

ESG for pension schemes: now and next

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The global health crisis has changed our perspectives in almost all areas of daily life and business. Further change and evolution is still to come, but it's clear that the effects of the pandemic have reconfigured how we look at a whole range of environmental, social and governance (ESG) issues. To date, the focus for pension schemes has been mainly on the 'E' of ESG, covering various environmental issues and, specifically, climate-related risks that are financially material to pension scheme investment decisions. The 'S' of ESG is now firmly on the agenda for corporates, pension schemes and asset managers, and the importance of governance as the underpinning framework is also clear.

In the 'next normal' where we live with Covid-19, or even move beyond it, it seems likely that ESG will be reshaped, with 'S' and 'G' continuing to receive increased attention, and focus on different aspects, than has been the case to date.

Meanwhile, pension scheme trustees are preparing for changes to disclosure requirements on investment governance issues, stewardship and engagement from 1 October 2020. We also expect additional requirements and guidance in the near future on ESG issues – and in relation to climate change in particular. Trustees are rightly focusing on key operational priorities at the moment – but it's also important to ensure that you are ready for these forthcoming changes, and have the right groundwork in place.

It is widely expected that national governments will seek to stimulate recovery with a 'green' and stakeholder focus, and that investors may ask hard questions about corporate governance and resilience, once the immediate crisis begins to recede. For strategic and practical reasons now is a good time, for schemes that have the capacity, to focus again on investment beliefs and on the information flows you are getting from your investment consultants and asset managers.

In this briefing we provide a reminder of what regulatory changes are in place already, what's still to come, and some thoughts on how investment beliefs, and the strategies that flow from them, may be reconfigured in light of Covid-19.

“The objective of the new disclosure requirements for pension schemes is to make more active stewardship part of ‘business as usual’ for schemes, either directly or via investment managers, and to ensure (in the Regulator’s words) that ‘action follows intent’.”

Neil Bowden, Partner

Current action points

Climate change: consultation on industry guidance

The government has stated that by 2022 all listed companies and large asset owners should make disclosure in line with the recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD). The Pensions Regulator (TPR) views climate change as a 'core financial risk' relevant to standards of governance and risk management by schemes. Although the timelines have slipped due to the pandemic, there is currently an open consultation on non-statutory industry guidance on TCFD disclosures.

The draft guidance covers assessing and managing climate-related risks as well as reporting aspects. It acknowledges that TCFD compliance will be very challenging for some schemes, and that

trustees may need to adopt robust governance procedures as a first step, before starting to consider the disclosure elements.

However, the government's view is that schemes should not need regulations in order to start actively working towards the TCFD recommendations and reporting on their progress. The Code is intended to 'lay the groundwork and develop good practice' for disclosure and will be updated once TPR publishes its governance Code of Practice (see further below), which will include guidance on climate-related issues.

What's the impact for schemes?

Compliance with the guidance (at least in its current form) is likely to require significant time investment and additional documentation – for example, a record of the main risks and opportunities for each time

horizon and their potential impact, together with how you identify and assess materiality in this context; and your view of resilience to different scenarios (including relevant metrics). It will include commentary on your due diligence regarding stewardship activities, including where these are delegated to asset managers, in order to hold managers and investee companies to account.

Consideration of the draft guidance may also be a useful exercise in identifying principles to be applied more widely – for example, to support a review of your governance practices and the information and metrics available to you, and to help with assessing the resilience of your investment strategy to current market shocks.



The consultation on the guidance closes at 11:45pm on 2 July 2020 – although it would be easy for this to slip under the radar, it's worth making time if possible to consider the implications for your current practices and respond to the consultation if appropriate.

SIP reviews and the implementation statement

Most UK pension schemes reviewed and/or updated their statement of investment principles (SIP) during 2019, to comply with updated requirements relating to ESG issues and stewardship matters. A further review is required before 1 October 2020 to ensure that the SIP covers the trustees' arrangements with asset managers, including how those arrangements promote alignment with the scheme's investment strategy, and information about the remuneration and monitoring of asset managers. In addition, your policy on engagement should already state 'the circumstances under which you would monitor and engage with relevant persons about relevant matters', but this element is being extended.

From 1 October 2020 the 'relevant persons' category will be widened and 'relevant matters' will have to include an issuer's capital structure and its management of actual or potential conflicts of interest (as well as matters such as performance, strategy, risks, social and environmental impact, and corporate governance that are already covered).

The requirement for schemes with 100+ members to publish an implementation statement in the next scheme annual report published on or after 1 October 2020 is a further consideration during your review of the SIP. When you come to write your implementation statement, it will be important that the SIP accurately reflects your intentions and actions.

If it says that the voting policies of asset managers are reviewed 'regularly', what does that mean? If they are reviewed annually, does that happen in practice? You will need to set out in your implementation statement whether or not you have carried out these reviews in the relevant year, how you did it and what you found – so it's worth ensuring that commitments in the SIP reflect your intentions and practice.

As part of this process, you may identify gaps in your data (for example on voting and engagement activities), where you will need additional information from your investment consultants and managers. Our briefing ['The implementation statement: how to prepare for it'](#) sets out a list of questions to help you get started.



- Ensure that your scheme SIP will comply with statutory requirements from 1 October 2020.
- Depending on the date of publication of your next annual report, start gathering information to prepare the implementation statement.

Implementation statement content requirements:

DB or DB + AVC schemes with 100+ members

The annual report must include a statement that:

- sets out how, and the extent to which, the trustees' policy on the exercise of rights (including voting rights) attaching to investments, and engagement activities, has been followed during the year; and
- describes the voting behaviour by, or on behalf of, the trustees (including the most significant votes cast) during the year and states any use of the services of a proxy voter during that year.

Relevant DC schemes¹ with 100+ members

The annual report must include a statement that:

- sets out how, and the extent to which, the SIP (including the policy on voting and engagement) has been followed during the year;
- describes any review of the SIP undertaken/any changes made to the SIP during the year and the reason for any change, and the date of the previous review if there was no review during the year; and
- describes the voting behaviour by, or on behalf of, the trustees (including the most significant votes cast) during the year, and states any use of the services of a proxy voter during that year.

Trustees must publish the implementation statement online (at the same time as, or after, the annual report – the final deadline for publication is 30 September 2021) and tell members about its availability.

The government's intention is that 'requiring trustees to report on how they have followed their investment principles will ensure that the text [of the SIP] reflects what pension

schemes aim to do, and that schemes act on the principles they set out'.

“The new requirements will enable members, campaign groups and others to scrutinise and compare approaches across the market. We expect to see approaches evolving over time. The Regulator has also suggested including additional content such as ‘lessons learned’ about specific issues (on a voluntary basis).”

Jane Higgins, Partner

¹ 'Relevant DC schemes' means, broadly, DC schemes with more than 12 members but excluding AVC-only arrangements and public service schemes.

Strategic objectives for investment consultancy providers

As a side-note, from December 2019 many schemes fell within the scope of new rules from the Competition and Markets Authority requiring trustees to set strategic objectives for investment consultancy (IC) providers. Regulations establishing a similar (but not identical) replacement regime were due to take effect from April 2020, and regulatory guidance was to be updated accordingly. Due to the intervening impact of the global health crisis, those regulations have not yet been published.

There are a few points to watch here:

– Many schemes were expecting to review their initial set of strategic objectives this year in line with the expected regulations, and for schemes with in-house investment consultants that were exempt from the CMA rules, the regulations would have been the trigger to ensure that appropriate objectives

were in place. The regulations are still expected at a later date, but the timing is uncertain.

– Under the DWP regulations, the mechanism for annual reporting would be the scheme return – but under the CMA rules that currently apply, trustees must submit a compliance statement to the CMA by 7 January 2021 confirming the extent to which relevant parts of the Order have been complied with. The form of the compliance statement is set out in the Order; trustees must also provide a certificate stating that they have complied with the Order in all material respects during the period, and reasonably expect to continue to do so. This will generally be signed by the Chair of trustees. These reporting provisions will apply to in-scope schemes unless the CMA Order is superseded by regulations.

The CMA rules provide that trustees must not enter into a contract for IC services (or continue to obtain these services) unless they have set strategic objectives for the provider. ‘IC services’ has quite a broad definition and includes ‘any matters in respect of which the Pension Scheme Trustees are required by law to seek advice in relation to the preparation or revision of the statement of investment principles’. As a result, if your scheme has sought advice from a new provider in relation to changes to the SIP and the scheme falls within the scope of the regulations, you are required to have appropriate objectives in place. The CMA Order also includes a requirement to report any non-compliance (for example, obtaining relevant services without having strategic objectives in place) within 14 days of becoming aware of the failure to comply.

ESG: the changing outlook

Stepping back for a moment from the compliance obligations mentioned above, many schemes will be monitoring key investment strategy issues very carefully in the light of market volatility in recent weeks.

For some schemes, a wider review of investment beliefs and strategy may be appropriate, especially in view of the increasing disclosure requirements around ESG issues.

Have your investment beliefs altered as a result of recent events? What evidence have you gained about the resilience of your strategy and the sustainability and approach of investee companies?

Environmental

Issues including:

Climate change
Extreme weather events
Biodiversity loss
Deforestation
Resource depletion
Pollution, emissions
Waste
Natural resource management
Sustainability

“Governments are increasingly seeing their recovery programmes as a unique opportunity to divert public and private sector funds into more sustainable investments. Despite initial concerns, it seems clear that Europe intends to use this as a way of driving forward the Green Deal agenda. We may ultimately look back and see this period as a tipping point.”

Matt Townsend, Partner

‘Covid-19 and climate change present a collision of systemic crises which should be managed simultaneously to reinvigorate and decarbonize the global economy. Action taken now to mitigate the negative effects of both systemic threats will materially reduce the magnitude of the impact experienced by future generations.’

ICGN Statement of Shared Governance Responsibilities during the Covid-19 pandemic

Social

Issues including:

Working conditions
Health and safety
Income equality
Human rights
Modern slavery
Child labour
Employee/customer relations
Community engagement
Reputation
Conflict zones/conflict minerals

“The current global health crisis has pushed workforce and supply chain issues even more substantially into the foreground.

Apart from the potential reputational damage for companies that are judged (perhaps with hindsight) to have treated staff and suppliers poorly when the crisis hit, there is a huge emphasis on keeping workers safe and valuing their contributions on their return to work post-lockdown – and, for customer-facing businesses, ensuring public safety. Corporates that fail to rise to the challenge could be weakened as a result.

Conversely, some companies will have gained public and stakeholder confidence through their approach to the crisis.”

Suzanne Spears, Partner

‘Understanding how a company treats its workforce is... crucial to pension funds’ decisions about which companies they invest in... and we believe should figure prominently in companies’ annual reports.’

Pensions and Lifetime Savings Association, June 2019

On 29 April 2020, the European Commissioner for Justice, Didier Reynders, announced that the European Union plans to develop a legislative proposal by 2021 requiring businesses to carry out due diligence in relation to the potential human rights and environmental impacts of their operations and supply chains.

Governance

Issues including:

Shareholder rights
Accounting and reporting
Executive pay
Bribery and corruption
Money laundering
Board diversity and structure
Gender pay gap, diversity and inclusion
Data protection and cybersecurity

“Organisations are facing unprecedented challenges in Covid-19 and climate change. Corporate governance was already high on the agenda, and is more so now. Underpinning how effectively an organisation responds is good governance, including risk assessment, checks and balances, and informed decision making.”

James Roe, Partner

‘Investors will seek assurance on the competence of board directors in steering through this crisis... Demonstrating resilience as a complement to sustainable value creation is a new priority.’

ICGN Statement of Shared Governance Responsibilities during Covid-19 pandemic

“Cyber security/resilience is increasingly seen as a governance risk that should be a priority for investors, because of the severe business disruption, as well as financial and reputational damage, that can be caused by a breach. Cyber security risks may be financially material, but recent reporting suggests that there is little consistency in how these risks are taken into account by asset managers in their engagement activities, and that they may not be routinely covered in sustainability and stewardship reports.”

Andy Cork, Partner

The International Corporate Governance Network has published a statement of Shared Governance Responsibilities during the Covid-19 pandemic, aimed at both corporates and investors. Among the issues it highlights are:

- social responsibility, including treatment of the workforce
- resilience and sustainability
- an holistic, equitable and long term approach to capital allocation.

Future regulatory change

Pension Schemes Bill: further disclosure requirements to come

For the moment, TCFD-style disclosures are voluntary, but further climate change risk management and reporting requirements for trustees are included in the current Pension Schemes Bill.

The proposed legislation would pave the way for regulations to (a) require trustees to publish climate change-related risk information and (b) impose other requirements with the aim of ensuring effective governance of the scheme with respect to the

effects of climate change (including risks and opportunities). This may (at least initially) be limited to large pension schemes, but no details of any scheme size thresholds for disclosure are yet available.

Requirements may include:

- reviewing the exposure of the scheme to certain risks (and developing and reviewing a strategy for managing the risk exposure);
- assessing the assets of the scheme in a prescribed manner;
- developing and reviewing targets relating to the scheme's exposure to certain risks and measuring performance against these targets; and
- reporting requirements

Trustees would be required to have regard to statutory guidance when complying with the regulations, and non-compliance could result in a compliance notice or fine.

IORP2 and the governance Code of Practice

Further governance requirements are on the way, courtesy of IORP2. The Pensions Act 2004 was amended from 13 January 2009 to provide that: 'The trustees or managers of an occupational pension scheme must establish and operate an effective system of governance including internal controls, which must be proportionate to the size, nature, scale and complexity of the activities of the occupational pension scheme.'

The expected consultation on a new Code of Practice, setting out the Regulator's expectations in this area, has been delayed, but we know that the code will include guidance on (among other things):

- how a scheme's effective system of governance should include consideration of environmental, social and governance factors related to investment assets in investment decisions;

and, in relation to the scheme's own-risk assessment:

- where environmental, social and governance factors are considered in investment decisions, how the trustees or managers assess new or emerging risks, including risks relating to climate change, the use of resources and the environment; social risks; and risks relating to the depreciation of assets as a result of regulatory change.

Further guidance on the way

The Pensions Regulator has put most of its regular programme of work on hold during the current health crisis, so it's not clear when further guidance or consultations may be published.

In relation to implementation statements, the Pensions and Lifetime Savings Association has set up an industry group that aims to produce guidance on good practice,

together with a voting behaviour template for asset managers.

This is designed to help trustees to compare engagement and voting behaviour and to produce their own disclosures, and the aim is that this will be available in time for summer trustee meetings – though as outlined above, trustees should not wait until then to start considering the issues.

For more help with preparing your implementation statement, please see our March 2020 guide: ['The implementation statement: how to prepare for it'](#).

Action points

– This may be an opportunity to pause and review your investment beliefs and strategy - are these changing in light of the pandemic? How resilient has the scheme's strategy proved to current market shocks?

– Consider information flows and monitoring in light of an expected strengthening of focus on ESG issues and the forthcoming implementation statement requirements. Are you getting the information you need to comply with your duties (which in turn depends on what you plan to report)?

– Review whether any adjustments are required to strategic asset allocation and mandates for asset managers and advisers.

– Review your voting and stewardship approach, and whether any changes are required to implement your investment beliefs and strategy.

– Consider how ready your scheme is to apply the TCFD recommendations and plot a course towards future disclosure requirements.

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