SQUIRE PATTON BOGGS

Pensions Quick Guide

Environmental, Social and Governance (ESG)

ESG and Climate Change – Why Are They Relevant in a Pensions Context?

Trustees are subject to legal requirements when setting their investment policy and choosing investments, and this includes a requirement to take account of ESG factors, including climate change. Trustees of schemes that have 100 or more members have disclosure obligations and the largest pension schemes will have to produce and publish reports in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD).

There are also good practice and general reputational considerations for trustees in the ESG sphere.

What Are the Legal Requirements?

Trust Law

Trustees are the legal and beneficial owners of the scheme's assets and they have a fiduciary duty towards members and beneficiaries. They must act in good faith and for the purposes of the trust, which usually means acting in the best financial interests of members and beneficiaries. Trustees have a positive duty to invest the trust assets and to do so in a prudent manner. Our quick guide on investments sets out trustees' general investment duties in more detail.

Regulations

There is a regulatory requirement for trustees of occupational trust schemes with 100 or more members (and/or where there is a default arrangement in a defined contribution (DC) section or scheme) to produce and publish a statement of investment principles (SIP) and to choose investments in line with that SIP, so far as reasonably possible. Trustees must also produce and publish an implementation statement, setting out how they have implemented the policies set out in their SIP. For more information on how to produce a SIP and implementation statement, see our quick guide on SIPs.

When setting their SIP and choosing investments, trustees are required to take account of financially material considerations. This is where ESG comes into play. Regulations provide (in case trustees were under any illusion to the contrary) that ESG factors are financially material considerations, which trustees must take into account.

Trustees must, therefore, actively consider and determine what their policy will be in relation to ESG factors over the lifetime of the scheme, including how those considerations are taken into account in the selection, retention and realisation of investments. ESG includes, but is not limited to, climate change.

Since 1 October 2021, trustees of the largest schemes, and authorised master trusts, have been required to produce and publish a TCFD report online in a publicly available format. It is likely that this requirement will extend to most schemes by 2025. For more information, please see our quick guide on the publication of TCFD reports.

What Are ESG Factors?

ESG factors are wide ranging. For example, environmental factors include how a particular investee company uses natural resources and the impact its operations have on the environment.

Social factors could cover health and safety in the supply chain, workforce conditions, employee engagement, product quality and safety, customer privacy and data security, and community engagement. The UK government has recently said that it expects institutional investors to be monitoring risks to their investments posed by breaches of international human rights law.

Governance factors could include diversity of the board of the investee company, risk management processes and pay policies.

Taking account of climate change is a topic in its own right. It is good practice, and in line with their duties in relation to taking account of financially material considerations, for trustees to implement governance to maintain oversight of climate-related risks and opportunities that are relevant to their scheme.

What Else Should Trustees Consider?

Regardless of the letter of the law, there are various good practice measures that trustees can implement – and which they are encouraged to do so by The Pensions Regulator (TPR).

In Relation to Climate Change

The Department for Work and Pensions has published non-statutory guidance, produced by the Pensions Climate Risk Industry Group, which offers practical tips and suggestions to assist trustees with implementing good governance around the risks and opportunities posed by the effects of climate change.

Trustees of most schemes will be required to assess and manage the risks and opportunities associated with climate change as part of TPR's new single code of practice. This will involve considering the possible short-, medium- and long-term effects of climate change on the objectives of the scheme and its operations, maintaining and documenting processes for identifying and assessing climate-related risks and opportunities, and integrating these processes into risk management and governance arrangements.

TPR has also published guidance for trustees to support them in meeting the new TCFD governance and reporting requirements, and notes that trustees who are not yet subject to the regulatory requirements for TCFD reporting may still wish to follow the guidance to improve the governance and resilience of their schemes in relation to climate change.

Stewardship

Trustees should actively monitor and engage with the companies in which scheme funds are invested and their policy on doing so will need to be reflected in their SIP. If investments are made via pooled funds, it will be the investment manager that undertakes these stewardship activities. Trustees should, therefore, understand how ESG can be integrated into relationships with their investment consultants and managers.

TPR encourages trustees to sign up to the UK Stewardship Code, as well as encouraging use of the Pensions and Lifetime Savings Association's (PLSA) stewardship disclosure framework, which allows trustees to see, at a glance, the stewardship policies and activities of an asset manager who has completed the framework and submitted it to the PLSA.

Should Trustees Take Account of Others' Views?

The distinction between non-financial factors (such as members' views generally) and financially material factors is becoming less clear. While, generally speaking, trustees are not required to take account of members' views on ESG and climate change issues because they are non-financial factors, trustees might want to consider whether, and how, to take account of members' views.

The trustees should also discuss with, and understand, the employer's investment beliefs in relation to ESG (including climate change) because it could be embarrassing for both the trustees and the employer if the views of each diverge completely.

Some Practical Points

Do	Don't
Do consider implementing a responsible investment strategy and consider the approach you wish to take as a trustee board – where do you sit in the spectrum of minimum compliance to industry-leading innovation?	**Don't** assume that the employer will have the same ESG strategy or beliefs. Update any information-sharing protocols so that you can consider the employer's approach to ESG and take account of this when assessing the employer covenant.
Do take account of all relevant risks, such as investment performance, reputational issues, litigation risks and sponsor alignment.	**Don't** expect all trustees to have the same level of knowledge and understanding in relation to ESG issues – arrange training where appropriate.
Do put in place a breach response plan so that you could act quickly if you discover that assets have been invested contrary to your beliefs or in a way that may be damaging (whether reputationally or financially).	**Don't** sign up to "standard" investment management agreements without first understanding the extent to which they will enable the trustees to comply with their own ESG policy.

What Are the Consequences of Failing to Comply?

The maximum penalty for failing to comply with legal requirements is £5,000 for an individual trustee and up to £50,000 for a corporate trustee. Different penalties apply in relation to the production of a TCFD report (see our quick guide on the publication of TCFD reports).

Additionally, while there is no legal requirement to comply with some of the good practice measures outlined in this guide, doing so will contribute towards demonstrating that trustees have adequate knowledge and understanding of their duties as trustees. Failure to carry out some of the more obvious good practice measures could result in TPR fining a trustee board (up to £5,000 per individual and £50,000 per corporate) for a lack of trustee knowledge and understanding.

Finally, do not forget that there could be potential reputational damage if trustees are not fully conversant with the ESG credentials of their managers or the funds in which they are invested.

Contact

Clifford Sims
Partner, London
T +44 20 7655 1193
E clifford.sims@squirepb.com

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