The future for pensions is green

Louise Webb looks at the covenant-related ESG issues and how sponsors, trustees and advisers will need to adapt to the new world.

With COP26 just over, it's strange to think environmental, social and governance (ESG) issues might not top everyone's priority list. For pension trustees, ESG factors in investment decisions have long received air time but their impact on the sponsor's covenant is a newer consideration.

It's common knowledge that the primary focus of a defined benefit (DB) pension scheme trustee is to pay members what they are due at the right time. However, the promise to pay benefits was generally made in a bygone era and, with various corporate restructurings and M&A in its wake, the mothership may have shed the paternalistic sentiments of her forebears. This can make the trustee's task challenging.

Enter the pandemic

When a global pandemic was thrown into the mix, for those schemes with 31/03/2020 valuation dates, things looked pretty dismal. It was unclear what impact Covid-19 would have on death benefits and liability management. As the global economy ground to a halt, corporate insolvencies were anticipated and trustees waited for the inevitable wave of contribution payment holidays. The Pensions Regulator (TPR) issued guidance for trustees on deferrals of deficit contributions and pension transfer lockdowns were announced. Cyclical economic turmoil is to be expected, but this was unfamiliar territory.

With hindsight we now see that bank lending hit record levels, low interest rates staved off insolvency and government support in the form of furlough, VAT and rates relief supported businesses. Some even thrived from the switch to online, reporting high performance and profitability. Reports for the month to 30 September 2021 showed that the deficits of UK pensions schemes against long-term funding targets reduced by £34bn in the month due to a favourable mixture of high gilt yields, equities bouncing back, low interest rates and rising long-term inflation expectations to approximately 4% in Q4 2021. Ironically, for many schemes, funding levels are now at the highest level for some time.

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Despite this, the fallout from Covid-19 (and Brexit) is yet to be understood and material uncertainty remains. In the meantime, climate change and ESG factors have accelerated up the issues list with a growing expectation that they may have a bigger long-term impact for businesses – and the DB schemes they support.

When it comes to understanding the implications of ESG, trustees bring an understanding to the table, but their knowledge has evolved in an investment landscape where decisions are a choice, and disinvestments and diversification an option. The mindset of the trustee and sponsor, and their advisers, will need to adapt to the exercise of considering ESG on the potentially more fundamental sponsor covenant.

ESG and trustee duties: a historic view

Historically, ESG was considered in the context of the trustee's duties and powers of investment. A run of court cases (*Scargill, Church Commissioners* and *Cowan*) established that:

- Trustees should take advantage of a full range of investments in the best interests of the beneficiaries, which are normally their best financial interests.
- Non-financial factors are not generally relevant to achieving the purpose of a scheme's investment power (including factors motivated by moral, ethical, social or political concerns).
- An exception was permitted 'if the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters'.

Covenant was a secondary concern. The primary questions were whether a sponsor's covenant was sufficiently strong to justify the trustees taking non-financial considerations into account; and if the sponsor's covenant could support an ESG strategy that was expected to result in lower investment performance.

Pre-pandemic: investment focus

Pre-Covid-19, trustees became accustomed to building ESG factors into investment strategy. ESG became mainstream, with TPR encouraging trustees to reflect it in investment principles, reporting, operations and journey planning. It was discussed in the context of asset diversity and allocation, good stewardship, investor engagement and voting. There was also a developing belief among investors and investment managers that corporates with good ESG performance metrics fare better in the long term.

The tables had really turned. Trustees were no longer forced to account for the potentially adverse consequences of ESG-focused investments. Instead they were chastised for failing to anticipate the impact of ignoring ESG, as illustrated in 2020 when a beneficiary challenged the Australian Retail Employers Superannuation Trust by claiming the trustees had breached their duty to act with reasonable care and skill in managing scheme investments by failing to provide adequate information on a fund's exposure to climate change risk. In the

UK, the Association of Member Nominated Trustees made its position clear, updating its redline voting policies to cover a range of ESG considerations from executive remuneration, board diversity, modern slavery and human rights considerations and task force on climate-related financial disclosures (TCFD) reporting requirements.

ESG now: trustee and sponsor focus

Fast forward to today and there's a lot going on for trustees of DB pension schemes. The Regulator's single code of governance is expected to be implemented in Q2 of 2022. The new code on DB funding is expected late 2022, with pensions dashboards around the same time. In the meantime, the notifiable events regime and associated criminal sanctions of the Pension Schemes Act 2021 came into effect on 1 October just as trustees of certain types of scheme fell within the scope of the requirements of the TCFD.

With this level of change afoot, it's unsurprising that surveys show regulatory burden as the most pressing concern for pension scheme trustees. But ESG still features. EY's February 2021 report showed 94% of UK trustees surveyed agree that addressing ESG factors is consistent with their fiduciary duty to act in members' best interests. Yet, the report shows only 12% factor climate change into their investment management processes and fewer than 19% account for ESG in the assessment of their sponsor's covenant. There is work to be done.

On the other side of the table, sponsor representatives are trying to predict the speed of recovery, return to profitability and future cash flow generation. They are alive to the benefits that positive ESG-focused policies and sustainable value creation can have on their balance sheets. Every strand of ESG resonates as a business imperative, businesses are adapting to calls for less business travel; smarter and more local supply chains, lower emissions and changing working patterns. Environmental regulation and government policy on climate is expected to force operational change, consumer-end employee preference is demanding a quicker pace, government stimulus packages tied to environmentally focused results require action and financing documents are starting to incorporate metrics to reward ESG performance.

Trustees' future approach to ESG

Climate reporting on TCFD is underway for schemes with AUM over £5bn. Trustees will have to try to measure and report on how aligned their investment portfolios are with the Paris Agreement and, importantly for covenant purposes, consider the effects of climate-related risk on scheme funding. It's this that brings ESG squarely into the remit of the covenant assessment report and funding discussions.

As investors seek to manage ESG and climate change risk more actively, companies must factor ESG into business plans if their reputation and underlying business are to survive. The case brought by several NGOs in relation to Royal Dutch Shell illustrates the potential significance of these moves. In that case, the District Court of the Hague ordered the oil company to reduce its CO2 emissions by 45% by 2030 (compared with 2019 levels). Activist shareholder groups and hedge funds on the other side of the Atlantic have had similar success with their vote to appoint two new directors to the board of ExxonMobil in a move to ensure the transition to a lower carbon strategy, a vote driven by Engine No 1 and supported by two Californian pension schemes.

Granted, covenant-related ESG issues will be less relevant to some schemes, eg those that have reduced reliance on the sponsor because they have de-risked, are close to buy out or have enforceable security to bridge a funding gap. Conversely, for those sponsors that operate in the green economy, the covenant may be strengthened.

Recognising the role covenant plays in determining member outcomes, trustees and covenant advisers need to engage now with sponsors to identify the data they need to understand the risks and opportunities created by ESG considerations. Pension trustees are a unique creditor, whose focus has always been on the long-term sustainability of the employer. They will want to work alongside sponsors on this journey to gather the information they need to make and evidence their informed decision-making processes, not only for their own governance and regulatory purposes, but in response to increasing member engagement in this area. Information will be far-reaching, taking into account production methods, geographic weather-based risks, supply chain exposure and changing consumer expectations etc. This is a complex area and information may not be immediately or readily accessible.

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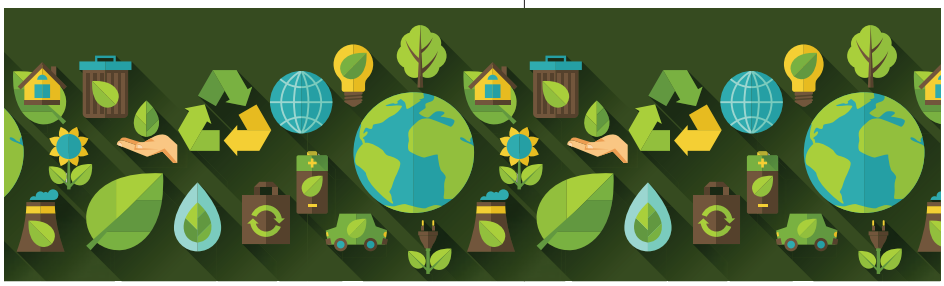
ESG will also drive M&A activity as groups roll out their sustainable strategies. Take the food sector: global groups are moving away from legacy animal-based food businesses, focused more on nutritional bioscience, development of meat alternatives and sustainable food sources. The early engagement that is now required under the Pension Schemes Act 2021 gives the opportunity for sponsors and trustees to discuss these strategies at an early stage and understand the sustainable long-term business model.

Over the coming year trustees will look to their covenant advisers and organisations such as the Covenant Adviser Association and R3 to help them to understand the particular challenges. Covenant advisers who can explain any climate or ESG implications on covenant, with scenario analysis to support the decisions trustees make will be in demand. Support in more nuanced funding discussions will be key. TPR has long expected trustees to use their leverage and significant potential liabilities to act like banks. The financial markets are playing their part in driving change: Klöckner Pentaplast, a German plastics company, refinanced and issued a term loan that included a ratchet mechanism designed to reduce the margin by 2.5% if three sustainable goals are achieved by 2023 (tied to the use of recycled materials for production; emission reductions; and gender diversity within the management team). The covenant adviser that can demonstrate good understanding and work collaboratively with sponsors to weave ESG factors into funding discussions, for the long-term benefit of sponsor, scheme and members is the covenant adviser that trustees will look to. ◻



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