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**ESG factors and changes in the law to pension trustees’ investment obligations**

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Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005 currently requires the trustees of a trust scheme to secure the preparation of a ‘statement of investment principles’ (“SIP”) that must cover “the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments”.

As of 1 October 2019, this will change. Regulations[[1]](#footnote-1) amending Regulation 2(3) will now require the SIP to cover “financially material considerations over the appropriate time horizon of investments, including how those considerations are taken into account in the selection, retention and realisation of investments”. Financially material considerations include but are not limited to environmental, social and governance considerations (“ESG considerations”), including climate change, which the trustees of the trust scheme consider to be financially material.

The “appropriate time horizon” means “the length of time that the trustees of a trust scheme consider is needed for the funding of future benefits by the investments of the scheme”.

This means that trustees of occupational pension schemes with more than one hundred members will be required to set out their policy on how they take account of financially material factors, including ESG considerations, in their investment decision making.

Other amendments relating to non-financial matters, the exercise of rights including voting rights and the undertaking of engagement activities have also been the subject of amendments. Each requires action to be taken in relation to the SIP.

Any trustee who has failed to take all reasonable steps to secure compliance may be subject to a civil penalty under section 10 of the Pensions Act 1995. The maximum amount in the case of an individual is £5,000 and £50,000 in any other case. More importantly potentially is the stigma that will attach to any particular occupational pension scheme that fails to properly address ESG considerations and the associated reputational risk.

Environmental NGO ClientEarth has already advertised its intent to take this seriously. The organisation wrote to the trustees of 14 pension schemes[[2]](#footnote-2) that they described as “already in the spotlight” after the House of Commons’ Environmental Audit Committee’s green finance inquiry highlighted a poor understanding of climate risk among some of the UK’s largest pension schemes. It was reported that this “less engaged” group tended to see climate change as just another ESG factor which did not appear to have been considered specifically as a strategic risk by the Board. There was little identified evidence of strategic input or oversight from the pension scheme’s governing body and no current plans to report on climate risks and opportunities in line with recommendations on climate-related financial disclosures.

ClientEarth has already reported four major UK companies to the Financial Reporting Council over failures to address climate change trends and risks in their reports to shareholders[[3]](#footnote-3), as well as writing letters to the company auditors to ask them to explain their approach to the risks and trends that climate change or the low carbon transition poses to the businesses. Similarly three insurance firms were reported by ClientEarth to the Financial Conduct Authority[[4]](#footnote-4) for failing to disclose climate risks in their annual reports. Pension scheme obligations are likely to attract the same level of scrutiny.

Environmental risks include risks posed by climate change but also include risks resulting from pollution, waste and sustainability. Social and ethical factors have the potential to affect the financial performance of investments but are also likely to be non-financial considerations.

If the requirement to include ESG considerations in a SIP seems like it could be contrary to the basic duty to act for a “pensions purpose” and solely in the furtherance of the benefit of the fund, that is an argument that has already been unsuccessfully advanced in relation to a similar provision found in Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (“the 2016 Regulations”).

The Court of Appeal case of *(1) R (on the application of Palestine Solidarity Campaign Ltd), (2) Jacqueline Lewis* v *Secretary of State for Communities and Local Government* [2018] Pens. L.R. 15[[5]](#footnote-5) considered whether certain passages of the Guidance published by the Department of Communities and Local Government in respect of Regulation 7 of the 2016 Regulations were unlawful. The Court held that it was plainly within the scope of the Guidance to cover the extent to which non-financial considerations may be taken into account in an investment strategy statement (in this case by a local authority).

Regulation 7 of the 2016 Regulations concerns ‘investment strategy statements’ for local authority pension funds and states that an authority must, after taking proper advice, formulate such a strategy in accordance with the Guidance that was the subject of challenge. Regulation 7(2)(e) requires that the strategy must include “the authority’s policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments,” which is remarkably similar to the requirement coming into force on 1 October.

Those who will have to comply with the amended Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005 and include ESG considerations in their SIP may consider it worthwhile to take account of the July 2017 Guidance issued in respect of Regulation 7 of the 2016 Regulations.

In addition to the 2017 Guidance, there is also the UK Corporate Governance Code 2018, which was published in July 2018. A consultation on a draft 2019 UK Stewardship Code closed on 29 March 2019 and will be published later this year. Until it does, the 2012 Stewardship Code remains available on the FRC’s website[[6]](#footnote-6).

The key points to take away are that, as of 1 October 2019, trustees of schemes with more than one hundred members are required to update their SIP to set out their policies on:

* How financially material considerations, including ESG factors (which will include but is not limited to climate change), are taken account of in the selection, retention and realisation of investments;
* The extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments. 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;
* The exercise of the rights (including voting rights) attaching to the investments;
* The way in which the scheme undertakes engagement activities in respect of the investments, including the methods by which and the circumstances under which the trustees would monitor and engage with relevant persons about “relevant matters”. Relevant matters includes but is not limited to matters concerning an issuer of debt or equity, including their performance, strategy, risks, social and environmental impact and corporate governance.

Ideally, the change in the law relating to the SIP should be well in hand. The updated SIP will need to be approved before 1 October. Consultation and advice should have already been sought. Time is rapidly running out.

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1. Specifically, Regulation 4 of the snappily titled, The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018. [↑](#footnote-ref-1)
2. <https://www.clientearth.org/top-uk-pension-funds-put-on-notice-over-climate-risk/> [↑](#footnote-ref-2)
3. <https://www.clientearth.org/easyjet-among-companies-reported-to-regulator-by-clientearth/> [↑](#footnote-ref-3)
4. <https://www.clientearth.org/insurance-firms-could-face-fines-over-climate-reporting-failure/> [↑](#footnote-ref-4)
5. Judgment was handed down on 6 June 2018. At the time of writing this case may still be subject to an appeal to the Supreme Court having been granted permission on 29 November 2018. [↑](#footnote-ref-5)
6. <https://www.frc.org.uk/investors/uk-stewardship-code> [↑](#footnote-ref-6)