Pensions, ESG and sustainable investment

Can it and should it be more than a tick-box exercise?

GOWLING WLG

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As a trainee in the Gowling WLG Pensions Team, I am new to the world of pensions and trusteeship. Like many in my generation, I have a strong interest in environmental issues. The relationship between trusteeship and sustainability has, therefore, piqued my interest. It has been fascinating to see how issues relating to sustainability are being discussed and actioned by trustees of UK pension schemes.

As other industries move away from treating environmental, social and governance (ESG) issues as tick-box exercises, are pension schemes falling behind and if so, why? Is it a lack of legislative reinforcement or a reflection of trustees' approach to ESG? A further central question is: can pension scheme trustees make a difference and how do they go about doing so?

In this article, I consider if trustees can do more beyond low-level reporting and whether they can actually have an impact in light of the discretion trustees have on investment matters.

What are the current ESG duties on trustees of occupational pension schemes?

As things currently stand, statutory and regulatory ESG requirements permit trustees to have wide discretion in how far they take the implementation of sustainable investment practices.

Trustees are guided by two main factors when considering ESG investments:

- statutory and regulatory requirements; and
- trustee fiduciary duties.

Statutory and regulatory requirements

Statutory and regulatory requirements on ESG and pension schemes currently focus on:

- the Occupational Pension Schemes (Investment) Regulations 2005;
- requirements for ESG considerations in statement of investment principles (SIPs); and
- disclosure requirements (including general obligations on reporting on financial and non-financial factors and stewardship in their annual report and specific requirements applying to schemes with more than £1 billion of assets on Task Force on Climate-related Financial Disclosures reporting).

These are covered in detail in our detailed guides for DC and DB schemes - ESG for pension scheme trustees – navigating the duties and best practice for your scheme.

Fiduciary duties

Although fiduciary duties are not creating a block on the adoption of a sustainable investment approach, they still need to be considered as ESG investing can be carried out by pension schemes in line with trustees' fiduciary duties. This is especially the case for schemes that are planning to run on and thus have medium and long-term investment strategies.

Further, even though fiduciary duties do not require ESG-compliant investing, there is a growing consensus that ESG factors should be considered in respect of all scheme investments. Failing to do so risks trustees making investment decisions that do not maximise the medium and long-term investment returns for the scheme. This is a sentiment that is echoed by The Pension Regulator's (TPR) approach to ESG and stewardship.

What does the General Code say on ESG?

TPR's General Code includes a further requirement that trustees must disclose ESG policies via their SIPs in terms of their approach to:

- financially material ESG considerations and non-financial matters (should the trustees choose to take these into account);
- trustee stewardship of investments, including, in relation to undertaking engagement activities and the exercise of voting on matters relating to climate change; and
- arrangements with their asset managers, encompassing those in respect of ESG-related financially material considerations and non-financial matters.

How have the Courts approached challenges on ESG investing and pensions?

An appropriate focus on ESG not only directly promotes member benefits through investments, but also reduces ESG litigation risks. We have seen the beginning of what may become a trend of legal challenges in this area both in the UK and globally.

In light of trustees' fiduciary duty, the issues in cases such as *KlimaSeniorinnen Schweiz and Others v Switzerland*, where the relationship between human rights and the disregard of the climate was explored, are interesting to see. I look forward to seeing how this relationship will develop in the coming years and how it will affect the approach required to be undertaken by trustees.

Additionally, in *Universities Superannuation Scheme v McGaughey* [2022] EWHC 1233, a claim was brought by members against directors of a corporate trustee. The claim related to the alleged failure to divest from fossil fuel investments. Similarly, *ClientEarth v Shell Plc* [2023] EWHC 1137 shows the potential of climate-related litigation.

Courts have been, to date, wary of finding in favour of challenges to the status quo. However, this is a developing area that could see different approaches being adopted in the future. In considering this, trustees should aim to remain ahead of the curve and take ESG into account in their decision making. Doing so is in line with their fiduciary duties and mitigates the risk of member challenge.

Are trustees doing enough on ESG and sustainability?

Keeping these duties in mind, can pension schemes, individually and collectively, make an impact and bring about changes that deliver greater sustainability? There is a general worry about greenwashing, where ESG credentials are positioned for short-term gain rather than meaningful adjustments in the medium and long-term. Alongside this, as the majority of legislation surrounding ESG practices in pension schemes focus on risk identification, the worry remains that trustees will only do the bare 'tick-box' minimum, potentially owing to their limited resources.

TPR's latest review of trustee compliance provides a summary of trustees' current approach to ESG. TPR found that:

- trustees have often failed to demonstrate ownership of their policies or key activities in respect of ESG;
- broadly, where trustees delegated activities to managers, trustees often failed to explain or demonstrate oversight of ESG activities; and
- where schemes are invested in pooled funds, a number of trustees highlighted they had limited ability to influence managers on decisions related to ESG.

Notably, TPR identified that smaller schemes tend towards minimum compliance with the ESG aspects of SIPs and Implementation Statements.

Why is this?

Does current legislation go far enough in mandating action? Legislation has promoted ESG governance in pension schemes (e.g. through requirements like requiring the establishment of effective systems of governance and ESG provisions in TPR's General Code). However, exemptions and a lack of resources and support for trustees, especially of smaller schemes, run counter to this objective.

For example, the legislation requiring trustees and managers of occupational pension schemes to establish and operate effective system of governance allows for proportionality according to size, nature, scale and complexity of the scheme. This could be seen as permitting a minimum compliance approach, especially for smaller schemes.

The FCA's anti-greenwashing rule introduced in 2024 may signal a more robust approach developing on ESG regulation. The new rule allows the FCA to take action against misleading sustainability claims and could provide a blueprint for future supervisory and enforcement action by other regulators. While the FCA requirements do not directly apply to trustees of occupational pension schemes, they are an important consideration for trustees to understand what may be in their investments' supply chain, a naturally fundamental contemplation for any pension scheme's trustee.

As trustees see in concrete terms how companies and investment managers will plan for climate-related factors over time – and trust them to carry out these plans – it will become much easier for them to carry out their own long-term planning. In time, ESG is likely to be a higher profile consideration in pension schemes of all sizes.

Interestingly, a question raised in the House of Lords asked whether pension trustees need additional support through changes to the legal definition or understanding of their fiduciary duty. The response suggested that it is certainly "right that guidance is given". This is in light of the fact that trustees should also consider their scheme's context, maturity and member investment journeys. As such, the law surrounding fiduciary duty may in time continue to evolve to enable trustees to more easily account for a wider range of ESG considerations. In awaiting the consolidation of this area, trustees should still aim to avoid greenwashing and sufficiently consider ESG practices.

How can trustees make a difference?

However, how can trustees actually make a difference beyond doing the bare minimum? Schemes should adopt different approaches to ESG according to their scheme's type and size.

DB Schemes

In determining their ESG approach, I can see that bigger schemes that are aiming to remain active for longer, compared to smaller schemes that may seek to buy-in and / or buy-out, will have different considerations.

Where bigger schemes should be more focused on making the right investments in light of their longer time horizons; smaller schemes might be more concerned with finding the right buy-out insurers to potentially limit systemic risks. As climate change can affect insurer's future financial strength, trustees are in a strong position to engage in ESG risk management through their engagement with and selection of insurers.

Even before a buy-out, trustees of smaller schemes should still concern themselves with ESG. Forecasts have predicted that where a scheme is targeting buy-out by 2030 and have implemented a "low risk" investment strategy, where the markets are affected by a sudden fall due to changes in climate change policy, regulation, or new information, a scheme could suffer a 3% loss in funding.

In essence, a scheme that was nearing a buy-out position could be delayed materially from getting there. Even in cases of moving to buy-out, it is therefore increasingly important for trustees to also consider the general ESG landscape as legislative and societal pressures develop to promote sustainability. Fundamentally, a balance of prioritising financial return and ESG factors is essential.

DC Schemes

The key differential here is that members have a greater ability to decide where they want to invest. They tend to be open for longer and specific funds can be made available. However, as most members will end up in the default fund, trustees of DC Schemes should focus on the investments made within that default fund and consider the medium to longer term impacts of climate change and other sustainability issues. This would align with compliance of the fiduciary duty trustees owe to the members of their respective schemes.

Generally, the UK's DC Master Trusts will continue to benefit from their approach in taking increasingly active steps on voting on and exclusions of funds as a result of their failures to address net zero targeting. They are clearly leading the way in this respect, drawing on the more substantive resources they have available.

Next steps

Both trustees and legislation must work in tandem to achieve the best results, and to the extent the law allows through the concept of trustee discretion, trustees ought to consider the best interest of the beneficiaries in a holistic way, which includes long-term sustainability issues.

As a trainee new to the world of pensions, I think that while considerations may be approached differently by each type of scheme, the outcome should nonetheless be the same: trustees should prioritise ESG beyond ticking a box. It is a vital component of promoting a world for pension scheme members that is worth retiring into. That said, trustees need further support and help from the government, investment managers, advisers and companies, so a collaborative focus in this area is essential.

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