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Practical cross-border insights into ESG law

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ESG and UK Pension Schemes: A Matter of Governance

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Introduction

Occupational pension schemes in the United Kingdom (UK) are now subject to extensive environmental, social and governance (ESG) requirements. The law is being driven by a rapidly evolving combination of policymaking, scientific guidance and commercial commentary alongside wider societal expectations that, as institutional investors responsible for providing private individuals' retirement benefits, pension schemes ought to be deploying their capital to promote ESG objectives (or, at least, protecting that capital from adverse impacts caused by ESG risks).

In that context, much of the commentary on ESG for pension schemes naturally focuses on the substantive investment aspects of the topic, such as the risks and opportunities that exist, the financial products available, and how these can be aligned with scheme investment strategies.

This chapter suggests a slightly different perspective. It outlines the key aspects of ESG law for occupational pension schemes in England & Wales and argues that although the commercial investment perspectives are entirely legitimate, because of the way the law is structured, the governance element of ESG is particularly salient when approaching pensions.

The Starting Point: Fiduciary Duties and ESG

Case law in the 1980s and 1990s[1] highlighted an apparently fundamental tension between the duties of occupational pension scheme trustees to invest assets in order to fund pensions and other retirement benefits, and their ability to take ESG considerations into account when investing.

However, following two landmark Law Commission reports,[2] in very broad terms the current orthodox legal view is that:

- ESG considerations can and should feature in pension scheme investment decision-making where they are "financially material" (i.e., relevant) to investment performance or risk; and
- considerations driven by non-financial perspectives (such as political, ethical or philosophical beliefs) are known as "non-financial" factors. Additional legal tests must be met before non-financial factors may influence pension scheme investment decisions.[3]

In our view, there are arguments that this approach to the law could be developed and refined still further. Despite this, in practical terms, the central question for pension trustees at present remains whether, and to what extent, ESG considerations are *relevant* to investment performance or risk, such that they fall into the "financially material" category. In relation to this:

- Although a full discussion of the economics is beyond the scope of this chapter, economic evidence confirms that ESG considerations are capable of being financially material.
- There is also evidence that ESG investments can be compatible with achieving desired risk-adjusted financial returns.
- An increasingly diverse range of ESG-themed investment products are coming to the market and we have seen a number of pension schemes exploring these.

Naturally, these issues mean that the economic, commercial and financial aspects of ESG are an important and legitimate area of focus for pension trustees.

From a legal perspective, though, the key requirement is for trustees to discharge their fiduciary duties to use their investment powers properly and for proper legal purposes, and to invest in a manner consistent with their duty of care (as a prudent person would).

In effect, these duties mean the law requires trustees to identify the "financially material" ESG factors (that is, those ESG factors that are relevant to the proper lawful exercise of the trustees' investment powers in the circumstances of their scheme) and then integrate those factors into the investment decision-making process. In practice, this involves:

- obtaining information and advice to identify the financially material (relevant) ESG factors;
- considering the information and advice about those ESG factors and raising questions where necessary;
- balancing the relevant ESG considerations with other relevant factors (including other financially material factors) in order to reach an overall decision – probably through debate on the board or investment committee; and
- having sufficient expertise and understanding to be able to do all of the above.

As lawyers, we would argue that these steps amount to a *governance* duty. Of course, the end results will be practical, strategic and commercial investment decisions about where and how to deploy the pension scheme's assets – but these flow from the way the trustees have carried out their fiduciary duties in preparing for, and taking, those decisions. The substantive investment decisions are the output of a governance process.

ESG in Pensions Legislation

The governance-based approach to ESG is also firmly embedded in the legislative interventions there have been in this area.

Investment policies, disclosures and implementation statements

Pensions investment regulations now require ESG-related investment policies to be set out in a scheme's Statement of Investment Principles (SIP), covering:

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- financially material considerations (including, but not limited to, ESG and climate change) and how these are integrated into the investment strategy;
- how, if at all, non-financial factors are taken into account;
- stewardship and engagement with investees, co-investors and other stakeholders in relation to a non-exhaustive list of matters such as strategy, performance, capital structure and conflicts of interest; and
- arrangements with the scheme's asset managers (on areas such as incentivisation and alignment with SIP policies), or an explanation of why there are no such policies.

Many schemes are also required to publish their SIP on a publicly available website and to prepare an "implementation statement". Broadly, the implementation statement is an annual report tracking progress against the SIP policies and explaining how far these have been applied during the year.[4] Like the SIP, implementation statements must be disclosed online. For scheme years ending on or after 1 October 2022, new statutory and non-statutory Government guidance prompts deeper engagement by schemes with the development and implementation of their policies, particularly in relation to stewardship and engagement, as well as more comprehensive disclosures in the implementation statement.

Thus, although the substance of trustee investment policies is certainly an investment question, the underlying requirements to develop the policies, write them down, disclose them and then monitor and report on how far they have been implemented, amount to a series of ongoing governance obligations.[5]

Climate change

Over a phasing-in period starting from 1 October 2021, new legal obligations apply to many pension schemes[6] based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

The new regulations require that, on an ongoing basis, climate risks and opportunities be integrated into scheme governance, strategy and risk management processes (including investment and scheme funding strategies). There are also specific duties to undertake climate scenario analysis and calculate climate metrics and targets for the scheme, and for trustees to have sufficient knowledge and understanding of climate issues. As a result of the 26th United Nations Climate Change Conference of the Parties (COP26) held in 2021, the regulations and statutory guidance were further amended in 2022 to introduce a mandatory requirement for trustees to calculate a metric covering the extent to which their portfolio aligns with the Paris Agreement.[7] All of this is backed up by extensive additional public reporting requirements.

Where the climate regulations apply, they will therefore directly and immediately affect the shape of the scheme's governance systems and processes. In turn, those governance systems will support the trustee's ultimate strategic actions in relation to climate issues, including on investment.

Pensions Regulator single Code of Practice

In 2021, the Pensions Regulator consulted on a draft single Code of Practice, which will act as a quasi-legal statement of the actions required of trustees in line with the statutory duty to operate effective scheme governance and internal controls.

Although the finalised Code of Practice has not yet been published, the draft indicated that it may set out further and more specific expectations around trustee approaches to climate change and other ESG matters.

These, too, would amount to regulatory requirements to integrate ESG into scheme governance.

Beyond Investment

Other current and emerging themes continue the governance trend. They also, in our view, demonstrate that ESG in pensions is increasingly moving into new areas beyond investment. To give two examples:

- **Employer covenant**. Where the TCFD regulations apply to a defined benefit pension scheme (see above), there is now a clear legal obligation for trustees to consider how climate risks and opportunities may affect the ongoing financial support available from the scheme's sponsoring employers – the "employer covenant". Even for schemes where the TCFD regulations do not apply, we consider that there are arguments based on existing regulatory materials that climate and ESG factors should be considered in relation to the employer covenant where relevant.[8]
- **Diversity and inclusion**. An organisation's level of diversity and inclusion is a recognised ESG factor and is sometimes used as an indicator of financial performance or risk in pensions investment and funding. But diversity and inclusion considerations apply within a pension scheme too, most obviously in the composition of its trustee board. Looking ahead, we expect increasing regulatory focus on how diversity and inclusion might better contribute to the effective management of pension schemes.[9]

Rationale

Why is pensions ESG law structured around governance in this way?

One possible legal reason is that this reflects both the core fiduciary duty outlined above and a more deeply rooted legal tradition of respect for the autonomy of trustees. In essence, both the law and policymakers have tended to be reluctant to impose mandatory solutions in place of trustee decisions based on legally valid decision-making processes.[10]

A more practical reason is that the risks and economics of ESG are complex and developing fast. There are no one-size-fits-all solutions. In this context, it seems sensible to give trustees wider margins of discretion, allowing them to respond to ESG challenges in a way that is appropriately tailored to the circumstances of their particular scheme.

Conclusions

The commercial, financial and investment aspects of ESG are a significant focus in the pensions industry. This is legitimate and highly relevant in the context of trustee fiduciary duties and existing legislation.

However, we would suggest that the structure of the current law means the governance aspects of ESG deserve at least as much attention.

This is because, as this chapter has sought to demonstrate, almost all the relevant law in this area is couched in terms of governance. If ESG is the desired public policy outcome, then governance obligations are the legal delivery mechanism. Consequently, in our view, the foundation of effective ESG legal compliance for UK occupational pension scheme trustees is to have good governance systems in place. Good governance provides a clear legal framework within which trustees' substantive decisions will be made, acted upon and monitored.

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Endnotes

1. Notably *Cowan v Scargill* [1984] 2 All ER 750 and *Harries v Church Commissioners* [1992] 1 WLR 1241.
2. *The Fiduciary Duties of Investment Intermediaries* (2014) and *Pension Funds and Social Investment* (2017).
3. Aspects of this test were considered by the Supreme Court in *R (Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16 and by the High Court (indirectly) in *Butler-Sloss & ors. v Charity Commission & anor.* [2022] EWHC 974 (Ch). Nevertheless, there remain a number of areas of legal uncertainty. In addition, the legal thresholds for integrating non-financial factors into investment decisions are so high that it is difficult to see how many occupational pension schemes would be able to do so in practice.
4. The prescribed contents vary depending on the type of pension scheme.
5. The SIP and related requirements are not the only example. Regulations also require trustees to set objectives for their investment consultants by reference to the scheme's SIP and review consultants' performance against those objectives at least annually. Although this governance originated from competition law and policy, there is no reason in principle why investment consultants' objectives should not include ESG matters – a point that was picked up in the Society of Pension Professionals' *Environmental Social and Governance (ESG) Guide* (September 2021). See Regulations 34–36 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996, introduced by the Occupational Pension Schemes (Governance and Registration) (Amendment) Regulations 2022 with effect from 1 October 2022 or, if later, the date those regulations were laid.
6. Broadly, the regulations took effect from 1 October 2021 to all authorised master trusts, collective money purchase schemes and occupational pension schemes with relevant assets exceeding £5 billion. Occupational pension schemes with relevant assets exceeding £1 billion came into scope from 1 October 2022. Other schemes may come into scope from *c.*2023, subject to further consultation.
7. See the Occupational Pension Schemes (Climate Change Governance and Reporting) (Amendment) Regulations 2022.
8. Our view is strengthened by recent statements of industry groups, notably *Evaluating the impact of Environmental, Social and Governance risks in the Employer Covenant*, prepared jointly by the Society of Pension Professionals Covenant Committee and the Employer Covenant Practitioners Association (July 2022), see: https://the-spp.co.uk/category/esgcovenantguide.
9. The first industry statement of best practice for diversity and inclusion in UK pensions is the Pension and Lifetime Savings Association's *Diversity and Inclusion: Made Simple* guide (2020), co-authored with Travers Smith LLP. https://www.plsa.co.uk/Policy-and-Research/Document-library/Diversity-Inclusion-Made-Simple. In due course, further areas of scheme operations beyond investment strategy may come into scope of ESG legislation. The Mansion House speech by the Chancellor of the Exchequer on 1 July 2021 indicated that further sustainability disclosure regulation affecting UK pensions was likely, but the detailed proposals had still not been published at the time of writing.
10. For example, there was debate in Parliament about whether the TCFD regulations introduced under the Pension Schemes Act 2021 interfered with trustees' autonomy and discretion to choose investments in line with the core fiduciary duty.

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Jonathan is involved with key industry associations, including his roles on the Association of Pension Lawyers' Investment and Defined Contribution Sub-committee, the Society of Pension Professionals' Investment Committee, the Financial Markets Law Committee's Insurance & Pensions Scoping Forum, and the Pensions Management Institute's London Group Committee.

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