Written evidence from BT Pension Scheme (BTPS) (PSC0003)

Introduction

BT Pension Scheme (BTPS) welcomes this opportunity to respond to the call for evidence as part of the Committee's ongoing Pension Stewardship and COP26 Inquiry. We believe that being a good steward of capital involves engaging with legislators such as the Committee to shape capital markets and the environment in which companies and investors can operate more sustainably.

As the UK's largest private-sector pension scheme and one of the largest pension funds in Europe, we firmly believe investing responsibly supports long-term value, reduces risk, and contributes towards better outcomes.

Our investment strategy has sustainability at its core, and we consider the potential impact on the Scheme of long-term structural risks, including for example climate change and resource scarcity. These risks are inextricably linked and require systemic changes in the way companies operate, pension funds invest and in how we steward our assets. Through surveying our membership we know that they expect us to use our investments to make a positive impact.

We are a founding signatory of the UN's Principles for Responsible Investment and public supporters of the Transition Pathways Initiative (TPI) and the Taskforce for Climate Related Financial Disclosures (TCFD). We founded Hermes Investment Management and its Equity Ownership Service, one of the world's most influential stewardship service providers heavily involved in shaping the climate agenda. We believe in using our voice to address market-wide and systemic risks, and particularly in promoting well-functioning markets to support a sustainable future and provide sustainable investment opportunities. We also believe in the importance of industry-wide collaboration on these key issues.

We have a strong track record of industry-leading stewardship and climate change goals and were proud to announce our 2035 Net Zero goal in October 2020, aligning the Scheme with the goals of the 2015 Paris Agreement. The new goal applies across our entire portfolio and over time all of BTPS' investment mandates will be aligned with it.

Our response below draws on our experiences with stewardship and on climate change through setting our 2035 Net Zero goal. We would welcome the opportunity to give oral evidence as part of the inquiry if that would be helpful for the Committee.

Response to questions

1. ***How should pension schemes contribute to setting COP26 targets and helping to achieve the targets once agreed?***

Secure global net zero by mid-century and keep 1.5 degrees within reach

One of the principal steps the pension industry can take to help achieve and accelerate the COP26 goal of becoming Net Zero by mid-century is for all pension schemes to set net zero goals. This is one of the reasons why we have set our own, ambitious goal and urge all other schemes, when practically possible, to do the same. If schemes are also publicly vocal about their adoption of net zero goals, other stakeholders will be encouraged to take action. The Government should also work more closely with the schemes to create transition investment opportunities which are in line with their risk and liquidity requirements.

While setting net zero goals is an important step for the pension industry to support the COP26 goals, it cannot achieve it alone - data on emissions needs to improve from companies and governments.

For this to occur, greater climate-related measurement and disclosure across all asset classes is needed.

Adapt to protect communities and natural habitats

To adequately address the COP26 goal of protecting communities and natural habitats, once again data is the key ask, as far more information is needed to measure biodiversity impact. At present, our stewardship approach to improving ESG-related corporate actions with issuers, is done via our asset managers holding meaningful, structured engagement with companies' management teams and boards. However, due to the lack of good biodiversity data gathering, KPI setting and disclosure frameworks means those discussions cannot easily be had as investors and issuers alike do not know what they should discuss and report. Therefore, we support initiatives such as the recently launched Taskforce for Nature Related Financial Disclosures (TNFD), as they will allow investors to start gathering and framing data to assess biodiversity as a risk within investment portfolios. It is only through these types of data driven mechanisms that investors can identify beneficial and harmful investments, and direct investments to support biodiversity.

Mobilise finance

The pledges made by developed countries to utilise private and public sector finance to help developing countries transition to Net Zero is a critical goal to helping achieve the Paris Agreement. However, investors need clarity on the specific process under which private finance will be used to support these developing countries. This reflects a wider desire from investors for greater information around the broader COP26 goals.

2. ***What role should international standards have in supporting pension schemes to assess climate change risks when considering scheme investments?***

We believe the adoption of international standards, particularly around climate-related data and information across the globe, is critical in helping pension schemes assess climate change risks and thereby support the industry globally to become Net Zero. We therefore applaud Chancellor Sunak's successful tabling of mandatory TCFD reporting at the June G7 meeting and urge that the UK Government continues pushing for all countries to enforce mandatory TCFD reporting, so that investors can adequately assess climate-related risks and opportunities.

We would also like the Government to address the lack of climate change recognition in accounting standards. Although climate-related risks are mostly discussed outside of audited financial statements we believe that businesses materially impacted by climate change should clearly reflect this in their audited financial statements, as laid out by the IFRS. Adopting an internationally accepted and mandatory standard around this would allow investors to effectively interrogate any inconsistencies between a companies' narrative around climate change and what appears in financial statements.

Additionally, now that the UK has left the EU, clarity is also needed around the UK Government's plans for its own Green Taxonomy confirmed in the Spring Budget. The Scheme is very supportive of the UK creating its own green taxonomy, however, to ensure that capital is directed to the right place, investors require greater clarity over whether the UK's version will be aligned with the EU's Green Taxonomy and what it will contain.

3. ***Are there suitable financial products to enable pension funds to make climate-conscious investments? How should such investment be facilitated and supported?***

We believe that there is greater clarity needed around what is universally considered a 'climate-conscious' investment. We appreciate this perhaps was a term used in this consultation, however there is a growing lexicon of terms used to describe investments that will help climate change but with little definition behind them, or if they will help achieve the Paris Agreement. The pensions industry must work with policymakers and regulators to find an appropriate way to conduct the analysis and determination around this.

As the UK's largest corporate pension scheme, we can determine the mandates we give our asset managers. This means we can design our own 'climate-conscious' strategies. However, there is a general lack of good and cost-effective products for retail and smaller pensions and a lack of consistency around naming conventions making facilitating these investments difficult. In addition, assessing the current landscape, the investment industry needs to focus more on positive future change on climate, not today's situation. Too many products labelled as 'climate aware' focus only on investing on companies that are already good – largely due to their business models, not because they are necessarily focused on improving their climate footprint. More capital and effort needs to be focused on the companies that need to change most – and if they do change for the better – it should lead to better financial and climate outcomes. The same can be said for climate benchmarks, where the focus is about day 1 reduction of emissions without much thought put towards the transition.

Further, many climate-conscious investments can be found and made through the public market as listed companies are often the ultimate buyer of these technologies. However, unless they are a listed, renewable pureplay, investors can struggle to identify and invest in the specific underlying technologies. Therefore, to find opportunities elsewhere and to support the development of new technologies, investors typically must turn other nascent technologies that are near the start of their investment journey. This means investing in assets that are often much more illiquid and high-risk, and often, in the private markets. This creates a barrier for pension schemes to make these investments. As a large scheme the main obstacle to investing in new green technologies is that only small allocations can be made currently due to the limited number of investment opportunities and high risks involved which aren't always in keeping with the mature nature of the scheme and its focus on reducing funding level volatility. The process would also involve appointing specialist managers and/ or fund of funds providers which add to the costs and the governance burden. We would be supportive of any attempts by Government to increase scalable investment opportunities in this area and provide a mechanism for larger and more mature pension schemes to access those in a more risk-controlled way.

We recognise the Government's proposals to encourage greater investment in illiquid assets such as these technologies by loosening the annual cap on the fees charged by asset managers of DC pension schemes of 0.75% of assets under management. However, the Pensions Regulator's recent proposals to restrict pension scheme investment could negatively impact climate-conscious investments. The proposal to limit investment in private market assets to no more than a fifth of a plan's portfolio could significantly limit the ability of schemes such as BTPS to invest in green infrastructure. We oppose this proposed investment cap and look forward to reading the outcome of TPR's consultation and the Code of Practice more broadly.

4. ***How should the UK seek to share and learn from international best practice?***

We do not feel best placed to answer this question.

5. ***What regulatory changes or other government action has been most effective in delivering change in the UK; and what changes on the part of Governments elsewhere should the UK learn from?***

As stated above, we are supportive of the TCFD and believe that greater disclosure is key to obtaining reliable and consistent data, which improves investors' ability to assess climate-related risks and opportunities across investments. As a public supporter of TCFD, we encourage investee companies to improve disclosure and report in line with the recommendations.

We therefore welcomed the Government's decision to include provisions in the Pension Schemes Act to require pension scheme trustees to fully consider and disclose their climate-related financial risks and opportunities in line with recommendations by the TCFD. We have been pleased to see that the Government has moved at pace to consult on the draft regulations and statutory guidance for pension schemes on effective governance and reporting on climate-related risks and opportunities.

We were also pleased to see The Pensions Regulator publish its climate change strategy in April 2021. The new strategy outlines TPR's expectations following the passage of the Pension Schemes Act and the new rules that will be in place for larger schemes. Whilst this guidance is helpful, we also welcome TPR's recognition that work on climate change needs to happen right across the pensions landscape.

We wholeheartedly agree with TPR that the scale of the challenge that climate change presents requires the whole pensions industry to play its part. We therefore welcome the Government's commitment to review the impact of its climate change governance and reporting measures in 2023, with a view to extending them out further to smaller schemes. We hope that the Government will maintain its ambition in this area and broaden the requirements to cover all schemes.

We do however ask that the Government ensures that amongst the proliferation of ESG, stewardship, climate change etc reporting initiatives that have been launched, all Government and financial bodies (such as the DWP, the FCA, the FRC, the LGA, the TPR, the PLSA, the IA, and HMT) deliver alignment between all these different efforts. Not only is there already a duplication of work occurring, but asset owners are being pulled in so many different directions and groups, that there is a risk of taking resources away from value adding stewardship and impactful engagement activities.

Overall, we believe that significant progress has been made by the UK Government and we welcome its leadership in this area. We would like to see the Government take the next step and make the setting of a Net Zero target mandatory for all pension funds. The Government has thus far been hesitant to take this step. Whilst we appreciate this requires more market intervention, the risks of climate change and the impact on biodiversity have not been fully priced into the market and if the UK is to meet its overarching Net Zero target, then all schemes need to be setting their own targets too. We therefore believe the Government needs to mandate the setting of targets, to ensure that their ambitions to revolutionise pension investment to make it "better, safer and greener" are met.

6. ***Do pension schemes have suitable information to assess climate risk, or do there need to be international reforms to financial reporting?***

As we state in response to question 2, we believe there is a need for greater alignment across reporting standards and the move by the G7 to make TCFD reporting mandatory will have far reaching and positive consequences.

However, this move only benefits equities and corporate credit, and pension funds have significant exposure to other asset classes. Sovereign bonds are one of the largest of all asset classes and a significant percentage of diversified investment portfolios, especially among institutional investors focused on liability matching like BTPS. Despite this, few investors consider their climate risk and opportunities due to a lack of appropriate metrics and actionable insights.

We believe that there is a need for greater data, analysis and reporting from governments in this area. The three key dimensions include:

1) Carbon exposure or "transition risk", including dependence on fossil fuel reserves and the carbon intensity of the economy;

2) Physical climate change risk, including a country’s exposure to extreme weather events, water scarcity, and food price shocks, and resilience to these events; and
3) A country’s policy response including its adherence to climate agreement pledges.

BTPS is working with a collaboration of the leading organisations in the UK pensions industry and international investor climate initiatives, to develop the Assessing Sovereign climate-related Opportunities and Risk (ASCOR) framework. This will enable investors to measure, monitor and compare sovereign issuers’ current and future climate change governance and performance fairly and appropriately. We believe that there is a critical need for such a tool for the reasons stated above: globally the sovereign bond market is vast and there has been little work done to date by investors on assessing the climate risks.

ASCOR will draw on several well-recognised data sources such as the World Bank indicators and national government greenhouse gas inventories, to provide an assessment framework. We believe that this will act as a tool to help investors engage more with governments, providing opportunity for investors to work with governments on policy and help support countries to address the changes they need to make.

Whilst we believe this tool will be valuable for investors, we would also like to see the UK Government itself produce better, more digestible information on the risks and opportunities linked to its debt, for investors to better understand the risks in their portfolios. This will involve a more joined up approach across Government departments on the climate agenda. Whilst we realise that this is a cross-cutting issue and therefore multiple departments have remit in this area, we believe there could be better alignment between those involved and more clarity on policy leads to better streamline the process.

Finally, the UK Government has worked very hard to become a global leader in the climate change space and COP26 can continue ratcheting swift global action. However, there is the risk that once the conference is over, climate change will take a back seat to other political discussions. We ask instead that the UK Government ensures that ambition does not fizzle out after November 2021 and its commitment to taking action on climate change remains a top, national priority.

I hope this letter provides you with the information you were seeking. If you would like to discuss the topic further, please get in contact.

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