Burges Salmon Pensions Law Summary

Environmental, Social and Governance (ESG) and Pension Schemes

Burges Salmon

Scope and Summary

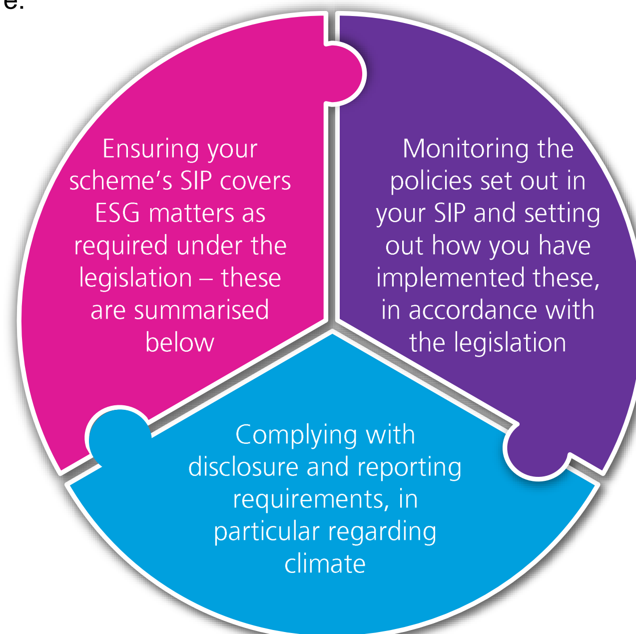
This note provides a practical summary of some key aspects relating to ESG in connection with the investment of pension scheme assets as at August 2021.

Key takeaway points include:

- Environmental, social and governance (ESG) factors are well recognised within the finance sector and present opportunities and risks when investing assets. ESG factors can materially improve investment return outcomes / reduce risks. This is separate from ethical considerations which might not have a material effect on performance.
- ESG is relevant for Trustees and Employers as ESG factors can affect the risk and returns relating to pension scheme investments. Given the severity of issues such as climate change, there has been an increased push within Government and the pensions sector more generally to support investment in entities which mitigate and adapt to climate change in particular. In light of this, schemes need to update their Statements of Investment Principles (SIPs), set out policies on non-financial considerations/stewardship matters, implement those policies and understand disclosure requirements.

Legal Position – Summary

The main ESG requirements are:

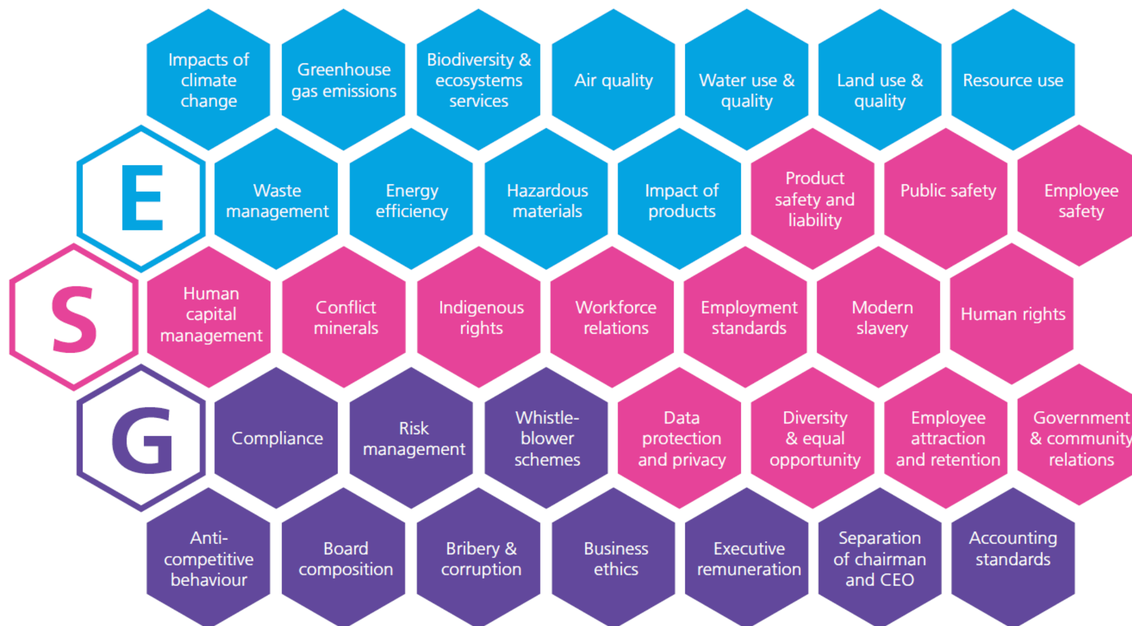


Each of these are considered further below including the practical steps that Trustees must take.

Statement of Investment Principles

Prior to October 2019, the SIP was only required to state "the extent (if at all) to which social, environmental or ethical considerations are taken into account ". Now it must actually set out the trustees' policies in relation to a number of ESG and stewardship matters as follows:

- **Trustees must set out how they take into account financially material considerations over the appropriate time horizon.** These are defined as including but not limited to ESG considerations (with a specific mention of climate change) which the trustees consider to be financially material.



- **The "appropriate time horizon" is the length of time that the trustees consider is needed for the funding of future benefits by the investments of the scheme.** The intention is to refer to the length of time of the scheme, and not the duration of individual investments, and to prompt schemes which are approaching buy-out or wind-up to consider financially material short-term risks, whilst encouraging other schemes to look towards the longer term in a way which reflects the demographics of members and beneficiaries.

- **Trustees must set out their policy on the extent (if at all) to which non-financial matters are taken into account.** "Non-financial factors are defined as "the views of the members and beneficiaries including (but not limited to) their ethical views and their views in relation to the social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme". While such non-financial matters are clearly subordinate to their main fiduciary duty of ensuring positive investment return in order to provide a pension, trustees may take account of non-financial factors if they have a good reason to think that scheme members share a particular view AND their decision to take those non-financial factors into account does not risk significant financial detriment to the fund.

- **Trustees must set out their policy on stewardship matters** – that is how they exercise their voting rights and how they undertake engagement activities. In practice, these activities are likely to be undertaken by investment managers on behalf of trustees, especially where investments are made via pooled funds. So trustees will wish to familiarise themselves with their managers' stewardship policies, and stewardship is also likely to be used as a criterion when shortlisting and selecting managers.

- **Trustees must set out their policies in relation to their arrangements with any manager**. There are a number of elements to this, but one example is including a statement about how these arrangements incentivise the manager to align its investment strategy and decisions with the trustees' investment policies generally. Another is how they evaluate and remunerate a manager's performance in line with their investment policies.

Monitoring and Implementation

Historically, trustees were only required to report against their investment policies if they had been breached. The amended Investment Regulations have expanded that requirement so that trustees have to proactively consider and set out how they have implemented the policies, explaining any changes made during the scheme year and the reasons for the change.

This means that from 1 October 2020 DC schemes, and 1 October 2021 for DB schemes, trustees will be required to produce what is known as an Implementation Statement setting out how, and the extent to which, in their opinion, the SIP has been followed during the year. This statement must also describe any review of the SIP that has been undertaken (as a reminder the SIP must be reviewed at least every three years and without any delay after any significant change in investment policy).

The regulations do not prescribe the contents of the implementation statement, although TPR's Investment Guidance does touch on this.

In addition, from 1 October 2021, the implementation statement must also set out how their policy on the exercise of voting rights and engagement activities has been followed during the year, and a description of their voting behaviour during that year.

In practice, we expect that trustees will rely heavily on reports issued by managers e.g. on the actions they have taken to incorporate ESG issues into their investment analysis and decision-making; and any material changes to the ESG risks and opportunities in the portfolio. Managers will also need to provide a voting summary and summary of their engagement actions.

Ensuring Disclosure Requirements are met

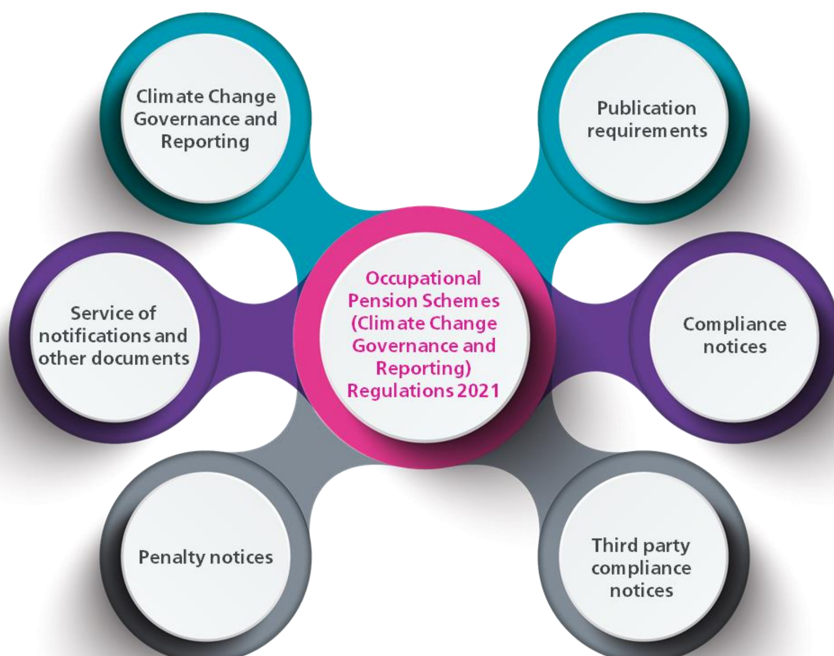
There is a drive for greater transparency in relation to ESG matters. As well as including your SIP in your annual report, you must also publish it on a publically available website. The same is true for the implementation statement.

"Publically available" has its natural meaning which means it should be available on a website, not through a portal or filter page. It must be available free of charge and should be capable of being found by a search engine.

Understanding New Climate Change Risk Reporting Requirements

The Pension Schemes Act 2021 gave the Government new regulation-making powers regarding climate change risk.

Very recently published for consultation are the draft Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021: the draft legislation includes several requirements in relation to pension trustees. Points to consider will include:



Trustees need to keep a close watching brief on these new requirements.

Practical Steps

As well as making sure you take the advice you need to understand how to fulfil your legal obligations as mentioned above, trustees can also draw upon the various resources available to assist them, such as:

- The PLSA cross-industry group on ESG and stewardship. This group aims to help schemes achieve the ESG and stewardship disclosure duties following changes to the Investment Regulations. It also provides a voting behaviour template for trustees to compare asset managers' engagement and voting behaviour.

- The Investment Consultants Sustainability Working Group (ICSWG) has a guide to help pension scheme trustees assess investment consultants on their climate competency. The guide sets out five competency themes alongside examples of positive/negative indicators for each theme to help trustees identify and raise investment consultants' standards.

It is clear that trustee boards will need the skills and expertise to properly carry out their investment duties and meet regulatory expectations. Trustees boards need to reflect on any gaps in their knowledge and take steps to plug these with a combination of training and advice.

Conducting proper governance is also key. Trustees should take care not to take a superficial "tickbox" approach but should dig deeper and really test the approach. For example, by asking their advisers questions around the methodology behind their ESG ratings. Other questions that trustees might ask themselves are:

- Do we really understand the extent to which ESG is already integrated into our decision-making?

- Are we satisfied with our current approach to stewardship? Do we currently set the right level of expectations for our managers regarding any outsourced stewardship activities?

Conclusion

- To conclude, ESG factors are particularly prominent when considering pension scheme investment. Due to the rise of issues such as climate change, regulatory bodies have increased need for transparency, disclosure, planning and consideration among those managing pension schemes. Trustees now have further duties, and this is only likely to increase. Therefore, it is crucial that trustees engage with the points from this note and recognise areas of weakness, in order to fulfil these duties correctly.

- Please contact us if you would like further information or advice on anything in this note.

- This practical summary is not intended to be a full statement of the law on this topic and is not legal advice. It does not take account of any developments since it was written or last updated.

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