium to long-term financial and non-financial performance of issuers of debt or equity and to engage with such issuers in order to improve their performance in the medium to long term;
- how the method of evaluation and remuneration of the asset manager's performance is in line with the trustees' investment policies;
- how trustees monitor portfolio turnover costs; and
- the duration of the agreement with the asset manager.

For defined benefit schemes, the SIP must be published on a publicly available website.

Implementation statement

A scheme's annual report and accounts produced on or after 1 October 2020 must contain an implementation statement.

For defined contribution schemes, this implementation statement must cover the following and be published online once the accounts have been signed after 1 October 2020 (but no later than 1 October 2021):

- the extent to which the SIP has been followed;
- any review of the SIP in the year and an explanation of any changes that have been made to the SIP;
- the date of the last review of the SIP if a review in the year was not undertaken; and
- a statement on the voting behaviour by or on behalf of the trustees.

For defined benefit schemes this implementation statement must describe:

- how the trustees' stewardship policy has been followed; and
- the voting behaviour by or on behalf of trustees.

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Implementation statement

For defined benefit schemes, the implementation statement must be published online by 1 October 2021.

How can trustees comply with their obligations?

The PLSA has issued a guide to help set out how trustees can incorporate financially material ESG factors into their investments and be effective stewards of their assets. The impetus behind this guide was the new legislative requirements with regards to SIPs and implementation statements, and trustees may have carried out these steps in ensuring they have met these new obligations.

However, the guidance makes clear that ESG and stewardship is not a 'once and done' exercise, but something that requires ongoing monitoring and updating. This therefore remains a useful example journey plan for trustees to keep in mind when ensuring they continue to fulfil their fiduciary duties when it comes to ESG and stewardship, and remains a good basis for helping schemes to achieve good practice for the future. Full details of these steps are available on the PLSA website and a high level overview is set out below.

Assessment of current approach and requirements	Ascertaining and agreeing investment beliefs	Setting the policy	Methods of implementation	Monitoring and reporting
Trustees should familiarise themselves with key ESG and stewardship concepts and market practice. Trustees should consider seeking views from other parties, such as employer representatives and advisers. They should also understand the ESG and stewardship activities that their investment advisers and managers are taking on their behalf.	Trustees should then agree a set of investment beliefs (as opposed to personal beliefs) around ESG considerations and stewardship practices. This should be properly documented. An agreed view on the extent, if at all, non-financial matters are to be taken into account should also be considered.	Once the beliefs have been decided, the Trustees should inform the policies within the SIP and other relevant documents, such as the DC Chair's Statement. The policy should capture the investment beliefs and how investment beliefs will be actioned. Where required, the policy should also be capable of being shared online.	Changes will need to be implemented in line with the trustee's investment beliefs. Different considerations will apply for DB and DC schemes and also to different asset classes. There should also be a plan for the ongoing stewardship of the portfolio.	Trustees must regularly review the performance of advisers, managers and other service providers and must have in place a plan to monitor the performance and effectiveness of their advisers' and managers' decision-making.

Further obligations on the way?

Additional governance and disclosure obligations for certain schemes

The Pension Schemes Bill

The draft Pension Schemes Bill is currently making its way through Parliament. This Bill contains powers for regulations to be made:

- imposing requirements on scheme trustees with a view to securing effective governance of the scheme with respect to the effects of climate change;
- requiring information relating to the effect of climate change on the scheme to be published; and
- imposing penalties to ensure compliance with the above.

Over the summer the DWP issued a consultation suggesting one use of this regulation making power would be to enable recommendations set out by the Task Force on Climate-related Financial Disclosures (**TCFD**) to be mandated for larger occupational pension schemes, including master trusts and collective money purchase schemes. It will place into pensions law governance and disclosure obligations in line with the recommendations made by TCFD.

The TCFD is a global private sector group established by the Financial Stability Board. It was established to develop recommendations for climate related disclosures to promote, amongst other things, more informed investment. It published recommendations in June 2017.

The proposed new governance and disclosure obligations

Which schemes would the new requirements apply to?

Scheme type	Deadline for governance requirements	Deadline for disclosure requirements
Schemes with £5 billion or more in assets	From 1 October 2021	Earliest of (i) within 7 months of first scheme year to end after 1 October 2021 and (ii) 31 December 2022
Authorised master trusts		
Collective money purchase schemes		
Schemes with £1 billion or more in assets	From 1 October 2022	Earliest of (i) within 7 months of first scheme year to end after 1 October 2022 and (ii) 31 December 2023
Schemes with less than £1 billion in assets	The government will look to review the position in 2024 and consult again before extending the requirements to other schemes	

What are the new governance and disclosure obligations?

The governance and disclosure obligations largely focus upon trustees assessing and understanding climate-related risks and opportunities to pension scheme assets, liabilities, investments and, where appropriate, funding strategies. Please see the Appendix at the end of this document where the proposed new obligations are set out in full.

It is proposed that statutory guidance will be produced by the DWP to set out detailed assistance to trustees in meeting these duties. In addition to this proposed statutory guidance, trustees are also signposted to the non-statutory draft guidance by the PCRIG on aligning pension scheme disclosures with the TCFD.

> "…the proposals…do not seek to be simply another disclosure requirement…our policy, and…eventual regulations, will make clear that these changes concern governance decisions, and the disclosure requirements should instead be viewed as part of a wider, robust governance process." - DWP

None of the proposals will, however, attempt to direct trustees in their investment decisions; the discretion as to how to invest will remain with the trustees.

What are the proposed reporting obligations?

The consultation proposes that the trustees' TCFD report must either be published or signposted in certain places. Discretionary penalties can be imposed by TPR for any failure in this regard (see below for more detail on penalties).

Proposed audience	**Reporting obligation**
General	The consultation proposes that schemes will have to publish their TCFD report on their website, or on the scheme sponsor's website. A link to the report will also have to be provided in the Annual Report and Accounts.
The scheme members	Members must be told in their annual benefit statement where they can locate the TCFD report.
The Pensions Regulator	The web address of where the report is published must be included in the annual scheme return form (as well as the link to their SIP implementation statement and published excerpts of the Chair's statements).

What are the proposed penalties for non-compliance?

A new penalty regime will be set out in the Pension Schemes Bill 2019 to deal with a failure to comply with the new requirements. This will allow TPR to issue penalty notices to both trustees and third parties. Penalties will be discretionary, unless there has been wholesale non-compliance where no TCFD report has been published at all. Such non-compliance would attract a mandatory penalty of at least £2,500. TPR has discretion to determine the amount of a fine in the case of a discretionary penalty. The maximum penalty for any breach of the requirements would not exceed £5,000 for an individual or £50,000 for a corporate trustee.

A few relevant codes and guidance notes

Below is an overview of some of the codes of practice and guidance notes available to trustees in this area. There are also other materials available, for example the Law Commission reports and PLSA Responsible Investment Guide 2019, which are discussed above.

The UK Stewardship Code

The Financial Reporting Council published a revised UK Stewardship Code which came into effect on 1 January 2020 and revised previous iterations of the code. It is a code of best practice on stewardship by institutional investors, such as pension funds. TPR has encouraged trustees to adhere to the code in their stewardship activities in order to improve long-term returns and reduce the risk of poor outcomes due to poor strategic decisions[5].

Signatories to the code will need to, amongst other things:

- produce an annual Activities and Outcome Report which will explain how they have applied the Code in the previous 12 months; and
- take into account ESG factors, including climate change, when making investment decisions to ensure these decisions are aligned with the needs of their beneficiaries.

TPR defined contribution and defined benefit Investment Governance Codes

In these codes, TPR highlights that consideration of ESG factors allows trustees to consider the short and long term financial risks and opportunities of investments. When applying an ESG policy, the codes note that demographics of the particular schemes and what types of ESG issues could affect the return the members may receive should be considered. Trustees should understand how the available funds approach ESG matters. This consideration should also be taken into account when choosing new funds and in monitoring investment managers. The guidance emphasises that trustees should understand the implications of climate change on investment decisions.

The codes also provide useful guidance on trustees' duties when considering financial and non-financial considerations, as well as providing examples of each.

Draft PCRIG guidance

In March 2020, the PCRIG published draft guidance for pension scheme trustees on aligning pension scheme disclosure with the TCFD. The TCFD recommendations are currently discretionary, but this guidance intends to assist trustees who want to get ahead of the curve and start implementing the recommendations of the task force. These recommendations are discussed in more detail above.

[5] See TPR Investment Guidance for defined benefit pension schemes and TPR Investment Guidance for defined contribution schemes

A sign of things to come?

The following developments are further examples of how the role of ESG factors in trustee investment decision making may continue to evolve. However these matters may progress, trustees should be prepared to ensure ESG factors are given the appropriate consideration when setting investment strategy.

The Responsible Investment Bill

ShareAction, a charity concerned with building responsible investment, has proposed new legislation known as the Responsible Investment Bill.

The Bill provides that when fiduciary investors, such as pension scheme trustees, are required to act in the best interests of beneficiaries, these best interests will include the beneficiaries' environmental and social interests. Trustees would also be required to understand their beneficiaries' viewpoints.

The Bill also requires default funds, and any funds marketed as sustainable, to align with the Paris Agreement goal to limit climate change to below 2°C.

Pension schemes to explain how stewardship policies and activities are in members' best interests

The Stewardship and Stakeholder Working Groups of the Asset Management Taskforce have published a report on placing stewardship at the heart of the investment decision making process. The taskforce is made up of representatives from the Government, asset management industry, regulators and other key stakeholders. The report contains 20 recommendations for a blueprint for an economy wide approach to stewardship. Two of these are aimed at pension schemes specifically:

- UK pension schemes must explain how their stewardship policies and activities are in members' best interests

  The report recognises that in order for trustees to be able to do this, they must understand the investment and stewardship objectives of their beneficiaries. The report supports the use of technology to enable schemes to do this. The report also provides that TPR should issue related guidance on how trustees might evidence that their stewardship policies and activities are in members' best interests.

- A dedicated council of UK pension schemes should be established by June 2021 to promote and facilitate high standards of stewardship of pension assets

  Members of the council should either be signatories of the UK Stewardship Code (discussed further below) or have publicly committed to signing the Code within two years of joining the council. All UK occupational pension schemes will be encouraged to join the council, with particular focus on schemes with over £1 billion of assets and authorised master trusts.

Consideration of trustee voting policies when selecting, appointing and monitoring fund managers

The Association of Member-Nominated Trustees has produced a report on Bringing Shareholder Voting into the 21st Century. This report was produced against the UK regulatory environment where there is an expectation for trustees to develop voting policies and have these implemented. One way to achieve this is for trustees' fund managers to implement their scheme specific voting policy on an comply or explain basis. However, in reality, the report notes that this is not happening especially when it comes to pooled fund arrangements. As a result, the current system is not fit for purpose.

The report sets out recommendations for overcoming these barriers for fund managers, investment consultants and trustees. For those trustees that wish to have their voting policies directly implemented by their fund managers, the report recommends that they should write to their fund managers asking them how they plan to adhere to the new UK Stewardship Code requirements and also review their voting policies against that of their fund managers. This should then inform the trustee's selection, appointment, and ongoing monitoring process of their fund manager. Trustees should also write to their investment consultants asking how they plan to support them in their efforts to have their voting policies implemented.

On the back of the report, the Taskforce on Pension Scheme Voting Implementation has been established. It will be supported by the DWP but be separate from it. This group has a remit to look at:

- how to deliver solutions to voting system issues which overcome the present obstacles to trustees implementing their own policies;
- how to increase the number of asset managers who are prepared to follow, or as a minimum 'comply or explain', trustee voting policies including via pooled arrangements; and
- recommending regulatory and non-regulatory measures to ensure the convergence of asset managers' approaches to voting policy and execution with trustees' policies and preferences, especially in pooled funds.

Scottish Widows divests £440 million from companies that do not meet ESG standards

It was recently announced that Scottish Widows will be divesting at last £440 million from companies that do not meet its ESG standards. Its exclusion policy will include investments from the group's pension fund, including its workplace default. Investment in a number of companies will be excluded, including those that derive more than 10% of their revenue from thermal coal and tar sands, as well as manufactures of controversial weapons. It is likely that Scottish Widows will extend this exclusion to other funds in the future. The rationale behind the move is to play a role in shielding customers from ESG investment risks. This is a clear example of how ESG factors are considered financially material in reaching investment decisions.

In its consultation, the DWP has made clear that the proposal to make compliance with the TCFD recommendations mandatory is intended to encourage collaboration with business, as opposed to disinvestment, as the most effective means of holding companies to account on climate change. It recognises that in holding such assets, trustees are in a powerful position to influence companies' approaches to ESG considerations. It is therefore noteworthy that Scottish Widows, in taking the approach that it did, commented that those companies on the exclusion list were those posing the most severe investment risk, which could not be addressed through engagement.

Appendix

The proposed governance and disclosure requirements

Under the DWP consultation, the governance and disclosure requirements that will apply to the relevant schemes are as follows:

	Governance requirements	**Annual Disclosure requirements**
Governance	Establish and maintain, on an ongoing basis, oversight of climate-related risks and opportunities.	Establish and maintain processes by which trustees, on an ongoing basis, satisfy themselves that the persons managing the scheme are assessing and managing climate-related risks and opportunities.
	Describe the trustees' oversight of climate-related risks and opportunities.	Describe the role of the persons managing the scheme in assessing and managing climate-related risks and opportunities, only insofar as they relate to the scheme itself, and the process by which trustees satisfy themselves that this is being done.
Strategy	Identify, on an ongoing basis, climate-related risks and opportunities that will have an effect on the investment and, in the case of defined benefit schemes, on the funding strategy of the scheme, over the short, medium and long term.	Describe the climate-related risks and opportunities identified over the short, medium, and long term
	Assess, on an ongoing basis, the impact of the identified risks and opportunities on the scheme's investment and, in the case of defined benefit schemes, funding strategy.	Describe the impact of climate-related risks and opportunities on the scheme's investment and, in the case of defined benefit schemes, funding strategy.
Scenario analysis	At least annually, as far as they are able, assess the resilience of the scheme's assets, liabilities and investment strategy and, in the case of defined benefit schemes, funding strategy to climate-related risks in at least 2 climate-related scenarios, including at least one scenario that represents an eventual global average temperature	Describe the resilience of the scheme's investment and, in the case of defined benefit schemes, funding strategy, as far as trustees are able, in at least two climate-related scenarios, including at least one scenario of between 1.5°C and 2°C.

	rise of between 1.5°C and 2°C on pre-industrial levels	
Risk management	Trustees must adopt and maintain, on an ongoing basis, processes for identifying and assessing climate-related risks.	Describe the processes that the trustees have put in place for identifying and assessing climate-related risks.
	Trustees must adopt and maintain, on an ongoing basis, processes for managing climate-related risks.	Describe the processes that the trustees have put in place for managing climate-related risks.
	Trustees must ensure, on an ongoing basis, integration of climate-related risks into their overall risk management.	Describe how these processes are integrated within their overall risk management.
Metrics	Select at least one appropriate greenhouse gas emissions (**GHG**) based metric and at least one other non-emissions-based metric to assess scheme assets against climate-related risks and opportunities and review the selection on an ongoing basis.	Disclose the emissions-based metric(s) and non-emissions-based metric(s) that the scheme has calculated and that is used by trustees to assess the climate-related risks and opportunities relevant to the scheme.
	At least quarterly, calculate at least one GHG emissions-based metric to assess scheme assets against climate-related risks and opportunities. At least quarterly, calculate at least one other, non-emissions-based metric to assess scheme assets against climate-related risks and opportunities.	Describe why, if trustees have only been able to obtain partial or estimated data, their data does not cover the whole portfolio.
Targets	At least annually, set at least one target to manage climate-related risks for one of the metrics, which can be an emissions-based metric, or a non-emissions-based metric.	Disclose the target(s) selected.
	At least quarterly, measure, as far as trustees are able, performance against the target(s).	Disclose performance measured against the selected target(s).

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