Getting entangled in sustainable investing red tape

Summary
- Pension schemes will play a significant role in the transition to net zero.
- However, sustainability regulations are overly complex, resulting in a focus on reporting rather than real-world impact.
- Inadequate data is hindering effective measurement.
- A streamlined regulatory regime could free up trustees to focus on meaningful change.

UK pension schemes have a unique role to play in driving sustainable impact, but complex rules are slowing momentum

With a long investment horizon, pension schemes are well-positioned to drive sustainable investment, as they are able to take a long-term view of environmental, social and governance (ESG) factors.

"As large institutional investors holding billions in assets, pension funds have a central role in the UK's transition to net zero and management of climate and other ESG risks," says Eversheds Sutherland partner, Charlotte Cartwright. "If trustees do not consider and take steps to manage these systemic financial risks to which they and their members are exposed, it will have a long-term detrimental impact on members' financial outcomes."

Barnett Waddingham sustainable investment consultant, Jordan Griffiths, argues that the long time horizon of DC schemes gives them greater scope to embrace sustainable investment opportunities. But, as well as "greater potential to generate positive impacts (that may not be available to shorter-term investors), it also exposes them to increased ESG risks and the potential to exacerbate negative impacts".

Griffiths adds: "Whilst some DB funds may have short-term time horizons, their decision making will have consideration for the long term. For example, entering a buy-in is a long-term investment decision, so an investor shouldn't disregard ESG risks when selecting their insurer."

Overly complex regulations?

Despite the key role of pension schemes in driving sustainable investing, the complexity of regulations poses significant challenges for trustees.

A recent paper titled *Ideas to Help Pension Scheme Trustees Focus on More Impactful Investment Decisions* by the

Investment Consultants Sustainability Working Group (ICSWG) highlights the complexity of UK sustainability regulations and policies.

The paper argues that regulations aimed at driving behavioural changes are consuming valuable time and resources for trustees. It highlights a growing concern that this regulatory reporting is being viewed merely as a 'tick-box' exercise, rather than achieving tangible results.

Hymans Robertson investment associate consultant, Chris O'Bryen, says: "Trustees are required to comply with multiple, often overlapping, reporting standards, which can be time-consuming and costly. This red tape can lead to increased costs and time spent on compliance rather than on actions that directly benefit scheme members and the environment."

O'Bryen also notes these issues are compounded by "the fragmented nature of the UK asset owner market. Many small schemes exacerbate these burdens, as the impact that small schemes can have may be perceived by some as disproportionate to the time spent on ESG topics due to the intense nature of compliance expectations".

Evolving rules

The current complexity has evolved over the years, with regulations originating from both legislation and case law, says Eversheds Sutherland partner, Michael Jones. "This is a difficult dynamic for trustees and there is a risk they consider the implications of certain judgments in isolation rather than interpret them in a modern-day context, taking into account current political and socio-economic conditions and the different types of schemes that we have today."

Jones points out that while some level of regulation is necessary, there remains concern about whether these regulations are excessive. "Schemes that are subject to the Task Force on Climate-Related Financial Disclosures (TCFD) requirements, and in particular those who also voluntarily submit reports in relation to net zero, UN PRI, and the Stewardship Code, are subject to a significant reporting burden. Ideally those reporting requirements would be streamlined so that trustees can spend more of that time implementing their sustainability strategies in practice."

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Lack of clarity

In addition, trustees face a complex array of ESG metrics, standards, and reporting frameworks that change over time.

College of Lawmakers chairman, Robin Ellison, states: "The definition of sustainability and the metrics are very uncertain, and no one knows how to define it. What's sustainable to one group isn't sustainable to another group." This lack of clarity often leads to lengthy reports that offer few actionable insights. As Ellison says, "the metrics are changing all the time".

Griffiths highlights that inadequate data provides a barrier to sustainable investing. "Whilst we have seen significant improvements in climate data over recent years, there is some way to go before we have consistent and robust data. Furthermore, data quality and consistency in other areas, such as nature and social issues, are lagging its climate counterparts. Such data issues can prevent outputs from being decision-useful and may delay actions."

Emerging challenges

Beyond the rules, there are also emerging challenges for trustees, such as the political push back on ESG, says Independent Governance Group head of sustainability, Tegolin Harding. She comments that this pushback "is causing both companies and asset managers to backtrack or water down on their net-zero commitments. There is a gap emerging between the expectations of asset owners and the ability or willingness of asset managers to engage companies on these issues on their behalf".

She adds: "It is becoming clear that the transition *[to net zero]* is not happening as quickly as it was anticipated even a few years ago. There is a risk that a delayed transition causes unexpected risks for those who have taken climate risk into account in the way in which they invest."

A more streamlined regime needed?
Looking ahead, regulators adopting a more streamlined reporting framework could significantly ease the burden faced by pension trustees.

"There are a number of actions that could be taken by regulators," says O'Bryen, including a complete overhaul of the current regime.

The ICSWG calls for a consolidated regulatory reporting framework with a single sustainability policy for schemes. Large schemes would update this policy annually, and smaller ones every three years. Guidance would be principles-based with reports on high-quality case studies.

Their paper proposes clarifying trustees' fiduciary duties following the Financial Markets Law Committee's report, shifting the focus from single materiality (impact on investment portfolio) to double materiality (impact of investment portfolio on the real world), and reducing barriers to investing in illiquid sustainable assets.

Alongside these proposals, the ICSWG aims to work with regulators to help improve sustainability reporting.

Redington head of stewardship and sustainable investment strategy and workstream member, Paul Lee, says: "It's clear that participants in the investment chain should play a fuller role in policy and regulation, as these frame the well-functioning capital markets on which our clients' financial wellbeing depends."

How can trustees navigate the rules?
Despite the complex landscape, several practical measures can help trustees navigate the current rules and improve long-term outcomes for members.

Harding comments: "Trustees firstly need to understand the rules and how they are changing and how they might need to adjust their approach in response. For example, schemes that are entirely reliant on the engagement of companies by asset managers to achieve their climate objectives may need to review this approach if their asset manager has changed in response to the political and regulatory environment we find ourselves in. Where appropriate they may wish to explore other avenues such as policy engagement, capital allocation and collective action."

She adds: "Considering a transition plan can be a useful exercise as it allows trustees to think through the levers they have available to them and which are most effective in the current environment."

Griffiths adds a note of optimism, observing that 74 per cent of DC and DB schemes reported having no barriers to improving their understanding of climate change in a recent survey by The Pensions Regulator. "This suggests that, despite the steep learning curve that investors have had to climb in terms of their understanding of climate change, a large majority do not see this as an issue going forward. Such insights show that these barriers are penetrable, and progress is being made, providing optimism for the future of sustainable investing."

Written by Alice Guy, a freelance journalist