Clarifying and Strengthening Trustees' Investment Duties

"the same considerations also apply to all long term investment decisions"

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ESG Definition

Environmental, Social and Governance ("ESG") is a measure of the sustainability and ethical impact of investment in a business. Examples of the aspects of the operation of a business that fall into each of these three categories include:

- **Environmental**
  Natural resource depletion, including water waste, pollution and deforestation
- **Social**
  Working conditions, including slavery and child labour; health and safety; employee relations and diversity; ageing populations and income equality
- **Governance**
  Executive pay; anti-bribery and corruption; board diversity and structure.

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Background

The UK has recently introduced regulations requiring pension scheme trustees to set out how they take account of Environmental, Social and Governance ("ESG") factors, including climate change, in their investment decisions where these could affect investment performance. In addition, trustees will need to set out their policies on engagement and monitoring of companies in which they are invested.

The changes stem from a Law Commission report into the application of fiduciary duties to investment decisions. In particular, the report was responding to the Government's question about the extent to which trustees were required to maximise returns over a short timescale, disregarding longer term considerations that might impact on company performance. The Law Commission concluded that trustees should take account of factors which were financially material to the performance of an investment, whatever their source. It also concluded that there were circumstances when trustees could make investment decisions based on members' views.

What are the benefits of ESG investing?

Taking ESG factors into consideration and investing, for example, in companies that have strategies for dealing with climate change, uphold fair employment standards and have strong and transparent governance is expected to result in higher investment returns in the long run. With pension schemes now representing some of the largest and most influential investors in the UK, the Government's intention is that this shift towards responsible investment policies will, over the long term, also generate positive effects for the economy, society and the environment.

This greater emphasis on ESG issues recognises that investors are becoming increasingly aware of how and where they choose to invest could have an impact on the world; many saving for retirement will not want their pension contributions earning money at someone else's peril or harming the environment. This increasing focus on the ESG aspect of investment is expected to further drive the move towards responsible investment and the need for transparency on these policies.

Changes to Statement of Investment Principles

From 1 October 2019 UK Trustees will need to expand their Statement of Investment Principles ("SIP") to include their policies on:

- Financially material considerations over the period that the trustees consider is needed for the funding of scheme benefits. These considerations include, but are not limited to, climate change and other ESG factors that trustees consider to be financially material. The SIP will need to include an explanation of how these policies are taken into account, not just in the selection of investments, but also their retention and realisation. Trustees could, for example, allow for these factors in the selection of investments by excluding investments that do not meet specified criteria. However increasingly trustees are also making positive choices by selecting investments that already meet higher ESG standards.

- Non-financial matters where these are taken into account by the trustees. This could include the views of members. This might be ethical factors or views on the social and environmental impact on the quality of life. The Government has confirmed that trustees will not be required to seek or follow views of members; trustees retain primacy over investment decisions.

- Stewardship including the process for exercising voting rights, as well as when and how trustees would undertake company engagement activities. Trustees can promote an investment's long term success through monitoring, engagement and/or voting, either directly or through their investment managers. Investments include equities (shares) in a company but equally could also include bonds and alternative asset classes, such as infrastructure projects. Areas in which trustees may wish to engage include strategy, performance and corporate governance.

  The Government recognises that the very smallest schemes may expect to have limited leverage over the firms they hire to manage assets on their behalf, which is one of the reasons the Government is actively pursuing measures to remove barriers to consolidate both DC and DB schemes. However, such schemes can take into account the stewardship records of managers in the appointment or switching of asset managers and funds.

New Disclosure Requirements for DC Schemes

From 1 October 2019 UK DC schemes will have to:

- Include in their annual report their stated policy on financial material considerations, stewardship and where relevant, non-financial matters
- Make the SIP freely available online. (The Government hopes that schemes will compare their policies and drive up standards amongst schemes)
- Alert members to the availability of this information in their annual benefit statements

From 1 October 2020 trustees of DC schemes will also need to prepare and include in their annual report an Implementation Statement which must meet the following requirements:

- Set out the details of the extent to which and how, in the opinion of the trustees, they have followed their scheme's SIP
- Provide a description of any review of the SIP undertaken in the last year
- Include an explanation of changes to the SIP during the year and the reason for the changes
- Where no review has been undertaken in the last year, the date of the last review
- Make the Implementation Statement freely available online with members notified of its availability in their annual benefit statements.

These requirements generally apply to schemes with 100 or more members. However, smaller DC schemes are also required to produce SIPs in respect of their default arrangement. Additional disclosure requirements and changes will also apply to these SIPs and are illustrated below.

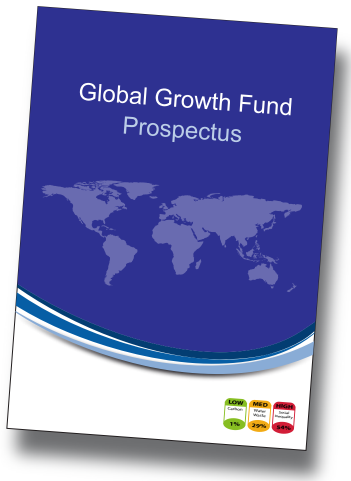
Conclusion

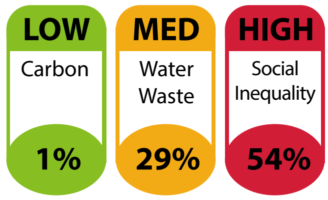
The pace of change of disclosure regulations, especially for DC schemes, has been rapid. Trustees will need to revisit their policies and update their SIPs to ensure they keep up with these changes.

There is a clear steer from the Government that pension schemes should not just be looking to maximise returns in the short term, but should also be taking into account long term ESG factors linked with long term risks or opportunities for pension schemes.

While these requirements specifically apply to UK pension schemes, the same considerations also apply to all long term investment decisions; this is likely to become an area of increasing focus and evolving best practice. Currently there is a lack of standardised measures and metrics for assessing the effectiveness of ESG integration. However this is likely to improve over time, enabling trustees, members and other investors alike to make clearer choices.

We are all familiar with the traffic light labelling which is now so prominent on food packaging, how long will it be until we see it on an ESG assessment of a particular investment?





	New Requirements	
	<100 Members	100+ Members
DC	**DC Default SIP** ■ Add policies on financially-material considerations and any non-financial matters	**DC Default SIP** ■ Add policy on stewardship to default SIP **DC Disclosure** ■ Publish scheme SIP on website[2] ■ Include policies in annual report ■ Publish implementation statement [2,3] **Scheme SIP** ■ Add policies on financially-material considerations, stewardship and any non-financial matters
DB[1]	NONE	

[1] *Includes DB schemes with money purchase AVC's*
[2] *Members' benefit statements to include a link to these documents*
[3] *From 1 October 2020 - on website and include in annual report*