Good governance: the legal bedrock of ESG

Introduction

It can be very easy to get trapped in the detail of all the different ESG laws that now apply to workplace pension schemes. As lawyers, we are bound to say that complying with the specific requirements is non-negotiable. However, we believe that the pensions sector is likely to get better value from ESG by treating it as a bigger picture *governance* matter. Our view is that the law supports this, but to deliver it effectively there needs to be genuine collaboration between schemes and their different professional advisers.

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Legal obligations around ESG

ESG can be complex and nuanced. In that context, a compliance-focussed approach is only natural: it emphasises more comfortable, concrete things like actions and deliverables. But there is a bigger picture beyond compliance, and helpfully the law gives schemes a set of legal tools to help them address this, using governance as the foundation.

At the top of this toolkit are the well-known trust law principles about how trustees take valid decisions. In brief, these require trustees to build up sufficient knowledge to understand the decision they're looking at, take account of relevant issues, take advice and ask questions as necessary, and then balance all the relevant issues together to reach an overall rational decision. Where a proper process has been followed a Court would not overturn the trustees' decision even if someone else might have made a different one. In the investment context, it is also clear that trustees are not judged with the benefit of hindsight (or with the expectation of perfect foresight). In our view these principles are, fundamentally, a *governance* duty.

Governance also features heavily elsewhere in the ESG legal toolkit. Regulations require most schemes to make public a host of ESG-related policies in their statement of investment principles, and then in many cases track how far those policies have been followed in an annual, public, implementation statement. One way of looking at this is to focus on the written deliverables the legislation requires. But a deeper look reveals that in practice, they will involve trustees thinking through what their policies should be, how they will be tracked, and how to report on them: what is this, if not a governance process? The point is even clearer for schemes that are in scope of the Task Force on Climate-Related Financial Disclosures (TCFD) climate reporting regulations, where there are specific governance and risk requirements.

Should we treat ESG as a means or an end?

From a financial perspective too, the emphasis within ESG is on evaluation and decision-making, with a broader assessment of risk and opportunity than conventional financial analysis may cater for. For example, if a company's core products were detrimental to public health (a 'social' or 'S' factor within ESG), ESG analysis might consider how to price the likelihood and impact upon the business if consumer demand fell away or its key products were regulated out of existence. It may not have been possible to consider these risk factors in the past through traditional assessments of financial statements or forward planning. Of course, the analysis may or may not lead the trustees to immediately divest or move into different assets at that point in time. It will depend on what makes sense at the strategic and portfolio level over the scheme's expected life-cycle. But whatever the trustees decide to do, their decision will certainly have been a better informed one and they will have a better understanding of potential risks in their strategy.

Viewed in that way, ESG is a *means*, not an end. It is an analytical tool that enables more sophisticated and holistic decision-making.

This naturally complements the emphasis the law places upon good governance.

Of course, for some members and other stakeholders, ESG or positively impactful investing can be a desirable end goal in itself. These perspectives are legitimate, but it takes some care to ensure they do not conflict with trustees' wider legal duties. This is possible up to a point, but it is also a major ongoing debate in the pensions industry, and definitely a topic for another day.

What does good look like?

From an understanding of ESG as a governance matter, the next step is to think about what ESG governance looks like. In our view it requires some good choreography between and among schemes and their professional advisers. Sensible steps would include:

- Making sure everyone is clear from the outset about the trustees' fundamental investment beliefs and the scheme's strategic objectives (and similarly funding, covenant and covenant support arrangements in defined benefit schemes).
- Assessing an ESG proposal against those beliefs and objectives to make sure they are genuinely aligned. This could involve a sense-check of what is really motivating the proposal: the purpose and goals of the scheme, or some wider or collateral purpose?
- Establishing and documenting a positive business case for the ESG decision in the scheme's specific circumstances. How does it help manage the scheme's risks and performance better over the relevant time horizon(s)?
- Making sure lawyers are fully briefed on the above before they advise. In our experience things can sometimes go awry if this does not happen, as the example below illustrates.

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Example: green gilts and greeniums

Green gilts are UK government securities issued to finance projects that have defined environmental benefits.

Typically there is a spread between green gilt yields and yields on traditional (or 'brown') gilts: the so-called 'greenium'. So, assuming that green and brown gilts carry the same level of credit risk (because the UK government is the debtor under both), trustees might simply ask their legal adviser: can we choose the environmentally-focussed one with the lower yield?

If the question is posed in that way, many lawyers will feel duty bound to say "no": why should trustees actively choose a lower return for the same level of risk? Are they investing for the purposes of the scheme, or for the collateral purpose of improving the environment?

In fact, the problem here is the lawyer working in a silo. A more open dialogue between lawyers, trustees and investment advisers could have brought to light a number of other significant points, none of which would necessarily have come through in the narrower discussion above:

- Whether green gilts and brown gilts are as directly comparable as investments as has been assumed (we are aware of investment consultants who query whether this comparison is valid).
- Understanding the different potential secondary market for green gilts and the implications and opportunities this may create for the trustees.
- Explaining the proposal in the context of the scheme's portfolio as a whole, as opposed to considering the issue a potential investment.
- The reasons why the green gilts are considered suitable from an investment advice perspective (and potentially why other investments are less suitable), taking account of the scheme's strategy and objectives as referred to in the scheme's statement of investment principles.
- Recording the thought process and the issues that were reached a different final conclusion, a proper process was followed and a rationale outcome reached.
- Making clear that the motivation for investing in green gilts is their financial role for the scheme Environmental benefits might be noted, but they are an output of the investment rather than a driving purpose for investing.

Looking at the issues in that way, the key question becomes whether the proposal to invest in green gilts has been properly considered and makes financial sense within the scheme's investment strategy. That could produce a very different legal answer, where trustees and advisers share a mutual understanding of both the investment rationale and the legal tramlines: a much more joined-up approach to decision-making.

Conclusions

There are good reasons why it can be helpful to approach ESG as a governance matter. A governance focus encourages careful decision-making processes where new but valid risk and performance considerations are brought to the table. It helps set the issues into the proper context of the scheme's own circumstances. It can help trustees feel more comfortable that their decisions will be legally resilient if challenged (and that the trustees will be able to demonstrate this if asked). But above all, it means decisions will be better informed and more rounded. That might sound a little dull – but it is surely a good outcome for everyone in pensions.