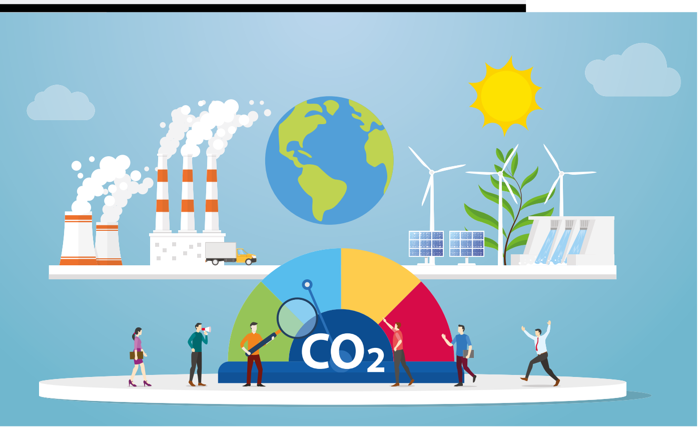
Summary
• Environmental, social and governance (ESG) considerations have gained significant importance in the pensions sector, particularly after the introduction of Task Force on Climate-related Financial Disclosures (TCFD) recommendations and related regulations.
• Regulators are encouraging trustees to enhance their oversight of ESG factors, moving beyond minimal compliance to demonstrate active engagement and accountability.
• Balancing ESG factors with fiduciary duty remains a challenge, but many trustees now recognise that considering long-term ESG impacts aligns with members' best financial interests.

Striking the right balance

Paige Perrin examines the delicate balancing act faced by pension scheme trustees as they navigate the growing demands of environmental, social, and governance (ESG) considerations, alongside their fiduciary duty to act in the best interests of scheme members



There has been an increased importance placed on ESG considerations for the pension sector, particularly following the mandate of TCFD recommendations in 2021.

The Pensions Regulator's research found that while most trustees are meeting their ESG duties, many do so at only a minimal compliance level. As a result of this, the regulator said it wants to see more evidence of trustee oversight where management of financially material risks, engagement, and voting had been delegated to an investment manager.

However, this is a complex challenge. Trustees must balance ESG considerations with their fiduciary duty – acting in the best financial interests of scheme members while responding to the growing demand for sustainable investments.

Fiduciary duty is not always straightforward, as Redington head of stewardship and sustainable investment strategy, Paul Lee, explains: "Because fiduciary duty arises under common law, it is not as narrowly and precisely defined as it might be if it were created by statutory legislation. That leads to less certainty and a greater requirement for judgement."

Legal and regulatory landscape

Trustees must incorporate ESG considerations under key regulations, including the Pensions Act 2004, Occupational Pension Schemes (Investment) Regulations 2005, and the Pension Schemes Act 2021.

The Pensions Schemes Act 2004 requires trustees to prepare a statement of investment principles (SIP), outlining investment objectives and policies, including ESG factors.

The Occupational Pension Schemes (Investment) Regulations 2005 mandate disclosure of ESG approaches, including climate change, within the SIP.

Additionally, the Pension Schemes Act 2021 introduced requirements for trustees to report on climate-related risks and opportunities, aligned with TCFD recommendations.

In the UK, the requirement to report in line with the TCFD recommendations applies to larger pension schemes, including master trusts and collective DC schemes and schemes with £1 billion-plus in assets.

Pension Management Institute director of policy, Tim Middleton, says this requires these schemes to prepare an annual report covering the governance structures for managing climate-related risks, climate risk and opportunity assessments, scenario analysis on potential climate impacts, and reporting on climate metrics and targets.

Despite these regulatory developments, there is an ongoing debate around ESG's role in fiduciary duty. Bestrustees trustee executive, Michelle Darracott, clarifies: "These laws and regulations ensure that trustees consider both financial and non-financial ESG factors, balancing their fiduciary duties with broader societal and environmental responsibilities."

Trustees must also identify stewardship themes. Lee says: "All trustees choose climate change as one theme; they usually choose one or two further ESG themes. These form a key focus of scheme annual implementation statements."

Challenges

Fiduciary duty traditionally prioritises high-growth investments without considering societal or environmental impacts. However, as systemic risks like climate change emerge, ESG factors are increasingly seen as financially relevant.

Hymans Robertson defined benefit investment consultant, André Ranchin, emphasises that systemic risks such as climate change are financially material and likely to have a 'significant' impact on long-term investment returns.

Middleton states that to balance ESG and fiduciary considerations, trustees need to consider what investment strategies would be in members' best interests. He adds: "ESG is now a key consideration for most trustee boards, if only from the perspective of compliance with reporting requirements."

However, Lee argues that if the investment world had "dealt with *[ESG issues]* appropriately" in the past, a separate category wouldn't be needed. He believes these issues were overlooked due to their long-term, uncertain financial impacts.

He stresses that pension funds, with their long-term horizons, must consider these factors when assessing investment risks and returns.

However, the challenge is evolving. Darracott states that balancing ESG considerations and fiduciary duty is less of a challenge than it used to be, as trustees increasingly recognise that ESG actions can positively impact long-term returns.

Middleton echoes this, noting that although ESG is not explicitly required under the term 'best financial interests', trustees are unlikely to be challenged over ESG-related investment decisions.

"There is in any event a growing consensus that many companies associated with pollution and climate change, such as those involved in fossil fuels, are actually a suboptimal investment," he says.

However, Charles Stanley Fiduciary Management senior portfolio manager, Barnaby Low, argues that while the challenge has become easier as regulation has clarified trustees' duties, trustees must remain mindful of issues such as greenwashing.

In addition to this, Lee says a potential disconnect could arise if trustees don't approach these issues as matters of investment risk and return.

He also highlights the growing challenge with climate commitments. "2030 is approaching and the world economy isn't shifting at the pace that the ambitions of the Paris Agreement would indicate, meaning that there is a risk that some 2030 ambitions might encourage trustees to dislocate their investment portfolios from the real economy. The investment implications of any such decisions need to be very carefully considered."

"Most trustees recognise *[ESG]* issues matter for investment portfolios over the time horizons that matter to their beneficiaries – so fiduciary duty requires them to consider *[ESG]* issues, it doesn't run counter to considering them"

Practical considerations

Darracott suggests a range of practical considerations that trustees can implement to navigate this, including clear policies, regular training, and engaging with investment managers.

One suggestion to balance fiduciary duty and ESG consideration is to engage with scheme members to understand their ethical and moral views, whether this be through surveys or consultations. This could help trustees align investment strategies with member preferences.

Another is ensuring that any non-financial ESG considerations do not compromise financial returns, as trustees should be able to demonstrate that their decisions are in the best financial interests of the beneficiaries.

Clear policies are also vital to guarantee that ESG is balanced with fiduciary duty correctly, and this should be done in the SIP and reviewed regularly.

In addition to this, regular training for trustees on ESG issues and their financial implications can help trustees stay informed about the best practices in ESG investing.

Other ways to ensure trustees balance ESG considerations and fiduciary duty is to engage with investment managers to ensure they understand and implement the scheme's ESG policies and conduct scenario analysis to understand the potential impact of ESG factors on the investment portfolio.

Railpen climate lead, Adam Gillett, underscores the need for collaboration. "Collaboration and consistent, forceful advocacy from the investment community is needed when faced with systemic challenge," he says.

The Society of Pension Professionals member, Clare Keeffe, notes that some market participants still view ESG factors as separate from other risks.

However, she says Financial Markets and Law Committee guidance clarified that trustees can consider both "numbers and narrative" in their decisions, recognising ESG data is still developing.

Lee adds: "The paper made clear it is entirely within their fiduciary duties for trustees to consider climate and other sustainability matters within decision-making – provided that they approach those issues through the lens of investment risk and return."

As regulations evolve and the financial materiality of ESG factors becomes clearer, trustees are increasingly integrating these considerations into their fiduciary duties. While challenges remain, the overall trend shows that ESG is firmly on the agenda and will continue to shape decision-making in the pension sector.

Written by Paige Perrin