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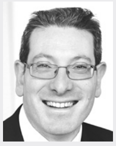
Road to 2030: the Role of ESG in Navigating Change in UK Pension Schemes



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Introduction

The UK pensions landscape faces significant shifts over the next five years. These have been brought into focus by the Pension Schemes Bill 2025, which seeks to legislate for a smaller number of bigger, better governed, better value pension schemes, investing in a wider range of productive assets.

Trustees of UK occupational pension schemes will encounter environmental, social and governance (ESG) challenges on an ever-greater scale as regulation, policymaking, scientific guidance, commercial commentary and wider societal expectations continue to evolve. For instance, trustees need to be alive to the risk of ESG-related litigation, as scheme members, other stakeholders and activist claimants look more closely at trustee decision-making and disclosures in connection with ESG issues. Greater scale and resources at a scheme level will also provide new opportunities to deploy their capital to promote ESG objectives, enhance long-term financial returns and protect that capital from adverse impacts caused by ESG risks.

This chapter focuses on three areas where ESG considerations are most often relevant to how trustees of UK pension schemes carry out their duties:

(i) decisions concerning the investment of scheme assets;
(ii) litigation risk in respect of ESG-related issues, including public statements; and
(iii) the exercise of stewardship rights, including monitoring and engaging with investee companies and asset managers.

It also identifies how other ESG issues can arise specifically in the context of defined benefit (DB) pension schemes, including when assessing the support available from the scheme's sponsoring employers and when entering into buy-out or buy-in transactions with insurers.

Making Investment Decisions: Fiduciary Duties and ESG

Case law in the 1980s and 1990s[1] highlighted an apparently fundamental tension between the duties of occupational pension scheme trustees to invest assets in order to fund pensions and other retirement benefits, and their ability to take ESG considerations into account when investing.

However, following two landmark Law Commission reports in 2014 and 2017,[2] in very broad terms the current orthodox legal view is that:

- ESG considerations can and should feature in pension scheme investment decision-making where they are "financially material" to investment performance or risk; and
- considerations driven by non-financial perspectives (such as political, ethical or philosophical beliefs) are known as "non-financial" factors. Additional legal tests must be met before non-financial factors may influence pension scheme investment decisions.[3]

The Financial Markets Law Committee (FMLC) refined this approach further in 2024, observing that what distinguishes a "financial factor" is the motive underlying its consideration, rather than the nature of the factor. The FMLC also highlighted how broad financial factors are today, and how many factors that may appear to be "non-financial" are in fact "financial" when properly understood. Trustees who consider sustainability-related issues may be better able to identify unrewarded or unmanaged risks and improve investment returns.[4]

Pension trustees therefore need to assess whether and to what extent ESG considerations are "financially material", recognising the potential breadth and evolving nature of this concept. In relation to this:

- Although a full discussion of the economics is beyond the scope of this chapter, economic evidence confirms that ESG considerations are capable of being financially material, and that existing financial models do not necessarily adequately cater for ESG risks.[5]
- There is also evidence that ESG investments can be compatible with achieving desired risk-adjusted financial returns.
- An increasingly diverse range of ESG-themed investment products are coming to the market, and we have seen a number of pension schemes exploring these.

Naturally, these issues mean that the economic, commercial and financial aspects of ESG are a significant and legitimate focus for pension trustee conversations.

From a legal perspective, though, the key requirement is for trustees to discharge their fiduciary duties to use their investment powers properly and for proper legal purposes, and to invest in a manner consistent with their duty of care (as a prudent person would). This obligation sits alongside trustees' wider duties, such as the duty to give due or "properly informed" consideration to the exercise of any power or discretion. Where trustees decide to exercise a power, they must act in good faith and take reasonable steps to gather information that is relevant to the exercise of that power, or their decision may be overturned.

In effect, these duties mean the law requires trustees to identify the "financially material" ESG factors (that is, those ESG factors that are relevant to the proper lawful exercise of the trustees' investment powers in the circumstances of their scheme), and then integrate those factors into the investment decision-making process. In practice, this involves:

- obtaining information and advice to identify the financially material ESG factors;
- considering the information and advice about those ESG factors and raising questions where necessary;

- balancing the relevant ESG considerations with other relevant factors (including other financially material factors) in order to reach an overall decision – probably through debate on the board or investment committee; and
- having sufficient expertise and understanding to be able to do all of the above.

There will usually not be any single right or wrong decisions when it comes to investment strategy. Instead, there will be a range of reasonable decision-making, and trustees will need to satisfy themselves that they are within that range based on decision-making that is supported by appropriate governance, as outlined above.

An organisation's approach to equality, diversity and inclusion (EDI) is a recognised ESG factor and is sometimes used as an indicator of financial performance or risk in pensions investment and funding. But EDI considerations apply within a pension scheme too, most obviously in the composition of its trustee board. This is now an area of active regulatory focus, with the UK Pensions Regulator (the Regulator) publishing its first formal EDI guidance in March 2023. This guidance emphasises that EDI supports robust decision-making and makes recommendations in a variety of areas, including the role of the chair and diversity on governing bodies and among professional advisers.[6]

Living up to Your Statements: ESG-Related Litigation Risk

The Regulator announced in March 2023 that it will be focusing more on "climate and ESG non-compliance", which will involve checking that trustees of in-scope schemes have published Statements of Investment Principles (SIPs) and implementation statements (see below). The Regulator has stated explicitly that a failure to comply risks enforcement action. It has published detailed guidance for pension trustees to help them understand and meet the reporting requirements to which they are subject.[7]

A particular concern in this regard is "greenwashing". Whilst that term is widely used, it lacks a uniform definition. Broadly speaking, however, it refers to the practice of making misleading or overstated claims about environmental or sustainability credentials.

In order to resist greenwashing and other ESG-related allegations more effectively, trustees should ensure that their public statements concerning ESG matters: (i) are clear and unambiguous; (ii) are not misleading or overstated; and (iii) can be independently verified and corroborated by underlying evidence.

Investment policies, disclosures and implementation statements

Pensions investment regulations require ESG-related investment policies to be set out in a scheme's SIP, covering:

- financially material considerations (including, but not limited to, ESG and climate change) and how these are integrated into the investment strategy;
- how, if at all, non-financial factors are taken into account;
- stewardship and engagement with investees, co-investors and other stakeholders in relation to a non-exhaustive list of matters such as strategy, performance, capital structure and conflicts of interest; and
- arrangements with the scheme's asset managers (on areas such as incentivisation and alignment with SIP policies), or an explanation of why there are no such policies.

Many schemes are also required to publish their SIP on a publicly available website and to prepare an "implementation statement". Broadly, the implementation statement is an annual report tracking progress against the SIP policies and explaining how far these have been applied during the year.[8] Like the SIP, implementation statements must be disclosed online.

The increased transparency that is now required provides a strong impetus for schemes to demonstrate that they are taking genuine, substantive action.

One reason for this is that there have already been live cases of schemes being challenged by stakeholders on the adequacy of their reported ESG activities, with attendant cost and publicity implications.[9]

Another reason is that statutory and non-statutory Government guidance applicable from 2022 onwards sets extensive expectations for schemes to:

- explain, in detail, exactly what they are doing on ESG and stewardship; and
- in effect, justify why their chosen level of activity (as opposed to alternatives) is in members' best interests.

These developments seem to have attracted comparatively little attention to date but, in our view, they make it increasingly difficult to argue that mere compliance with the letter of the law will be sufficient for schemes aiming to demonstrate good practice in ESG. Rather, we believe these developments amount to a very clear prompt to deliver broader, deeper, and higher quality ESG activity in the pensions sector moving forward. This may include placing greater emphasis on ensuring that the guidelines set out in the scheme's investment management agreements are consistent with the policies set out in its SIP.

Climate-related reporting

There is a similar picture in the specific area of climate change. Over a phasing-in period starting from 1 October 2021, legal obligations have applied to many pension schemes,[10] starting with the largest schemes, developed from the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

These require that on an ongoing basis, climate risks and opportunities must be integrated into scheme governance, strategy and risk management processes (including investment and scheme funding strategies). There are also specific duties to undertake climate scenario analysis and calculate climate metrics and targets for the scheme, and for trustees to have sufficient knowledge and understanding of climate issues. All of this is backed up by extensive additional public reporting requirements.

Where the climate regulations apply, they therefore directly and immediately affect the shape of the scheme's governance systems and processes. The climate governance outputs feed into trustees' ultimate strategic activity, including on investment.

The focus on raising standards is evident in this area too. In April 2024, the Regulator published a review of the second wave of climate-related disclosures. The review acknowledged widespread technical compliance and examples of good practice that went beyond strict legal requirements. It nevertheless highlighted a number of specific areas for further work and the Regulator's expectations for "continuous improvement" to address gaps in future reports.[11]

Trustees are only required to carry out certain activities (e.g. undertaking scenario analysis and obtaining greenhouse emissions data) "as far as they are able", broadly where such steps are reasonable and proportionate, taking into account the costs and time needed to meet such requirements. As these costs and other obstacles change, for instance lessening where more data becomes readily available (or alternatively becoming more onerous in jurisdictions where corporate reporting is scaled back), the trustees' duties will evolve to reflect this.

The Regulator has separately reaffirmed in its General Code of Practice (the Code) that managing climate change risk is not just a matter for large schemes.[12] The Regulator expects trustees to maintain and document processes for identifying and assessing climate-related risks and opportunities for their scheme and to integrate these processes into their risk management and governance arrangements – even where trustees are not required to prepare climate-related disclosures. This is a key development and, in our view, a notable extension of climate change regulatory requirements within the occupational pensions industry in the UK.

The UK Government has also consulted in 2025 on how to introduce climate-related transition plan requirements for a range of UK-regulated financial institutions, including pension funds.[13] As part of that consultation it asked for views on how new transition plan requirements should integrate with the existing climate-related reporting requirements for larger pension schemes. The Regulator has been asked to assess the practicalities of transition plans for pension schemes and has convened an industry working group to present its findings to the UK Government.

Nature-related disclosures

There has been a growing recognition of the risks posed by biodiversity loss to the pensions industry, and the interaction between nature and climate-related risks. The Taskforce on Nature-related Financial Disclosures (TNFD) has developed a set of disclosure recommendations and guidance on a framework that can enable investors, such as pension funds, to assess, report and act on their nature-related dependencies, impacts, risks and opportunities.[14] Whilst the TNFD's recommendations have not yet been incorporated into UK law, certain pension schemes have used this framework on a voluntary basis.

Active Owners: Stewardship and Engagement

The regulatory drive to require trustees to disclose how they implemented their investment policies has developed alongside an expectation that this will involve a more proactive approach to stewardship and engagement. For instance, many UK pension schemes have already gone beyond the existing climate change requirements and have adopted voluntary net-zero targets. In practice, this involves selecting and monitoring asset managers equipped to implement these strategies, holding company management and boards to account through active stewardship, use of tools and analysis (such as from the Science Based Targets initiative (SBTi) and the Transition Pathway Initiative), and collaboration with industry bodies (such as the Institutional Investors Group on Climate Change).

Stewardship has also been associated with creating or preserving "long term value" for beneficiaries, taking environmental and social factors into account. For instance, the UK Stewardship Code 2026 notes that effective stewardship "*supports investors to make well-informed investment decisions to deliver returns that meet the objectives of their clients and beneficiaries today, without compromising the ability to do so in the future. In doing so, investors take account of long-term risks and opportunities, having regard to the economy, the environment and society, upon which beneficiaries' interests depend*".[15] This value-driven objective is well-aligned with the purpose of pension scheme trustees' investment powers, which is to invest scheme assets in order to provide members with their retirement benefits.

The Regulator has emphasised in its Code that stewardship is a valuable part of the trustee investment toolkit and an important component of trustee legal duties.[16] The Regulator expects trustees to incorporate stewardship into their "effective system of governance" by:

- identifying the stewardship rights attached to their investments and considering their approach to voting and engagement;
- ensuring they are familiar with their investment manager's stewardship policies, seeking to influence them, as appropriate, and monitoring and regularly reviewing their managers' stewardship practices; and
- seeking to establish engagement approaches with investee companies and collaborative industry initiatives, either directly or via their investment managers, and considering co-operating with other institutional investors in engaging with investee companies.

As with allocation decisions, obtaining the information and advice and ensuring trustee boards have sufficient expertise and understanding to interrogate this material can be particularly important here. While more issuers and investment managers are required to publish, or voluntarily do publish, information about their stewardship, climate and wider ESG practices, the information is often complex and may not immediately translate to the needs of trustees. It is often necessary to negotiate with investment managers to ensure the right asset allocation is aligned with the trustee's stewardship goals and to secure contractually appropriate stewardship rights and reporting.

Funding and Investment in DB Schemes

Trustees of DB pension schemes face particular challenges in relation to funding and long-term strategy, where ESG issues can also become relevant to their decision-making. To give two examples:

- **Employer covenant**. Where the climate regulations (see above) apply to a DB pension scheme, there is now a clear legal obligation for trustees to consider how climate risks and opportunities may affect the ongoing financial support available from the scheme's sponsoring employers – the "employer covenant". Even for schemes where the climate regulations do not apply, we consider that there are arguments based on existing regulatory materials that climate and ESG factors should be considered in relation to the employer covenant where relevant.[17]
- **Bulk annuities**. An increasing number of trustees of DB schemes have also been considering sustainability when entering into bulk annuity transactions, for instance when assessing the credentials and covenant of insurers. Many have used "the Sustainability Principles Charter for the bulk annuity process" (launched by Accounting for Sustainability in January 2024) when setting their expectations and evaluating whether these have been met. The Charter promotes four key principles, namely transparency, sustainable decision making (including in relation to stewardship), reporting and engagement, and sector-wide collaboration.[18]

Conclusions

The commercial, financial and investment aspects of ESG investing are a significant focus in the pensions industry. This is legitimate and highly relevant in the context of trustee fiduciary duties and existing legislation. Trustees of UK occupational pension schemes also need to be alive to the risk of ESG-related litigation as their ESG disclosure obligations, and public focus on ESG topics, continue to increase.

Good governance and verification systems, and negotiating appropriate contractual rights, are the key ways in which trustees can go beyond a narrow approach to compliance, develop how they make decisions, manage ESG-related risks and carry out stewardship activities. Such systems and rights will provide a clear framework within which trustees' substantive decisions will be made, acted upon and monitored.

Endnotes

1 Notably *Cowan v. Scargill* [1984] 2 All ER 750 and *Harries v. Church Commissioners* [1992] 1 WLR 1241.

2 The Fiduciary Duties of Investment Intermediaries (2014) and Pension Funds and Social Investment (2017).

3 Aspects of this test were considered by the Supreme Court in *R (Palestine Solidarity Campaign Ltd & anor.) v. Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16 and by the High Court (indirectly) in *Butler-Sloss & ors. v. Charity Commission & anor.* [2022] EWHC 974 (Ch). Nevertheless, there remains a number of areas of legal uncertainty. In addition, the legal thresholds for integrating non-financial factors into investment decisions are so high that it is difficult to see how many occupational pension schemes would be able to do so in practice.

4 Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change (6 February 2024), at: https://fmlc.org/wp-content/uploads/2024/02/Paper-Pension-Fund-Trustees-and-Fiduciary-Duties-Decision-making-in-the-context-of-Sustainability-and-the-subject-of-Climate-Change-6-February-2024.pdf

5 See, for example, the report of the Carbon Tracker think tank, Loading the DICE Against Pensions (27 July 2023), at: https://carbontracker.org/reports/loading-the-dice-against-pensions

6 See: https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/governing-body-detailed-guidance/equality-diversity-and-inclusion/governing-body-edi-guidance. The first industry statement of best practice for diversity and inclusion in UK pensions was the Pension and Lifetime Savings Association's *Diversity & Inclusion: Made Simple Guide* (2020), co-authored with Travers Smith LLP: https://www.plsa.co.uk/Policy-and-Research/Document-library/Diversity-Inclusion-Made-Simple

7 See: https://www.thepensionsregulator.gov.uk/en/environmental-social-and-governance

8 The prescribed contents vary depending on the type of pension scheme.

9 For example, see *McGaughey v. Universities Superannuation Scheme* [2023] EWCA Civ 873 and the Pensions Ombudsman ruling concerning the Shell Contributory Pension Fund (Mr D, PO-27469, 2019).

10 Broadly, the regulations took effect from 1 October 2021 for all authorised master trusts, collective money purchase schemes and occupational pension schemes with relevant assets exceeding £5 billion. Occupational pension schemes with relevant assets exceeding £1 billion came into scope from 1 October 2022. Other schemes may come into scope after 2023, subject to further consultation.

11 See: https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/review-of-climate-related-disclosures-year-2#d3f2266165144522a35efe4ff8a644d0

12 See: https://www.thepensionsregulator.gov.uk/en/document-library/code-of-practice/funding-and-investment/investment/climate-change

13 See Consultation on Climate-related transition plan requirements by the Department for Energy Security and Net Zero: https://www.gov.uk/government/consultations/climate-related-transition-plan-requirements

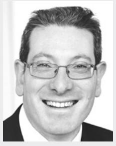
14 See: https://tnfd.global/publication/recommendations-of-the-taskforce-on-nature-related-financial-disclosures

15 See the Introduction to the Financial Reporting Council's UK Stewardship Code 2026: https://media.frc.org.uk/documents/UK_Stewardship_Code_2026.pdf

16 See: https://www.thepensionsregulator.gov.uk/en/document-library/code-of-practice/funding-and-investment/investment/stewardship

17 Our view is strengthened by statements of industry groups, notably Evaluating the impact of Environmental, Social and Governance risks in the Employer Covenant, prepared jointly by the Society of Pension Professionals Covenant Committee and the Employer Covenant Practitioners Association (July 2022), see: https://the-spp.co.uk/wp-content/uploads/SPP-paper-ESG-Risks-in-Employer-Covenant-1.pdf

18 See: https://www.accountingforsustainability.org/en/about-us/our-networks/asset-owners-network/bulk-annuity-sustainability-principles-charter.html



Jonathan Gilmour is a partner and head of the Derivatives & Structured Products Group at Travers Smith. His practice encompasses all aspects of pensions investment work from both a transactional and advisory perspective. He is regarded by peers and clients as a leading specialist in his field, and as a champion of "buy-side" interests in the UK derivatives market.

Jonathan's clients include some of the UK's largest and most sophisticated occupational pension schemes. His work includes advising on evolving ESG and sustainability investment policies and horizon scanning in relation to ESG and sustainability regulations. He has worked on a number of projects for the Impact Investing Institute, the UN PRI and the Green Finance Institute, is an active member of the Industry Development Committee of the UK Sustainable Investment and Finance Association and is a member of the Travers Smith ESG and Impact Committee, with responsibility alongside our pensions partner team for ESG requirements applicable in the pensions sector and sustainable finance initiatives. He is also a Recommended Individual in *The Legal 500* Green Guide.

Jonathan is involved with key industry associations, including his roles on the Association of Pension Lawyers' Investment & DC Sub-committee, the Society of Pension Professionals' Investment Committee, the Financial Markets Law Committee's Insurance & Pensions Scoping Forum and the Pensions Management Institute's London Group Committee.

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Harriet often speaks at industry events and has spoken at the Association of Pension Lawyers' Summer Conference on stewardship and the Association of Member Nominated Trustees' conference on trustee fiduciary duties. Harriet sits on the Society of Pension Professional's Investment Committee and contributes regularly to industry consultations and papers. She has a Certificate in ESG Investing from the CFA Institute and contributed to the United Nations PRI's "A legal framework for impact (UK)".

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