

Engaging with ESG: Climate Change



## The Pensions Policy Institute (PPI)

We have been at the forefront of shaping evidence-based pensions policy for 20 years.

The PPI, established in 2001, is a not-for-profit educational research organisation, with no shareholders to satisfy – so our efforts are focussed on quality output rather than profit margins.

**We are devoted to improving retirement outcomes.** We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. The PPI gives you the power to influence the cutting-edge of policy making. Each research report combines experience with independence to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **Independence** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

### Our Vision:

**Better informed policies and decisions that improve later life outcomes**

We believe that better information and understanding will help lead to a better policy framework and a better provision of retirement income for all.

### Our Mission:

**To promote informed, evidence-based policies and decisions for financial provision in later life through independent research and analysis**

We aim to be the authoritative voice on policy on pensions and the financial and economic provision in later life.

By supporting the PPI you are aligning yourself with our vision to **drive better informed policies and decisions that improve later life outcomes** and strengthening your commitment to better outcomes for all.

As we look forward now to the next 20 years, we will continue to be the trusted source of information, analysis, and impartial feedback to those with an interest in later life issues. The scale and scope of policy change creates even more need for objective and evidence-based analysis. There is still much to do, and we look forward to meeting the challenge head on.

For further information on supporting the PPI please visit our website:

[www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk)

or contact Danielle Baker, Head of Membership & External Engagement

[danielle@pensionspolicyinstitute.org.uk](mailto:danielle@pensionspolicyinstitute.org.uk)



The future is ever changing,  
but the PPI remains a constant  
**“Voice of Reason”**  
in the ongoing debate on the  
future of retirement in the UK.

Pensions Policy Institute  
**PPI**  
EST. 2001

**This report has been authored by:**

**Lauren Wilkinson, Senior Policy Researcher**



**Lauren Wilkinson** joined the PPI in September 2016 as a Policy Researcher. During her time at the PPI Lauren has produced research on a range of topics, including Defined Benefit, consumer engagement, pension freedoms and Collective Defined Contribution.

Lauren was promoted to Senior Policy Researcher in January 2019.

Prior to joining the PPI, Lauren achieved an undergraduate Masters in Politics and Philosophy at the University of Glasgow, followed by a Masters in Public Administration and Public Policy at the University of York.

A Research Report by Lauren Wilkinson

Published by the Pensions Policy Institute

© February 2021

ISBN 978-1-906284-97-8

[www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk)

This report is kindly sponsored by:



**PHOENIX GROUP**

Along with series sponsors



**Baker  
McKenzie.**

**PENSIONS AND  
LIFETIME SAVINGS  
ASSOCIATION**



Sponsorship has been given to help fund the research, and does not necessarily imply agreement with, or support for, the analysis or findings from the project.

# Engaging with ESG: Climate Change

---

Sponsor's Foreword.....	i
Executive Summary .....	1
Introduction .....	4
Chapter One: What is the pensions investment landscape relating to climate change? .....	6
Chapter Two: How are schemes approaching consideration of climate change?.....	11
Chapter Three: What role do members play in climate change approaches?.....	18
Chapter Four: What practical steps may be needed to overcome barriers relating to climate change investment? .....	26
References.....	38
Glossary .....	40
Acknowledgements and Contact Details.....	42

# Sponsor's Foreword



**Michael Eakins**

One of the defining global issues of today is climate change. With weather patterns shifting, sea levels rising, carbon dioxide concentrations increasing and continual threats to food production, every industry has a role to play to create a tide of change. Without immediate action, the United Nations predicts more than 140 million people in Sub-Saharan Africa, Latin America and South Asia will be forced to migrate within their regions by 2050, causing major threats to international peace and security.

However, it is not too late to stem the tide. It will require major transformations in all aspects of our lives. From food production to energy and from logistics to land use, every sector will have to play their part.

As the UK's leading long-term savings and retirement business, Phoenix Group has a significant responsibility not only to its 14 million policyholders, as stewards of their savings but, to the industry as a whole. As a business we have committed to being net-zero in our operations by 2025 and in our investment portfolio by 2050. This will take our net zero target into account for all the unit linked fund solutions we design with our investment partners. We know this is important for our customers, clients, trustees and their advisers. This is why at the end of last year we launched a new ESG default fund solution for Standard Life's workplace pension clients, which screens out companies with sustainability risks.

In making this commitment, we have set targets that will contribute to the reduction of greenhouse gas emissions and accelerate our transition to a low carbon economy, which are core to the Group's sustainability agenda. Phoenix has also become a Business Ambition for 1.5°C signatory.

With the United Nations Climate Change Conference (COP26) set to take place in Glasgow later this year, Phoenix Group stands ready to play its part.

This is why we were eager to be involved in the Pensions Policy Institute's (PPI) thought provoking research, which cuts through much of the confusion surrounding ESG and climate change. What is clear from this articulate and thorough report is that there is no easy or quick fix to the issues we face. Both industry and government must work hand in hand to establish a more consolidated strategy, with simpler, centralised data sources. This lack of a harmonised reporting process is proving to be a substantial barrier to improving the effectiveness of risk mitigation in schemes'

investment strategies. With more than a quarter (28%) of respondents saying that too much information had been a challenge when designing their approach to ESG and 22% saying that conflicting information had also been a challenge, it is clear that this issue and others raised in this research paper, requires strong leadership and industry wide solutions.

Phoenix Group would like to thank the PPI for writing an outstanding report and to Lauren Wilkinson for all her efforts in putting this research together. The report also benefits from cross-industry support and expertise with it having been reviewed by colleagues from across the industry who are supporting the PPI with this important research series. It is research such as this that will enable us to combat and conquer climate and environmental change and we look forward to furthering the conversation and playing our part to make a difference, and urge the entire industry to collaborate together to ensure we find the right answers.

**Michael Eakins, Chief Investment Officer, Phoenix Group**



# Executive Summary

Recent changes in regulation require that pension schemes demonstrate they have at least considered Environment, Social and Governance (ESG) factors when formulating their investment strategy. As a result, understanding and awareness have grown, and there is an increasing focus on the financial risk-mitigation component of ESG investment. Climate change in particular has received increasing focus from policy-makers and social movements around the globe. However, there are concerns that some schemes are still not engaging with these considerations in a meaningful way. Following on from *Engaging with ESG: The story so far*<sup>1</sup>, an introductory Briefing Note which provides an overview of historical and regulatory developments, this report delves deeper into the attitudes and behaviour affecting consideration of climate change in pension scheme investment. A second report will follow this one, exploring pension scheme investors' consideration of ESG as a whole. This series aims to identify areas where further support, guidance or intervention could help improve engagement and implementation of appropriate risk management.

**This report explores the way in which pension scheme investment takes into account climate change within the current regulatory landscape, as well as future opportunities and challenges, and explores proposals for more effective support to encourage evolution and improved risk mitigation.**

Relatively rapid regulatory changes mean that schemes will need to improve their knowledge and understanding, as well as their engagement with their external managers, to drive forward improvements in data and reporting in order to comply and appropriately protect members against climate risks.

1 <https://www.pensionspolicyinstitute.org.uk/research/research-reports/2020/2020-12-02-briefing-note-number-124-engaging-with-esg-the-story-so-far/>



While climate change has been the main area of focus of ESG strategies and some schemes (as well as pension providers and asset managers acting on their behalf) are doing a lot to mitigate these risks, there is still a lot of work to be done as physical and transition risks associated with climate change become more pressing. Schemes will need to take direct action, a more joined-up approach across the industry, from government, regulators, industry bodies and third parties such as consultants and asset managers, will be needed to drive forward progress.

This report uses data from PPI's Engaging with ESG survey 2020. Carried out in November 2020, the survey sought to gather insight on the approaches being used by schemes in order to take into account ESG risks, as well as the challenges they may have faced along the way. The survey was open to responses from both schemes and third-parties involved in the process, such as consultants and asset managers. There were 62 responses in total, including those covering 31 pension schemes, 48% of which were Defined Contribution (DC) and 52% Defined Benefit (DB). When drawing conclusions from the data it should be recognised that the responses cover a subset of the market, and those who responded are more likely to be more engaged on ESG in general.

This report has also been informed by qualitative interviews carried out with a broad range of stakeholders across the industry.

### **Relatively rapid regulatory changes mean schemes will need to improve their knowledge and understanding, as well as their engagement with their external managers, to drive forward improvements in data and reporting in order to comply and appropriately protect members against climate risks**

- Policy and regulatory changes relating to climate change are occurring rapidly, which can be challenging for schemes that do not already have the necessary knowledge and expertise to catch up at pace.
- Although knowledge and understanding has grown across the industry, there is still a gap in some areas which may require more cohesive efforts from Government and industry to address.
- A lack of consistency and clarity in data and reporting is a fundamental barrier to improving the effectiveness of climate risk mitigation in schemes' investment strategies. Although the availability and quality of data is improving, schemes may need to take a more active role in encouraging evolution from external managers.
- Schemes that are heavily dependent on external asset managers will need to increase engagement with and monitoring of these managers in order to improve the effectiveness of their investment strategies and mitigation of climate risks. In some cases, schemes may need to directly demand more climate-aware products and strategies from their pension providers and external managers.
- Alternative asset classes may offer opportunities for climate risk mitigation but schemes may not have the expertise or familiarity to effectively integrate them into their portfolios.

## Joined-up goals, strategies and data sources across Government and industry will improve scheme engagement with climate change:

- **Integrated goals:** Establishing a consensus across all stakeholders (Government, schemes, asset managers and platform providers) on goals, and the practical steps needed to achieve them, to ensure that climate change considerations are integrated across the investment landscape by a certain date.
- **Engagement and stewardship:** A greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals.
- **Encouraging innovation from third parties:** Pressure from Government, regulators and industry bodies on those involved in schemes' approach to climate change (such as pension providers, external asset managers and consultants) to provide products and strategies that meet the needs of schemes in integrating these risks, as well as improving the data they provide schemes about their own activities relating to climate change.
- **Increasing knowledge and understanding:** Improving scheme decision-makers' knowledge and understanding of climate change across the industry, especially around the more practical aspects such as the implications of different investment approaches. This could be standardised and measured through a specific training module in The Pensions Regulator's Trustee Toolkit, for example.
- **Standardised data:** Producing a centralised data source which can provide a starting point for schemes that are unsure where to begin or are overwhelmed by the quantity of data available, particularly given inconsistency across different metrics. Feasibly, this would need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

# Introduction

The financial implications of Environmental, Social and Governance (ESG) factors are becoming increasingly important considerations in pension schemes' investment decisions as these issues become more pressing, both in terms of being more widely recognised as material risks and as a result of external regulatory and societal pressures. Schemes are now required to show that they have at least considered ESG factors when formulating their investment strategy. Understanding and awareness have grown, particularly since the introduction of new Statement of Investment Principles (SIP) requirements, and there is an increasing focus on the financial risk-mitigation component of ESG investment. However, even among those with a good understanding, determining how to implement ESG factors can be challenging given the range that may need to be considered and the various approaches available. Although regulation has strongly encouraged trustees, providers and Independent Governance Committees (IGCs) to become more informed on ESG risks, there are concerns that some schemes are still not engaging with these considerations in a meaningful way.

Traditionally, much of the focus on ESG considerations has been on environmental risks, especially climate change.

However, while some schemes are leading the way on climate risk mitigation, others may need greater support, particularly around understanding of the available data and the rapidity with which regulatory change is happening in this area.

**This report explores the way in which pension scheme investment takes into account climate change within the current regulatory landscape, as well as future opportunities and challenges, and proposals for more effective support to encourage evolution and improved risk mitigation.**

This is the second in a series of three publications which delve deeper into the attitudes and approaches currently being implemented in relation to ESG, with the aim of highlighting areas where further support, guidance or intervention could be beneficial in order to improve engagement and implementation of appropriate risk management. **The first publication in this series, Briefing Note 124 - Engaging with ESG: the story so far, provides an overview of historical developments and regulatory changes that have led to the current ESG landscape in the UK. The final publication in this series will explore remaining ESG considerations, excluding climate change.**

**Chapter One** presents a number of infographics that provide background and details about climate change and the way it relates to pension scheme investment.

**Chapter Two** examines the way in which pension schemes are approaching climate change issues in relation to the design and implementation of their investment strategy.

**Chapter Three** explores the role of member views in the design of climate change strategies, now and in the future.

**Chapter Four** highlights the barriers schemes may face when designing and implementing their investment strategy and identifies the practical steps that may be needed from Government and industry in order to drive forward progress on climate change, and improve the way in which pension schemes' investment strategies take account of these risks.

# Chapter One: What is the pensions investment landscape relating to climate change?

**This chapter presents a number of infographics that provide background and details about climate change and the way it relates to pension scheme investment.**

Climate change and the way in which it relates to pension schemes' investment is a complex area. The following infographics provide background and details about:

- The risks associated with climate change (Figure 1.1)
- The key recent developments in legislation and regulation (Figure 1.2)
- The stakeholders involved in pension schemes' approach to climate change (Figure 1.3)
- The investment approaches available to schemes (Figure 1.4)
- The key sources of guidance currently available to schemes (Figure 1.5)

Figure 1.1

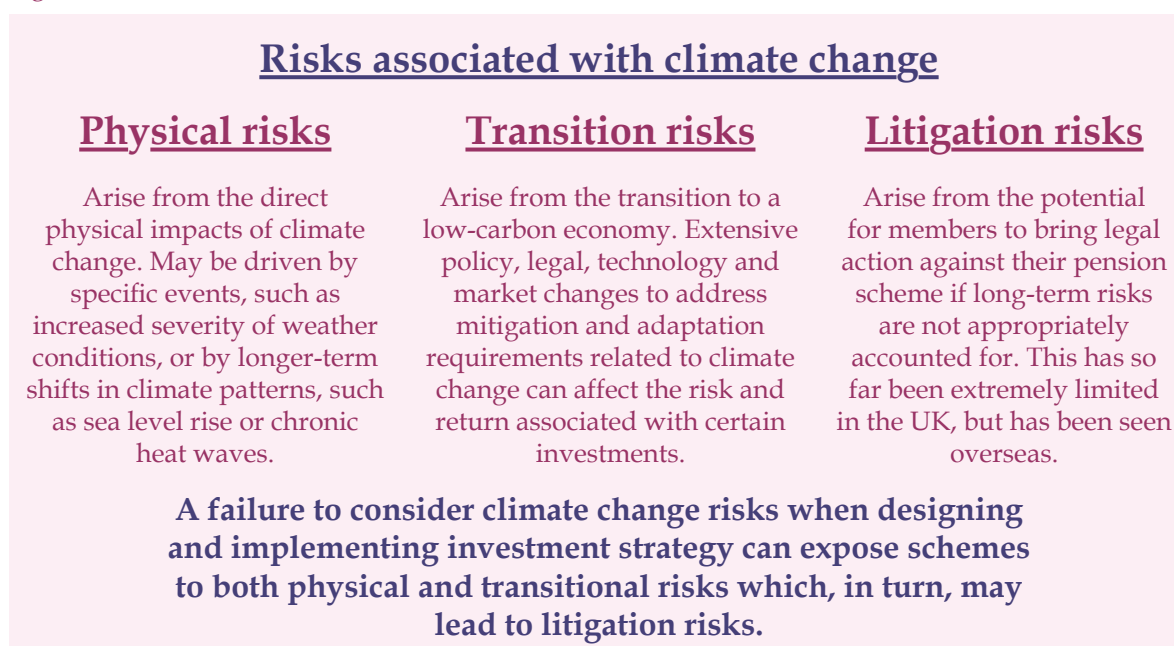


Figure 1.2

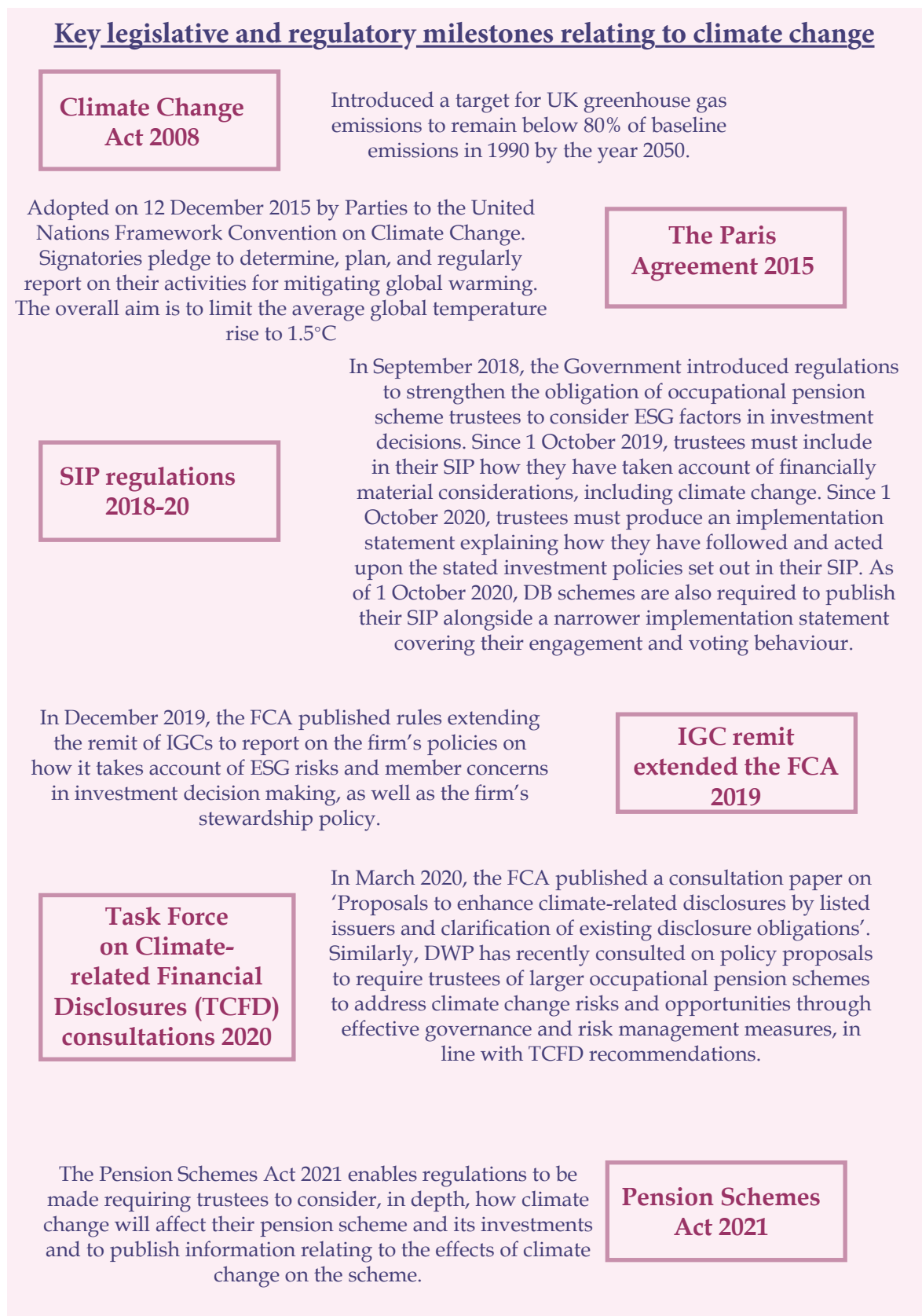


Figure 1.3

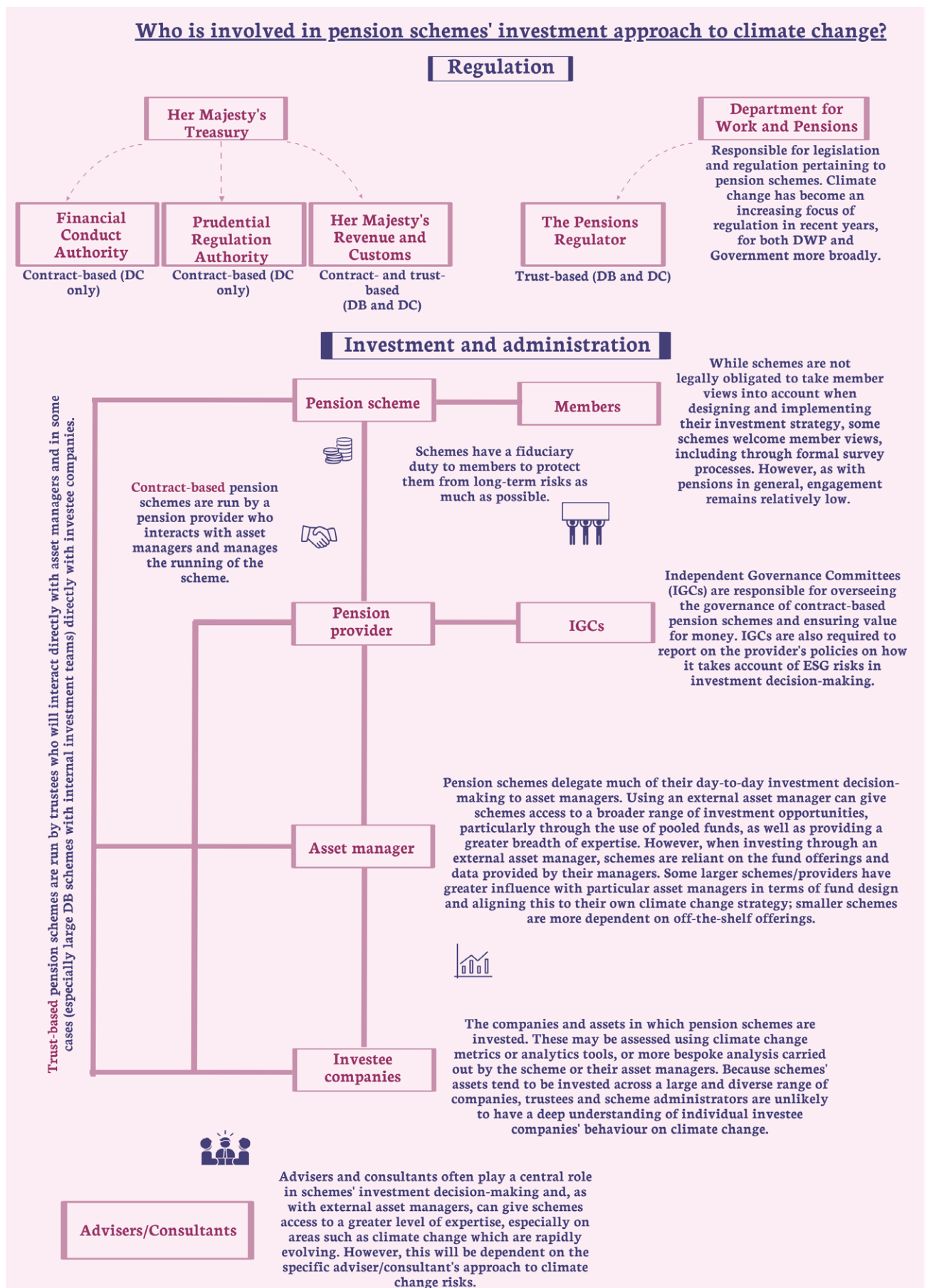


Figure 1.4





## Infographic 5

**Climate change guidance sources**

There are a broad range of guidance sources from across government and industry to aid decision-makers in their approach to climate change. Below are some examples of available guidance sources.

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

A guide to help trustees evaluate the way in which climate-related risks and opportunities may affect their strategies by making use of the TCFD recommendations.

**PLSA: 'ESG and Stewardship: A Practical Guide to Trustee Duties'**

A guide to help trustees understand what they need to do in order to meet their legal and regulatory duties, and how they can achieve good practice in relation to ESG and stewardship.

**The United Nations Principles for Responsible Investment (UNPRI) and CFA Institute: 'Guidance and Case Studies for ESG Integration: Equities and Fixed Income'**

A best-practice report to help investors understand how they can better integrate ESG factors into their equity, corporate bond, and sovereign debt portfolios. This guide provides a global insight on the ESG integration techniques of leading practitioners.

**PLSA: 'More Light, Less Heat: A Framework for Pension Fund Action on Climate Change'**

A guide designed to help governance bodies understand the importance of integrating climate change considerations into their investment practices. It identifies a programme of action largely applicable by pension funds of all type and size.

**ShareAction: Asset manager surveys and reviews of voting activity**

ShareAction provides investors with practical information which they can use to better engage and question those acting on their behalf to understand the actions being taken and how it fits with their own policies on climate change.

**Climate action groups**

Climate action groups, such as Climate Action 100+ and the Institutional Investors Group on Climate Change (IIGCC), also provide guidance and initiatives for integrating climate change into investment strategy. IIGCC's Net Zero Investment Framework', for example, will assist asset managers and owners in implementing strategies in line with the Paris Agreement's goals.

**Regulators**

Both TPR and the FCA include reference to ESG and climate change in their investment guidance for pension schemes.

## Chapter Two: How are schemes approaching consideration of climate change?

---

This chapter examines the way in which pension schemes are approaching climate change issues in relation to design and implementation of their investment strategy.

This report uses data from PPI's Engaging with ESG survey 2020. Carried out in November 2020, the survey sought to gather insight on the approaches being used by schemes in order to take into account ESG risks, as well as the challenges they may have faced along the way. The survey was open to responses from both schemes and third-parties involved in the process, such as consultants and asset managers. There were 62 responses in total, including those covering 31 pension schemes, 48% of which were Defined Contribution (DC) and 52% Defined Benefit (DB). When drawing conclusions from the data it should be recognised that the responses cover a subset of the market, and those who responded are more likely to be more engaged on ESG in general.

This report has also been informed by qualitative interviews carried out with a broad range of stakeholders across the industry.

## Although climate change has received greater focus than other ESG considerations, and some schemes are doing a lot in this area, others need improvement in order to appropriately mitigate risks

Traditionally, much of the focus on ESG considerations has been on environmental risks, especially climate change. It is therefore unsurprising that some schemes have focused on climate change particularly when designing and implementing their ESG strategy. However, most schemes do not have a differentiated approach to climate change risks, with most favouring a holistic ESG approach, which doesn't necessarily provide as much risk-mitigation as a more nuanced approach. While rapid regulatory change is pushing more schemes to consider climate risks in their investment strategies, collective climate movements and voluntary initiatives are also helping to move the landscape forward. However, some schemes' climate strategies still need major improvement in

order to appropriately account for these risks, particularly when it comes to scheme oversight and understanding of engagement and stewardship behaviours.

While schemes need to develop internal policies and approaches to climate change, most will not be directly involved in designing an investment strategy that takes account of these risks. Many DC schemes do not have the scale to design and implement their own investment strategy directly, so depend on off-the-shelf solutions from pension providers. This also means that in many cases it is the provider rather than the scheme that engages with external asset managers.

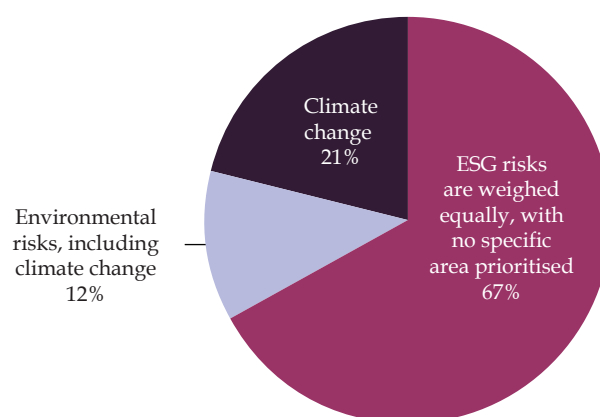
## Climate change is a top priority for many schemes

Although the majority of schemes consider ESG holistically, rather than separating out environmental, social and governance factors, a third of schemes consider climate change to be a top priority when designing and implementing their investment strategy (Chart 2.1).

Chart 2.1

## While most schemes consider ESG issues holistically, climate change is a top priority for a third of schemes

PPI Engaging with ESG survey 2020: 'Which area of ESG is your main priority when making decisions about investment strategy?'



There were no respondents that selected social and/or governance factors as their main priority.

## Broader societal focus and collective climate movements have contributed to a greater focus on climate change within schemes' investment strategies

In recent years, climate change has been increasingly at the forefront of media coverage, as the frequency of extreme climate events and climate change protest movements increase,

and the pressure to take action on climate change grows. As well as general social movements calling on Government, businesses and individuals to act on climate change, there are collective initiatives that specifically target large institutional investors such as pension schemes to pledge their capital to the transition to greater sustainability (Box 2.1).

Box 2.1:

## Examples of collaborative climate initiatives

### Climate Action 100+

An investor initiative launched in 2017 to ensure that the world's 100 largest corporate greenhouse gas emitters take action on climate change. More than 450 investors with over \$40 trillion in assets collectively under management are engaging companies to:

- Curb emissions,
- Improve governance and
- Strengthen climate-related financial disclosures.

### Institutional Investors Group on Climate Change (IIGCC)

A European membership body for investor collaboration on climate change. IIGCC has more than 240 members, mainly pension funds and asset managers, across 15 countries, with over €33 trillion in assets under management. IIGCC works to support and help define the public policies, investment practices and corporate behaviours that address the long-term risks and opportunities associated with climate change. IIGCC's 'Net Zero Investment Framework' will assist asset managers and asset owners in implementing investment policies and strategies in line with the Paris Agreement's goals by recommending methodologies and actions to achieve this.<sup>2</sup>

## Schemes are more likely to recognise the financially material nature of risks associated with climate change, compared to other ESG considerations

Because of growing regulation, significant focus on climate change across society broadly and initiatives targeted at institutional investors, climate risks are increasingly difficult for pension schemes to ignore. Compared to other ESG factors, climate change is more likely to be referenced specifically in schemes' SIPs - but detail in SIPs is limited. A review of 30 SIPs, carried out at the end of 2019, found that climate change was the only individual area of ESG mentioned. Half of the SIPs reviewed mentioned climate change, although only in passing, rather than setting out a differentiated climate approach in any detail. SIPs that mentioned climate change specifically typically referred to 'ESG issues, such as climate change', using wording which reflects the ESG regulations. Only two of the SIPs reviewed discussed climate change in any

level of detail, briefly discussing the ways in which climate change poses risks to scheme investments, stating the trustees' view that both the physical effects of climate change and policy interventions to mitigate climate change create sources of risk.<sup>3</sup>

## Despite a greater focus on climate change compared to other areas of ESG, very few schemes use a differentiated strategy

The majority of schemes that responded to PPI's Engaging with ESG survey do not use a differentiated approach for integrating separate Environmental, Social and Governance considerations into their investment strategy, with three quarters (76%) using a single, holistic approach to cover all ESG considerations. However, among those schemes that do differentiate between Environmental, Social and Governance considerations, more than half (60%) have policies relating specifically to climate change (Chart 2.2).<sup>4</sup>

2 IIGCC (2020)

3 UK Sustainable Investment and Finance Association (2020)

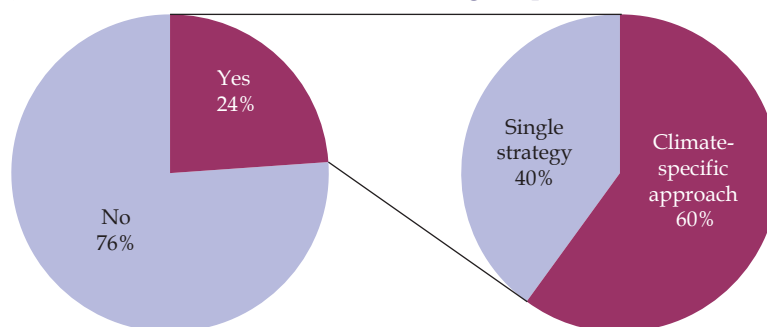
4 PPI Engaging with ESG survey 2020

Chart 2.2<sup>5</sup>

### Three quarters of schemes use one holistic strategy for ESG issues, but more than half of those who do differentiate, also have specific policies for climate issues in particular

PPI Engaging with ESG survey 2020

Do you have a differentiated strategy for each Environmental, Social and Governance areas or do you approach them holistically (one strategy for ESG as a whole)?



There are benefits and disadvantages of both differentiated and holistic strategies:

- Developing a differentiated approach for each area of ESG and climate change individually is likely to be correlated with higher cost and governance demands.
- Using a differentiated approach may produce a strategy that more effectively considers and responds to the specific nature of risks within each area, which may produce a greater level of risk mitigation. However, the additional risk mitigation provided may not offer value for money if the associated resource and governance costs of developing each individual strategy outweigh the benefits.
- Using a differentiated strategy for climate change may mean that some parts of the scheme's investment portfolio do not adequately protect members' savings from other ESG risks.

### Divestment continues to be a popular approach to mitigating the risks of certain industries, however higher engagement strategies are growing

Early ethical approaches to investment tended to be focused on negative screening (divestment), whereas the landscape has now begun to move in the direction of more active engagement

Do you use one strategy that covers climate change and other environmental issues or do you have specific policies that relate to climate change in particular?

approaches, though largely this is led by external asset managers rather than the schemes themselves. However, divestment continues to be a popular approach for mitigating some of the investment risks associated with climate change, especially amongst those using a differentiated strategy. Among respondents to the PPI's ESG survey, only 28% of those who use a single holistic approach to ESG risks said they had chosen to mitigate risk through negative screening. Among those with a specific strategy in place for climate change, two thirds (67%) said they used negative screening as part of their investment strategy in order to mitigate climate change risks; although, given the smaller sample size of schemes using a differentiated strategy compared to those using a holistic approach, this finding is not necessarily representative.<sup>6</sup>

### Divestment and exclusion are supported by many climate action groups, but the decision on whether this is the right approach for a pension scheme is more complex

There are a plethora of climate action groups calling directly upon pension schemes to divest from sectors that may accelerate climate change and challenge the transition to a low-carbon economy.<sup>7</sup> There are also many

<sup>5</sup> PPI Engaging with ESG survey 2020

<sup>6</sup> PPI Engaging with ESG survey 2020

<sup>7</sup> Collective climate action groups are discussed in more detail in the next section of this chapter.

online sources of guidance for members on how to encourage their pension scheme to divest. While divestment has in the past often been used to screen out investments associated with

ethical or moral controversy (such as weapons and tobacco), some schemes are using negative screening to drive forward the transition to a low carbon economy (Box 2.2).

### Box 2.2

#### Nest's divestment approach<sup>8</sup>

**In July 2020, Nest announced plans to decarbonise its investment portfolio, with the aim of aligning to the goals of the Paris Agreement. Nest aims to be net-zero across its portfolio by 2050. To help achieve this, Nest has made a series of immediate commitments:**

- To move £5.5 billion of equities into climate aware strategies, representing 45% of Nest's portfolio.
- To begin divesting from companies involved in thermal coal, oil sands and arctic drilling, and to be completely divested by 2025 at the latest, unless they have a clear plan to phase out all related activity by 2030.
- To invest a greater proportion of its funds directly in green infrastructure, building on the £100 million Nest has already invested in renewable projects across Europe.
- To actively pressure investee companies to align with the Paris goals and divest from companies that show little progress following sustained engagement.
- To commit its fund managers to making progress against set benchmarks, including analysing how Nest can halve its emissions by 2030.

While screening continues to be the most common approach to the incorporation of ESG factors into index strategies (41% compared to 28% tilted funds),<sup>9</sup> it may have unintended consequences. Excluding too many particular companies or sectors concentrates risk by limiting the scheme's spread of investments. Exclusion will also not necessarily have the intended positive impact on ESG factors:

- The industries commonly excluded by negative screening do not tend to rely on equity capital to fund growth, as they are typically very profitable in and of themselves. This means that selling (or not buying) shares will have limited effect on these industries' funding.<sup>10</sup> However, this does mean that not buying these companies' debt (whether private, or public in the form of corporate bonds) is likely to have an impact.
- As long as these industries continue to deliver positive returns, there is likely to be a supply of investors. If investors who are particularly sustainability-minded divest

from these industries, equities are likely to be bought by investors who care less about ESG risks, which could lead to poorer ESG progress in the long-term.

- Exclusion prevents the scheme or asset manager from engaging either unilaterally or collectively with the excluded company which might otherwise improve the company's ESG performance, although by not holding these investments the pension scheme has mitigated the risks associated with them in relation to their members' savings.<sup>11</sup>
- Some of the companies in sectors that are traditionally high carbon are also making substantial investment in working towards a low-carbon future, so by divesting from these companies, investors may be withdrawing capital from companies who are leading low-carbon innovation.

Tilting strategies, particularly those that use a 'best-in-class' approach rather than one based on absolute ESG ratings, offer an approach that

8 <https://www.nestpensions.org.uk/schemeweb/nest/nestcorporation/news-press-and-policy/press-releases/Nest-going-net-zero-to-support-green-recovery.html>

9 PRI (2019)

10 Schroders (2019a); Schroders (2017)

11 Blitz & Swinkels (2020)

may be less likely to concentrate risk as they do not generally exclude whole sectors. However, it is possible that an investment strategy which allocates funds in proportion to the current sizes of market sectors may not offer as great a level of financial risk-mitigation against future changes over the longer-term. For example, the total value of firms currently in the oil and gas sector may shrink relative to the wider market over the medium-term. All schemes in the Engaging with ESG survey that use a differentiated approach to climate change risks use tilting as part of their strategy, compared to a third (33%) of schemes that use a holistic ESG approach.<sup>12</sup>

Active, outcome-oriented strategies offer more flexibility in terms of financial-risk mitigation and the potential in some circumstances for improved outcomes, whilst impact investing has its focus on real-world outcomes (for example, the slowing of negative effects associated with climate change). However, for trustees who are still struggling to recognise the connection between climate change and financial risk mitigation, these approaches are likely to be less attractive.

### Active engagement and stewardship activities are an increasing focus of ESG and climate strategies

Strategies that involve direct engagement can be more cost and governance intensive than screening, tilted or impact funds. Direct engagement strategies are typically used by large DB schemes with internal investment teams and formalised ESG policies, mainly via segregated mandates (an individual fund run solely for this scheme). Passive strategies rely on indices to determine their asset allocation and security selection, whereas active strategies require much more research into the underlying assets and practices of companies in constructing a portfolio. Portfolios primarily held in index funds and some active and rules-based funds are likely to be invested in a large number of companies, which makes it less likely that engagement with any one company in which the scheme is invested will have a material impact on the portfolio's overall performance.

Trustees who do not fully recognise the financially material nature of ESG risks or those with more limited resources, such as smaller schemes, may judge that direct engagement

strategies are not worth the level of cost and governance required compared to the financial risk mitigation provided in return.<sup>13</sup>

Nevertheless, higher engagement strategies can offer opportunities and benefits above those offered by divestment strategies:

- Engagement allows investors the opportunity to influence the companies they are invested in, in order to improve policies and behaviour relating to climate change.
- Engagement can provide investors with more up-to-date information about the companies in which they are invested and their policies in relation to climate change.<sup>14</sup>

Because DC schemes generally invest through pooled funds offered by an external asset manager, they may not have as much opportunity to enact higher engagement strategies. Although some asset managers are more proactive on climate change and have their own engagement policies in place, individual DC schemes invested in pooled funds will not be able to influence these according to their own values and policies as extensively as they would if invested directly. However, this barrier may become less of an issue as climate policies among collectives of investors become more commonplace (see Box 1.1) and as larger DC schemes result from further consolidation. Even if they are invested primarily through pooled funds, individual smaller schemes can formulate their own policies for investment and engagement on climate change and use these in the selection or retention of pooled products.

### Investment approaches to climate change are not mutually exclusive and different combinations of approaches will be most appropriate for different schemes

There are a variety of approaches that schemes can use in order to effectively mitigate climate risk within their investment strategy. Different approaches will be more appropriate for some schemes than others and in many cases a combination of these approaches will be most effective.

12 PPI Engaging with ESG survey 2020

13 PRI (2019)

14 PRI (2018)

# Chapter Two Conclusions

## **Climate change is a top priority for many schemes when designing an investment strategy that takes into account ESG risks**

Rapid regulatory change in relation to climate issues, as well as broader societal focus and collective climate movements, may contribute to schemes attributing a greater focus to climate issues when designing and implementing their investment strategy. While most schemes consider ESG issues holistically, climate change is a top priority for a third of schemes.

## **Divestment continues to be a popular approach to mitigating the risks of certain industries, however higher engagement strategies are growing**

Divestment from sectors that have a particularly negative effect on climate change is an approach supported by many climate action groups, but the decision on whether this is the right approach for a pension scheme is more complex. Schemes face complicated decisions about the cost, governance demands and impact of the various approaches available. Different approaches will be more appropriate for some schemes than others and in many cases a combination of these approaches will be most effective.



# Chapter Three: What role do members play in climate change approaches?

This chapter explores the role of member views in the design of climate change strategies, now and in the future.

## Member views on climate change are growing stronger and may be more influential on scheme investment decisions in the future

As pension schemes' focus on climate change has grown, so too has discussion of member views in this area and the role they may play in determining future investment strategies. Some schemes are increasingly choosing to engage with members on climate change in order to inform decisions about investment strategy. Member views are likely to play an increasing role going forward as scheme members, perhaps especially those in younger generations, become more engaged on these issues. However, some trustees and providers that are still confused about the perceived conflict between the financial and ethical components of ESG investing may find it more difficult to engage with members on these issues.

## Some schemes are actively engaging with members on climate change, while others do not currently take member views into account

Although pension schemes are under no legal obligation to take member views into account, some schemes conduct member research and consider these views when designing and implementing the scheme investment strategy. Four schemes in the PPI Engaging with ESG Survey 2020 explicitly mentioned carrying out member surveys focused on responsible investment and ESG considerations.

Schemes that choose to take member views into account need to balance this against fiduciary duties to protect members against risks, but in the area of climate change members' views may be more likely to match up with the aims of financial risk mitigation, compared to more niche ethical areas. There has historically been

some confusion around the interaction between the financial and ethical components of ESG and climate change, which still persists among some in the industry. However, the belief that the fiduciary duty to pursue the highest possible returns means that non-financial factors cannot be taken into account is incorrect. In its 2014 report on the fiduciary duties of investment intermediaries, the Law Commission establishes that the law permits trustees to make investment decisions that are based on non-financial factors, provided that:

- They have good reason to think that scheme members share the concern; and
- They do not result in any financial detriment.<sup>15</sup>


### Member engagement on ESG and climate change varies considerably across the industry

When asked about the extent to which member views and expectations factored into the investment decision-making process, responses to the Engaging with ESG survey ranged from very little engagement or consideration of member views, to much more active engagement processes among some schemes (Box 3.1).

Box 3.1:

#### Responses from PPI’s Engaging with ESG survey

**To what extent were member views and expectations factored into the decision-making process?**

<u>Defined Benefit</u>		<u>Defined Contribution</u>
‘Not at all’		
‘Minimally’		
‘None. Member views are a complete irrelevance’		‘Member views are actively and regularly engaged and suggestions sought. Engagement from members, however, remains limited’
‘Member views, if provided proactively, were considered but were not the driving factor’		‘For some employers, an online questionnaire completed by members informed decision-making about the choice of default’
‘Through member representatives, such as member nominated trustees and trade unions’		‘We take regular informal feedback from our members’

Because most of the risk associated with DB funding falls to the sponsoring employer, DB schemes are less likely to take member views into account. Larger DC schemes, particularly master trusts, are more likely to seek member views on ESG and climate change. However, there is limited evidence on the extent to which these views are considerations when designing and implementing investment strategy.

### Although many people are becoming more engaged on climate change generally, direct member engagement with pension schemes is still low

Increased societal focus and environmental movements have led to a growth in engagement with climate change. In 2019, 70% of investors said they would like their investments to avoid harm

<sup>15</sup> Law Commission (2014)

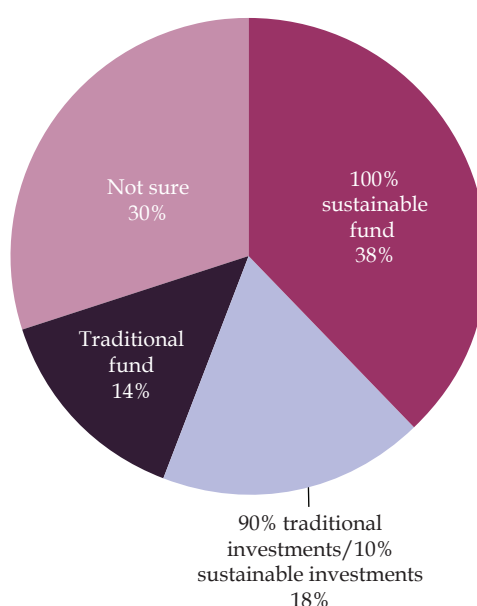
and achieve good for the planet, while 57% said that they are interested in learning more about the impact their pension savings are having on climate change.<sup>16</sup> Two in five (38%) say that they would prefer for their pension savings to be

invested in a fully-sustainable fund in which 100% of the investments are sustainable, compared to 14% who say that they prefer to be invested in a traditional fund that does not seek positive impact on people and the planet (Chart 3.1).<sup>17</sup>

Chart 3.1<sup>18</sup>

### Two in five investors say they would prefer to be in a pension scheme with a fully-sustainable investment portfolio

Survey of 5,123 individuals representative of the UK population by gender, age and region + a booster sample of 1,018 individuals with at least £25,000 investable assets



### While awareness of climate change is growing, direct engagement from members of pension schemes remains low

Although there is a broader societal focus on climate change which has led to greater engagement with climate issues, as with pensions engagement generally, direct engagement on these issues between schemes and members remains limited. One consultant who responded to the Engaging with ESG survey said that while member views are 'actively and regularly engaged and suggestions sought' by the schemes they advise, 'engagement from members remains limited'.

### Levels of engagement with pensions are generally low and unlikely to be substantially increased solely by concern for climate change

Engagement levels with pensions in general are low as a result of a combination of low levels of financial capability, inertia and communication challenges. Engagement can be difficult to measure, especially since the introduction of automatic enrolment with no active choice needed to join a workplace pension scheme. One way to potentially measure engagement with pensions is through the proportion of scheme members who have actively registered to access their account online. As of 2018, only around one in 10 scheme members were connected with their pension provider through their online platform.<sup>19</sup> This suggests that very few scheme members are actively engaging at all, let alone exploring in detail

16 HM Government (2019)

17 HM Government (2019)

18 HM Government (2019)

19 ShareAction (2018)

the ESG and climate credentials of specific investments within the scheme portfolio. However, some members who are especially engaged on climate change may be driven to increase engagement with their scheme on this basis, particularly as many collective climate initiatives, such as Make My Money Matter

(Box 3.2), aim to increase awareness among scheme members of the impact of their pension investments. However, for most members, an interest or concerns around climate change will not be enough to incite engagement, without efforts to increase pension engagement more generally.

### Box 3.2

#### **Make My Money Matter**

A people-powered campaign fighting for a world where we all know where our pension money goes, and where we can demand it's invested to build a better future. The campaign seeks to empower pension scheme members to put pressure on those responsible for investing their savings to ensure that it is invested in ways that do not contradict their values and beliefs about ESG and responsible investment.

Increasing levels of engagement is not inherent to improving outcomes and, in some cases, may lead to poorer outcomes for individual members. While increased engagement can lead to increased saving and more informed decisions about pension savings, in some cases increased engagement may lead to poorer pensions outcomes for individuals; for example, if a member chooses to opt out of their pension scheme as a result of investments that do not align with their own ESG and climate opinions.

**There is some evidence that a greater focus on ESG and climate change can increase member engagement with their pension, but this will need to be monitored over the longer term to assess the full effect**

In 2019, 78% of 22-39 year olds said that the investments made by their pension scheme

either don't align with their values or they don't know if they do, but that they would engage with their annual pension statement if it included more information on responsible investment. Among this age group, 45% said they would be motivated to increase their level of contributions if their pension scheme's investment strategy was more aligned with their own views on responsible investment.<sup>20</sup> This survey, like much of the existing research on the link between responsible investment and increased engagement, relies on members self-reporting hypothetical behaviour in response to a greater focus on responsible investment, rather than evidencing actual increases in engagement. Although evidence of actual increased engagement is less readily available, there are some examples (Box 3.3

### Box 3.3:

#### **An example of increased engagement as a result of ESG communications<sup>21</sup>**

In 2019, Nest members were sent an email with the subject line 'Nest is going tobacco-free across all our funds' and a call to action to click a link to 'view your pension pot'. Although active members who had previously logged in and registered their account were more likely to open the email, with seven out of 10 doing so, the open rate for unregistered members was also relatively high: 45% of unregistered members opened the email. The click-through rate on the call-to-action link was nearly one in five for unregistered members who opened the email, illustrating an increased level of engagement from members who had not previously engaged with their pension online.

<sup>20</sup> Franklin Templeton (2019)

<sup>21</sup> Nest Insight & LGIM (2020)

Levels of engagement will need to be monitored over the longer term in order to measure the impact of responsible investment and will be dependent on schemes' success in communicating these issues effectively to members. Communication of ESG and responsible investment practices will need to employ simple and accessible language to ensure that members are not discouraged from engaging by the use of industry jargon.

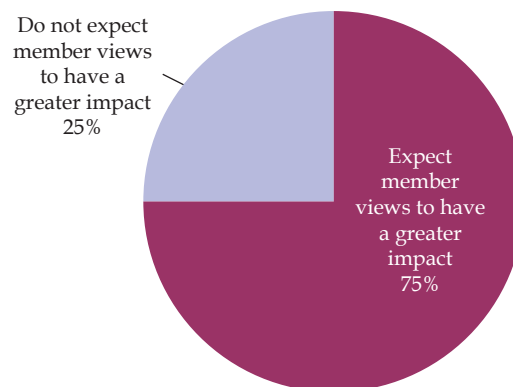
### Member views are likely to have a greater impact on scheme investment decisions in the future

The majority of schemes responding to the PPI's ESG Survey expect member views to have more of an influence on scheme behaviour in the future (Chart 3.2).

Chart 3.2

### Three quarters of schemes expect member views to have a greater influence on decisions about investment in the future

PPI Engaging with ESG survey: 'Do you expect members to have more of an influence on scheme behaviour in future?'



### Member engagement on climate change may grow as younger members age and become more engaged with pensions in general

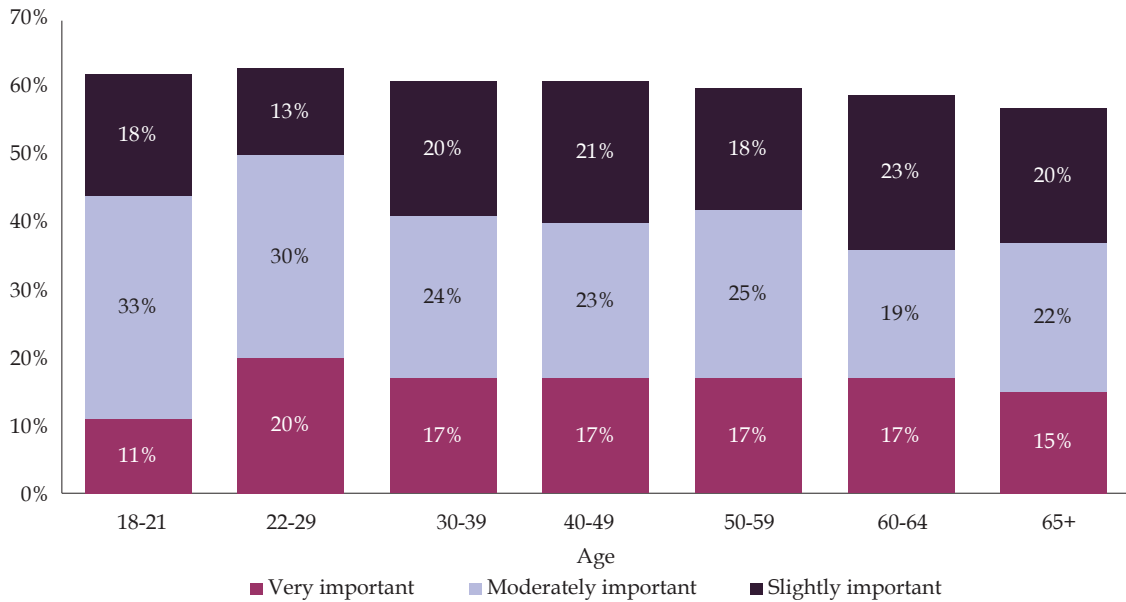
Younger members tend to be more engaged on climate change but less engaged on pensions in general. Younger generations are likely to have a greater awareness of climate change, given its increasing salience which means it has

been prominently discussed for most of their lives and taught during primary and secondary education. This may mean that younger scheme members place a greater importance on their pension investments aligning with their views on climate change. In 2020, 50% of 22–29 year olds expressed that sustainable pension fund options were either very or moderately important to them, compared to 37% of over 65s (Chart 3.3).

Chart 3.3<sup>22</sup>

**In 2020, 50% of 22-29 year olds expressed that sustainable pension fund options were very or moderately important to them**

Survey of 5,757 adults aged 18+, weighted to be representative of the UK population

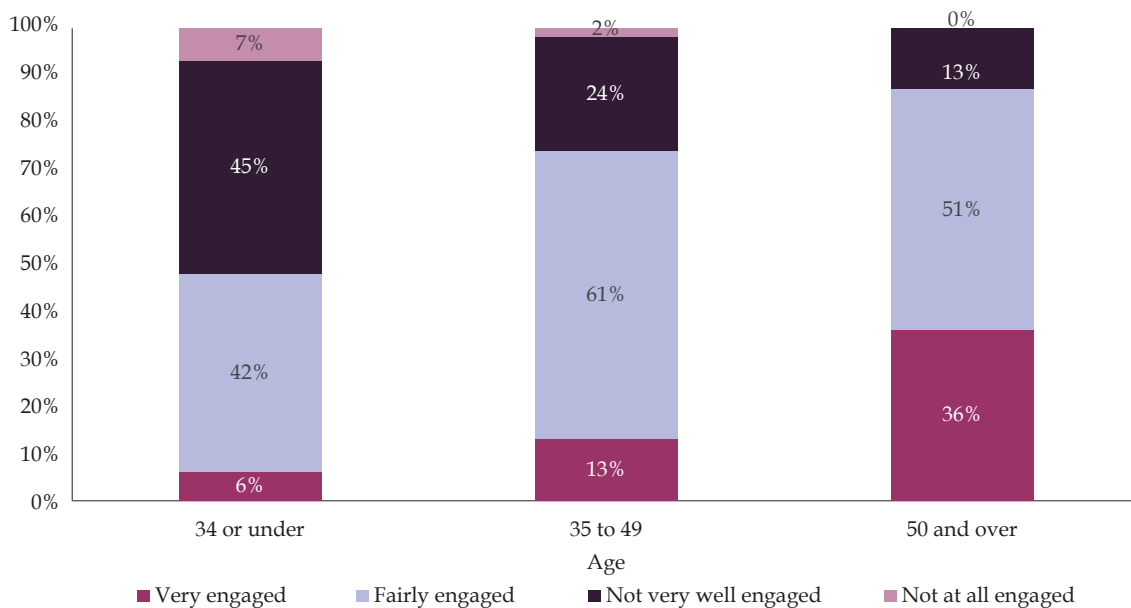


While younger members may be more engaged on climate change and the responsible investment landscape more generally, they tend to be less engaged with pensions than those who are closer to retirement (Chart 3.4).

Chart 3.4<sup>23</sup>

**Younger scheme members tend to be less engaged than those who are closer to retirement**

Survey of 189 employers, representing a mix of large and small businesses and industry sectors



22 Scottish Widows (2020)

23 Aegon & CBI (2018)

## Member action on climate change may become more direct in future

Although direct member engagement on climate change has traditionally been low, in recent years there have been overseas examples of legal action being brought against schemes that have failed to appropriately protect their members against climate risks, for example Box 3.4.

### Box 3.4

#### An example of legal action by pension scheme members<sup>24</sup>

##### **McVeigh v. Retail Employees Superannuation Trust**

In July 2018, Mark McVeigh, a member of the Australian Retail Employees Superannuation Trust (REST), filed a lawsuit against his pension scheme alleging that the fund violated the Corporations Act 2001 by failing to provide information related to climate change business risks and any plans to address those risks.

In November 2020, the parties reached a settlement in which the pension fund agreed to incorporate climate change financial risks in its investments and implement a net-zero by 2050 carbon footprint goal.

The rapid direction of travel of UK regulation regarding schemes' duties to consider climate risks may mean such legal cases are less likely to be brought by members of UK pension schemes. However, the existence of legal cases elsewhere suggests that there may be appetite for more direct member engagement on climate considerations in the future, as these issues become more pressing and the population of savers more aware.

24 <http://climatecasechart.com/non-us-case/mcveigh-v-retail-employees-superannuation-trust>

# Chapter Three Conclusions

---

## **Member views on climate change are growing stronger and may be more influential on scheme investment decisions in future**

Although not obligated to do so at present, some schemes are actively engaging with members on climate change to better understand their views. Increased societal focus and environmental movements have led to a growth in engagement with climate change generally, but engagement with pension schemes specifically remains low, despite members expressing an interest in the impact of their pension savings when directly surveyed. There is some evidence that a greater focus on ESG and climate change can increase member engagement with their pension. However, this will need to be monitored over the longer term to assess the full effect, as ESG and climate change become a greater focus of pension scheme investment strategies and younger generations who are more engaged on these issues become more engaged with pensions as they approach retirement.



## Chapter Four: What practical steps may be needed to overcome barriers relating to climate change investment?

**This chapter highlights the barriers schemes may face when designing and implementing their investment strategy. It also identifies the practical steps that may be needed from government and industry in order to drive forward progress on climate change and improve the way in which pension schemes' investment strategies take account of these risks.**

Climate change has been the main area of focus for pension schemes when integrating ESG risks into their investment strategy. However, while some schemes, and those acting on their behalf such as providers or external asset managers, are doing a lot to mitigate these risks, there is still a lot of work to be done as physical and transition risks associated with climate change become more pressing. In order to be most effective (both in terms of risk mitigation – which is the vital consideration for pension schemes – and also real-world impact on climate change) in helping decision-makers to

overcome the barriers identified in this chapter, the main focus of this work will need to be around establishing joined-up goals, strategies and data sources across Government and industry. These include:

- **Integrated goals:** Establishing a consensus across all stakeholders (Government, schemes, asset managers and platform providers) on goals, and the practical steps needed to achieve them, to ensure that climate change considerations are integrated across the investment landscape by a certain date.

- **Engagement and stewardship:** A greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals.
- **Encouraging innovation from third parties:** Pressure from Government, regulators and industry bodies on those involved in schemes' approach to climate change (such as pension providers, external asset managers and consultants) to provide products and strategies that meet the needs of schemes in integrating these risks, as well as improving the data they provide schemes about their own activities relating to climate change.
- **Increasing knowledge and understanding:** Improving scheme decision-makers' knowledge and understanding of climate change across the industry, especially around the more practical aspects such as the implications of different investment approaches. This could be standardised and measured through a specific training module in The Pensions Regulator's Trustee Toolkit, for example.
- **Standardised data:** Producing a centralised data source which can provide a starting point for schemes that are unsure where to begin or are overwhelmed by the quantity of data available, particularly given inconsistency across different metrics. Feasibly, this would need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

### **Policy and regulatory change relating to climate change is occurring rapidly, which can be challenging for schemes that do not already have the necessary knowledge and expertise to catch up at pace**

In the last two years, focus on ESG considerations, and climate change especially, has grown rapidly, with many trustees and providers increasing their understanding and knowledge of this area - particularly driven by changes in regulation. As regulation in this area, as well as voluntary initiatives aimed at addressing climate change, have evolved quickly, schemes that weren't previously giving much thought to climate change or ensuring a decent level of knowledge and understanding among decision-makers may struggle to keep pace with changes.

### **Regulatory changes to SIP requirements in 2018 and the subsequent strengthening of these requirements in the 2020 mandate that schemes must at least consider climate risks when designing and implementing investment strategy**

In September 2018, the Government introduced regulations to strengthen the obligation of occupational pension scheme trustees to consider ESG factors in investment decisions and illustrate how they have done so in their SIP. From 1 October 2020, these regulations increased further, with trustees of DC schemes with 100 or more members now required to produce an implementation statement explaining how they have followed and acted upon the stated investment policies set out in their SIP. This includes reporting on the way in which the scheme monitors its asset managers who undertake investment and engagement activities on its behalf, and on whether these managers have acted in accordance with the trustees' stated policies. In December 2019, the FCA introduced similar reporting requirements for contract-based schemes, extending the remit of IGCs to include a new duty of considering and reporting on their firm's policies on ESG issues, member concerns and stewardship, for the products overseen by the IGC. As of 1 October 2020, DB schemes are also required to publish their SIP alongside a narrower implementation statement covering their engagement and voting behaviour.

### **Regulations based on TCFD recommendations are expected to further increase reporting demand on schemes**

In 2020, both the FCA and DWP consulted on proposals to increase climate-related disclosure. In March 2020, the FCA published a consultation paper on *Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations*. In August 2020, DWP announced a consultation on policy proposals to require trustees of larger occupational pension schemes to address climate change risks and opportunities through effective governance and risk management measures, in line with TCFD recommendations. The Government's response, *'Taking action on climate risk: improving governance and reporting by occupational pension schemes'*, was published in January 2021.

## The TCFD recommendations<sup>25</sup>

The TCFD recommendations focus on four key areas:

- **Governance:** The organisation's governance around climate-related risks and opportunities.
- **Strategy:** The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning.
- **Risk management:** The processes used by the organisation to assess and manage climate-related risks.
- **Metrics and targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The Pension Schemes Act 2021 will enable regulations to be made requiring trustees to consider, in depth, how climate change will affect their pension scheme and its investments, funding and liabilities, and to publish information relating to the effects of climate change on the scheme.

## The Pension Schemes Act 2021

Clause 124 of the Pension Schemes Act 2021 includes power to make regulations:

- Imposing requirements on scheme trustees with a view to securing that there is effective governance of the scheme with respect to the effects of climate change;
- Requiring information relating to the effects of climate change on the scheme to be published;
- Ensuring compliance with the requirements above.

In order for schemes to be able to deliver on this, they will need to ensure that they themselves are receiving appropriate reporting from their external service providers and from the underlying companies in which they invest. This was echoed by some responses to the Engaging with ESG survey. One scheme expressed concern that trustees would have to comply with TCFD requirements before Government and some corporate issuers are required to do so, which will make trustees' task more difficult to carry out to a reasonable standard.

The FCA will consult on the introduction of TCFD obligations for asset managers, life insurers and pension providers in the first half of 2021.

### Although regulatory change is occurring rapidly, schemes need to take a long-term view to climate change strategy

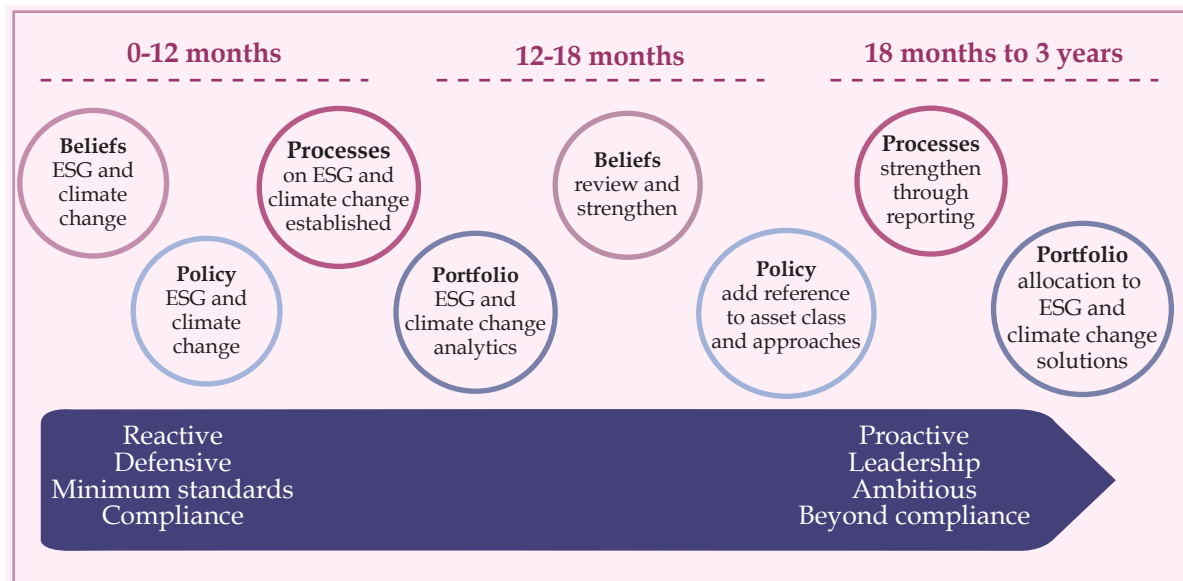
The rapid change observed in the ESG investment landscape in recent years does not look set to slow down, meaning that many schemes will have to make equally

rapid adjustments in order to comply with regulation. However, schemes also need to take a long-term view on the process of designing and implementing a strategy that appropriately protects their members against climate risks as much as possible. While schemes that are not already in compliance with incoming regulatory changes will need to take the necessary steps to comply immediately, their overarching climate strategy will likely take longer to establish and will involve periods of review and revision along the way. Mercer has proposed a Responsible Investment Pathway that broadly sets out the steps that schemes may need to take over a three-year period (Figure 4.1). Working proactively through this process to establish a robust strategy on climate change risk will protect schemes' assets from future regulatory changes which may be even more rapid and abrupt than the changes observed in regulation so far. Constructing a climate change strategy that goes beyond reactive compliance will provide schemes with greater protection against transition risks associated with climate change.

25 TCFD (2017)

Figure 4.1

**Mercer’s Responsible Investment Pathway<sup>26</sup>**



**Establishing an agreed-upon goal across all stakeholders to ensure that climate change considerations are integrated across the investment landscape by a certain date, using agreed steps on how to get there**

Making progress towards more effective consideration of climate change risks in pension schemes’ investment strategy will require holistic efforts from across Government and industry. Increased regulations relating to climate change, such as the introduction of increased reporting in line with the TCFD recommendations, will mean that schemes will need to improve the way in which they take account of these risks - but without a joined-up strategy from all those involved in the process, scheme progress is likely to be constrained. For schemes to be able to deliver on this effectively, they will need to ensure that they themselves are receiving appropriate reporting from their external service providers and from the underlying companies in which they invest.

In order to make sure that schemes can effectively improve the way in which they approach climate change risks, **there may need to be increased reporting regulations placed on external asset managers and investee companies.**

The UK Net Zero target of achieving a balance between the amount of greenhouse gas emissions produced and the amount removed from the atmosphere could provide a suitable target for all stakeholders to aim for and measure behaviour against. However, a clear and joined-up set of action points for getting there and who is responsible for each one will be needed to measure progress effectively. While focus on these targets appears to be growing, only half (52%) of respondents to PPI’s Engaging with ESG survey said that they consider the Net Zero Paris Agreement in their investment strategy.

**Although knowledge and understanding has grown across the industry, there is still a gap in some areas**

Changes in regulation, as well as the increasingly imminent risk presented by some ESG factors, especially climate change, have encouraged many trustees and providers to improve their knowledge and understanding of these issues. However, there is still a clear knowledge gap in some areas of the industry.

26 Mercer (2019)

## When designing their approach to climate change, it is vital that decision-makers understand the data available to them and how it can be applied to scheme investments

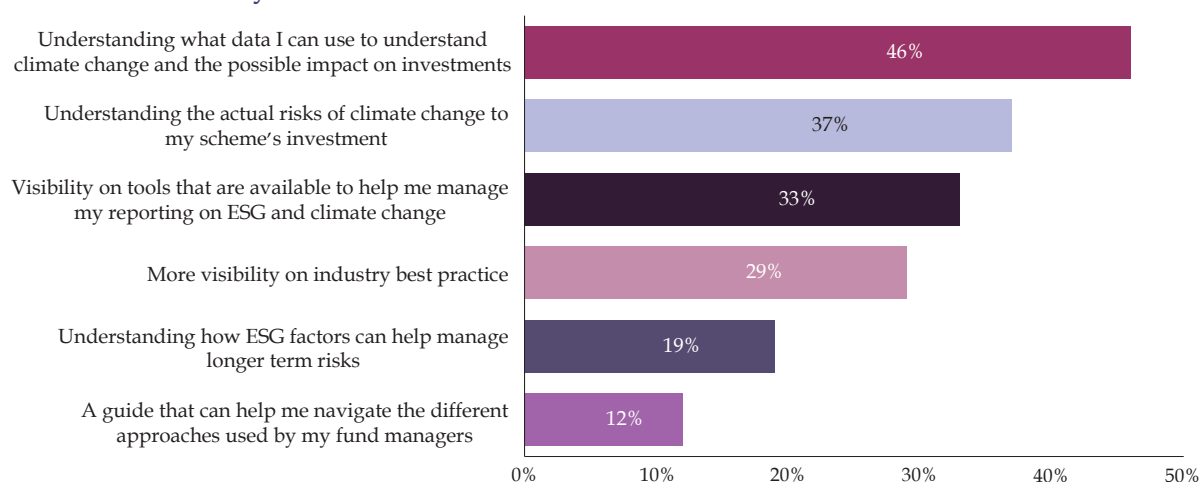
Understanding how to work with the available data on climate risks is a particular challenge

for trustees who lack expertise in this area. Nearly half of schemes in the 2020 PLSA survey said that understanding what data is available on climate risks and how it can be applied to their own portfolio is the biggest gap in their knowledge on ESG (Chart 4.1).

Chart 4.1<sup>27</sup>

### Schemes consider identifying and utilising available climate data one of their biggest knowledge gaps

PLSA scheme survey 2020



### Too much focus on past performance can obscure the focus of ESG strategies, which is the materiality of future risks

While evidence of ESG performance varies across different studies, failure to consider climate risks within investment strategy exposes members to unnecessary risk as these issues become more material, both in terms of physical risks and transition risks. Past performance of investments does not predict future performance, particularly when looking at longer-term risks that are increasing. Because the ESG investment landscape has developed rapidly in recent years, there is also less availability of historical data. In some cases, investment decision-makers may be holding ESG investment to a higher standard than traditional strategies when assessing performance, not acknowledging the fact that the value of integrating ESG risks into investment strategy lies in the materiality of future risks.<sup>28</sup>

Both cost and governance considerations can restrict the types of scheme for whom each approach may be most suitable, however smaller schemes should not use this as a justification for less-effective integration of climate risks. For some

schemes, this will require that efforts are made to improve knowledge and understanding of climate change and its associated issues, as well as increased engagement with external managers to drive forward innovation and ensure that pooled products meet their needs and preferences in accordance with scheme climate policies.

### Improving scheme decision-makers' knowledge and understanding of climate change across the industry, especially around the more practical aspects such as the implications of different investment approaches, will be an important aspect of driving improvements

Climate change is a rapidly evolving area, and one which many trustee boards and their advisers don't necessarily have sufficient knowledge and experience to address without additional guidance and training. In order to establish a minimum level of knowledge and understanding among decision-makers, there may be a need for specific training offered by

27 PLSA (2020a)

28 SSGA (2019)

industry-bodies or even asset managers who are particularly engaged on climate change. Once established, these training offerings could be geared towards qualifications that require all trustees to have a minimum level of knowledge on these issues. This could be standardised and measured through a specific training module in The Pensions Regulator’s Trustee Toolkit, for example. DWP has announced its intention to require trustees to ‘have knowledge and understanding of the principles relating to the identification, assessment and management of risks to occupational pension schemes arising from the effects of climate change.’<sup>29</sup>

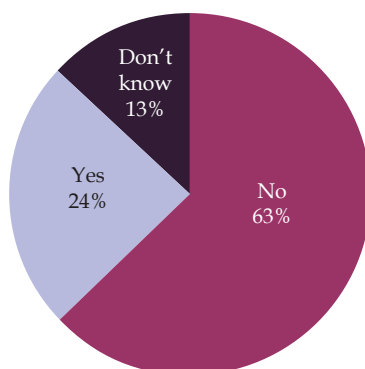
### A lack of consistency and clarity in data and reporting is a fundamental barrier to improving the effectiveness of climate change risk mitigation in schemes’ investment strategies

More than a quarter (28%) of respondents to the Engaging with ESG survey said that too much information had been a challenge when designing their approach to ESG, while 22% said that conflicting information had also been a challenge. Similarly, a 2020 PLSA survey found that nearly two thirds of schemes did not feel they had sufficient information to be able to translate climate change risks into their investment strategy (Chart 4.2).

Chart 4.2<sup>30</sup>

### Nearly two thirds of schemes do not feel they have sufficient information to integrate climate risks into their investment strategy

PLSA scheme survey 2020: ‘Do you have sufficient information to be able to translate climate change risks into your scheme’s investments?’



### Metrics and analytics tools are an important part of designing an investment strategy that mitigates climate risks, but there are concerns about the quality and consistency of data available to investors and asset managers

Metrics and analytics tools enable pension schemes to make more effective decisions about how to integrate climate considerations into their investment strategy. However, the quality, quantity and consistency of data available will determine the effectiveness of the chosen investment approach. There are a number of limitations that schemes may face when utilising metrics and analytics tools:

- **Quality:** Data can face issues of reliability and consistency as it is largely self-reported.
- **Coverage:** Data tends to be more readily available on larger companies, in part because metrics have only become prominent in the last decade. Data on climate performance of smaller companies tends to be less detailed, if available at all. Data is also less widely available in emerging markets.
- **Consistency:** Calculation and reporting methodologies are complex and vary across providers, meaning that the same company can score very differently according to the metrics used or the way scores are combined.
- **Frequency:** Many metrics are updated on an annual basis, making it harder to respond in a timely way to manage risk or enhance returns.<sup>31</sup>

29 DWP (2021)

30 PLSA (2020a)

31 Blackrock (2018); Berg, Koelbel & Rigobon (2020)

## Producing a centralised data source which can provide a starting point for schemes that are unsure where to start or are overwhelmed by the quantity of data available

Schemes that do not have a working understanding of the data available and the way in which it relates to their investment strategy are less likely to be able to design and implement an approach that appropriately protects members against the long-term risks associated with climate change. They will also find it more challenging to hold third parties involved in the design and implementation of their investment strategy to account on climate change.

A centralised pool of data on climate change and pension scheme investment that covers both the basic aspects and the more complex investment considerations could help schemes to identify practical steps forward. This data would need to be provided by a neutral source, such as Government, regulators or an industry-wide body, rather than an asset manager or consultancy firm, and data would need to be thoroughly checked and verified. Feasibly, this would need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

A standard framework clarifying definitions around climate change and investment would ensure a higher level of shared understanding across the industry. Collaboration between Government and industry to produce a framework of common language and taxonomy could help to clarify existing confusion resulting from the wide range of competing standards and definitions that currently exist.<sup>32</sup> This could be a starting point towards a more extensive centralised data pool.

## Availability and quality of data is improving, but schemes will need to take a more active role in encouraging innovation from pension providers and external asset managers

Although there are broad issues associated with generating data analytics, there are some very significant and accessible data sources currently available.<sup>33</sup> Furthermore, some asset managers who are particularly engaged on ESG issues are working on differentiated solutions. Over time, this will enable them to provide pension schemes with more accurate data to better inform their decision making. However, in order to push this evolution forward, schemes will need to consider the quality of data provided when selecting and retaining external managers, rather than accepting current standards as they are. While improvement in this area will require work on the part of external managers, schemes must work with their managers and make clear that there is strong demand.

Establishing higher standards of company disclosure, perhaps in the form of a standard reporting framework, could help to improve the effectiveness of analytics processes and, as a result, the level of climate change risk mitigation within pension schemes' investment strategies. In 2020, the International Financial Reporting Standards Foundation (IFRS), a non-profit organisation responsible for the development of a single set of consistent and globally accepted accounting standards, consulted on the establishment of a new Sustainability Standards Board. The proposals set out in IFRS consultation paper build upon existing initiatives and suggest a 'climate-first' approach because of the urgency of current shifts in climate change.<sup>34</sup>

While challenges around data availability, consistency and schemes' understanding of how it relates to their investment strategy, can

32 PLSA (2020a)

33 FCA (2020)

34 IFRS Foundation (2020)

make it more difficult for schemes to identify the most appropriate approach to climate change risks, this is not a reason for schemes not to engage with these decisions. Approaches to climate change risk are likely to become more effective as data and knowledge improves, but schemes must act now with the data available in order to protect members against risks. Schemes can then assess and revise their strategy as more data becomes available.

### **Schemes will need to increase engagement with and monitoring of pension providers and external managers in order to improve the effectiveness of their investment strategies and mitigation of climate risks**

Although many schemes, particularly DC, are heavily dependent on pension providers and external asset managers to perform investment, engagement and stewardship activities on their behalf, scheme decision makers must ensure that they have appropriate levels of knowledge and understanding, as well as clearly established climate policies, in order to hold external managers to account and ensure that they are acting in accordance with scheme policies where possible.

### **DC schemes are heavily reliant on, and limited by, ESG offerings of pension providers and external asset managers**

From October 2020, trust-based DC schemes are required to publish an implementation statement explaining how they have followed and acted upon the stated investment policies set out in their SIP. The Pensions Regulator has said that, ‘the purpose of this report is to help ensure that “action follows intent” as much as possible.’<sup>35</sup> This includes reporting on the way in which the scheme monitors its asset managers who undertake investment and engagement activities on its behalf and whether these managers have acted in accordance with the trustees’ stated policies.

More than a quarter (28%) of schemes that responded to the PPI Engaging with ESG survey said that the need for a platform, asset manager or other third party in implementing their strategy proved to be a barrier to constructing it exactly as they would have liked. Schemes may need to engage with and challenge their pension provider and external managers more directly in order to drive forward innovation to ensure that off-the-shelf and pooled products meet their needs and preferences in accordance with their internal climate policies.

### **Although schemes predominantly outsource their day-to-day investment decisions, they retain oversight of the engagement and stewardship activities being undertaken on their behalf**

The high availability of pooled funds, alongside the governance and budget required to establish an internal policy, mean that most schemes do not have their own detailed voting and engagement policies. However, now that implementation statements are part of the regulatory requirements, there is a need for all trustees and providers, regardless of scheme size or type and the level of direct day-to-day involvement with ESG approaches, to have a sufficient level of knowledge and understanding in order to best fulfil their role to effectively scrutinise external managers used by their scheme.

In research carried out at the end of 2019, the majority (85%) of SIPs stated that trustees had given their investment manager full discretion over the exercise of stewardship and voting rights, however only just over half (54%) said that trustees monitor investment managers’ stewardship activities.<sup>36</sup> Only around two in five (42%) SIPs stated that trustees considered ESG factors when deciding whether to appoint or retain an investment manager, and less than one in 10 (8%) gave details on how they do this in practice.<sup>37</sup>

35 TPR (2019)

36 UK Sustainable Investment and Finance Association (2020)

37 UK Sustainable Investment and Finance Association (2020)



The PLSA Stewardship Checklist includes a section focused on holding asset managers to account, illustrating how even schemes who

have handed day-to-day stewardship activities to an external provider can implement at overarching ESG strategy (Box 4.1).

#### Box 4.1

### The PLSA Stewardship Checklist - 'Holding Service Providers to Account'<sup>38</sup>

The PLSA produced a checklist to be used for monitoring external asset managers and the engagement activities they undertake on schemes' behalf:

- Seek to ensure that fund managers and other service providers respond to scheme policies (around stewardship and ESG) and objectives to deliver effective integration of long-term ESG factors into their investment approach.
- Explicitly set out expectations for outsourced stewardship activities in legal documents.
- Agree a schedule for monitoring and reviewing outsourced stewardship activities.

Pensions Minister Guy Opperman also suggested four questions that trustees should be asking of their asset managers:

- How often do they vote against company resolutions?
- Do they support resolutions on climate change?
- Do they propose their own shareholder resolutions?
- Where the manager doesn't want to, do they let the trustees cast their own votes?<sup>39</sup>

The Pensions Minister has subsequently set up an independent working group to review pooled fund voting to understand how trustees who wish to can set their own voting policies in pooled funds and ask managers to report against them.

### The reporting chain makes regulatory compliance more difficult

Many pension schemes will have their research, assessments and engagement carried out on their behalf by their pension provider or external asset managers, although larger schemes are more likely to have in-house research capabilities. This means that trustees are often partly dependent on the quality of their asset manager's report when constructing their own. Some trustees report that the quality of asset manager reporting is variable and that some trustees may not be furnished with sufficient evidence of an asset manager's ESG process to comply with regulation.<sup>40</sup>

### There will need to be a greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals

Too heavy an allocation to funds that use negative screening, as well as over delegation of engagement and stewardship activities to third parties without sufficient oversight is likely to lead to slower overall progress towards climate change goals, although individual schemes will not be exposed to the risks associated with those industries and/or companies from which they have divested. Strategies that involve greater levels of engagement and stewardship behaviour have a greater likelihood of improving behaviour relating to climate change across the investment landscape, which will make it easier over time to design and implement investment strategies that better take account of climate change risks. Schemes must ensure that they have sufficient understanding and that they are being provided with appropriate data on engagement and stewardship activities being undertaken on their behalf by external managers, even if this is done through other parties such as their provider.

38 PLSA (2020b)

39 Opperman (2019) *Time for pensions to walk the walk on climate risks and ESG* [Responsible Investor]

40 PLSA (2020a)

**Pressure from Government, regulators and industry bodies on third parties to provide products and strategies that meet the needs of schemes in integrating climate change risks, as well as improving the data they provide schemes about their activities relating to climate change, is also likely to be needed**

While individual schemes can put pressure on external asset managers and platform providers to improve their climate change offerings, rapid change that will allow schemes to effectively meet climate change goals is likely to need a more joined-up approach. Pressure from Government, regulators and industry bodies may be needed in order to drive forward innovation in products and strategies so that schemes can effectively respond to rapidly changing climate change regulations and ensure that their investment strategy appropriately takes account of climate change risks as much as possible.

An industry-wide consultation may be needed to better understand where third parties may be holding schemes back, with the potential for regulation to follow.

**Alternative asset classes may offer opportunities for climate risk mitigation, but schemes may not have the expertise or familiarity to effectively integrate them into their portfolio**

Many investment opportunities arising from climate change will be in alternative asset classes that trustees may be less familiar with. This knowledge gap is likely to inhibit schemes from accessing climate change opportunities and appropriately protecting members against climate risks.

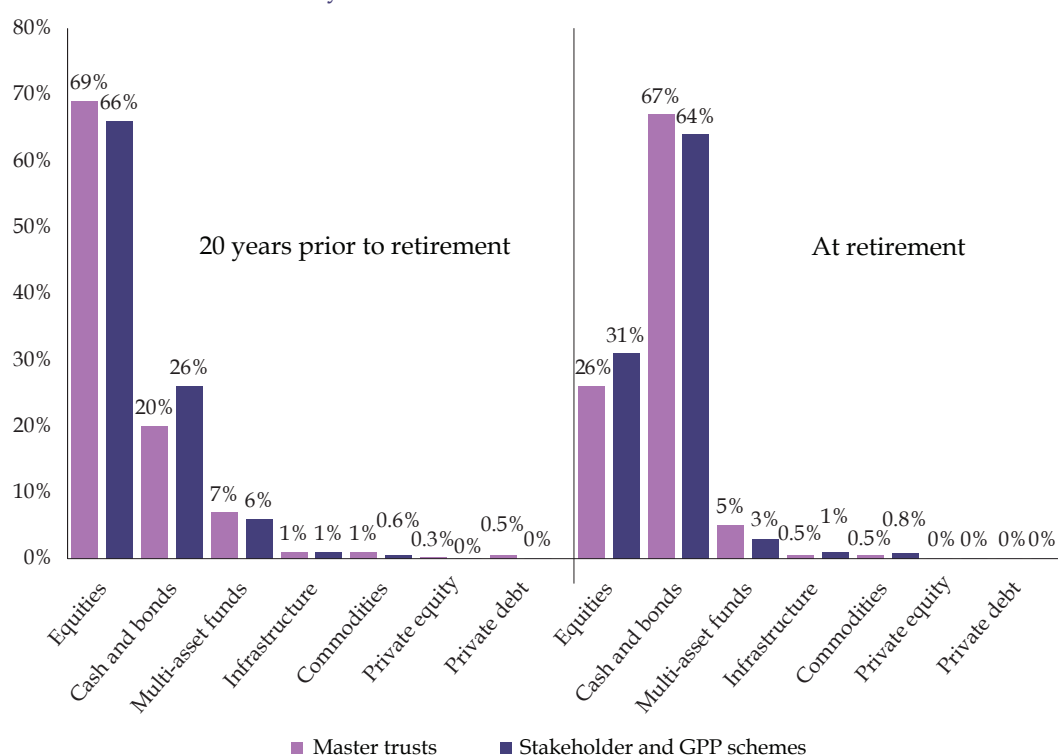
**DC schemes are generally heavily allocated to traditional asset classes such as equities and bonds**

DC schemes typically invest most of their assets in equities and bonds. The 2020 PPI DC Assets Allocation Survey found that 20 years prior to retirement around two thirds of assets are invested in equities, with the remainder predominantly invested in bonds. At-retirement asset allocation shifts towards less volatile fixed-income products, with around two thirds invested in bonds and between a quarter and a third invested in equities (Chart 4.3).

Chart 4.3

**DC scheme assets are predominantly invested in equities and bonds**

PPI DC Assets Allocation Survey 2020



The ability to assess ESG factors and their potential impact on returns varies between asset classes:

- **Equities:** The nature of equities lends itself well to ESG analysis, as well as allowing investors or asset managers on their behalf to employ direct engagement strategies.
- **Fixed income:** In many cases, bond issuers can be analysed by a process similar to equities, though engagement and stewardship opportunities are more limited. However, there are some pooled social bond funds with explicit social impact approaches and defined outcomes which have much more direct engagement with issuers.
- **Alternative assets (e.g. real estate and infrastructure):** ESG analysis of alternative investments can be complex and resource heavy due to diversity of these assets and a lack of transparency in available data. However, as with pooled social bond funds, pooled real estate and infrastructure funds that have explicitly defined environmental outcomes should have robust frameworks.

Differences in the quality of data available across different asset classes and sectors creates the possible risk that investment may be focused in areas with better data, rather than those that are actually the most sustainable and beneficial for returns.<sup>41</sup>

### **Alternative asset classes provide additional opportunities to mitigate climate risks, but trustees and providers are likely to have less expertise on these assets due to low exposure**

Although some 'real assets' such as real estate, agriculture and forestry are likely to be exposed to above-average physical risks associated with climate change, allocation to infrastructure can provide a mitigation of transition risks, due primarily to expected exposure to renewable assets in most infrastructure allocations. This will vary on a case-by-case basis. In order to meet the targets set out in the Paris Agreement and the Sustainable Development Goals, new infrastructure must be sustainable, low-carbon and climate-resilient. While this can increase initial cost of investment by as much as 5%, sustainable infrastructure can also generate lower operating costs over the life of the investment while also reducing external risks exposure.<sup>42</sup>

41 Schroders (2019b)

42 Mercer (2019)

# Chapter Four Conclusions

**Policy and regulatory change relating to climate change is occurring rapidly, which can be challenging for schemes that do not already have the necessary knowledge and expertise to catch up at pace**

In the last two years, focus on ESG considerations, and climate change especially, has grown rapidly, with many trustees and providers increasing their understanding and knowledge of this area - particularly driven by changes in regulation. However, those schemes that weren't previously giving much thought to climate change or ensuring a decent level of knowledge and understanding among decision makers may struggle to keep pace with changes. Regulatory changes do not look set to slow down, with increased reporting requirements relating to climate change expected in 2021. In order to protect members against both physical and transition risks associated with climate change, schemes need to take a long-term view to developing their climate investment strategy that can adapt to regulatory changes as they occur.

**A standard framework clarifying definitions around climate change and investment, as well as minimum standards of expertise among decision makers, may be needed to identify and address knowledge gaps**

Although knowledge and understanding has increased in recent years, there is still a clear gap in some areas of the industry. Climate change is a rapidly evolving area, and one which many trustee boards and their advisers don't necessarily have sufficient knowledge and experience to address without additional guidance and training. Knowledge of alternative asset classes is also likely to play a vital role in designing more effective climate strategies.

**A lack of consistency and clarity in data and reporting is a fundamental barrier to improving the effectiveness of climate risk mitigation in schemes' investment strategies**

Availability and quality of data is improving, but schemes will need to take a more active role in encouraging evolution from external asset managers. In order to improve this there will need to be a collaborative effort across the industry to agree upon standardised metrics and analytics tools, as well as standardised language to be used when talking about climate change.

**Schemes will need to increase engagement with and monitoring of external managers in order to improve the effectiveness of their investment strategies and mitigation of climate risks**

Although schemes predominantly outsource their day-to-day investment decisions, they retain oversight of the engagement and stewardship activities being undertaken on their behalf. Schemes must ensure that decision makers have appropriate levels of knowledge and understanding, as well as clearly established climate policies, in order to hold external managers to account.

---

# References

---

- Aegon & CBI (2018) Engaging with saving:** *CBI/Aegon guide to pension engagement*
- Berg, Koelbel & Rigobon (2020) Aggregate confusion:** *The diversion of ESG ratings*
- Blackrock (2018) Sustainable investing:** *a “why not” moment*
- Blitz & Swinkels (2020) Is exclusion effective?**
- DWP (2021) Taking action on climate risk:** *improving governance and reporting by occupational pension schemes*
- FCA (2020) Climate Financial Risk Forum Guide 2020:** *Data tools providers*
- Franklin Templeton (2019) The power of emotions:** *Responsible investment as a motivator for Generation DC*
- HM Government (2019) Investing in a better world:** *Understanding the UK public’s demand for opportunities to invest in the Sustainable Development Goals*
- IFRS Foundation (2020) Consultation paper on sustainability reporting**
- IIGCC (2020) Net zero investment framework for consultation**
- Law Commission (2014) Fiduciary duties of investment intermediaries**
- Mercer (2019) Investing in a time of climate change:** *The sequel*
- Nest Insight & LGIM (2020) Responsible investment as a motivator of pension engagement**
- PLSA (2020a) A changing climate:** *How pension funds can invest for the future*
- PLSA (2020b) PLSA stewardship guide and voting guidelines 2020**
- PRI (2018) How ESG engagement creates value for investors and companies**
- PRI (2019) How can a passive investor be a responsible investor?**
- Schroders (2017) Demystifying negative screens:** *The full implications of ESG exclusions*

**Schroders (2019a)** *Divestment – does it drive real change?*

**Schroders (2019b)** *Multi-asset investments: The practical considerations of ESG in multi-asset portfolios*

**Scottish Widows (2020)** *2020 Retirement Report: Investing Responsibly For the Future*

**ShareAction (2018)** *Pensions for the next generation: Communicating what matters*

**SSGA (2019)** *Into the mainstream: ESG at the tipping point*

**TCFD (2017)** *Final report: Recommendations of the Task Force on Climate-related Financial Disclosures*

**TPR (2019)** *A guide to investment governance: To be read alongside our DC code of practice no.13*

**UK Sustainable Investment and Finance Association (2020)** *Changing course: How pensions are approaching climate change and ESG issues following recent UK reforms*

# Glossary

---

<b>Active strategy</b>	A form of investment strategy in which assets are actively bought and sold with the aim of outperforming a benchmark or index which would be used in a passive strategy.
<b>Best in class approach</b>	Rather than excluding certain sectors or industries entirely, a best in class approach invests in companies that are leaders within their sector in terms of meeting ESG criteria.
<b>Climate change</b>	The changes observed in weather patterns as a result of the heating of the Earth's atmosphere.
<b>Divestment/Exclusion</b>	Selling or not buying assets associated with companies or sectors that perform poorly on ESG metrics.
<b>ESG</b>	Environmental, social and corporate governance considerations.
<b>Litigation risks</b>	Litigating risks arise from the potential for members to bring legal action against their pension scheme if long-term risks are not appropriately accounted for.
<b>Metrics</b>	Measures of quantitative analytics used for comparing and tracking performance.
<b>Net-zero</b>	Targeted balance of the amount of greenhouse gas produced and the amount removed from the atmosphere.
<b>Passive strategy</b>	A form of investment strategy based on an index or representative benchmark, such as the S&P 500 index. Passive strategies generally hold assets over a longer time horizon than active strategies.
<b>Physical risks</b>	Physical risks arise from the direct physical impacts of climate change. May be driven by specific events, such as increased severity of weather conditions, or by long-term shifts in climate patterns, such as sea level rise or chronic heat waves.

<b>Pooled fund</b>	Funds that combine the capital of many investors in order to benefit from economies of scale such as lower trading costs and access to diversification.
<b>Segregated mandate</b>	A fund run exclusively for a single investor, typically an institutional investor such as a pension scheme.
<b>SIP</b>	Statement of Investment Principles detailing the policies which govern how a pension scheme invests.
<b>Tilting approach</b>	A form of investment approach that integrates ESG rankings alongside traditional indices or benchmarks.
<b>Transition risks</b>	Transition risks arise from the transition to a low-carbon economy. Extensive policy, legal, technology and market changes to address mitigation and adaptation requirements related to climate change can affect the risk and return associated with certain investments.



# Acknowledgements and Contact Details

---

The Pensions Policy Institute is grateful for input from many people in support of this paper, including:

Danielle Baker	David Farrar	Sarah Luheshi
Mark Baker	Ed Gore-Browne	Nicki Lundy
Lindsey Bass	Michael Green	Peter Lunt
Paul Black	Nathan Griffiths	Lee Massey
Patrick Bloomfield	Janine Harrison	Ian McKnight
Ian Burger	Jill Hart	Maria Nazarova-Doyle
James Carter	Marc Hommel	Annabel Nelson
Chris Curry	Hetty Hughes	Alastair Offor
Joe Dabrowski	Ian King	Nareser Osei
Lavinia Dawkins	Rebecca Kowalaski	Reuben Overmark
Elly Dowding	Sindhu Krishna	Andrew Parry
Bailey Dunn	Kate Larsen	Lauren Peacock
Mark Ellis	Sarah Lawson	Chris Reilly
Robin Ellison	Maritha Lightbourne	Derek Scott
Caroline Escott	Katharina Lindmeier	Anastasios Sepetis
Rachel Esland	Bethan Livesey	Adam Sewell
Louise Farrand	Keith Logan	Daniela Silcock

Georgia Smith

Alex Struc

Karen Tasker

Pankaj Tekchandani

Chantal Thompson

Kristina Touzenis

Rona Train

Gareth Trainor

Sandy Trust

Peter Walsh

Kevin Wesbroom

Lynda Whitney

Paul Williams

Hamish Wood

Editing decisions remained with the author who takes responsibility for any remaining errors or omissions.

© Pensions Policy Institute, 2021

**Contact:** Chris Curry, Director

**Telephone:** 020 7848 3744

**Email:** [info@pensionspolicyinstitute.org.uk](mailto:info@pensionspolicyinstitute.org.uk)

**Pensions Policy Institute**

King's College London

Virginia Woolf Building

1<sup>st</sup> Floor, 22 Kingsway

London WC2B 6LE

The PPI is grateful for the continuing support of its Supporting Members:

<p><b>PLATINUM MEMBERS:</b></p>	<p>Aviva Columbia Threadneedle Investments Just The Pensions Regulator</p>	
	<p><b>GOLD MEMBERS:</b></p>	<p>AXA Investment Manager Capita Legal and General Investment Managers NEST RPMI Smart Pension Wealth at Work Ltd</p>
<p><b>SILVER MEMBERS:</b></p>		<p>Cardano Group (including Cardano, NOW: Pensions and Lincoln Pensions) Department for Work and Pensions MFS Investment Management Phoenix Group Scottish Widows The People’s Pension</p>
	<p>ABI AON BP Pensions Trustees Ltd Exxon Mobil PLSA Royal London Shell Which?</p>	<p>Age UK Barnett Waddingham Chartered Insurance Institute MNOFF Quilter Sackers USS</p>

Published by  
PENSIONS POLICY INSTITUTE

PPI

[www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk)

ISBN 978-1-906284-97-8