



LCP's guide to responsible investment requirements for pension schemes

October 2019

At a glance

Significant changes have been made to the law regarding the investment of occupational pension scheme assets. These include:

- new policies to be included in the Statement of Investment Principles (SIP);
- an implementation statement to be included in annual reports; and
- online publication of these documents.

For relevant schemes, the implementation statements relate to the whole SIP, whereas for other schemes, only voting and engagement must be covered.

Some of the new requirements came into force on 1 October 2019 and others are being phased in between now and October 2021, as summarised in the table below.

Relevant schemes are essentially those providing money purchase benefits other than AVCs (including schemes also providing DB benefits).

Requirement	Deadline (relevant schemes)	Deadline (other schemes)
SIP policies on financially material considerations, non-financial matters and stewardship	1 October 2019	1 October 2019
SIP policy on asset management arrangements	1 October 2020	1 October 2020
Publication of SIP on website	1 October 2019	1 October 2020
First implementation statement included in annual report	First annual report signed on or after 1 October 2020	First annual report signed on or after 1 October 2020
Publication of first implementation statement on website ¹	When first annual report is signed off on or after 1 October 2020 (and before 1 October 2021)	1 October 2021

¹ Subsequent implementation statements to be published on a website as each future annual report is signed

The Pensions Minister has indicated that government and regulators will look critically at how schemes comply with these requirements. Subject to changes at the political level, we expect enforcement to be strict and further requirements to be introduced.

Background

This guide covers two [sets](#) of [regulations](#) that impose requirements on trustees of occupational pension schemes in relation to environmental, social and governance (ESG) factors, stewardship and asset management arrangements. These regulations operate by amending the existing investment and disclosure regulations.

The Pensions Regulator has updated its guidance on investment for trustees of [DC](#) and [DB](#) occupational pension schemes to incorporate most of these changes.

Relevant schemes and other schemes

The requirements differ for DB and DC schemes, particularly regarding the content of the annual implementation statements. The legislation does not refer to DB and DC. Instead it refers to *'relevant schemes'*. These are defined as schemes providing money purchase benefits, subject to some exemptions that include schemes for which the only money purchase benefits provided are additional voluntary contributions (AVCs).

This guide examines the requirements for all types of scheme, highlighting where there is different treatment for relevant schemes (both pure DC schemes and hybrid schemes providing DB and non-AVC DC benefits) and other schemes (that only provide DB benefits, with or without DC AVCs). The requirements mostly only apply to schemes with 100 or more members. However, the requirements to include policies on financially material considerations and non-financial matters **do** apply to relevant schemes with less than 100 members that are required to produce a SIP for their default strategy. None of the requirements apply to schemes with less than 100 members; these are not required to produce a SIP.

Most of the requirements outlined in this guide do **not** apply to schemes with less than 100 members.

SIP changes

Financially material considerations and ESG

Since 1 October 2019, all SIPs have had to cover the trustees' policy on *'financially material considerations'* over the *'appropriate time horizon'* of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments.

SIPs must cover the trustees' policy on *'financially material considerations'* over the *'appropriate time horizon'*.

Financially material considerations are not defined but are specified to include ESG considerations (which in turn include climate change) which the trustees of a scheme consider to be financially material.

Appropriate time horizon is defined in legislation as *“the length of time that the trustees of a trust scheme consider is needed for the funding of future benefits by the investments of the scheme”*. The Regulator’s guidance explains that this requires trustees to consider risks in the context of a scheme’s own demographics.

The guidance elaborates in detail on the Regulator’s interpretation of the legislation as follows:

- Consideration of ESG factors allows trustees to evaluate the short and long-term financial risks and opportunities of their investments by looking at the current practices of firms in which they invest. Examples of the type of considerations that might be taken into account include carbon emissions and water management under the environmental heading, employee or local community relations under social, and board diversity and remuneration under governance.
- When applying their ESG policy, trustees are told that they should carefully consider the demographics of their scheme and the nature of potential ESG issues that may affect the risk-adjusted return achieved.
- Trustees who invest in pooled funds are told that care is required to understand the ESG approach of the available funds, including in the selection criteria for new funds, and to monitor how managers take account of ESG factors in practice.
- Onus is placed on advisers and asset managers helping those trustees who do not have in-house expertise to understand the implications of the systemic risk of climate change (both long-term and short-term) on investment decisions when developing their SIP and adjusting investment portfolios.
- As climate change is a systemic, macro-economic risk, trustees should consider how engagement with investee companies, policymakers and collaborative industry initiatives could be used to mitigate the risk.
- As many pension scheme assets will be invested for a long time and exposed to longer-term financial risks, including ESG ones, the Regulator expects trustees to take account of risks affecting the long-term financial sustainability of the investments when setting investment strategy.

The guidance goes on to note that all financially material factors should be taken into account when considering investment decisions/setting investment strategy and that trustees may need professional legal advice to clarify their understanding of this requirement. Trustees should be able to demonstrate that they, or their advisers, have considered, understood and adequately addressed issues of financial materiality.

Aspects that may be relevant in assessing materiality include the size of financial effects relative to the scheme’s exposure to the factor. For example, the threshold for a financial factor to be considered material will be lower for a fund used in a DC default arrangement than for a self-select fund in which only a few members are invested.

The guidance elaborates in detail on the Regulator’s interpretation of the legislation.

Our viewpoint

The Regulator's guidance goes a lot further than a reading of the legislation in isolation would suggest and signals an expectation of greater trustee activity than many trustee boards may have anticipated.

Of course, Regulator guidance does not have any particular legal weight and so the specific activities which the Regulator suggests but which are not mentioned in the legislation are not compulsory. However, responsible investment is a topic attracting significant regulatory and political attention, so we expect the Regulator to take a close interest in how trustees engage with this topic.

Taking into account non-financial matters

Since 1 October 2019, all SIPs have had to cover the trustees' policies on 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 is defined as meaning "the views of the members and beneficiaries including (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme".

The (if at all) in the SIP requirement is important. There is no legal requirement on trustees to take such matters into account (and the guidance states that trustees "are never obliged to do so") or to explain why they are not taken into account. However, if trustees wish to take them into account, they are required to have good reason to think that scheme members share a particular view and their decision must not risk significant financial detriment to the scheme.

SIPs must cover the trustees' policy on the extent (if at all) to which 'non-financial matters' are taken into account.

There is no legal requirement to take non-financial matters into account.

Our viewpoint

This SIP requirement is clearly intended as a nudge for trustees to consider taking members' views about ethical and other matters into account. The guidance discusses how trustees might go about developing a policy on this. But care is needed as some of the guidance examples are not clear-cut and are more permissive than legal advice we have seen.

Stewardship

Since 1 October 2019, all SIPs have had to include the trustees' policies in relation to voting and engagement (ie the main components of stewardship). Although trustees previously had to state their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments, the words 'if any' have been removed. The requirement to state the engagement policy is new.

The trustees' policy on stewardship must be included in the SIP.

The guidance specifies ‘*engagement*’ in this context to be:

- monitoring and engaging with ‘*relevant persons*’ – the issuers of debt or equity in which the trustee is invested, their investment managers, other holders of debt or equity, or (from 1 October 2020) other stakeholders. The Regulator states that this explicitly acknowledges that stewardship can include direct engagement with an investee or debtor company, indirect engagement via an investment manager, and peer-to-peer engagement with fellow shareholders of an investee company.
- on ‘*relevant matters*’ – including matters concerning the investee or debtor entity, including performance, strategy, risks, social and environmental impact and corporate governance. From 1 October 2020, relevant matters will also include capital structure and management of actual or potential conflicts of interest.

The Regulator states that it is up to the trustees to exercise stewardship and ensure, as far as they are able, that this is done through the whole length of the investment chain. It would like trustees to adhere to the UK Stewardship Code with a view to improving long-term returns and reducing the risk of poor outcomes due to poor strategic decisions.

The Regulator’s stewardship expectations have increased

Our viewpoint

Stewardship is an important tool for improving long-term returns as it provides a means of addressing systemic risks that cannot be avoided through security selection. The Regulator’s guidance substantially raises the expectations of trustees in this area, encouraging them to take a much more active role than is currently typical. It mirrors increasing interest in stewardship from policymakers and other financial regulators.

A substantially revised UK Stewardship Code is due to be issued imminently which is expected to be significantly more onerous than the current one. Whilst we welcome increased expectations of investment managers in this area, it remains to be seen how feasible it is for pension scheme trustees to adhere to the new code, particularly for smaller schemes.

Arrangements with asset managers

By 1 October 2020, pension schemes will have to include in their SIP a policy on the arrangements that they have with their asset managers. This policy must set out the following matters or else the trustees must explain the reasons why not:

- How the arrangement with the asset manager incentivises the asset manager to align its investment strategy and decisions with the trustees’ investment policies.
- How that arrangement incentivises the asset manager to make decisions based on assessments about medium to long-term financial and non-financial performance of an issuer of debt or equity and to engage with issuers of debt or equity in order to improve their performance in the medium to long-term.

The trustees’ policy on asset management arrangements must be included in the SIP

- How the method (and time horizon) of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with the trustees' investment policies.
- How the trustees monitor portfolio turnover costs incurred by the asset manager, and how they define and monitor targeted portfolio turnover or turnover range; and
- The duration of the arrangement with the asset manager.

Our viewpoint

This implements requirements from the revised EU Shareholder Rights Directive but seem ill-suited to UK pension schemes that invest in pooled funds. The drafting presents various practical difficulties and it is disappointing that the Regulator has not provided any guidance in this area. We can provide trustee clients with draft SIP wording that enables them to comply with these requirements in a proportionate manner.

SIPs to be published online

There is a new requirement for schemes to make their SIP freely available on a website. The deadline for doing so was 1 October 2019 for relevant schemes and is 1 October 2020 for other schemes.

For relevant schemes, there is [statutory guidance](#) from the Department of Work and Pensions (DWP) that expands on the requirement for SIPS and Annual Chair's Statements to be made freely available online, including that they should be published in a manner which allows for the content to be indexed by search engines and that no password or personal information can be required to view the documents. In addition, members' annual benefit statements must include a specific web address for the various materials they are required to publish online.

Implementation statements

Implementation statements for relevant schemes

From 1 October 2020, relevant schemes are required to include in their annual reports and make freely available on a website an implementation statement that:

- Sets out how, and the extent to which, in the opinion of the trustees, the SIP has been followed during the year.
- Describes any review of the SIP during the year (whether as required every three years or after any significant change in investment policy or otherwise) or the date of the last review if none in the last year.
- Explains any change to the SIP made during the year and the reason for the change.

Trustees of relevant schemes must publish an annual implementation statement setting out how the SIP has been followed.

- Describes the voting behaviour by, or on behalf of, the trustees during the year (including the most significant votes cast) and states any use of the services of a proxy voter during that year.

The references to a year are to the scheme year covered by the annual report. The DWP guidance referred to above also applies to online publication of the implementation statements. The provisions regarding the timing of the first implementation statement are complex: see below for details.

The Regulator states that the purpose of the implementation statement is to help ensure that *'action follows intent'* as far as possible and that the process of having to consider the content of the report will help to focus trustees' minds on how well their investment policies and stewardship arrangements are delivering against their scheme's agreed investment principles.

The guidance states that the implementation statement should explain the extent to which objectives have been achieved and, where unsuccessful, what actions to be taken to rectify the situation.

The Regulator suggests that relevant schemes' implementation statements might include detail on the following:

- How policies on voting and engagement were developed, including the relevance of investment beliefs underpinning those policies and their investment time horizons.
- How those policies have been implemented in practice, for example:
 - Actions taken with investor coalitions (for example, on climate change), including leadership roles as part of any such coalitions.
 - A review of investment manager mandates, perhaps resulting in a decision to replace an existing manager with one whose engagement policies were in line with those of the scheme.
 - Engagements undertaken, together with their purpose, objectives, and planned escalation strategies where relevant.
- Public policy work undertaken.
- Lessons learned in engaging with specific assets on specific issues; and
- The relative effectiveness of these actions in achieving their aims.

Regulator guidance suggests detail which might be included in the implementation statement.

The guidance also states it is important that trustees include relevant useful information and do not simply produce a 'tick box' report.

Our viewpoint

The implementation statement is a significant new requirement that is intended to prompt trustees to reflect more carefully on how they implement their investment policies than they may have done in the past. Along with publication of the SIP, it will be a trigger for closer scrutiny of trustees' policies and practices.

It is unfortunate that the Regulator's guidance only provides suggested content relating to voting and engagement when the legislative requirement for relevant schemes covers the whole SIP. Moreover, many trustees do not participate directly in investor coalitions, public policy work or engagements with specific assets, so will not find these suggestions relevant.

Trustees should start to consider what they would like to report in their implementation statements and whether this has any implications for their investment activities (eg manager monitoring). They will be reliant on asset managers for information on voting and engagement, and we will be working with managers to provide this information to trustees in a streamlined manner.

Implementation statements for other schemes

From 1 October 2020, schemes that are not 'relevant' are required to include in their annual reports, and, by 1 October 2021 make freely available on a website, a statement:

- Setting out how, and the extent to which, in the opinion of the trustees, their policies on exercising rights (including voting rights) and undertaking engagement in respect of their investments have been followed during the year, and
- Describing the voting behaviour by, and on behalf of, trustees (including the most significant votes cast by trustees or on their behalf) during the year and state any use of the services of a proxy voter during that year.

The references to a year are to the scheme year covered by the annual report. The provisions regarding the timing of the first implementation statement are complex: see below for details.

Annual implementation statements for other schemes only need to cover voting and engagement

Our viewpoint

The Regulator's investment guidance for DB trustees does not yet cover the implementation statement requirements. These requirements are more limited in scope than those applicable to DC schemes, but no doubt the Regulator will have similar expectations.

Timing of the first implementation statements

The regulations relating to when the implementation statement requirements come into force are complex and ambiguous.

Relevant schemes must publish implementation statements online **from 1 October 2020**. We understand, from correspondence with the DWP, that the policy intention is that implementation statements for relevant schemes should be included in annual reports **signed on or after 1 October 2020**. Hence the first implementation statement for a relevant scheme with a 31 December year end will cover calendar year 2020, must be produced by 31 July 2021 (the deadline for producing the annual report, seven months after the year-end) and be published online **as soon as it is finalised** (and before 1 October 2021).

We understand that other schemes should also include implementation statements in annual reports **signed on or after 1 October 2020**. However, the deadline for publishing the first implementation statement is later than for relevant schemes: it needs to be available online **before 1 October 2021**. Hence the first implementation statement for a non-relevant scheme with a 31 December year end will cover calendar year 2020, must be produced by 31 July 2021 (the deadline for producing the annual report) and be published online before 1 October 2021.

Our viewpoint

It is unfortunate that the timing provisions are so complex and that there is no official interpretation of them. Trustees may therefore wish to ask their lawyers for help in working out how the implementation statement requirement fits into their reporting cycle.

Although on the face of it, the requirements start a year earlier for relevant schemes, in practice we expect that the timetable for producing the first report will essentially be the same for both types of scheme. The only difference is that relevant schemes need to publish the statement online straightaway, whereas other schemes can wait until 1 October 2021.

Schemes for which the seven-month period for producing annual reports straddles 1 October (eg those with 31 March, 5 April and 30 June year ends) will need to consider carefully the timetable for producing their 2019/20 and 2020/21 reports. If trustees sign the 2019/20 report before 1 October 2020, we understand that it need not include an implementation statement. However, in this case, they will need to ensure that their 2020/21 report is signed off before 1 October 2021 (with an implementation statement).

The timing provisions for implementation statements are complex and ambiguous.

The timetable for producing the first implementation statement is likely to be the same for DB and DC schemes.

Future changes

Despite the recent flurry of new requirements relating to responsible investment, trustees can expect a continued focus and further changes in this area. In June 2019, the Pensions Minister, Guy Opperman MP, said² that *“this is not a ‘once and done’ exercise. Pension schemes will be expected to monitor, update and develop their statements on ESG and stewardship over time”*. He then wrote to the largest 50 pension schemes on 27 September 2019 asking for information about their ESG and stewardship policies, saying that *“I am compiling a record so I can both monitor compliance and celebrate and support best practice”*.

In addition to this scrutiny, further policy changes have been announced. The Regulator is due to consult on a Code of Practice that covers the IORP II governance requirements, including an ‘own risk assessment’ that covers – where ESG factors are considered in investment decisions – how the trustees assess new or emerging risks. In addition, in its July 2019 Green Finance Strategy, the Government announced that an industry working group will produce climate change guidance for pension schemes and the Regulator is expected to consult on putting this guidance on a statutory footing during 2020.

Our viewpoint

It is highly unusual for a Minister to write to pension schemes like this and shows that Guy Opperman is taking a strong personal interest in responsible investment. This interest is visible among politicians from all the main political parties and so, despite the volatile political situation, it seems likely that trustee engagement with responsible investment matters will remain high on the policy agenda. We expect that the Regulator will be keen on policing compliance with legal requirements, possibly extending their interpretation beyond the strict meaning of the legislation.

Trustees should keep responsible investment on their agendas and stay abreast of developments in this area, ensuring that their policies keep pace with Regulator and policymaker expectations.

² In the foreword to a [Pensions and Lifetime Savings Association publication](#).

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