EVERSHEDS SUTHERLAND

The road to success

Pension trustees' approach to environmental, social and governance (ESG) issues

In my experience, pension trustees' approach to environmental, social and governance ("ESG") factors is on a journey. I'd like to explore that journey and look at some of the pitfalls ahead.

What needs doing on ESG and by when?

By 1 October 2019, most pension trustees will need to include in their pension scheme's statement of investment principles ("SIP") their policy on "financially material considerations", their policy on voting rights ("Activism"), and their policy on the extent to which they take into account "non-financial matters."

"Financially material considerations" means matters which the trustees consider as financially material including "environmental, social and governance considerations (including but not limited to climate change)."

"Non-financial matters" means "the views of the members and beneficiaries including (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme."

By 2020, the SIP will need to be made publicly available on a website.

Where did the journey begin?

For many trustees, they would historically have commonly taken 'ESG'-type matters into account in their investment strategy, to the extent financially material and without being identified expressly. If they were asked about ESG, however, they would naturally have seen this as an ethical matter, and so not something for them.

Many have now "seen the light" in terms of their perception of ESG: it has moved from an ethical matter to primarily a part of long-term risk management: something which is consistent with their duties and perhaps even essential for some schemes with a longer timescale.

With this territory comes legal risk however, which needs to be thought through before trustees rush to ESG funds and update their SIPs accordingly.

We want to build in ESG – how do we do it?

Get some training! We tend to see trustees asking their current consultant, an ESG specialist consultant and their lawyer to give this.

Decide what your beliefs are in terms of ESG and its relevance for your scheme. For example, it may be that your scheme's lifetime is very short, so certain ESG factors may be less financially material for you.

Do you want to ask members what their opinions are? I come back to this below.

- focus the strategy to include preferred assets like clean energy projects ("thematic investment")
- integrate your ESG beliefs across your strategy. There are various ways to do this: it can be resource heavy though, so this may one only for larger schemes
- activism – engage (either directly or via fund managers) with the companies in which your scheme invests on the areas to be improved
- screening – exclude "bad companies" from investment. Members may like this but it is not straightforward legally

DC default funds – ESG?

If investment consultants are saying that ESG is a financially material risk, shouldn't all DC schemes move to default funds with an ESG "tilt"? This feels like the direction of travel.

Be careful with the legal risk here: if members are defaulted into an "ESG" fund, it could perform less well than equivalent non-ESG funds. Conversely, if trustees decide not to use the ESG fund as the default and the ESG fund then outperforms the default, the trustees could also face criticism and claims.

The key here is the process followed by the trustees. They will need to be comfortable (i.e. have financial advice that supports the conclusion) that what they did was in members' best financial interests. This is an ongoing risk: the fund's performance will need to be regularly checked and verified.

The world of ethics, subjectivity, member views and pressure groups

By 1 October 2020, trustees will have to make their SIPs publicly available. By this time, this SIP will commonly include a statement about what the trustees do on ESG matters, and their policy (if any) on taking members' views into account in relation to ESG.

Members may not see the distinction between financially-material ESG factors and ethical (i.e. non-financially matters). Some members could have very strong views on "ethical" ESG, and certain pressure groups are also very focused on this.

The issues for trustees are that:

- trustee statements about ESG open them up to material comments/publicity from members (with potentially very strong views, in many different, contradictory ways);
- pressure groups may approach this from an ethical position – it's the 'right thing' to do. This is largely a different lens to the trustees' approach from a legal perspective;
- SIPs tend to be complex to read and understand: members could easily misunderstand things and get concerned; and
- the sponsor will have views on ESG: it needs to be consulted and its views taken into account. Trustees may wish to ensure that they are not making statements about ESG which clash with the sponsor's public position on ESG matters

This all means that trustees could easily find themselves being dragged into debates and arguments with various parties about their ESG policy. This could push them away from objective, long-term financial risk management, and into the land of ethics, subjectivity, conflicting member views and pressure groups. Travel with care...

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