

A CHANGING CLIMATE: HOW PENSION FUNDS CAN INVEST FOR THE FUTURE



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FOREWORD

ONE OF THE PLSA'S KEY POLICY PRIORITIES THIS YEAR IS INVESTING FOR GOOD. CLIMATE-AWARE INVESTING IS A CRUCIAL ELEMENT OF THIS, AND I BELIEVE THAT THIS PAPER SETS OUT A WAY FORWARDS FOR THE PLSA, FOR PENSION SCHEMES, AND FOR THE INVESTMENT INDUSTRY GENERALLY.

I was delighted to host the roundtable debates that were held to provide thoughts and evidence for this paper. With more than 80 delegates attending, representing some 60 funds directly and many hundred more indirectly, it genuinely felt as though the industry as a whole was speaking.

And it spoke with one voice. Though the delegates represented every part of the pension investment chain, from asset owners, through advisers and providers including asset managers right down to the investable assets themselves, the feedback from all 80 of these people was that they want to invest in ways that deliver value to beneficiaries while doing good. In this specific case, they want to invest in a way that takes account of the impact of climate change on the value of the companies and other assets in which they invest. Even the sole climate change 'denier' among the attendees agreed with the principle that we should invest to mitigate it as a risk.

We heard universal and overwhelming agreement about the need to invest in a climate aware way. This means positioning portfolios for the expected future and to limit financial risks in the short- and medium-term. In the context of what will be a difficult transition to a less carbon-intensive economy, this will give schemes the best chance of delivering on the pension promise to their beneficiaries.

I realised that the investment chain has been unfairly presented. There is no ghost in the machine trying to block the progress of investing for good, motivated, perhaps, by a misaligned incentive or pecuniary interest. There is no ghost in the machine trying to exploit an imagined

opportunity to steal a leap on their competitors. There is no ghost in the machine that sees climate change or the risk of climate change as some sort of conspiracy theory that it is their duty to thwart.

Now that's not to say there aren't systemic challenges that slow or can even halt progress – there are – but they are caused not by ill-will but by history and the challenges of operating systems.

That's why this report, with its system-wide assessment of the challenges, is so important. It offers ways to clear some of those historic barriers and to simplify the complexities of the system. Its recommendations for action are ones we at the PLSA, and I hope the whole investment industry, will champion and deliver. We need to, for the sake of the climate and of the future generations that will inherit the earth we pass on.

Of course, we recognise also that there are some issues that are out of our hands. Our biggest challenge will remain that of influencing others to change as much as we recognise we must ourselves.

RICHARD BUTCHER

Acknowledgements: We must express our gratitude to all the PLSA members and participants in the investment chain who have provided input and contributions to the discussions that have been the foundation of this paper, in particular the 80 roundtable participants and all the respondents to the Call for Evidence, who gave up their time freely to build our communal knowledge of these issues. I also express my personal gratitude to the PLSA team that has drawn together this report in response to all that we heard.

EXECUTIVE SUMMARY

- ▶ There is universal appetite among pension schemes and their service providers to take climate change seriously and to invest with a sense that a carbon-constrained future is coming. We sought out the views of dozens of trustees, and investment professionals, involving them in roundtables and in smaller discussions of the issues. Even the rare individual who is sceptical about the causes of climate change accepts that pension funds need to invest recognising the economic risk caused.
- ▶ While there is appetite to invest in a climate-aware way, and some schemes have already taken a proactive and leading position, those investors identified a series of barriers to their being able to do so. In some cases, these are about an immature infrastructure around climate-aware investing, such as inconsistent definitions and language; limited or poor quality data; or lack of products with a full range of necessary characteristics. Other challenges arise from limited expertise and training on climate change issues across the investment chain, including the senior decision-makers at pension schemes (most notably on trustee boards). In other cases, the issues are around structural challenges in the investment chain and the need for better alignment of duties and disclosures along it.
- ▶ None of these issues is fundamental or insurmountable, but they do need system-wide change to be overcome. The PLSA is willing to play its part to help the pensions industry address them, and to work with other parties in the investment chain to deliver the necessary change.
- ▶ This report sets out our analysis of the barriers impeding climate-aware investing and identifies key recommendations for action designed to overcome them. These are set out under each of the relevant issues we have identified:
- ▶ **Issue 1: Clarifying definitions of climate-aware investment**
 - ▶ Analysis: There is substantial confusion about what climate-aware investment actually involves, and whether particular approaches can appropriately be referred to as relevant responses to climate change. Definitions differ, language is used inconsistently, and confusion is often the only real outcome.
- ▶ The PLSA:
 - ▶ Recommends a joint-industry/government review to examine the wide range of competing standards and definitions that currently exist, any initiatives already underway to achieve harmonisation, and to identify a framework to achieve a common language and taxonomy. The review should be established with the goal of delivering a common framework ahead of COP26 and take into account the views of employers, savers, pension schemes and intermediaries.
- ▶ **Issue 2: Addressing poor-quality climate data and information**
 - ▶ Analysis: Significant issues arise because there is little consistency in the availability of data and less in how information is presented. There are gaps in the disclosure of information by companies, especially outside the largest public companies in European markets, and there are also gaps (some, but not all, a consequence of these gaps in corporate disclosure) in the information provided by fund managers. This hinders pension funds' ability to invest intelligently for a carbon-constrained future.
- ▶ The PLSA will:
 - ▶ Encourage the government and regulators to move towards more widespread adoption of the TCFD recommendations, applying them not just to premium-listed companies but to all issuers of debt and equity, and to all major banks, asset managers and insurers.
 - ▶ Support measures to increase equivalence of climate reporting or regulatory obligations from the top to

The bottom of the investment chain, for example, by the FCA applying new duties for Authorised Fund Managers that are analogous to those placed upon Independent Governance Committees, or the recent proposal from the IFRS Foundation to consider sustainability reporting standards. In particular, we will support the proposed creation of a new Sustainability Standards Board.

► **Issue 3: Delivering greater climate expertise and education**

► Analysis: Few in the investment industry have experience in considering and dealing effectively with climate change risks and its implications for portfolios. Among others, few trustee boards and their traditional advisers have sufficient skill appropriately to address the challenges which climate change brings.

► The PLSA will:

- Encourage more industry-led ESG training and education, and encourage schemes to consider adding trustees with climate change expertise, particularly those with experience of managing the implications of climate change for investment risk and opportunity.
- Work with TPR to ensure guidance for schemes is suitable; that the Trustee Toolkit contains ESG training and that standards for professional trustees are stretching in respect of climate awareness.
- Support the FCA in working to design explicit climate (as well as stewardship, and responsible investment more generally) conduct expectations in its forthcoming regulatory regime for investment consultants.

► **Issue 4: Articulating requirements on investment managers more explicitly**

► Analysis: If pension schemes are to deliver on an intention to invest in a climate-aware fashion they need to articulate that intention clearly enough that it will be delivered by their agents, including in investment mandates, RFPs, DDQs and service level agreements – and they need to hold their agents to account for delivery against those intentions.

► The PLSA will:

- Work with the International Corporate Governance Network (ICGN) in revising

and renewing its Model Mandate.

Ensuring that the new version continues to reflect the long-term investment expectations of pension asset owners will be important, including a need to add further detail regarding the challenge of climate change.

- Produce guidance, templates and best practice material for members and trustees with regards to areas such as manager reviews, RFPs and DDQs, including with regard to climate change issues.

► **Issue 5: Enabling better climate stewardship**

► Analysis: Stewardship is a key element of the tools of a responsible investor. Exerting influence through stewardship will often be the best way to give effect to beliefs in respect of climate change.

► The PLSA will:

- Develop guidance for members on what good practice expectations ought to be with regard to stewardship services. This might form part of work in relation to the Model Mandate, or otherwise.
- Work with the investment industry and regulators to find solutions to the challenges schemes face when exercising stewardship and voting ‘rights’ in pooled funds.
- Continue to encourage schemes and managers to adopt the Stewardship Code, and to play a pro-active role in industry Stewardship groups. This will include further developing our Voting Guidelines so that they put forward additional recommended ways in which pension schemes could vote to reflect their climate change investment beliefs.

► **Issue 6: Improving supply of appropriate climate ‘products’**

► Analysis: Pension funds continue to express frustration about the investment vehicles that are in practice available to them. Among other things, there are concerns that the substantive financial characteristics of many climate-aware investment products do not suit pension fund needs.

- ▶ The PLSA will:
 - ▶ Continue to make the case to Government for the issuance of a Green Gilt by the UK Government.
 - ▶ Develop principles for asset management funds/products to adhere to on responsible investment generally, or specifically with regards to climate.

▶ **Issue 7: Communicating and explaining climate aware investment**

- ▶ Analysis: Communication to beneficiaries and stakeholders remains a challenge for the pensions industry. Delivering such communication successfully is made harder by the scale of change across financial services and wider society, as well as practical issues such as data quality issues of data quality and lack of common definitions that have been discussed earlier. One answer may be to avoid jargon altogether and simply to discuss what has been done, both in terms of integrating climate change considerations into investment decisions, and in terms of stewardship activity.

- ▶ The PLSA will:
 - ▶ Explore the feasibility of creating a Pension Quality Mark for ESG – either as a stand-alone standard or as an extended module of an enhanced PQM qualification. Such an ESG PQM would offer a way for schemes to demonstrate they are hitting certain standards around the governance of their approach to climate and responsible investment generally.
 - ▶ Build on our work on implementation statements to consider how best to support members in their communications with beneficiaries, including on climate and other ESG matters.



INTRODUCTION

THE WORLD'S BUSINESS-AS-USUAL TRAJECTORY SEEMS SET TO TAKE US BEYOND 4 DEGREES OF WARMING ABOVE PRE-INDUSTRIAL LEVELS BY 2100. SOME ESTIMATES SUGGEST THIS WOULD HAVE AN ECONOMIC COST OF THE ORDER OF MULTIPLE HUNDREDS OF TRILLION DOLLARS. THAT IS AN ALMOST UNIMAGINABLE NUMBER. BUT WITH THE ANCIENT ARCTIC TUNDRA MELTING, GREENLAND'S ICE COVER RETREATING, THE WORST FIRES IN LONGER THAN LIVING MEMORY IN THE WEST COAST OF THE US, BRAZIL AND AUSTRALIA (AMONG OTHER PLACES) AND EXTRAORDINARY LEVELS OF RAINFALL AROUND THE WORLD LEADING TO DAMAGING FLASH FLOODS – EVEN AT OUR CURRENT WARMING OF AROUND 1 DEGREE ABOVE PRE-INDUSTRIAL TIMES – WHAT WAS ONCE UNIMAGINABLE IS BECOMING ALL TOO VISIBLE.

Business as usual does not seem consistent with a sustainable planet and so something has to change – perhaps nearly everything must change. Certainly, the way that long-term investment is thought about will need to recognise the impending realities of climate change and the investment risks and opportunities that it creates. Pension schemes should be at the vanguard of that thought, but they need the support of their service providers and an appropriate context set by legislators and regulators to assist.

This is reflected in the Paris Agreement, which committed signing nation states to “Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.”

Pension schemes have often seemed first in line for making finance flows consistent in this way, perhaps because of their high profile role at the top of the investment chain, which is seen as placing them in a position to use their influence to draw good practice on climate change up through that complex chain. Certainly, much policymaker

attention has been on the pension industry, as has that of civil society players, noting the influence that individual savers may be able to wield at pension schemes.

For example, Guy Opperman MP, Minister for Pensions and Financial Inclusion, speaking at a recent pensions industry conference sent a very blunt message to trustees: *“You are responsible for your own destiny ... While the government is doing our bit, it has to be asked: what are you doing? Only the pension schemes – and other institutional investors – can direct financial flows. You might say, what about asset managers? To which, I would say, remind me, who hired the asset manager? I am looking at all of you. It’s your choice.”*

He went on: *“Some asset managers won’t support climate resolutions...If you use these people – well, then you as trustees are far from limited in what you can do. Put simply, you can fire them. You have a great deal of power.”*

Trustees certainly have influence. Yet pension schemes cannot act alone if they are to deliver the change that is necessary. They need information on which to base their decisions. They need to be able to set clear expectations and hold service providers to account against them. They need relevant skills and expertise. And they need appropriate products and vehicles through which to invest in a carbon-constrained future. The heterogeneous nature of pension schemes makes these issues still more complex: the needs of a mature DB scheme are clearly very different from those of a young DC fund in the accumulation phase. Their investment profile and attitude to risk (risk across the spectrum, including narrow financial risks as well as climate change related risks) will differ significantly, and will be reflected fully in very different asset mixes. The following table, from the PRI,¹ gives some indication of the heterogeneity and complexities of the pensions industry in the UK, and the consequences this has for governance and their approaches to sustainability:

¹ Private Retirement Systems and Sustainability: United Kingdom, <https://www.unpri.org/download?ac=10853>

TYPE OF SCHEME	PRIVATE SECTOR OCCUPATIONAL				LOCAL GOVERNMENT OCCUPATIONAL	NON- WORKPLACE PENSIONS
	DB	DC Trust	Of which, Master Trust	DC contract		
Total assets (GBP billion) [hybrid assets allocated to DB or DC as appropriate]	1,615	170 (all schemes) 71 (excluding micro- schemes)	38.5	180	341	470
Sector concentration	5,500 schemes, top 20 circa 30% of assets	2,000 schemes (excludes micro), top 150 hold 83% of assets	Top 5 circa 65% of assets	2,140 schemes 12 GPPs with IGCs 4 GPPs have circa 40% of assets	England & Wales 8 pools	25 main platforms Share of top 4 firms in individual personal pension market 46%
Service provider concentration	Top 3 asset managers > 70% of institutional pension assets Top 2 investment consultants > 40% of market Top 5 fiduciary managers > 70% of market					
Regulator FCA	TPR	TPR	TPR	FCA	Ministry/ Directorate TPR for governance and administration	FCA
Governance structures	Trustee	Trustee	Trustee	Independent Governance Committee	Local administering authorities/pension boards	
Asset allocation	Equity 24% Bonds 63% Property 5% Hedge funds 7% Other 5% Cash 4%	10 years to retirement Equity 42% DGF 47% Managed/ balanced 4% Bonds 6% Other 1%	10 years to retirement Equity 51% DGF 9% Managed/ balanced 22% Bonds 14% Other 4%	10 years to retirement Equity 37% DGF 22% Managed/ balanced 25% Bonds 12% Other 4%	Equity 62% Fixed income 22% Cash 1% Property 8% Other 7%	
	No regulatory barriers Smaller schemes lack capability/resource					Lack of participant engagement, focus on simplicity
Key barriers to system sustainability	Focus on solvency, de-risking		Focus on cost especially in default Implementation e.g. liquidity, platforms, passive strategies			

Hence our effort to understand what are the barriers hindering schemes from acting more rapidly, and what the PLSA and other players can do to assist progress to be made. This paper discusses ways in which the PLSA might assist pension schemes to respond to the challenge of climate change, and ways in which the overall investment system might be altered to enable this to happen.

The PLSA is unique in having its membership drawn from across the full investment chain. Together with our own analysis, conversations with experts and so on, we worked in 2020 to speak to the full breadth of our membership, to find out the challenges they face, explore further how different schemes tackle climate investment, and consider possible solutions. We held a series of Climate Roundtables, mounted a Call for Evidence and commissioned a survey (our survey) in partnership with CACEIS. This report draws together what we have learned through this process, discussing in depth the 7 key issues that we have identified in relation to pension schemes and climate aware investment. For each issue it offers a range of potential solutions and then sets out a focused set of “Recommendations for Action” to policymakers and our industry.

We are ready to step forwards on this necessary journey. We would welcome your support and company on that journey.

PENSION FUNDS AND THE CLIMATE INVESTMENT CHALLENGE

WHILE THE PHYSICAL DOWNSIDES OF CLIMATE CHANGE ALREADY MAY TO BE BEING FELT IN MANY PARTS OF THE WORLD (FIRES IN CALIFORNIA, BRAZIL AND AUSTRALIA AMONG OTHER PLACES; INTENSE RAINFALL LEADING TO FLASH FLOODS AROUND THE WORLD; RISING SEA LEVELS RISKING COASTAL INFRASTRUCTURE AND PROPERTY), THE ISSUE IS STILL SEEN AS A MEDIUM- TO LONG-TERM RISK. CERTAINLY, UNLESS CO2 EMISSIONS ARE RESTRICTED AND PERHAPS REVERSED IN THE FUTURE THESE PHYSICAL IMPACTS WILL ONLY WORSEN.²

The immediate and growing risks are financial: climate impacts have already caused physical damage to property and infrastructure, reducing property values, disrupting logistics and communications and infrastructure, creating additional insurance burdens. Further, the risks of the transition to a lower carbon economy that the science urges on us will also have significant financial implications: some current assets will become obsolete, other investment opportunities will blossom. If these changes are planned for they will cause less financial disruption, but the longer change is resisted the more disorderly the shift may become. An investor conscious of fiduciary duty to beneficiaries will need to keep these risks in mind when investing, particularly when investing for the medium- to long-term.

Given that it is perceived to be a medium- to long-term risk, it is typical of the issues that pension scheme investors need to worry about. The risks will cause financial impacts over the life of pension scheme investments and yet they are not usually factored in to a financial system that tends to assume business as usual will persist into the future and focuses more on short-term risks. The world cannot sustain the current “business as usual” – there needs to be a transition to another less carbon-intensive economy, with all the financial implications that go with that. Pension schemes need to invest and influence conscious of the changes that are likely to happen over their investment horizon.

Because pension fund time horizons are typically longer than those of other participants in the investment chain, the issues of climate change are more pertinent for schemes than for the range of investment intermediaries with which they tend to operate – though government action and regulatory change is bringing the impacts of climate change more into the immediate future. This leads pension schemes sometimes to believe that the products and services they are offered by their service providers do not fulfil all of their needs. It also means that perhaps a disproportionate level of regulatory and political attention is focused on pension schemes in the expectation that their long-term focus and their influence on the investment chain can help align the system into a more long-term mind-set. Trustees are not always convinced that they can influence the entire investment chain in this way, not least because the small scale of many pension schemes can limit their influence. Further, the closure of DB schemes and the maturity of many of the pension schemes that were formerly significant owners of UK equities has led to pension funds moving much of their investment portfolios into fixed income and real assets, so that they now hold only 2.4% of UK shares (discussed further below).

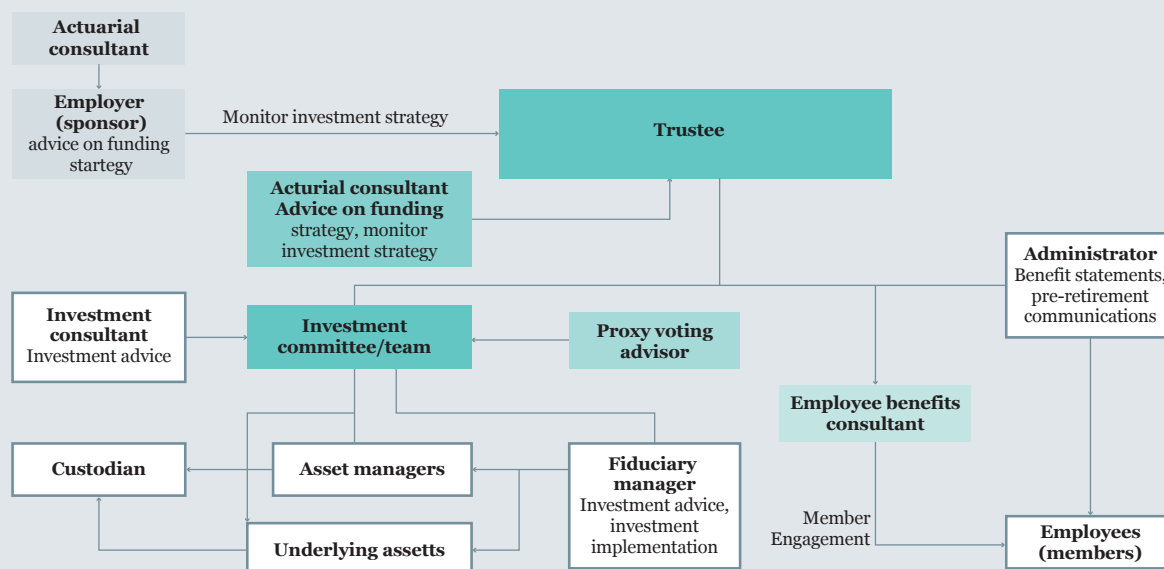
THE INTERMEDIATED INVESTMENT CHAIN

Pension schemes operate as fiduciaries directly on behalf of the underlying savers and (where relevant) on behalf of the sponsoring employer. They are therefore at the top end of the investment chain and in theory can influence how the whole investment chain operates. That theory is challenged, however, given the heavily intermediated nature of the investment chain, which places a number of service providers and legal entities between the pension fund and the underlying asset in which it invests (a company in the case of equity or corporate bond investment, but other assets depending on the asset class), and it is also challenged by the fact that the scale of some of those intermediaries is significantly greater than many pension schemes.

² <https://www.un.org/en/climatechange/science/key-findings>

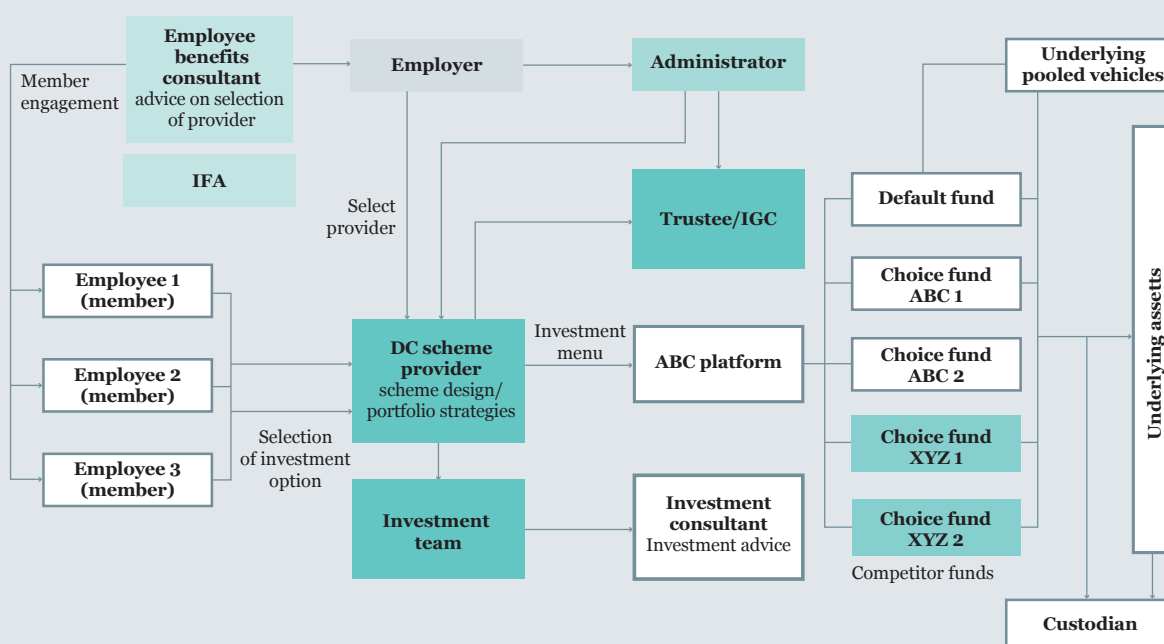
The following charts, from the PRI publication *Private Retirement Systems and Sustainability: United Kingdom*³, give an indication of the complexity of the intermediated investment chain for both DB and DC pensions:

DB GOVERNANCE AND VALUE CHAIN



As there is no straight line from the trustee to the assets, there is a risk that stewardship activity gets “lost” if trustees are not vigilant. Trustees may believe that their consultants, investment team (or investment sub-committee if they have one), asset managers, or custodian is carrying out this activity for them.

DC GOVERNANCE AND VALUE CHAIN



³ See <https://www.unpri.org/download?ac=10853>

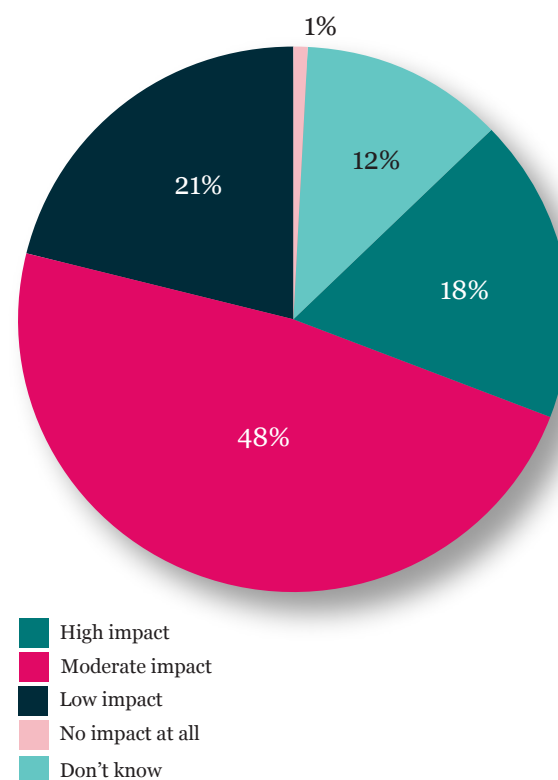
This intermediation and the market dynamics mean that rather than pension funds believing that they can dictate terms and shape investment to suit their needs, they can on occasions believe that they are takers or will be takers of terms and investment styles. Certainly, investment managers often make clear the benefits of economies of scale are available should pension funds accept standard products and practices, and suggest that more bespoke services may require greater fee levels. Given pension schemes' fiduciary duty to deliver value for money, such negotiations can lead to a decision to accept the standard product at a price that is less than would be charged for other services. Such considerations will also factor in the reality that a manager is unlikely to be a perfect match across all elements of service and any agreement is likely to be subject to some compromises.

The different levels of intermediation between the pension scheme and the underlying investments can often also mean that long-term investment intentions become translated through the system as shorter-term signals. An investment consultant that believes it may be replaced if its recommendations underperform over a multi-year time horizon may place pressure on the fund managers it chooses to perform over a time horizon that is shorter than this. Those fund managers, fearing that they may be replaced if their performance does not improve, may then put pressure on the managers and boards of invested assets to deliver performance over still shorter time-horizons. Thus, even considering only three levels of intermediation the pressure for shorter-term performance can intensify rapidly. At the same time, longer-term messages such as the need to consider the potential for downsides from climate change will tend to become less clear as more intermediaries become involved.

Pension schemes thus need to work hard to ensure that their investment beliefs, strategy and medium-to long-term perspective is properly reflected in the investment approach of their service providers throughout the complex investment chain.

The desire is there: the survey reveals a strongly shared view that climate change will have an impact on pension scheme investments, with only 1% of respondents believing there will be no impact at all. The challenge is to respond appropriately to that desire, and aligning the investment chain to respond appropriately to that desire:

LEVEL OF IMPACT ON SCHEME'S INVESTMENTS



PLSA/CACEIS

ROLE OF PENSION FUNDS IN RELATION TO CLIMATE CHANGE

The main aims of pension funds in relation to the challenge of a changing climate must be to manage and mitigate the financial implications of the physical impacts of change, and to position portfolios effectively for the transition to a less carbon-intensive economy. Investing in a climate-aware way means exactly this: positioning for the expected future and to limit damage in the short- and medium-term. Their role is not to change corporate behaviour or financial systems for their own sake, but in order to enable pension schemes to invest in ways that give the best chance of delivering on the pension promise to beneficiaries.

This was the conclusion of the Law Commission in its 2014 report on the Fiduciary Duties of Investment Intermediaries: that incorporating material ESG factors is in beneficiaries' best interests because it helps deliver stronger long-term returns, and limit downside risks.⁴ It is not an aim in itself, but a way of delivering effectively for beneficiaries. The Law Commission's thinking was reflected in 2018 changes to the Occupational

⁴ Law Commission at <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>

Pension Scheme (Investment) Regulations, not because the Commission thought change was needed but rather because it was believed the reforms might deliver positive behavioural change.

Expecting UK pension funds on their own to deliver climate change-preparedness at UK-listed companies does not make sense. That is the case not least because the Office for National Statistics analysis⁵ of the ownership of the £1.88 trillion value of UK quoted companies reveals that pension funds own only 2.4% of all shares. This compares to 4% owned by insurance companies and 13.5% owned by individuals – and nearly 55% ownership by foreign investors. Pension funds' influence through bond ownership may be somewhat greater than this: UK insurers and pension schemes together hold £70 billion of the UK corporate bond market – a share of 32%, though this is down from 60% in 2000 (OECD 2020).⁶

PENSION FUNDS IN THE REGULATORY CONTEXT FOR CLIMATE INVESTING

Much of the regulatory attention has been focused on pension funds. To take one example, current proposals see the recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD) being applied to pension schemes from October 2021. It will be hard for pension schemes to deliver such reporting with full confidence unless they themselves receive appropriate reporting from their service providers and from the underlying companies in which they invest, and yet there are no current plans to require TCFD reporting from fund managers, unless they are premium-listed companies on the London Stock Exchange. Such companies are to be asked to respond to TCFD on a comply or explain basis from the start of 2021, but clearly this represents only a small portion of the underlying investments in pension scheme public equity portfolios, let alone across all asset classes.

There is a clear aspiration that pension funds will be able to insist on better disclosure and reporting by their service providers and their investments. However, this may be harder to deliver than assumed given the intermediated nature of the investment chain and the limited scale of most pension funds. Unless regulatory expectations are applied across the investment chain it may be harder to achieve the concrete changes that are sought.

Thus, what schemes need now – and what would be most likely to deliver concrete change as quickly

as possible – is that the policy and regulatory frameworks for fund managers, consultants and other service providers to pension schemes should be aligned with the expectations for pension schemes. This will help ensure that trustees have the right information and the best possible opportunity to make effective climate investment decisions.

WAYS FORWARD FOR UK PENSION SCHEMES

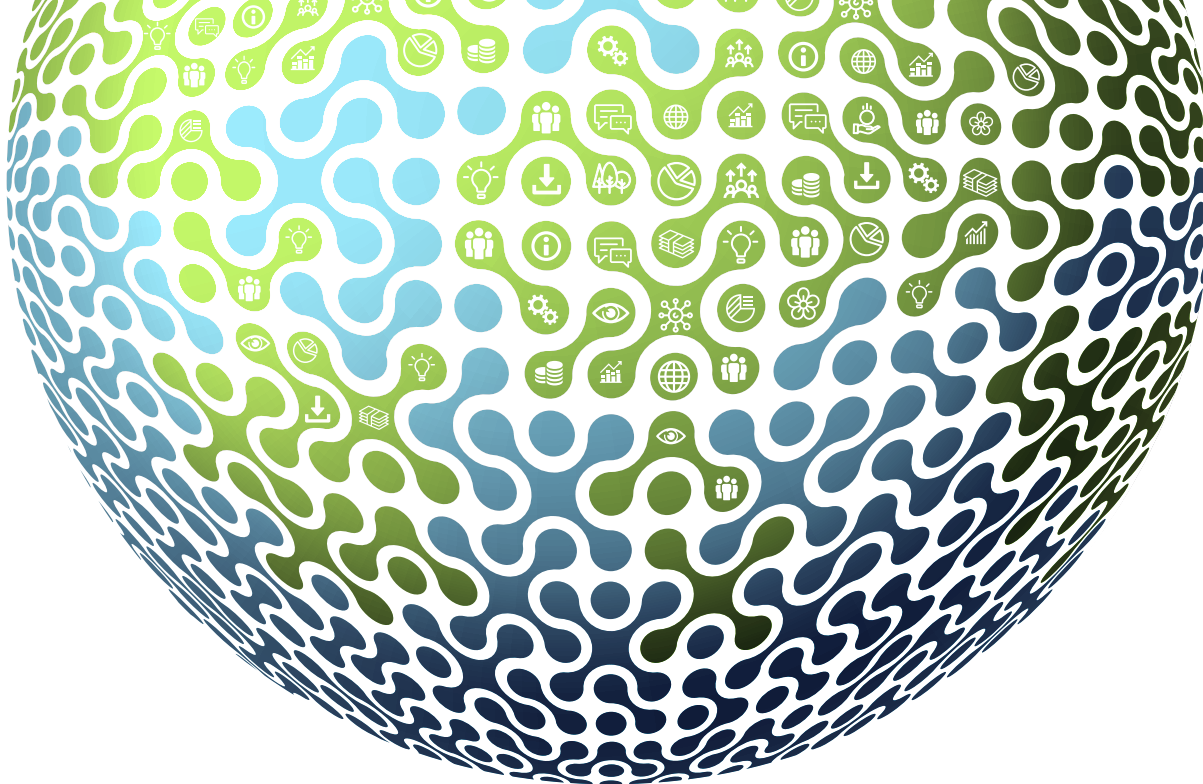
This report therefore develops some concrete recommendations for how the PLSA and others can further assist its members with the climate change investment challenge, and also recommendations for changes that could be made to the regime for other parties in the investment chain. Together, the aim is that the investment industry as a whole can move forward collectively in addressing the challenge of climate change-aware investment.

To inform this report we mounted a call for evidence and held a series of roundtables of key representatives of our members to hear their concerns and understand their ideas about the best ways forward to enable the pension fund industry more fully to respond to the challenge of investing in a climate-aware way. We offered an initial analysis of the main barriers and issues and gained general consensus that this analysis was right. There is a real desire to do more in terms of more effectively investing appropriately in response to climate change, but there is considerable confusion about the practicalities, not helped by the inconsistent use of language across the industry and perceived risks of greenwash from some market participants.

While some schemes have been rightly commended for their proactive stances with regard to ESG and climate, several schemes have found themselves criticised, in ways many find unfair, for being perceived to be behind in this area – or to be behind in their articulation of their approach to the area. Much regulatory and non regulatory change is happening rapidly and in quick succession, which adds pressure on the limited governance bandwidth of schemes, and also adds to the pressure they place on their advisers (which also have bandwidth and expertise challenges). It was acknowledged that having perceived climate change experts or advocates among the trustees (more likely to be the case at the larger schemes) makes it easier to deliver change.

⁵ Ownership of UK quoted shares 2018 <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2018>

⁶ <http://www.oecd.org/corporate/ca/Corporate-Bond-Market-Trends-Emerging-Risks-Monetary-Policy.pdf>



A particular focus of discussions was the provision of services by fund managers. There is some frustration about the availability of quality products across the asset classes, particularly ones that offer both climate change awareness and appropriate financial characteristics. Communications is also a significant area of concern, both in terms of a need for more standardised reporting from managers, so that pension schemes can better compare and contrast their climate performance as well as their financial performance. Pension schemes are also eager for support in terms of model requests for proposal (RFPs), communications and reporting to beneficiaries.

All of these areas are discussed in more detail below, and the PLSA offers potential solutions and a series of recommendations aimed at helping to address some of the key challenges our industry faces. We recognise the scale of the challenge posed by climate change, and the risk it poses to investment portfolios and long-term beneficiary well-being; we believe that pension schemes are more than ready to play their part in addressing it, alongside other members of the investment chain, regulators and legislators.

ISSUE 1 | CLARIFYING DEFINITIONS OF 'CLIMATE-AWARE'

THIS SECTION IDENTIFIES ISSUES WITH THE LACK OF CLARITY AROUND: WHAT 'CLIMATE-AWARE INVESTMENT' REALLY IS; WHAT A PORTFOLIO ALIGNED WITH THE GOALS OF THE PARIS AGREEMENT MIGHT LOOK LIKE – AND HOW IT MIGHT BE MEASURED; AND THE DIFFERENT LANGUAGE AND STANDARDS USED BY DIFFERENT INDUSTRY PARTICIPANTS.

THERE IS SUBSTANTIAL CONFUSION ABOUT WHAT CLIMATE-AWARE INVESTMENT ACTUALLY INVOLVES, AND WHETHER PARTICULAR APPROACHES CAN APPROPRIATELY BE REFERRED TO AS RELEVANT RESPONSES TO CLIMATE CHANGE. DEFINITIONS DIFFER, LANGUAGE IS USED INCONSISTENTLY, AND CONFUSION IS OFTEN THE ONLY REAL OUTCOME.

Dialogue with PLSA members, including at our specially-convened roundtable meetings, revealed differences of understanding of what climate-aware investment actually involves, and whether particular approaches can appropriately be referred to as relevant responses to climate change. There are multiple different ways of describing climate-aware investment approaches, and the same words are used to mean different things by different investment providers. This is in spite of a range of initiatives seeking to provide definitions and models for framing an understanding of climate-aware investment risks and opportunities – though the fact that there are such a number of different initiatives, each with its own alphabetic abbreviation, itself may add to the confusion.

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

- ▶ **For there to be fully informed investment decision-making, in an ideal world there would be shared understanding of key terms.**

The mere fact that there is such a range of terms for investment in this area is evidence of the problem: ESG investment, sustainable investment, responsible investment, socially responsible investment or impact investment. The fact that a given practitioner may be able to distinguish between these terms does nothing to help other practitioners let alone 'the ordinary beneficiary. Moving towards some shared understanding would enable every participant in the investment chain to be fully informed about what they were exposed to and benefiting from.

- ▶ **The industry recognises that this is an issue and there have therefore been several different initiatives to try to agree definitions.**

These initiatives have included the following:

- ▶ **The EU Sustainable Investment Taxonomy**, of which the first part to come into effect, in December 2021, is required disclosures with regard to activities that substantially contribute to climate change mitigation and adaptation.⁷
- ▶ **The British Standards Institute Sustainable Finance Standardization Programme**, which includes an intended specification on responsible and sustainable investment management, aiming to provide standards for establishing, implementing and managing the process of integrating ESG and sustainability considerations into fund management.
- ▶ **The Investment Association Responsible Investment Framework**, which seeks to provide clear differentiation between

⁷ The UNPRI has recently published case studies utilising the Taxonomy. <https://www.unpri.org/eu-taxonomy-alignment-case-studies/testing-the-taxonomy-insights-from-the-pri-taxonomy-practitioners-group/6409.article>

what is delivered firm-wide and what at the individual fund level, and to provide transparency over the nature of the promise made by each fund in relation to exclusions, sustainability focus, impact investing, ESG integration and stewardship.

- ▶ **The CFA Institute is consulting on an ESG Disclosure Standard for Investment Products**, which the Institute intends to issue in May 2021. This also attempts to align terminology and definitions as well as setting out defined disclosure standards for different styles of investment fund.

There are also a number of investor-led initiatives specifically on climate change aiming to assist the investment community to understand climate risks and opportunities more fully and so to invest on the basis of greater information. Among them are:

- ▶ **The Transition Pathway Initiative**, which aggregates and compares information on the climate change approaches of different companies within individual sectors, indicating whether they are close to delivering a trajectory consistent with Paris Agreement goals.
- ▶ **The Climate Disclosure Standards Board (CDSB)**, which has developed a framework for reporting companies to prepare and present environmental information, particularly that related to climate change, in their mainstream reporting to the investment community.
- ▶ **The IIGCC Net Zero framework**. The Institutional Investor Group on Climate Change (IIGCC) has developed this blueprint for investors to help them shape their progress towards net zero carbon investment, including actions, methods and metrics (at the time of writing, this draft framework is out for consultation).
- ▶ **CDP**, which provides detailed insight into the environmental footprints of individual companies. Formerly known as the Carbon Disclosure Project, the principal area of information provided is carbon emissions.
- ▶ Although these initiatives are positive steps to achieve clarity, the fact that there are so many of them, rather than a single one, is adding to the confusion. It is a further sign of the risk of **an increasingly dense “alphabet soup” that runs the risk of exacerbating the confusion.**

In addition to the CDSB and CDP initiatives mentioned above, there are a range of reporting standard-setters and commercial analysis providers, including: the Corporate Reporting Dialogue (CRD), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC), the Sustainability Accounting Standards Board (SASB), the Task Force on Climate-related Financial Disclosures (TCFD); and Morningstar, MSCI and Sustainalytics. These are in addition to the FASB (Federal Accounting Standards Board) and IASB (International Accounting Standards Board), which set the official financial reporting standards for the US and the bulk of the rest of the world respectively.

The IFRS Foundation, which oversees the IASB, has just proposed to consider sustainability reporting standards, and suggested that it should create a Sustainability Standards Board. While this might be seen as just a further addition to the alphabet soup, the SSB may be a mechanism to rationalise and simplify the current range of approaches, just as the IASB has substituted a single global set of accounting standards for the prior confusion of national and regional standards.

Moreover, it is perhaps inevitable that limited engagement from many participants may lead to shorthand assumptions about what certain words mean, especially as the terminology has changed markedly over time.

RECOMMENDATION

The PLSA recommends a joint-industry/government review to examine the wide range of competing standards and definitions that currently exist, any initiatives already underway to achieve harmonisation, and to identify a framework to achieve a common language and taxonomy. The review should be established with the goal of delivering a common framework ahead of COP26 and take into account the views of employers, savers, pension schemes and intermediaries.

ISSUE 2 | ADDRESSING POOR-QUALITY CLIMATE DATA AND INFORMATION INVESTMENT

THIS SECTION DISCUSSES THE CHALLENGE THAT ARISES FROM THE LACK OF CLEAR, CONSISTENT AND COMPARABLE DATA TRANSPARENCY ON CLIMATE MATTERS FROM PARTICIPANTS ACROSS THE INVESTMENT CHAIN. THIS INCLUDES THE INFORMATION PRESENTED TO TRUSTEES BY THEIR MANAGERS (AND THEIR INVESTMENT CONSULTANTS, WHERE THE CONSULTANT IS SCORING MANAGERS ON THEIR CLIMATE INVESTMENT APPROACHES), AS WELL AS THE INFORMATION PROVIDED BY COMPANIES TO INVESTORS.

THIS LACK OF CONSISTENT TRANSPARENCY MAKES AGGREGATION OF DATA ACROSS PORTFOLIOS DIFFICULT IF NOT IMPOSSIBLE, AND INCREASES THE CHALLENGE INVOLVED IN ATTEMPTS TO COMPARE EXISTING OR POTENTIAL SERVICE PROVIDERS.

In order to invest intelligently for a carbon-constrained future, pension schemes need consistent and reliable information on the climate risks and opportunities of funds and of the underlying assets in which they invest (whether that is companies or other assets). Significant issues arise, therefore, because there is little consistency in the availability of data and less in how information is presented.

These issues start at the level of individual companies (and other assets), many of which make limited climate-related disclosures at most. There are services which provide calculated values based on a range of assumptions to fill these gaps in disclosure. The inevitable inaccuracies that arise from these interpolated numbers are then built upon further in analyses of fund manager

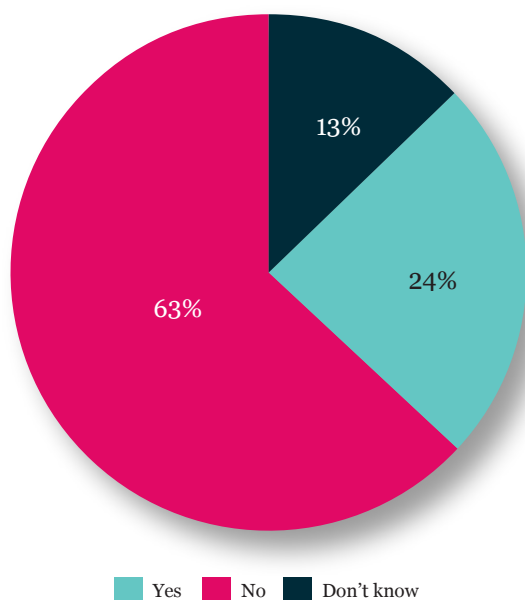
portfolios and associated ratings. Given that the quality of disclosure provided by companies themselves varies dramatically around the world, the levels of assumption and associated errors also vary dramatically. This can mean that (for example) the data for emerging markets portfolios will inevitably be worse than that for holdings only in larger European companies. Private companies are also much less likely to disclose data themselves than those on the public markets.

As the Pensions Climate Risk Industry Group (PCRIG) guidance on pension scheme reporting against TCFD says: “It is recognised that data needs to come not just from the asset manager but from listed companies, real-asset holders and national governments. This can be hard to solicit. In such an event, however, trustees can request that service providers analyse their funds using market average techniques and assumption-based modelling.” Unless gaps in reporting are filled, all schemes will be challenged in their own reporting; that will be especially true for broadly diversified pension schemes, with private assets and holdings in markets where reporting is less well developed.

In combination, the best available information for pension schemes is based on many assumptions and extrapolated numbers. Making concrete decisions in the absence of concrete information is a major challenge, and it will also prove difficult for pension schemes themselves to report transparently to their beneficiaries in the absence of clear and reliable data. So, simply, the available data needs to improve. Not least as regulatory reporting burdens are arriving for pension schemes – it would be welcome if disclosure requirements and their timing could be aligned throughout the investment chain such that pension schemes can fulfil what is being asked of them.

At present, pension schemes do not believe that they have the information they need to make decisions. That was one of the clear conclusions of *our survey*.

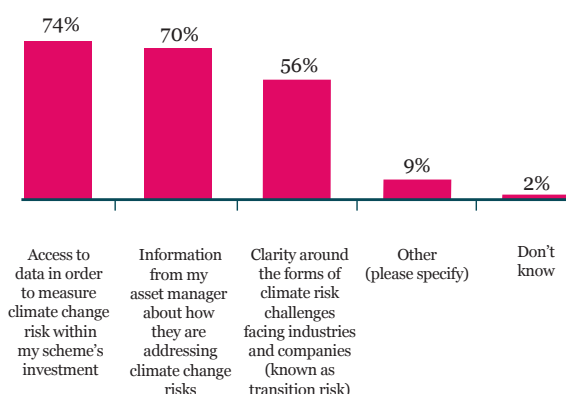
DO YOU HAVE SUFFICIENT INFORMATION TO BE ABLE TO TRANSLATE CLIMATE CHANGE RISKS INTO YOUR SCHEME'S INVESTMENTS?



PLSA/CACEIS

The information that pension funds believe is needed arises across the whole investment chain (portfolio-wide, fund managers, and underlying companies/investments):

INFORMATION REQUIRED



PLSA/CACEIS

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

It is clear that all **investors – including pension schemes, asset managers and beneficiaries – need standardised and comparable information in order to invest for the future with confidence**. This need applies to much responsible investment data, but perhaps particularly to climate change-related matters given the scale of the apparent challenges to business as usual that may arise from the transition to a less carbon-intensive world. In the absence of better data and better information it will continue to be difficult for investors to make the right forward-looking investment decisions.

Some 60% of attendees at the TCFD Plenary session at PLSA's 2020 Investment Conference said that they believe poor quality information from asset managers is the biggest barrier to climate-aware investment. Asset owners are frustrated that managers use different metrics, weightings and approaches to engagement, not all of which are transparent from the outside; and that consultants and agencies use different and often not fully transparent methodologies and weightings to 'score' managers and funds on their approaches to climate change and responsible investment more generally.

Members participating at our roundtables also recognised this as a significant issue at the company reporting level. As one put it: "various companies have such a wide range of environmental footprints that it is very difficult to measure and compare them".

It is thus welcome that **TCFD is becoming mainstream** (reporting according to the guidance of the Task Force on Climate-related Financial Disclosures). The DWP has proposed that larger pension schemes be required to report according to TCFD standards (with rollout to smaller schemes potentially to follow after a review), which will prove a challenge while the industry's agents and suppliers do not face the same obligation.

While the FCA has proposed that all premium-listed companies should report according to TCFD, this will only be on a comply or explain basis, and clearly not all investments or suppliers to pension schemes are premium-listed companies. In particular, few FCA-regulated asset managers would be caught by

this proposed rule.⁸ Yet their market impact would be significant, and their participation in reporting against TCFD would enable other parties to do so more easily as well. Disclosure by private markets investments remains poor, and requirements should be extended not just to public companies (particularly as pension fund disclosure expectations cover portfolios as a whole).

We note that New Zealand recently became the first country to move to mandate TCFD reporting by all sizeable banks, asset managers and insurance companies, and all issuers of equity or debt on the country's public markets.

- It is also welcome that the IASB, which sets accounting standards for the bulk of the world outside the US, recently published a paper setting out how **material climate change issues are fully embedded in its IFRS standards**. This sets a firm foundation for companies to disclose more fully and effectively their climate change impacts in their financial statements, not least because the IASB paper expects that the key underlying assumptions on climate-related factors will need to be disclosed. The paper also provides a more solid basis for auditors to challenge reporting companies about the quality of their reporting, and whether the assumptions that they have chosen to use are appropriate.

Such disclosure should make it more possible for investors to understand individual company dynamics in relation to climate, and also to seek to recalculate financial performance using assumptions that they regard as more consistent with climate sustainability. This should enable more climate-aware investment decisions.

- Greater reporting and **visibility of climate-related matters appears to be of particular importance to beneficiaries**, including DC savers. For example, according to the Franklin Templeton *Power of Emotions* report, climate change is the single most powerful opportunity to build beneficiary engagement: it is the sole issue to be mentioned by more than half of all respondents.

If these consumers have confidence in the nature of, and consistency of information from, so-called 'green' and 'sustainable' retail funds (and DC offerings) there is a significant

opportunity for incremental retail savings and consequential further security in retirement. Settled definitions and standard forms of disclosure might help build confidence and allow greater comparability. A failure to engage with beneficiaries on these issues is likely to damage perceptions of the approach and general trustworthiness of the pension provider.

There is potentially a further opportunity here as well as consolidation gathers pace. One key way in which leading master trusts, insurers or superfunds might seek to differentiate themselves is through a fully worked through and articulated approach to climate change and responsible investment generally. This could prove an important element of the attractions of such consolidators to sponsoring employers and to their underlying beneficiaries. At present, however, there appears to be insufficiently clear differentiation in this area for this to form an appropriate deciding factor.

RECOMMENDATIONS

The PLSA will:

- Encourage the government and regulators to move towards more widespread adoption of the TCFD recommendations, applying them not just to premium-listed companies but to all issuers of debt and equity, and to all major banks, asset managers and insurers.
- Support measures to increase equivalence of climate reporting or regulatory obligations from the top to the bottom of the investment chain, for example, by the FCA applying new duties for Authorised Fund Managers that are analogous to those placed upon Independent Governance Committees, or the recent proposal from the IFRS Foundation to consider sustainability reporting standards. In particular, we will support the proposed creation of a new Sustainability Standards Board.

⁸ Some limited best practice guidance on reporting is provided to fund managers and other financial market participants in the Climate Financial Risk Forum's *Guide 2020: Disclosures Chapter*

ISSUE 3 | DELIVERING GREATER CLIMATE EXPERTISE AND EDUCATION

CLIMATE INVESTMENT IS COMPLEX AND SCHEMES HAVE LIMITED GOVERNANCE BUDGETS AND TIME. PLSA MEMBERS TELL US THAT SOME OF THE ADVICE THEY RECEIVE FROM THEIR ADVISERS IS POOR. COMPANIES' OWN ADVISERS DO NOT SUFFICIENTLY UNDERSTAND HOW TO INTEGRATE CLIMATE RISK INTO BALANCE SHEET ASSESSMENTS.

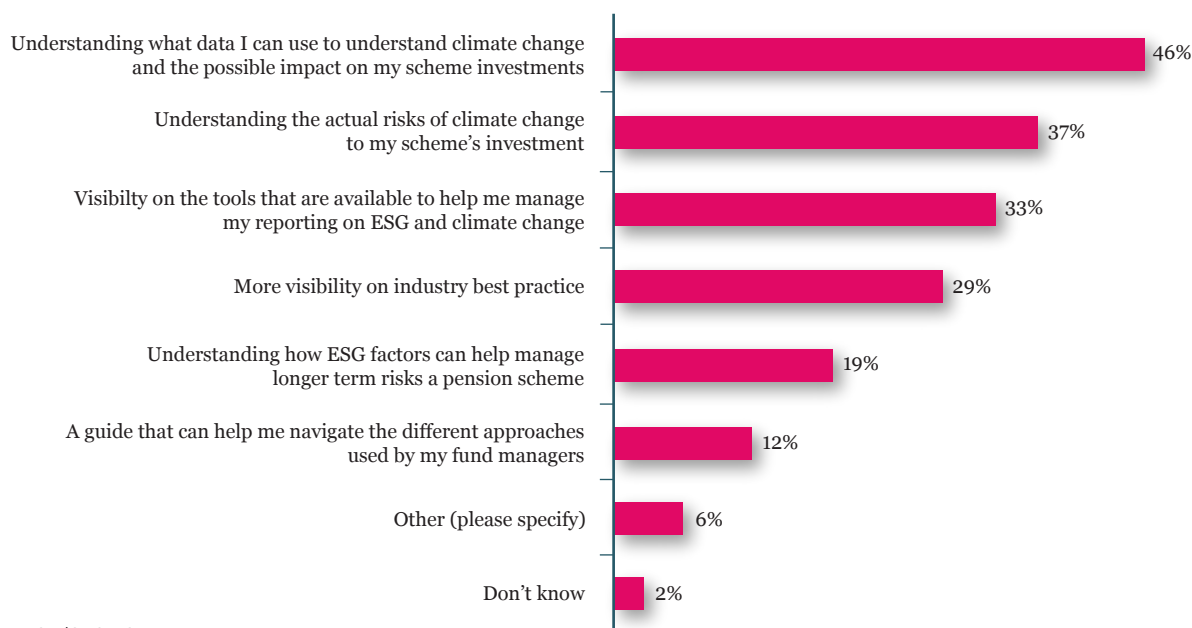
THIS APPARENT LACK OF EXPERTISE AND SKILL MAY MAKE IT HARDER FOR PENSION SCHEMES TO CHALLENGE THE INFORMATION THAT THEY RECEIVE FROM THEIR SERVICE PROVIDERS, INCLUDING INVESTMENT CONSULTANTS AND FUND MANAGERS, AND MAY ON OCCASIONS LEAD TO SUB-OPTIMAL DECISION-MAKING. FILLING GAPS IN TRAINING AND EXPERTISE MAY INCREASE THE CHANCE OF BETTER LONG-TERM DECISIONS.

Climate change is a risk whose financial impacts have only begun to be properly recognised in the last few years. Therefore, few in the investment industry, particularly those at senior levels, have experience in considering and dealing effectively with climate change risks and its implications for portfolios. Thus, few trustee boards and their traditional advisers have sufficient skill appropriately to address the challenges which climate change brings.

These gaps in experience bring risks that trustees may insufficiently challenge themselves and their service providers in relation to climate change matters. This may hamper the quality of debate among trustees and so may lead to sub-optimal decisions. There is a risk that these gaps are more prevalent on smaller boards with less access to outside advice.

Our survey reveals that there is a significant breadth to the gaps in knowledge that pension industry participants believe need to be filled:

LARGEST ESG AND CLIMATE CHANGE KNOWLEDGE GAPS



PLSA/CACEIS

To limit these gaps, the level of skill and expertise on boards and among advisers should be enhanced. This can be achieved in two principal ways: hiring more people with the requisite skills already, and seeking training for the existing trustees, or at least a sufficient number of them so that debate can be enhanced. Having one ‘expert’ on a board may amount to a step forward, but risks limiting debate rather than enhancing it.

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

- ▶ “There is a **huge skills gap relating to ESG**,” said one participant at a roundtable, worrying that this may lead to failures to address broad challenges as well as climate-specific issues. “No consideration has been given by the government to build the skills to develop policies to achieve net zero.”

In the absence of the appropriate skills to address the challenges that schemes face, it will be hard to take decisions in the most effective way and with optimal outcomes. While the roundtable participant noted a lack of government action, the first responsibility must sit with the trustee boards themselves to seek out the skills and resources that they need in order effectively to deliver on their fiduciary duties.

Pension schemes always look to their investment consultants for support and advice in challenging areas, indeed they are required by law⁹ to take expert advice on investment

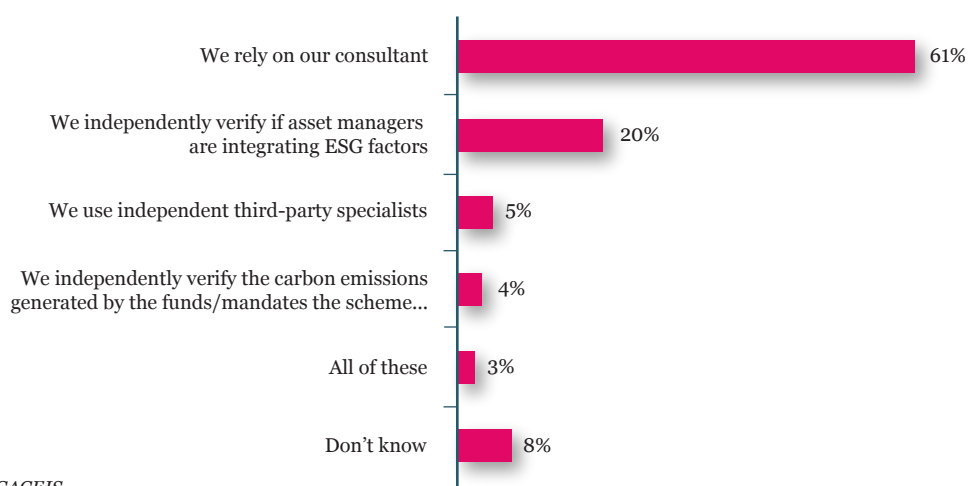
matters. It is therefore welcome that the 12 leading consultancy firms have now established the Investment Consultants Sustainability Working Group with the aim of supporting an improvement in sustainable investment practice across the industry.

- ▶ This is exacerbated by associated challenges around time availability and other resourcing. Board time is inevitably always a restricted resource and like all limited resources must be used wisely. **Schemes have limited governance budgets** and time, and thus need to find efficient and effective ways to hold their service providers to account – not least when asset managers, investment consultants¹⁰, companies, auditors and legal advisers are all rapidly seeking to add to their own skill base¹¹ on responsible investment.

The need for change is amply shown by the Sackers ESG survey last year revealing that 33% of surveyed trustees believed that the lack of time or appropriate resource was proving a material obstacle to implementing ESG policies in pension fund investing. While there is much going on across a whole range of issues, our industry should be doing better.

The need for investment consultants to be fully engaged in climate change issues is emphasised by the weight that pension funds place on their advice in this respect. The PLSA/CACEIS survey reveals that they are seen as by far the leading source of advice and support:

MAIN FOCUS FOR DEMONSTRATING THE IMPACT OF ESG AND/OR CLIMATE CHANGE ON PENSION SCHEME



PLSA/CACEIS

⁹ The Pensions Act 1995

¹⁰ The Principles for Responsible Investment (PRI)'s 2018 *Investment Consultant Services Review* found that “very little, if anything at all, is being taught [on RI] within the education syllabus and qualification processes for key professional examines in the sector.” Their research also found that “clients’ ability to access ESG related information and expertise is critically dependent on the individual consultants who manage the client relationship...the extent to which ESG issues are raised and discussed with clients is generally at the discretion of the relevant field consultant.”

¹¹ See, for example, *Asset managers engage in ESG ‘war for talent’* (Financial Times, June 16 2018).

- ▶ There is **significant and growing training support for pension fund trustees and the wider investment industry**. Not least, professional and industry bodies are seeking to fill the current gaps:
 - ▶ The PLSA itself has significant body of work, including dedicated sessions at our Conferences and also our practical guides, most notably *More Light, Less Heat* from 2017 and a range of broader ESG publications, as well as our Made Simple Guides, including those on Climate Indexes and ESG (see appendix).
 - ▶ The Institute and Faculty of Actuaries has produced a series of guides aimed at supporting actuaries on climate change issues, including *Climate Risk: A Practical Guide for Actuaries working in Defined Contribution Pensions*, *Climate Scenario Analysis for Pension Schemes: A UK Case Study*, *A Practical Guide to Climate Change for Life Actuaries*, *a Practical Guide to Climate Change for GI Practitioners*, as well as more general environment-related publications.
 - ▶ In a similar way, the International Actuarial Association launched a series of publications on climate with the release in September 2020 of *Importance of Climate-Related Risks for Actuaries*.
 - ▶ The CFA Society of the UK has successfully launched its first ESG qualification for investment professionals, of which climate is an important element of a broader course, and just released an expanded and updated edition of the training manual. The take-up of this course has been high, stronger than expected, and the model is being adopted by other CFA societies around Europe.
 - ▶ The ICAEW (Institute of Chartered Accountants of England and Wales) is also developing a suite of resources and training, supporting members in practice and on boards to understand and respond to the climate challenge.

The Sackers ESG survey reports that 74% of trustee boards have undertaken, or will undertake, trustee training on ESG – though this datapoint does not make clear what proportion have actually done so, or only have plans to do so. It is also not clear whether this training is climate-change specific or ESG more generally, nor whether trustees feel that this

appetite for training is yet being satisfactorily satisfied.

- ▶ There is a danger with **specialist courses and training on responsible investment matters or climate-related risks in that it can become** narrow and focused solely on the issues themselves. The most successful training will marry with traditional investment understanding and consider climate as a set of financial and operational risks alongside others. The more it is considered as part of the general approach to risk and opportunity, the more likely it will be appropriately assimilated into investment decision-making.

At the same time, there is a risk that the level of the public debate on climate investment becomes too binary and assumes that there is only one appropriate response to the challenges of climate change. Given that climate risks are best approached as a range of scenarios, and investment considered in the light of those different scenarios, having an understanding of the range of possible outcomes is more likely to lead to investment success. Dealing with the uncertainty through a range of acceptable responses remains the logical response.

- ▶ Training may not be enough. Board dynamics and thought processes will always depend as much on the individuals who sit around the table, and **therefore willingness to engage with climate depends on trustee board make-up**, and should be part of good governance and the diversity that trustee boards are seeking. Our roundtable conversations made this transparently clear: “A change of the board has resulted in greater consideration of ESG... so changing staff can lead to more change in this space”.

The regulatory challenges that the industry is facing, not least the advent of TCFD, and the new SIP and implementation statement disclosures, will in time lead to an increasing recognition that there are new and desirable skillsets and experience that need to be given active consideration when recruiting new trustees. Some trustee boards have already recognised this and have added individuals with relevant skills and experience – and they report seeing the benefit of this – but many more have yet to make such moves.

- ▶ One misconception that training and newly skilled trustees will need to overcome is the **mistaken view that climate (or ESG**

generally) is relevant only to equities, not fixed income and other asset classes.

Property and infrastructure investments risk being especially impacted by the physical impacts of climate change, and given that the cement industry alone is responsible for 7% of all man-made carbon dioxide, major changes will be needed in a carbon-constrained world. Added to which, as much infrastructure investment is related to transport in various forms, business models may be dramatically affected depending on alternative policy responses to climate risks.

The issue with bonds is particularly acute given the preponderance of fixed income investments for mature pension schemes in particular. One roundtable attendee noted: “you can liquidate and sell out of equity. But when you buy-out, the insurer needs to buy long-dated, investment-grade credit... ESG risk is more about credit and not equity.” While it is hard to agree that ESG and climate are irrelevant for equity investments, it is certainly true that they also matter for fixed income. Engagement on long-term matters is possible in respect of fixed income holdings, though the approach is less well developed. Exclusionary, screened and tilted funds are possible, and indeed available on the market. This is true of sovereign debt as well as corporate, though again the ESG market in sovereigns is still less well developed.

- ▶ **Another misconception among some DB-only trustees is that new climate regulations were not relevant to them.** One said: “if you are a small, closed DB scheme a couple of years from buy-out and the prime focus is to pay the pensions on time, the focus should be on short-term investment positions... you shouldn’t be worrying about doing a survey of members and ESG preferences”. There is some truth that many ESG risks are medium- to longer-term issues, though climate change is becoming more and more immediate. But the simple fact is that the pension liabilities and rules continue to exist and apply after buy-out so if members favour ESG investment trustees should, all other things being equal, actively consider choosing an insurer with good ESG credentials to deliver investment in accord with beneficiary wishes.



RECOMMENDATIONS

The PLSA will:

- ▶ Encourage more industry-led ESG training and education, and encourage schemes to consider adding trustees with climate change expertise, particularly those with experience of managing the implications of climate change for investment risk and opportunity.
- ▶ Work with TPR to ensure guidance for schemes is suitable; that the Trustee Toolkit contains ESG training and that standards for professional trustees are stretching in respect of climate awareness.
- ▶ Support the FCA in working to design explicit climate (as well as stewardship, and responsible investment more generally) conduct expectations in its forthcoming regulatory regime for investment consultants.

ISSUE 4 | ARTICULATING REQUIREMENTS MORE EXPLICITLY

MANY SCHEMES ARE WELL-PRACTISED AT HOLDING THEIR FUND MANAGERS AND INVESTMENT CONSULTANTS TO ACCOUNT ON GENERAL INVESTMENT ISSUES, MANY ARE LESS EXPERIENCED AT CHALLENGING THEM WITH REGARD TO CLIMATE INVESTMENT AND STEWARDSHIP MATTERS (AND INDEED WITH REGARD TO RESPONSIBLE INVESTMENT GENERALLY).

AS WELL AS MONITORING AND CHALLENGE IN THE CONTEXT OF REGULAR PERFORMANCE APPRAISAL MEETINGS, PENSION SCHEMES WOULD WELCOME SUPPORT AND ADVICE ON HOW BEST TO ARTICULATE EXPECTATIONS ACROSS THEIR LEGAL CONTRACTS (INCLUDING INVESTMENT MANAGEMENT AGREEMENTS (IMAS), SERVICE LEVEL AGREEMENTS (SLAS), TRUSTEE OBJECTIVES AND SO ON).

Few pension schemes will carry out all their investing directly; the majority act through fund managers. Thus, if they are to deliver on an intention to invest in a climate-aware fashion they need to articulate that intention clearly enough that it will be delivered by their agents – and they need to hold their agents to account for delivery against those intentions.

This need to articulate clearly and hold agents to account applies not just to fund managers but also to investment consultants, lawyers and other advisers, so that the climate-aware investment approach can be delivered effectively as the trustees wish. Building climate-related expectations into RFP processes and due diligence questionnaires will help ensure that appropriate providers are chosen at the start of a relationship, as well as ensuring that

potential providers have clearer insight into what might be required of them.

The articulation of expectations may need to be formal, and written into legal agreements (such as IMAs and SLAs), but it should also be informal and form part of broader discussions, particularly regular meetings to discuss performance, so that the message is reinforced and is not dismissed as merely paying lip-service.

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

► **The most effective basis on which to hold investment service providers to account is setting explicit expectations in legal documents.** This includes in the Investment Management Agreement (IMAs) and other legal documents (e.g. side letters, or SLAs for investment consultants).¹² Most model contract terms have been developed by the fund management industry and so do not always suit the needs and expectations of pension schemes. The ICGN Model Mandate was developed predominantly by asset owners and so potentially captures more relevant long-term thinking from a pension scheme's perspective.

Members tell us that responsible investment issues are often, or were historically, a lower priority when drawing up legal contracts. This is unfortunate, given that the moment of agreeing the contract is the time when pension funds will have the most leverage and ability clearly to set their expectations of their service providers. If they miss this opportunity, it is much harder to backfill and express views that will establish expectations which will have a clear effect on service provider behaviours. Challenging service providers and calling them to account for delivery on an ongoing basis is easier when there are clear legally binding standards against which to assess their performance. Some of these issues are discussed in the recent PLSA/Investor Forum publication *Engaging the Engagers*.¹³

¹² For instance, the ICGN in 2012 provided guidance and templates for *Model Mandates* which provided a model contract designed to promote "optimal alignment" between asset owners and asset managers on ESG and stewardship issues.

¹³ <https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2020/Engaging-the-Engagers-stewardship-toolkit.pdf>

One part of the process that comes ahead of the contractual negotiations and the legal agreement is the RFPs and due diligence questionnaires (DDQs) which typically launch the process of hiring a fund manager or other service provider. Building in any climate-related, or broader ESG investment, expectations into these RFPs and DDQs will help establish an understanding early in the process, and provide the best possible chance that the two parties to the contract that is eventually agreed have the same perspectives on these crucial issues.¹⁴

- ▶ In many of these discussions, it feels as though the service providers are the dominant negotiating party – not least because of the fragmented nature of the pension scheme industry and the small scale of so many individual schemes. It is easier for larger schemes to exert influence in negotiations, from RFPs, DDQs, contracts and in manager review discussions. In contrast, trustees tell us that **some smaller schemes or those in pooled funds can struggle to influence outcomes and behaviours.**

In addition to the issue of negotiation, smaller schemes and those with less resourcing in this area are likely to be at a further disadvantage in dealing with the reporting that they receive. Not only are they less likely than larger peers to be able to dictate the format and style of reporting that they receive from service providers, they may also struggle to compare and contrast the data and information that is provided by service providers given that it is likely to be presented in a number of different ways.

- ▶ Again, it is important for pension funds to make clear the extent to which their **expectations with regard to climate-aware investing apply across the full range of asset classes.** This is not an issue or approach that can or should be restricted to equities only, so ensuring that a similar approach is applied to RFPs, contracts and manager reviews across the asset classes is likely to prove important to deliver on trustee aims. Some but not all of the specific requirements may be identical across the portfolio as a whole.

The PLSA fostered the development of a statement from a group of large UK pension schemes on their expectations for reporting on equity investment and hosts the resulting document. This guide to reporting expectations in effect implies expectations with regard to substantive activity as well as just setting out reporting expectations. Reviving this process, or something similar, so that pension scheme expectations with regard to other asset classes can be articulated clearly could assist smaller schemes in particular.

- ▶ Senior representatives of members have noted that there is **only a small subset of key legal advisers who are fully engaged by the challenge of climate change.** Given the importance of legal advice to pension schemes, particularly where they are exploring what their duties are beyond the narrow traditional financial-only understanding of fiduciary duty, this is a matter of some concern. In this context, perhaps it is no wonder that climate change is not always fully reflected in scheme contracts with service providers and other legal documentation. Finding ways to address this gap in service provision could lead to significant enhancements.

RECOMMENDATIONS

The PLSA will:

- ▶ Work with the International Corporate Governance Network (ICGN) in revising and renewing its Model Mandate. Ensuring that the new version continues to reflect the long-term investment expectations of pension asset owners will be important, including a need to add further detail regarding the challenge of climate change.
- ▶ Produce guidance, templates and best practice material for members and trustees with regards to areas such as manager reviews, RFPs and DDQs, including with regard to climate change issues.

¹⁴ Note The Pensions Regulators' guidance on tendering for services: <https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/tender-and-set-objectives-for-investment-service-providers>

ISSUE 5

ENABLING BETTER CLIMATE STEWARDSHIP

ALONGSIDE INTEGRATING ESG, INCLUDING CLIMATE CHANGE-RELATED RISKS AND OPPORTUNITIES, INTO THE INVESTMENT DECISION-MAKING PROCESS, STEWARDSHIP IS THE OTHER KEY WAY IN WHICH TRUSTEES CAN REFLECT THEIR UNDERSTANDING OF CLIMATE ISSUES IN THEIR INVESTMENTS. STEWARDSHIP REFLECTS THE INFLUENCE THAT INVESTORS CAN WIELD THROUGH THEIR RIGHTS AS INVESTORS (SHAREHOLDERS OR OTHERWISE), AND ENCOMPASSES ENGAGEMENT AND VOTING (WHERE RELEVANT TO THE ASSET CLASS).

FOR MANY INVESTORS, BEING ABLE TO ACT AS GOOD STEWARDS OF THEIR INVESTMENTS IS AN IMPORTANT ELEMENT IN MOVING BEYOND THE BINARY AND OFTEN LIMITING DEBATE ABOUT WHETHER TO DIVEST FROM CERTAIN ASSETS. SCHEMES' INFLUENCE WILL VARY DEPENDING ON FACTORS SUCH AS INVESTMENT SCALE, LEVEL OF RESOURCE, INVESTMENT ARRANGEMENTS AND SO ON; OFTEN, INVESTORS WILL BE MOST INFLUENTIAL BY SEEKING TO COLLABORATE WITH OTHERS.

Stewardship is a key element of the tools of a responsible investor. Investors gain rights and influence through their investments, and stewardship is the process of putting that influence to good use to drive long-term value and performance. Sometimes those rights are highly formalised, such as the voting rights held by shareholders, but often the most influential are the most informal, such as the influence that can be wielded through an effective meeting as a

share- and/or bond-holder with the CEO or chair of a major company, or through limited partner dialogue with the general partner of a private equity investment fund.

The consensus view of pension funds during the roundtables was that they would, in the majority of cases, seek to exert influence on carbon-intensive assets within their portfolio, first through stewardship, rather than choose to immediately divest. Setting out their approach and intent clearly may be the only answer that some asset owners are able to give beneficiaries or campaigners that may be noisily seeking divestments of particular assets or industries.

As the PCRIG paper states: “Although there is only one specific TCFD recommended disclosure on stewardship or engagement, it is difficult for trustees to have a meaningful and effective governance and decision-making framework – for instance regarding investment beliefs, or use of metrics, or in disclosing their approach on climate change – without consideration of how they fulfil their stewardship role.”¹⁵

There are a number of organisations that aggregate investor interests on ESG, and especially with regard to climate change. For example, pension funds have taken a leading role in the Climate Action 100+ engagement initiative. Often investors will be most effective in wielding their stewardship influence where they collaborate with others.

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

- ▶ One of the most **effective ways of putting climate change investment beliefs into practice is through stewardship**, including both engagement and voting (where relevant) to sanction poor corporate transparency or behaviour on climate change.

¹⁵ The Pensions Climate Risk Industry Group: *Aligning your Pension Scheme with the TCFD Recommendations*, see https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/877305/aligning-your-pension-scheme-with-the-TCFD-recommendations-consultation-guidance.pdf

In some cases, stewardship may be the only practical way for an asset owner to reflect its climate change investment beliefs because other investment decision-making may limit the scope for divestment of particular assets. Further, many participants in the investment chain argue that they can have greater influence through stewardship and engagement than they can if they have sold out of businesses. Yet the Redington Responsible Investment survey noted that fully 38% of participating managers do not have an engagement policy, and 39% could not provide a single example of an engagement on a climate-related issue.

- ▶ However, the challenge for climate-aware engagement by pension schemes is the same as that for engagement more generally: there is significant **intermediation in the investment chain** between the asset owner and the underlying assets in which they invest. There will almost always be a fund manager (or general partner in many illiquid asset classes) between the pension fund trustees and the invested asset, but very often (and particularly for smaller pension funds) there are further intermediaries, including investment platforms, fund of funds, as well as advisers and so on. The greater the extent of intermediation, the further away the trustee board is from exerting influence, and the harder it is for the trustees to deliver engagement.

In many cases therefore the answers to successful engagement will have to lie among those discussed under Issue 4 above: RFPs, DDQs, the design of the contracts between the pension fund and the fund manager, and in the effectiveness of manager review meetings. Similar issues arise with use of platform providers (a DC issue mostly) or intermediated arrangements such as master trusts. Such providers will need to step up to the challenges of stewardship and effective reporting.

Transparency of what fund managers do in their clients' names by way of stewardship is limited, sometimes from habit and sometimes from a sense that revealing such sensitive activities publicly is not appropriate. It is clear that reporting under the new UK Stewardship Code will mark a step-change in this regard,

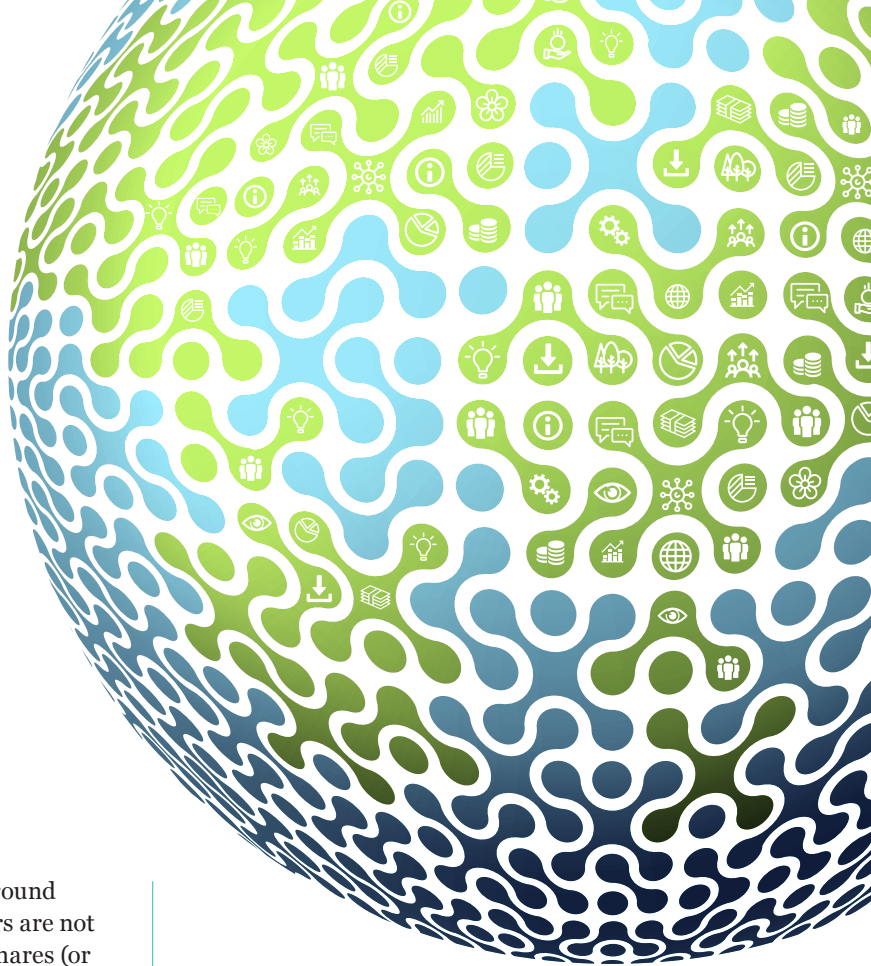


and pension funds will watch closely what is revealed by this new reporting.

Transparency and consistency of fund manager reporting on voting is a problem for pension schemes, which are now under duties to themselves report consistently to beneficiaries on their voting activities. The PLSA Vote Disclosure Template has been developed to facilitate this, as a model for consistent fund manager disclosure.

- ▶ Particular concerns arise for pension funds with regard to the **votes attached to holdings within pooled funds**. We have heard a growing sense of frustration among a number of PLSA fund members with regard to their ability to influence voting practices in pooled arrangements. With around 39% of private sector UK scheme assets invested in pooled fund, and the majority of DC assets¹⁶ this is no narrow interest (and economies of scale mean that this is particularly an issue for many of the smaller funds).

¹⁶ <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/articles/ukpensionsurveys/redevelopmentand2019results>



The nature of the legal structures around pooled funds mean that asset owners are not the legal owners of the underlying shares (or other assets); rather, they are the owners only of units in the fund itself. Thus, any voting rights attaching to the holdings within the fund are not the asset owner's to control, rather they are in the hands wholly of the fund manager. Indeed, some managers argue that some regulatory regimes require that it is they who exercise the votes at their own discretion. There is therefore an ongoing debate over how effectively the voting rights are exercised. Some asset owners believe that these votes are not always exercised with as long a term mindset as they would wish and it is notable that this is a growing issue for the pensions industry because most auto-enrolled DC funds are now investing through pooled funds.

- ▶ Schemes also tell us that the **weaker negotiating positions of some smaller schemes** means that they have to accept less favourable positions, and that they are less able to exert influence on fund manager behaviour. Due diligence on ESG issues or manager claims on stewardship, including climate change, is costly: "We start exploring these things and our advisers tell us there is a fee... We have to work out short-term cost vs. long-term game and how it will drive value for money for members." In practice, this will mean some schemes are not receiving the stewardship services that they believe would be optimal for their beneficiaries.

RECOMMENDATIONS

The PLSA will:

- ▶ Develop guidance for members on what good practice expectations ought to be with regard to stewardship services. This might form part of work in relation to the Model Mandate, or otherwise.
- ▶ Work with the investment industry and regulators to find solutions to the challenges schemes face when exercising stewardship and voting 'rights' in pooled funds
- ▶ Continue to encourage schemes and managers to adopt the Stewardship Code, and to play a pro-active role in industry Stewardship groups. This will include further developing our Voting Guidelines so that they put forward additional recommended ways in which pension schemes could vote to reflect their climate change investment beliefs.

ISSUE 6

IMPROVING SUPPLY OF APPROPRIATE CLIMATE 'PRODUCTS'

ALONGSIDE INTEGRATING ESG, INCLUDING CLIMATE CHANGE-RELATED RISKS AND OPPORTUNITIES, INTO THE INVESTMENT DECISION-MAKING PROCESS, STEWARDSHIP IS THE OTHER KEY WAY IN WHICH TRUSTEES CAN REFLECT THEIR UNDERSTANDING OF SCHEME INVESTORS TELL US THEY FACE ISSUES AROUND GOOD CLIMATE PRODUCTS IN TWO WAYS:

- 1) IT IS HARD TO FIND CLIMATE ASSETS WHICH REALLY HAVE THE IMPACT THEY ARE MARKETING AS HAVING (THIS ALSO LINKS TO PREVIOUS ISSUES AROUND DEFINITIONS BUT ALSO REFLECTS AN AVAILABILITY/SUPPLY ISSUE) AND
- 2) IT IS DIFFICULT TO FIND CLIMATE ASSETS WITH THE APPROPRIATE INCOME OR INVESTMENT CHARACTERISTICS OR STRUCTURE – PARTICULARLY IN THE FIXED INCOME SPACE (INCLUDING SOVEREIGN).

IN SPITE OF THE ONGOING NOISE REGARDING ESG, IT SEEMS FUND MANAGERS ARE NOT YET PROVIDING INVESTMENT VEHICLES COMBINING THE CHARACTERISTICS THAT PENSION FUND INVESTORS NEED.

Even though fund managers are developing new propositions on ESG, and particularly climate-aware, offerings, pension funds continue to express frustration about the investment vehicles that are in practice available to them. In part, this frustration arises from the lack of consistency in the use of language and the lack of clear definitions of terms (see Issue 1) means that there is limited comparability in the market and instead mostly confusion as to what is on offer.

Pension schemes also report that the substantive financial characteristics of many climate-aware investment products do not suit their needs. These issues are particularly acute in fixed income – an asset class of great importance to pension schemes, particularly mature DB schemes and DC schemes during the pre-retirement derisking phase.

We would expect the requirement, as proposed in DWP's recent TCFD consultation, for trustees to set targets to improve their climate metrics over time will result in fund managers to developing and offering more products that commit to improving the portfolio's climate metrics over time, in particular to align to the Paris Agreement.

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

- ▶ Roundtable participants and PLSA members generally report concerns about the **poor supply of quality climate products** with the investment characteristics that they need. This seems consistent with the evidence from the Sackers ESG survey, where 28% of surveyed trustees said that the lack of appropriate products was proving a material obstacle to implementing ESG policies.

In part, this is down to the challenge around a lack of definitions and clarity over terminology, as discussed under Issue 1, as well as the need for better data and reporting discussed under Issue 2. But there also appears to be a failure by service providers to marry up the financial characteristics that pension schemes need with the environmental characteristics that they are seeking. This is seen as a particular issue with regard to fixed income products.

There is some feedback that there are other asset classes where this apparent lack of appropriate supply does not seem to arise. In particular, one roundtable participant commented: "Climate assets seem more readily available in the private and illiquid assets space".

The lack of consistency in reporting is a particular problem for those funds that are seeking to have an impact through their investments and so wish to aggregate the impact that they are having across their different portfolios. Inconsistent reporting makes aggregation impossible.

- ▶ There are **risks that the green bond market falls into disrepute** because of the lack of assurance and consistent definitions – hence the creation of the non-binding Green Bond Principles by the International Capital Market Association. But because these remain purely voluntary, they lack teeth and there is limited consistency around what green bonds in fact are and the extent of the green ‘promise’ that each bond actually makes. An EU Green Bond Standard is also under consideration but its timetable is unclear, as is whether it will be binding. The strong market demand for such bonds is driving prices down and inviting in more participants with less strong green credentials. Some issues are clearly highly reputable and will deliver incremental environmental change, while others seem less likely to do so. It would be unfortunate for the market as a whole to be treated as unreliable if and when some of the poor behaviour is revealed.
- ▶ Trustees recognise a need for assistance and advice in this area, but seem frustrated by the quality of what is available. Some trustees report a **lack of confidence that consultants and advisers always have the expertise** to cut through the greenwash and genuinely distinguish worthwhile products from those that provide little of substance. Many trustees also firmly believe that a number of the ratings agencies are only slowly building the specialist assurance capacity that a properly functioning market requires.



RECOMMENDATIONS

The PLSA will:

- ▶ Continue to make the case to Government for the issuance of a Green Gilt by the UK Government.
- ▶ Develop principles for asset management funds/products to adhere to on responsible investment generally, or specifically with regards to climate.

ISSUE 7 | COMMUNICATING AND EXPLAINING CLIMATE AWARE INVESTMENT

THE CHALLENGES AROUND DATA QUALITY, AND THE LACK OF COMMON DEFINITIONS OF ESG AND CLIMATE-AWARE INVESTMENTS, GIVE RISE TO SIGNIFICANT ISSUES AROUND THE COMMUNICATION OF RELEVANT ACTIVITY TO PENSION SCHEME BENEFICIARIES. THIS CAN BE A PARTICULAR ISSUE GIVEN THAT SOME BENEFICIARIES CAN HAVE CLEARLY HELD PERSONAL VIEWS ON CLIMATE ISSUES AND WHAT INVESTMENTS ARE APPROPRIATE; RESPONDING TO SUCH EXPECTATIONS WITH AN UNCLEAR BASIS IN INFORMATION CAN GIVE RISE TO ISSUES.

SCHEMES ARE THEREFORE KEEN TO FIND APPROPRIATE AND EFFECTIVE WAYS TO COMMUNICATE THEIR APPROACH TO CLIMATE, NOT LEAST IF THEY ARE SETTING AMBITIONS FOR THE FUTURE (SUCH AS BEING 'NET ZERO' CARBON) AND HAVE TO COMMUNICATE PROGRESS OVER LONG PERIODS OF TIME TOWARDS THOSE AMBITIONS.

Communication to beneficiaries remains a challenge for the pensions industry. Encouraging beneficiaries to engage fully with issues around their own long-term financial well-being is not straightforward. In part this arises because the investment world feels divorced from the reality of many people's lives. One approach to bridge this gap is to relate investment activities by pension schemes to the real world; ESG generally, and perhaps climate change in particular, gives an opportunity for this sort of approach.

Delivering such communication successfully is challenging given the scale of the change that is happening and is required across financial

services and wider society, as well as being hampered by the issues of data quality and lack of common definitions that have been discussed earlier. One answer, is to avoid jargon altogether and simply to discuss what has been done, both in terms of integrating climate change into investment decisions (including exclusion decisions where relevant) and in terms of stewardship activity. Members, and their beneficiaries, seem keen to minimise confusion and to talk about underlying realities rather than focus too much on the headline titles of investment approaches. Put simply – *how do you seek to make a difference?*¹⁷

OUR ANALYSIS (BUILDING ON MEMBER FEEDBACK RECEIVED AT ROUNDTABLES AND OTHERWISE)

► **In the absence of clear mutual understanding, schemes believe it is difficult for them to demonstrate to beneficiaries that they are delivering high quality climate-aware investment.**

The lack of understanding and clear differentiation between providers also means that employers and individuals have little basis for informed choice where they have scope to change their pension saving providers.

Members at roundtables agreed that the quality of reporting from their fund managers was highly variable. One said: "Several years ago, some managers would look at you as if you were coming from a different planet [if you asked for ESG data]...we're getting better responses now." Another remarked that we "don't need to get all the definitions nailed down now...it will be important for PLSA to help pension funds and trustees to be active owners and help them set expectations for asset managers". Improved disclosure may assist understanding, but perhaps only better dialogue will truly reveal whether fund managers are in practice

¹⁷ Chapter 6 of our guidance provides further tips on how to communicate investment approaches to members <https://www.plsa.co.uk/Portals/0/>

delivering quality climate-aware investment approaches. Greater transparency will always be helpful, of both the intended approach and the actual activities undertaken, but concerns about greenwashing – energetic and positive disclosures masking limited action in substance – remain.

One of the challenges may have been the tendency to focus on definitions rather than to discuss what is actually done in practice. More clearly articulating what is meant by the investment underlying the headline title, both in terms of investment integration and stewardship activity, may build more confidence than spending time aligning the varied approaches to the definitional terms.

The worries regarding greenwashing may be well-founded. A recent survey from Redington highlights the contrast between fund manager rhetoric and reality. For example, while 76% of respondents asserted that climate-related risks are factored into their investment process, only 60% could give a concrete example of where climate concerns led it to avoid an investment or to a sale or reduction in a position. “It is encouraging that such a high proportion of managers consider climate change in their investment decisions, but this does not always translate concretely in real portfolio decisions,” says Redington. “This discrepancy illustrates some of the challenges facing our industry today.”

- ▶ There is a clear opportunity here: there is good evidence that **if the industry can communicate better, younger savers could become more engaged.**

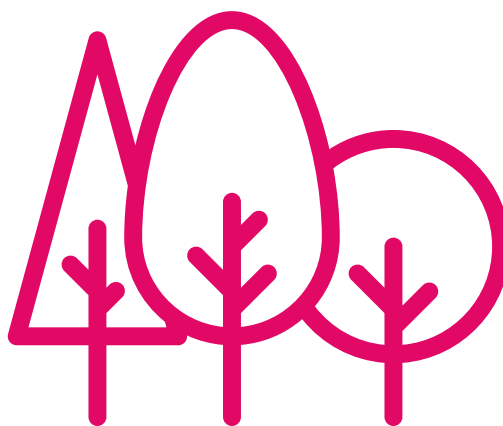
Take, for example, the NEST Insight 2018 Responsible Investment report, based on a survey of NEST participants, which revealed clearly that communicating on responsible investment activities helped build member trust; or the Franklin Templeton 2019 *The Power of Emotions* report, which found 78% of DC survey participants did not believe that their pension aligned with their values or did not know whether it did, and that they might boost their contributions by a further 20% if responsible investment was embedded in their pension investment approach. In a similar way, a 2020 Scottish Widows survey found that 68% of DC beneficiaries do not know how sustainable their pension fund is, and only 13% feel it is easy to ensure that their pension is invested in an environmentally friendly

manner. It seems a shame that communication hasn’t at least delivered this knowledge.

RECOMMENDATIONS

The PLSA will:

- ▶ Explore the feasibility of creating a Pension Quality Mark for ESG – either as a stand-alone standard or as an extended module of an enhanced PQM qualification. Such an ESG PQM would offer a way for schemes to demonstrate they are hitting certain standards around the governance of their approach to climate and responsible investment generally.
- ▶ Build on our work on implementation statements to consider how best to support members in their communications with beneficiaries, including on climate and other ESG matters.



RECOMMENDATIONS FOR ACTION

Based on the above analysis and an assessment of which actions are most deliverable and will give the greatest impact, the following are the planned recommendations for action that the PLSA is intending to take forwards from among these potential solutions:

1. CLARIFYING COMMUNICATIONS AND DEFINITIONS

A joint-industry/ government review to examine the wide range of competing standards and definitions that currently exist, any initiatives already underway to achieve harmonisation, and to identify a framework to achieve a common language and taxonomy.

2. ADDRESSING POOR QUALITY DATA AND INFORMATION

Encourage the government and regulators to move towards more widespread adoption of the TCFD recommendations, applying them not just to premium-listed companies but to all issuers of debt and equity, and to all major banks, asset managers and insurers.

Support measures to increase equivalence of climate reporting or regulatory obligations from the top to the bottom of the investment chain.

3. DELIVERING GREATER CLIMATE EXPERTISE AND EDUCATION

Encourage more industry-led ESG training and education, and encourage schemes to consider adding trustees with climate change expertise, particularly those with experience of managing the implications of climate change for investment risk and opportunity.

Work with TPR to ensure guidance for schemes is suitable; that the Trustee Toolkit contains ESG training and that standards for professional trustees are stretching in respect of climate awareness.

Support the FCA in working to design explicit climate (as well as stewardship, and responsible investment more generally) conduct expectations in its forthcoming regulatory regime for investment consultants.

4. ARTICULATING REQUIREMENTS MORE EXPLICITLY

Work with the International Corporate Governance Network (ICGN) in revising and renewing its Model Mandate. Ensuring that the new version continues to reflect the long-term investment expectations of pension asset owners will be important, including a need to add further detail regarding the challenge of climate change.

Produce guidance, templates and best practice material for members and trustees with regards to areas such as manager reviews, RFPs and DDQs, including with regard to climate change issues.

5. ENABLING BETTER CLIMATE STEWARDSHIP

Develop guidance for members on what good practice expectations ought to be with regard to stewardship services. This might form part of work in relation to the Model Mandate, or otherwise.

Work with the investment industry and regulators to find solutions to the challenges schemes face when exercising stewardship and voting 'rights' in pooled funds.

Continue to encourage schemes and managers to adopt the Stewardship Code, and to play a pro-active role in industry Stewardship groups. This will include further developing our Voting Guidelines.

6. IMPROVING SUPPLY OF CLIMATE PRODUCTS

Continue to make the case to Government for the issuance of a Green Gilt by the UK Government.

Develop principles for asset management funds/products to adhere to on responsible investment generally, or specifically with regards to climate.

7. COMMUNICATING AND EXPLAINING CLIMATE AWARE INVESTMENT

Explore the feasibility of creating a Pension Quality Mark for ESG – either as a stand-alone standard or as an extended module of an enhanced PQM qualification.

Build on our work on implementation statements to consider how best to support members in their communications with beneficiaries, including on climate and other ESG matters.

CONCLUSIONS

- ▶ Climate change is a complex systemic issue. It needs systemic responses, from governments, companies, investors, and indeed from all of us as citizens, savers and consumers.
- ▶ Recent regulatory change focused on asset owners has been helpful and builds on existing efforts by a number of leading pension funds, and by the investment industry generally. However, barriers remain. Those barriers will need a systemic response, from asset owners, from regulators, from fund managers and other service providers.
- ▶ We therefore make a series of recommendations for action which the PLSA and the pensions industry will seek to take to address these barriers across all the different parts of the investment chain.
- ▶ We welcome the engagement of all other parties in the investment chain to make our mutual aim, of fully climate-aware long-term investment, a reality.
- ▶ We have been energised by the engaged response of the industry as a whole to our Climate Roundtables and Call for Evidence. We look forward to building on this energy and desire for change to deliver the investment approach that beneficiaries need of us all.
- ▶ The time for action is now.



ANNEX X | CLIMATE ROUNDTABLE FEEDBACK (SUMMARY)

8 roundtables were held over June to August, with 80 attendees.

BARRIERS	MEMBERS' PROPOSED SOLUTIONS
Poor quality, conflicting and inconsistent information	A universal reporting framework (companies but also asset managers)
	PLSA could launch and oversee an ESG or climate change quality mark for pension schemes.
	PLSA gives trustees a standard set of questions to send to investment consultants and managers to engage more effectively
A proliferation of definitions and standards	PLSA could provide greater clarity around the definitions of responsible and climate investment.
	A standard scoring system for ESG data could be developed to help pension schemes better compare their investments.
Need to build resource and expertise on climate change among trustees, scheme managers and advisers	Education from PLSA, CFA or others for industry decision-makers (across industry)
	Empowering scheme members to be more engaged in the scheme and ESG issues.
	Small schemes should get outside help to engage as part of a bigger collective instead of doing it directly.
	Having a standardised approach which is efficient would be beneficial particularly to small schemes
	Small operational changes within schemes can lead to real change, for example international travel, cycling schemes, etc.
Schemes need to be explicit around climate expectations of service providers	More detailed and prescriptive legislation
	More collaboration across pension schemes to hold providers to account on ESG and climate issues.
	Need a government document to set out some broad principle-based guidance
	Encourage better communication between schemes and advisors.
Challenges in exercising scheme stewardship influence, including in pooled vehicles	More detailed legislation aimed at asset managers
	DB schemes: encourage them to exercise leverage/influence over a corporate sponsor which it considers to be lagging on climate activity and where it has concerns about the impact of this behaviour on covenant strength
	Steps to support robust engagement with providers has the potential to change the behaviour of managers and consultants.
	Guidance on how climate could be integrated into the sponsor covenant
	Responsible investment needs to put at the same level of trustee responsibilities as fiduciary duty in trust law.
Insufficient supply of suitable 'climate assets', especially outside equities	Green gilts which have a specific use for proceeds would allow schemes to maintain their gilt exposure while also knowing what impact they are having around climate risk.

APPENDIX: FURTHER READING AND KEY REFERENCES

PLSA GUIDANCE PUBLICATIONS

AGM Annual Voting Review, 2020

Climate Indexes Made Simple, 2020

Engaging the Engagers: How to achieve effective stewardship outcomes through your asset managers, 2020 (PLSA/Investor Forum)

ESG and Stewardship: A practical guide to trustee duties, 2019

ESG Made Simple Guide, 2019

ESG risk in default funds: Analysis of the UK's DC Pension Market, 2017

Implementation Statement Guidance, 2020

More light, less heat: A Framework for Pension Fund Action on Climate Change, 2017

Stewardship Disclosure Framework (forthcoming)

Stewardship Guidance and Voting Guidelines 2020

Vote Reporting Template, 2020

Vote Reporting Template: Guidance for Asset Owners, 2020

Available on the PLSA website

REGULATORY AND STANDARD-SETTING FRAMEWORKS

British Standards Institute Sustainable Finance Standardization Programme

CFA Institute ESG Disclosure Standards for Investment Products

EU Sustainable Investment taxonomy (a 'framework to facilitate sustainable investment')

Law Commission: *Fiduciary Duties of Investment Intermediaries*

Pensions Climate Risk Industry Group (PCRIG) guidance: *Aligning your Pension Scheme with the TCFD Recommendations*

Task Force on Climate-related Financial Disclosures (TCFD)

BEST PRACTICES

Climate Financial Risk Forum *Guide 2020: Disclosures Chapter*

Guide to Responsible Investment Reporting in Public Equity

ICGN *Model Mandate Initiative*

IIGCC Net Zero Investment Framework

International Capital Market Association Green Bond Principles

Investment Association *Responsible Investment Framework*

The Pensions Regulator guidance on tendering for services

The UNPRI Testing the Taxonomy case studies

EDUCATIONAL AND TRAINING MATERIAL AND SOURCES

CFA Society of the UK Certificate in ESG Investing Chapter Zero

ICAEW Climate Hub

Institute and Faculty of Actuaries practical guides in resource and environment practice area

International Actuarial Association *Importance of Climate Risk for Actuaries (2020)*

INDIVIDUAL REPORTS AND INSIGHTS

Franklin Templeton: *The Power of Emotions (2019)*

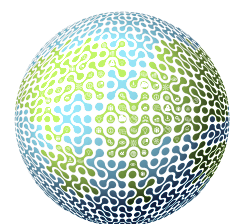
Principles for Responsible Investment: *Private Retirement Systems and Sustainability: United Kingdom*

Redington *Responsible Investment Survey 2020*

Sackers *ESG survey for pension schemes (2019)*

Scottish Widows 2020 Retirement Report: *Investing Responsibly for the Future*





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