Written evidence from Smart Pension (PSC0009)

Introduction

- This year's COP26 is particularly significant. Firstly, the Coronavirus situation has highlighted the need for greener, more sustainable economies and global collaboration on global problems. Secondly, COP26 is the first opportunity for countries to deliver their results and finalise the parameters needed to achieve the Paris targets.
- The UK continues to demonstrate leadership on both points. Its Sixth Carbon Budget incorporates the UK's share of international aviation and shipping emissions for the first time and includes the commitment to drive down emissions to 78% below 1990 levels by 2035, and net zero by 2050. In May 2021, the Climate and Environment Ministers of the G7, under UK leadership, committed to put climate, biodiversity, and the environment at the heart of the worldwide coronavirus recovery.
- While the UK's progress is encouraging, PwC has estimated that £400bn of investment in green infrastructure is required in the next decade to meet the net zero target, an amount far greater than the £12bn investment announced by the government. As such, the private sector is going to have to invest significantly if the UK is to reach its climate targets. The Committee on Climate Change reported that capital investment in net zero technologies will need to scale up from around £10bn/year to around £50bn/year by 2030 in order to meet emissions targets in 2035 and 2050.
- The UK pensions sector accounts for about £2.6tn in funds, so any shift towards investing in portfolios that address climate change would have a strong effect in investment and business. The reasons for pension funds to invest along this theme is also compelling. The transition to limiting global temperature increases to 2 degrees Celsius is expected to yield £1.5tn in global "green" investment opportunities for investors. On the other hand, if institutional investors do not act, they face a much greater and significant portfolio value loss triggered by the effects of rising temperatures.

Questions

Q1. How should pension schemes contribute to setting COP26 targets and helping to achieve the targets once agreed?

1.1. **Address the skills gap.** In order to contribute to the achievement of the COP26 goals, pension stakeholders need a broader understanding of investment and accounting standards, ways of measuring and managing climate metrics and governance expectations. The existing knowledge gap in this regard was identified by the Committee on Climate Change: "Climate skills and knowledge of the UK's financial practitioners should be deepened. The literacy, expertise and confidence of the end users of financial services should be built to increase demand for climate-aligned products." For pension schemes to contribute to target setting and achievement of those targets, we support the recommendation from the Advisory Group on Finance that suggests that there needs to be

a measurable roadmap for making sure that all of the UK's c1.1mn financial professionals have the right skills and behaviours.

1.2. **Include pensions professionals at industry forums, round tables and working bodies.** Once this knowledge gap has been addressed, there are a number of working groups, independent bodies, consultations and industry initiatives that pension schemes can be involved in to support the goals of COP26 and their achievement. We do however note that bodies such as the Green Finance Institute could perhaps benefit from more representation from the pension industry on its core team. By including pension professionals in bodies that already have reach, barriers to deploy capital can be identified and addressed early, helping to build an inclusive and resilient economy.

1.3. **Legislate that every default option should align to the UK's goal of net zero by 2050.** The Paris Agreement Article 2.1.(c) states "Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development." While the UK has committed to a net zero future, the Finance Advisory Group Report notes that a key challenge to achievement of this goal is that "The UK's net-zero goal is not yet embedded in the financial system as an objective that shapes behaviour to the same degree as the management of climate risk. " As such, requiring default options (where the vast majority of pension scheme funds are invested) to be aligned to the UK's goal of a just transition to net zero will support achievement of the Paris Agreement.

Q2. What role should international standards have in supporting pension schemes to assess climate change risks when considering scheme investments?

2.1. **International standards that could be adopted should be aligned to domestic standards where possible.** Trustees and pension professionals are already subject to legislative requirements that include international standards (e.g. requirement to report under the Task Force on Climate-Related Financial Disclosures, TCFD). Where a particular standard is identified, it should be kept in view the numerous existing requirements that trustees are already required to understand and report on, and the associated increase in time and resource to comply with additional international standards.

2.2. **The Sustainable Finance Disclosure Regulation (SFDR) and EU taxonomy should inform the UK's approach to equivalent standards.** While the EU continues to develop a framework of environment and social impact related reporting requirements with SFDR, the UK government is focusing more on climate reporting in its own green taxonomy. The UK adoption of TCFD recognises that TCFD is already widely used in voluntary disclosure programmes and although it lacks some of the granularity of the SFDR, TCFD disclosures will add value and will be a step forward.

Q3. Are there suitable financial products to enable pension funds to make climate-conscious investments? How should such investment be facilitated and supported?

3.1. **Although suitable products exist, they are not easily accessible to pension funds.** The regulatory framework (including fees) that applies to the pension industry means that the majority of financial products that have a meaningful effect on the achievement of net zero

are inaccessible to pension schemes. To address climate change at pace through financial products, a level of active management is required with a focus on decarbonisation (reduce climate risk) and technology (capture climate opportunities). With the investment belief that climate change is a financially material factor and subsequent desire to embed responsible investment in their portfolios within regulatory constraints, schemes are therefore compelled to utilise passive ESG tilts in their investment strategies. This investment approach will not deploy capital at the pace required to achieve the COP26 goals.

3.2. **Many products focus on climate (the "E"), but less focus on the outcomes of climate change.** Loss of biodiversity, lack of sustainable housing, mass human migration are all societal effects of the change in climate. While there are financial products that target climate change (and climate risk reduction specifically), there are less that target specific social factors.

3.3. **The use of offsets to meet net zero goals should be used with caution and/or policed.** When setting the UK's net zero goal, the Chair of the Committee on Climate Change noted that the UK targets should be met without recourse to buying offsets from other countries. The UK government also indicated that the UK's Nationally Determined Contributions (NDCs) under the Paris Agreement are to be met through domestic action in the UK. Offsets are controversial and although they have a part to play in the transition, the use of this product for schemes to declare net zero is misleading to the ultimate pension beneficiaries and will not decarbonise the economy fast enough to reach net zero by 2050.

3.4. **Impact investing has a role to play.** Decarbonising the economy will require investment into impact themes such as new technologies and innovation and renewable infrastructure. Additionally, one of the commitments of the signatories to COP26 is to direct new funds to climate change activities in developing countries, for example through microfinance. Investing along these themes is a challenge for pension funds, partly due to the regulatory frameworks that exist, but also because of the lack of pension-suitable impact investing products that are available. New financing mechanisms and capital structures are needed to connect net zero opportunities with savings and pensions. It is critical that net zero becomes the default option for savings and pensions, with more sustainability linked products providing financial incentives for decarbonisation.

3.5. **There is an opportunity to embed collective investments by pension schemes.** Investment in projects such as infrastructure could also benefit from collective investment by pension firms.

Q4. How should the UK seek to share and learn from international best practice?

4.1. **Domestically and internationally the UK is a leader on climate change.** The UK played a pivotal role in securing the Paris Agreement in 2015 and has reduced emissions quicker than any other country in the G20, drawing on the depth and breadth of UK low carbon knowledge and expertise and creating new economic opportunities. Since 1990 the UK economy has grown by two thirds while emissions have fallen by over 40%. In many senses, other countries are likely to look to the UK for best practice.

4.2. **Latin America and the IDB Natural Capital Lab.** The IDB Group is the leading source of development finance for Latin America and the Caribbean. IDB's Natural Capital Lab serves as a one-stop shop for the IDB Group to drive innovation in the conservation, landscape, regenerative agriculture, biodiversity, and marine ecosystem finance spaces. It "seeks to bridge the gap between traditional environmental and financial actors from the public and private sectors to incubate, accelerate, and scale new solutions to pressing problems" and has played a major role in creating green bond markets across the region. The UK has been behind on green bond issuance, ranking 12th in Climate Bonds annual 2020 figures (behind the US and China). Despite the first sovereign green bond being due in the summer of 2021, the UK may want to consider establishment of a body akin to the Natural Capital Lab in order to bolster investment in natural capital.

Q5. 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?

5.1. **The relatively recent legislation on the incorporation of ESG has achieved a lot but has perhaps neglected the "S".** Consideration of financially material factors (including climate change) has required pension schemes to fully embed ESG when setting their investment strategies. However, much of the focus has been on the mitigation of climate risk in the narrow sense. The natural environment is one of the most important and effective solutions we have for capturing and sequestering carbon long-term, and as such there is an opportunity to broaden the view of financially material factors. Additionally, the requirement to produce an implementation statement has also required schemes to demonstrate and evidence how their statement of investment principles had been executed. This requirement has been effective in calling for schemes to examine how they implement their sustainable investment beliefs.

5.2. **TCFD reporting requirements are a strong step forwards.** The Department of Work and Pensions published draft regulations in January 2021 which will introduce new duties for UK pension scheme trustees to report in line with TCFD. We support these regulations as a channel to deliver change. However, we recommend a robust set of guidelines and guidance to support trustees and the wider pensions advice industry in delivering meaningful TCFD reports (and not simply boilerplate text). This is particularly relevant given the skills gap identified by the Advisory Group on Finance across the financial industry when relating to sustainable finance.

5.3. **Educating and communicating the effects of climate change to pension savers has increased engagement.** The government's Together For Our Planet initiative and #RaceToZero has all helped to raise public knowledge of climate change. People generally understand that taking action such as reducing meat intake can help carbon emissions but are not necessarily aware that the way their pensions are invested can also have an effect. More can be done to establish the link between climate change action and pension savings, particularly for employers who generally choose the pension provider. The Make My Money

Matter campaign is helping to build awareness in the public, but as it is the employer that chooses the pension provider, campaigns focusing on employers should also be considered.

5.4. **Enable easier investment in technologies that address climate change (including start-ups and venture capital).** The government's ten point plan for a green industrial revolution states "We will harness the international reputation of the UK's world leading financial sector to encourage private investment into supporting innovation and manage climate financial risk." However, as noted previously, there are many barriers that exist for pension schemes to invest in this impact sleeve.

5.5. **Consider engagement targets, such as those implemented by PensionDanmark.** PensionDanmark "has set engagement targets that includes supporting collaborative and single engagements, backing SBTi [Science Based Targets] approved targets and net zero commitment in the companies in which we invest and assisting consultation papers aimed to make a real world change." An example of the commitment that PensionDanmark has made is to execute 20 engagements that contribute to net zero before 2021. This supports a strong stewardship approach to supporting the net zero goal. For some UK pensions (particularly those in pooled funds), direct engagement with companies has challenges. However, mandating meetings with managers regularly, having stewardship as a standing agenda item at trustee meetings, or engagement with managers on the top 10 emitters in the portfolio are all examples of the way the UK could adopt a similar approach to PensionDanmark.

5.6. **Provide flexibility in the regulatory framework to invest in illiquid assets (such as infrastructure or venture capital), such as legislation in Sweden.** In November 2018, Sweden introduced new investment guidelines for its public pension funds. These include flexibility to invest more in illiquid asset classes and mandates that these funds must be invested in a way that contributes to sustainable development. While the UK government has made it clear that investment strategies will not be prescribed to pension schemes, consideration of default strategies being net zero or increasing the ease with which to invest in illiquids could support COP26 targets.

5.7. **Strengthen TCFD requirements by considering France's approach.** The French Article 173-VI of the Energy Transition Act requires pension funds to provide information on how they integrate ESG factors in their investment, voting decisions, exposure to climate risks, and contribution to the transition to a low carbon economy in their portfolio construction. The energy transition for green growth extends these obligations to institutional investors and requires them to fully disclose their investment guidelines, the carbon footprint of their portfolios and their orientation to climate targets, as well as reporting their climate risks. This is a bold step but requires pension funds to translate their investment strategies into meaningful targets that align to national and international goals.

Q6. Do pension schemes have suitable information to assess climate risk, or does there need to be international reforms to financial reporting?

6.1. **Data is often hard to interpret and understand.** The Advisory Group on Finance noted "Decision-useful climate data remains incomplete and inconsistent. Data is often

misunderstood – and many users still do not have the skills to respond. Clear classifications (e.g. taxonomies) as well as trusted data are required for all assets, bolstered by mandatory disclosure and skills development across finance." We support this view. Data relating to climate and pension portfolios is often difficult to understand and has many different interpretations. It is also not always clear what data is required e.g. temperature pathways, carbon footprint of the portfolio, physical, transition or litigation risks flowing from climate disruption are all ways of measuring the effect of climate change on a portfolio.

6.2. **Data that allows pension schemes to "look through" their investments is not easily accessible.** Sustainable supply chains that decouple agricultural production from deforestation and forest degradation are key to meeting the COP26 goals. However, pension schemes often only have the data to measure the holdings in their portfolios, and not the supply chains that support those investments. This is particularly true where schemes are investing in passive funds with potentially thousands of holdings.

6.3. **Scenario testing of investment portfolios should be considered.** Similar to the stress tests required for capital adequacy, stress testing pension portfolios to climate risks should be considered. This will enhance the understanding of the risks to the portfolio and its resilience to climate change but requires robust data to underpin the tests.

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