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ESG and UK Pension Schemes: A Matter of Governance?

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Introduction

UK occupational pension schemes have been subject to extensive ESG requirements for some time now. Legal change continues to be 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 and Wales and makes two key arguments. The first is that although the commercial investment perspectives are entirely legitimate, because of the way the law is structured, ESG in pensions should also be approached as a governance matter. The second is that good practice is increasingly moving beyond a focus on mere compliance and towards an emphasis on greater depth and quality within schemes' ESG activities.

The Starting Point: Fiduciary Duties and ESG

Case law in the 1980s and 1990s 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.[1]

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" 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, and 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 is often whether, and to what extent, ESG considerations 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, and that existing financial models do not necessarily adequately cater for ESG risks.[4]
- 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 a significant and legitimate focus for pension trustee conversations.

From a legal perspective, however, 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 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 within 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:

- 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.[5] Like the SIP, implementation statements must be disclosed online.

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.[6]

A drive for quality?

In addition to the governance focus in the legislation, we would argue that the above framework means schemes should plan for an increased focus on higher standards of ESG activity in the years to come. The increased transparency that is now required provides a strong impetus for schemes to demonstrate they are taking genuine, substantive action.

One reason for this is that there have already been live cases of schemes being challenged by stakeholders on the adequacy of their reported ESG activities, with attendant cost and publicity implications.[7]

Another reason is that statutory and non-statutory Government guidance applicable from 2022 onwards sets extensive expectations for schemes to:

- explain *in detail* exactly what they are doing on ESG and stewardship; and
- in effect, justify why their chosen level of activity (as opposed to alternatives) is in members' best interests.

These developments seem to have attracted comparatively little attention to date, but in our view, they make it increasingly difficult to argue that mere compliance with the letter of the law will be sufficient for schemes aiming to demonstrate good practice in ESG. Rather, in our view, these developments amount to a very clear prompt to deliver broader, deeper, and higher quality ESG activity in the pensions sector moving forward.

Climate change

There is a similar picture in the specific area of climate change. Over a phasing-in period starting from 1 October 2021, new legal obligations have begun to apply to many pension schemes based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).[8]

These require that on an ongoing basis, climate risks and opportunities must 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. 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. They are, fundamentally, governance requirements. The climate governance outputs feed into trustees' ultimate strategic activity, including on investment.

The focus on raising standards is evident in this area too. In March 2023, the Pensions Regulator published a review of the first wave of TCFD reports. The review acknowledged widespread technical compliance but highlighted a number of specific areas for further work. The Regulator said "*we expect the quality of reports to improve year-on-year as trustees and wider industry evolve market practice*".[9] This point may also feature in the upcoming Government review of the regulations, expected to start late in 2023, which may also see the requirements being extended to smaller schemes.

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 (see above) apply to a defined benefit pension scheme, 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.[10]
- **Diversity and inclusion (D&I)**. An organisation's D&I is a recognised ESG factor and is sometimes used as an indicator of financial performance or risk in pensions investment and funding. D&I considerations apply within a pension scheme too, most obviously in the composition of its trustee board. This is now an area of active regulatory focus, with the Pensions Regulator publishing its first formal D&I guidance in March 2023. This guidance emphasises that D&I supports robust decision-making and makes recommendations in a variety of areas, including the role of the chair and diversity on governing bodies and among professional advisers.[11]

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 deeper-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.[12]

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 that 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.

The trade-off for the broad discretion is a larger number of public reporting obligations which increase the prospects of

ESG activities being actively scrutinised, driving a growing need for schemes to be able to justify the actions they choose to take.

Conclusions

The commercial, financial and investment aspects of ESG investing 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 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 for UK occupational pension scheme trustees is to have good governance systems in place.

Good governance around ESG will enable schemes to move safely beyond the current "compliance" state of play and towards the broader and deeper ESG engagement which we observe is now emerging as the expected level of good practice. Fundamentally, it provides a clear legal framework within which trustees' substantive decisions get taken, acted upon, monitored and reported.

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. See, for example, the report of the Carbon Tracker think tank 'Loading the DICE against pensions', 27 July 2023, at: https://carbontracker.org/reports/loading-the-dice-against-pensions
5. The prescribed contents vary depending on the type of pension scheme.
6. 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 statement of investment principles and review consultants' performance against those objectives at least annually. See Regulations 34 – 36 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996. Although this governance requirement 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).
7. For example, see *McGaughey v Universities Superannuation Scheme* [2023] EWCA Civ 873 and the Pensions Ombudsman ruling concerning the Shell Contributory Pension Fund (Mr D, PO-27469, 2019).
8. Broadly, the regulations took effect from 1 October 2021 for 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 after 2023, subject to further consultation.
9. See: https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/review-of-climate-related-disclosures#:~:text=From%201%20October%202021%2C%20the,on%20what%20they%20have%20done
10. Our view is strengthened by 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)
11. See: https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/governing-body-detailed-guidance/equality-diversity-and-inclusion/governing-body-edi-guidance. The first industry statement of best practice for diversity and inclusion in UK pensions was 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
12. 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. Interestingly, there seems to have been comparatively less debate around this issue in relation to proposals for schemes to allocate a specified proportion of their assets to "productive capital", announced as part of the Mansion House reforms in July 2023 (though the central announcement was in fact a voluntary commitment by large schemes with sufficient scale to achieve the desired allocation in a strategic way).

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Jonathan is involved with key industry associations, including his roles on the Association of Pension Lawyers' Investment & DC 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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