Saving (for) your future

Chantal Thompson and Mark Solomon explain why ESG factors should be important to trustees

With the Extinction Rebellion protests still recent, the Bank of England claiming that the global financial system is facing an existential threat from climate change and President Trump angling for a review of how US pension funds use their ESG (environment, social and governance) metrics, it is clear that ESG issues are at the top of the news agenda.

But, aside from the general good, why else should trustees of UK pension schemes care about ESG factors? And, with no shortage of other concerns, where do ESG factors stand in the pensions world?

This article explores ESG in the context of trustees' investment duties and discusses the steps that trustees will need to have taken by 1 October this year when the new legislation requiring trustees to consider ESG factors in their investment strategies becomes effective.

What are ESG factors?

ESG, in an investment context, relates to environmental, social and governance factors that affect the return on the investment, either directly or indirectly. Pension scheme trustees should consider ESG factors when discharging their investment duties and in seeking to manage risks. Given the media storm which surrounds the term, it would be easy to conflate ESG factors with wider moral, ethical or political considerations. However, ultimately (and somewhat counter-intuitively), trustees must be mindful that ESG factors can be relevant to investment risk and returns, irrespective of any moral, ethical or political consideration.

Trustees' duties to consider ESG factors

ESG integration into the financial strategies of pension schemes has been a slow process. However, in the UK, time is now up. From 1 October 2019, trustees will be required to include in their Statement of Investment Principles (SIP) commentary on ESG factors, including climate change, as part of their financially material considerations 'over the appropriate time horizon'.

Furthermore, 'relevant schemes' (broadly, occupational schemes that offer DC benefits in addition to AVCs) will, from 1 October 2019, have to publish that SIP on a public website and, from 1 October 2020, have to include a statement in their annual report on the extent to which the SIP has been followed during the year and an explanation of any changes to the SIP. Relevant schemes with more than 100 members will also be required to disclose the risks of their investments, including the ones arising from ESG considerations.

Trustees should also note that new governance regulations that came into force in January this year to comply with the European Directive IORP II will require them to carry out an 'own risk assessment', which will include how they consider ESG factors and assess new or emerging risks.

Changing tide

It is likely that increased awareness of ESG, particularly amongst millennials, will result in members taking greater interest in how their pension funds are invested. It seems likely that the investment decisions taken by DC schemes (with a younger, more diverse workforce) will face the greater scrutiny.

Encouragingly, a recent survey of our clients found that over 50 per cent had discussed ESG factors at a trustee meeting. However, for those trustees who have not yet discussed ESG, they will need to do so quickly and consider how to comply with the new reporting requirement by the 1 October deadline. Practical steps that trustees should take prior to the looming deadline include:

a) consideration of ESG factors and how to integrate these into their investment approach
b) discussions with investment consultants on ESG and stewardship policy
c) consultation with sponsoring company on any update to SIP that may be required in order to comply with the new requirement
d) for 'relevant schemes', review of default strategy and ensuring that the SIP is made available on a public website.

For help in complying with the new legislative framework, please contact Chantal Thompson, Mark Solomon or any other member of the pensions team at Baker McKenzie

There isn't a universally accepted list of ESG factors, but they include:

Examples of ESG factors		
Environmental	**Social**	**Governance**
Climate risk	Diversity	Management diversity and structure
Pollution	Equal opportunities	Executive compensation
Sustainability	Working conditions	Business ethics

Written by Baker McKenzie associate Mark Solomon and partner Chantal Thompson

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