Written evidence from the Investment Association (IA) (PSC0010)

About the Investment Association

1. The Investment Association (IA) champions UK investment management, a world-leading industry, which helps millions of UK households save for the future while supporting businesses and economic growth in the UK and abroad. Globally IA members manage £8.5trn for savers and institutions, such as pension schemes and insurance companies. £2.6trn of this is managed on behalf of UK pension funds. The UK investment management industry is the largest centre in Europe and second only internationally to the US. The IA is particularly proud to support members signing up to the Net Zero Asset Managers initiative and the Race to Zero and to date investment managers with more than £5trn of assets under management in the UK have made these net zero commitments.

Introduction

2. The investment management industry's purpose is to meet their clients' investment objectives while delivering long-term financial returns. These clients are individual retail savers and institutions like pension funds, insurers, charities and governments. Investment objectives are typically financial, for instance having enough money to live on in retirement, and require the consideration of financially material risks in the investment process. Climate change is one of the greatest systemic risks that we are now facing – our efforts to address climate risk are therefore among the most important actions the industry can take to act in the best interests of our clients.

3. UK-based investment managers invest £2.6trn on behalf of UK pension funds. Savers and institutions are significantly exposed to the detrimental impacts of climate change on the value of their assets. As stewards of clients' capital, a fundamental part of an investment manager's role is to oversee the assets in which they invest to encourage, develop and support sustainable business performance that leads to long-term returns for pension schemes and other clients.

4. With the UK Government now considering how best to trigger a green and sustainable recovery from the coronavirus crisis, we are facing a once-in-a-generation opportunity to set out a blueprint for the long-term growth of the UK economy. Action towards net zero emissions and limiting the damage from climate change must be at the heart of that long-term recovery and growth. The Government must set out clear, long-term signals and guidance on the nature and speed of the UK's transition to net zero, including the actions that will be necessary across different sectors of the economy. An appropriate level of detail in these sector-specific pathways will enable investment managers to better scrutinise the transition plans of the companies they invest in.

5. We do not face a choice between economic growth and climate action. Indeed, while the UK reduced its greenhouse gas emissions by 43% between 1990 and 2019, the UK economy grew by almost 80%[1]. Instead, this is a choice for long-term, resilient economic growth that takes account of the risks and opportunities posed by climate change to the financial system as a whole.

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

[1] HM Treasury, *Net Zero Review: Interim report*, December 2020

6. The current crisis triggered by the coronavirus pandemic only reinforces the understanding that natural events have a huge impact on the financial success of individuals, companies and whole economies. The consideration of a wide range of environmental, social and governance risks and opportunities, including climate change, in the investment process leads to better investment outcomes for clients. The assessment of these factors informs investment decision making and stewardship activities as investors' support and challenge companies to better manage material risks or impacts and to promote well-functioning markets. In aggregate and over the long-term, the explicit integration of all material risks into the investment process should also result in positive impacts for society, the environment and the economy. This wider impact can be accelerated where clients explicitly state their preferences and mandate their investment managers to achieve positive impact for the environment and society through their investment objectives.

7. The UK has a well-established and independent system for setting domestic targets for reducing greenhouse gas emissions. The Climate Change Committee (CCC), which was established under the Climate Act 2008, published its sixth carbon budget in December 2020 and the Government announced in April 2021 that it had accepted the CCC's recommendation to reduce emissions by 78% from 1990 levels by 2035. This target will be enshrined in law and adds to the existing target of a 68% reduction by 2030 – the UK's current Nationally Determined Contribution (NDC) under the Paris Agreement. Ultimately, the UK Government has a duty under the 2008 Act to achieve a 100% reduction by 2050.

8. A legally binding international treaty on climate change – the Paris Agreement – has been in force since 2016 which commits to keeping a global temperature rise this century well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C. Under the Chilean presidency of COP25, the Climate Ambition Alliance was launched to encourage Governments to commit to net zero emissions by 2050 in pursuit of this target and the Race to Zero was launched in June 2020 to encourage non-state actors, including pension funds, to make the same commitment.

9. We support the vision of the UK's High Level Climate Action Champion for COP26 and one of the architects of the Race to Zero, Nigel Topping, that COP26 should move from being focused on negotiation to be "the first implementation COP". In essence, the time has come to focus on how emissions reduction can be achieved.

10. In May, Alok Sharma, Mark Carney and Nigel Topping issued a call for action to private finance institutions[2] in which they sought commitments to Race to Zero initiatives, significant or innovative new investments into net zero carbon and resilience markets in developing and emerging economies, phasing out of coal, high quality disclosures in line with the full set of recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and support for 'nature positive' finance.

11. Pension schemes can join the Race to Zero as signatories of the Net-Zero Asset Owners Alliance and the investment management industry too through the Net Zero Asset Managers initiative. Both initiatives will feed into the new Glasgow Financial Alliance for Net Zero (GFANZ), chaired by Mark Carney, which will provide a forum for asset owners and investment managers to focus on how targets can be met. It bears repeating that the consideration of these targets and the steps needed for pension schemes and investment managers to work towards them are

[2] https://2nsbq1gn1rl23zol93eyrccj-wpengine.netdna-ssl.com/wp-content/uploads/2021/05/COP26-Call-for-Climate-Action-Announcements-from-Private-Financial-Institutions.pdf

informed by the need for investment decision making and stewardship activities to analyse and manage material risks and impacts. Both the threat of climate change and the significant policy action we can expect from Governments to meet treaty obligations to mitigate against it are likely to present long-term challenges to which investors will need to respond.

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

12. Greater transparency is needed across the financial system to enable all stakeholders, including investment managers and their pension scheme clients, to assess the impact that individual investments have on climate change. As long-term investors, we seek to channel capital on behalf of our clients to companies and other assets that are deemed likely to generate sustainable long-term value.

13. To achieve this, investment managers consider material risks and opportunities to the long-term value of their clients' investments and make judgements about the relative level of risk and return that is needed to achieve their investment goals. High-quality and relevant disclosure by investee companies regarding their exposure to and management of material risk factors helps investors to assess materiality and manage the risks arising from climate change in their investment processes.

14. We recognise that companies, investment managers, asset owners, and other stakeholders are on a journey to understanding and managing the impact of climate change. While we support efforts to ensure disclosure expectations are proportionate, it is essential that efforts are made with urgency to provide transparency and accountability on climate risk across the economy. It is imperative that these proposals provide consistency and comparability and are set at the right level of granularity to enable investment managers and asset owners to meet their own reporting requirements.

15. As the providers of capital to companies and real assets all around the world, investment managers have a keen interest in ensuring global efforts to improve sustainability disclosures are coordinated and aligned. The quality, availability, and comparability of data from investee companies and other assets across different jurisdictions is crucial for investment managers to contribute to a sustainable economic recovery. However, regulatory and regional fragmentation remains a significant challenge. Backing from the highest levels of government is needed to ensure significant progress is made on the international harmonisation of sustainability reporting standards for both issuers and investors. In this regard, we welcome the Government's intention to make TCFD aligned disclosures fully mandatory across the economy by 2025, including for large private companies.

16. It is welcome that Switzerland – with which the UK is negotiating a financial services mutual recognition agreement – officially became a supporter of TCFD in January this year and we support the UK using its presidency of this year's COP26 and G7 summits to advocate mandatory TCFD reporting in other jurisdictions on a similar timescale to that set out in the UK Government's TCFD roadmap.

17. The core G7 members represent nearly one billion people, one sixth of the world's land area and just under half of the world's economy. The members and invited nations at the summit held in the UK earlier this month are responsible for huge populations and vast parts of the natural

world, but they also carry an obligation to the whole planet. Until now, G7 members have acted unilaterally to take action on climate change and underpinning this are efforts to improve sustainability-related disclosures by businesses and investors. Enhancing these disclosures is critical to support capital to flow to a sustainable economy and will underpin the global transition to a net zero economy. In May, the IA wrote to these G7 members to urge them to show leadership in ensuring a coordinated global approach. Specifically, we recommended:

a. Support for the IFRS Foundation's International Sustainability Standards Board to work at pace to develop sustainability reporting standards and increased cooperation between national regulators to endorse and implement these standards.

b. For national regulators to commit to implementing mandatory economy wide reporting on international TCFD reporting agreed by national regulators.

c. International common standards to be agreed on green gilts by governments and national regulators.

d. Governments to set out at a high level sector-specific pathways to meet the Paris Agreement goals and prioritise providing further detail to reduce the risk of stranded assets.

18. The G7 Summit Communique[3] declared support for "moving towards" mandatory climate-related financial disclosures based on the TCFD framework and in line with domestic regulatory frameworks. The G7 Finance Ministers issued a communique on 5 June[4] in which they also agreed on the need for a baseline global reporting standard for sustainability and welcomed the IFRS Foundation's programme of work to develop an International Sustainability Standards Board (ISSB) ahead of COP26. The G7's clear commitment to TCFD and the ISSB is an important milestone in tackling climate change. As an industry which invests in companies around the world to deliver sustainable value on behalf of both UK and overseas savers and investors, we welcome this commitment which will enable us to take informed investment decisions which support these aims.

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

19. IA members manage £4trn for UK institutional clients and pension funds are the largest client type, with 65% of institutional assets under management (£2.6trn), followed by insurance companies at 22%.

20. There is undoubtedly growing awareness from society at large of the need to act on environmental issues, including climate change. This has been borne out in support for campaigns against the use of plastic and in trends for consumption with a lower carbon footprint (such as meat and dairy substitutes). It is also reflected in investor demand for sustainable investing. Our industry's clients and savers are demanding more information and choice as they seek, in increasing numbers, to contribute to climate action through their investment decisions.

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[3] https://www.g7uk.org/wp-content/uploads/2021/06/Carbis-Bay-G7-Summit-Communique-PDF-430KB-25-pages-1-2.pdf

[4] https://www.gov.uk/government/publications/g7-finance-ministers-meeting-june-2021-communique/g7-finance-ministers-and-central-bank-governors-communique

21. While there is interest from savers in the pure retail funds and retail pensions markets, demand in the workplace pensions market is being driven largely by trustees, pension providers and investment consultants. The institutionally-led focus on responsible investment is mainly due to regulation that has required trustees and providers to demonstrate how they are taking account of financially material environmental, social and governance (ESG) factors in their investment strategies, as well as the forthcoming requirements under the 2021 Pension Schemes Act for trustees to have effective governance of scheme investment and funding with respect to the risks and opportunities of climate change.

22. A recent study for the Defined Contribution Investment Forum[5], looked at the investments of the largest master trusts serving the DC market. These 18 schemes held assets of £58.9bn at the end of June 2020 and managed nearly 19 million accounts for more than one million employers. The study observes significant progress in the incorporation of ESG risks and opportunities within the default strategies and stewardship approach of schemes. The schemes use a mixture of engagement, exclusion, adjustments to indexes, and the building of specific portfolios with ESG themes.

23. UK pension schemes looking for suitable support to make climate-conscious investments are well served by the UK investment management industry. The UK is the world's second largest centre for investment management, and this means that we stand at the forefront of those UK industries ready to help tackle climate change. The Z/Yen global financial centres index (GFCI) is the leading tool for measuring the attractiveness of financial centres. While London is ranked on GFCI as the second most competitive financial centre in the world, it is also ranked as the third highest green financial centre on Z/Yen's Global Green Finance Index. No other financial centre ranks higher on both indexes.

24. As of Earth Day 2021, UK investment firms with more than £5trn assets under management (AUM) have signed up to the Net Zero Asset Managers initiative and committed to investing aligned with net zero emissions by 2050 or sooner. This represents more than 60% of IA members by AUM. This means that the industry (both at home and globally) has comfortably exceeded the Race to Zero Breakthrough target set by the COP26 President-designate Alok Sharma in January 2021 to commit 20% of AUM to the net zero target.

25. With increasing numbers of clients asking for both information on climate change and for products to deliver on their particular investment goals, including reflecting their attitudes towards climate change, investment managers are constantly innovating to fulfil their clients' needs and committing significant time and resource to the development of new sustainable products. In 2019, we saw significant growth in the number of sustainable funds launched. According to Morningstar data[6], in 2019 European sustainable funds held €668 billion of assets, which was up 58% from 2018. According to the same report, 2019 saw the launch of 360 sustainable funds, which brought the total number across Europe to 2,405. The report goes on to say that approximately 50 of the sustainable funds launched in 2019 had a specific climate-oriented mandate.

26. At the same time as developing such products, the investment management industry recognises that it is vital to clearly communicate the responsible and sustainable investment characteristics of the products it offers in order to empower pension schemes to make informed choices over

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[5] Richard Parkin Consulting, 'Growing Pains: Master trusts beyond auto-enrolment', https://e2pqox7skk4.exactdn.com/wp-content/uploads/2020/11/growing-pains-final-web.pdf

[6] https://www.morningstar.co.uk/uk/news/199190/record-shattering-year-for-sustainable-investments.aspx

asset allocation and fund selection. Extensive work on disclosure is already underway within the investment management industry both to implement significant regulatory changes in a robust and meaningful way as well as proactive work to improve the consistency and clarity of industry's sustainability-related disclosures. At the end of 2019, the IA published its Responsible Investment Framework to explain to all audiences in a consistent way how investment managers contribute to sustainability through different responsible investment approaches. Improving the clarity and consistency with which we communicate to all audiences remains a key priority of the investment management industry. It is crucial we continue to improve the disclosure of sustainability-related information in a way that is clear and decision-useful to clients to help inform their choices and meet their preferences.

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

27. Action is needed in the next decade to minimise risks and ensure alignment with the Paris Agreement. We ask that the UK use its privileged position as a leader in sustainability and responsible investment, and as host of COP26 and the G7, to drive forward change in the UK as well as to galvanise change in other countries. We set out in answer to question two (paragraph 17) how the UK can lead and learn with four recommendations for greater cooperation in areas where international best practice is being established.

28. The investment management industry is already working through HM Treasury's Asset Management Taskforce to improve stewardship practices in the UK and published a report[7] in November 2020 on placing stewardship at the heart of sustainable growth. This work will further help strengthen stewardship practices and embed the consideration of material ESG consideration in UK companies. A key pillar of the report's recommendations is to challenge the investment industry to put the interests of clients and savers at the heart of stewardship, delivering on the purpose of the investment industry to generate sustainable value and achieve clients' investment goals.

29. The relationship between asset owners and investment managers sets the tone for sustainable value creation and aligning incentives right across the investment chain. The report endorses the commitment by the IA and Pensions and Lifetime Savings Association (PLSA) to establish a new working group exploring how to embed a focus on stewardship in this relationship. This steering group was established in January this year and is seeking to give clarity to how a long-term focus can be achieved right through from selection to appointment and the contractual relationship that underpins this (including the investment mandate) and ongoing oversight and performance assessments.

30. As pension scheme members' interest in the sustainability of their investments increases, it is essential for funds to engage them on the role of stewardship in delivering sustainable value and in serving their best interests. The report calls for UK pension schemes to be required to explain how their stewardship policies and activities are in members' best interests.

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https://cdn.roxhillmedia.com/production/email/attachment/830001_840000/ff1f3c0f6132f825343ac0180916f717a135fa06.pdf

31. The report also notes a concern that pension funds have had historically low engagement with the stewardship agenda. To boost engagement, the report recommends the establishment of a dedicated council of UK pension schemes (both public and private) to promote and facilitate high standards of stewardship of pension assets, with a key focus being support for more pension funds to become signatories to the stewardship code. As the role of stewardship is crucial to supporting a focus on long-term value creation and addressing the risks posed from climate change, it is essential for Government policy to support wider engagement with the stewardship agenda, including through the aspiration for more pension funds to become signatories to the UK Stewardship Code.

32. We reiterate our support for pension schemes being required to report in line with TCFD and note that the market trend towards consolidation into fewer, but larger, pension schemes that DWP and TPR are encouraging will help here, since robust scheme governance of the kind needed to deliver high quality TCFD reports tends to go hand-in-hand with increased scale. TCFD is a clear example of international best practice and the transparency and accountability it will bring over time plays an important role in supporting UK pension schemes to prepare for the transition to net zero. It is important for Government take a consistent approach to implementation of TCFD across the economy to allow for the coherent flow of climate related information from investee companies, through investment managers to pension funds. For example, in order for pension funds to be able to report on the scope 3 emissions of their investment portfolios, it is essential that data is made available through the mandating of scope 3 emissions reporting for underlying investee companies. Similarly, it is important to ensure similar expectations on the granularity of climate related disclosure – the IA noted in our response to the BEIS consultation on mandating TCFD disclosures for large public and private companies a concern that the Government's proposals needed to be strengthened to enable robust risk management and disclosure from investment managers and in turn their pension fund clients.

33. However, the actions of pension schemes and investment managers alone are not enough, and further policy intervention is needed. The FCA has signalled that they will consult on enhancing investment managers' climate related disclosures in their capacity as regulated firms and we look forward to engaging with these proposals. We expect the consultation to be published imminently. Without specific recommendations at this stage, it is not possible to assess the extent to which the proposed regulatory obligations on investment managers will be consistent with the proposals for TCFD in pension schemes which the DWP consulted on earlier this year. At this stage we would simply recommend that where DWP proposes that pension schemes must carry out specific scenario analyses and calculate specific metrics, these should also be core requirements for investment managers' client facing disclosures.

34. We must not forget that both financial markets and climate-related risk are global. Beyond the disclosures aimed at UK pension schemes, the FCA and HM Treasury could also look at the climate metrics and methodologies specified under the EU's Sustainable Finance Disclosure Regulation (SFDR). There are significant efforts underway by investment managers to implement SFDR and the adoption of some of the metrics and methodologies of SFDR into TCFD disclosures will aid standardisation and comparability. Investors also support efforts from the IFRS Foundation to create a new International Sustainability Standards Board which will consider the development of common climate reporting standards, building on the work of the five major global standard setters and TCFD.

35. The Government also needs to set out, as soon as it is able to, clear, long-term signals and guidance on the nature and speed of the UK's transition to net zero, including the sector-specific actions that will be necessary. The industry is keen to work with policymakers to identify clear pathways to transition for different sectors of the economy and help tackle the gaps between the intention and delivery of the Paris Agreement goals. An appropriate level of detail in these sector-specific pathways will enable investment managers to better scrutinise the transition plans of the companies they invest in.

36. Ahead of Budget 2020, the IA advocated for the introduction of a UK sovereign green bond and we were pleased when the Chancellor announced (in November 2020) his intention to introduce them. We have continued to work with HM Treasury and the Debt Management Office to inform the development of the bond ahead of issuance. This is one example of how the industry can help to develop mechanisms for financing the Government's net zero objectives and the industry will continue to seek to identify areas of financing need where innovation can create new investment opportunities.

37. IA members have made significant net zero commitments, but they recognise that a significant part of the way to get there is by transitioning the parts of the economy that currently cause emissions. It is important to ensure that messaging on net zero reflects the need to invest to support transition and not simply to divest to quickly achieve net zero pension scheme portfolios. Leaving these assets stranded or under the ownership of somebody else will damage the credibility of the UK as an effective leader on climate transition. Those speaking for the UK on net zero, including the UK Government, must ensure that stakeholders, including pension schemes, recognise the importance of transition.

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

38. To make climate conscious investments, pension funds need high-quality, meaningful, and comparable disclosures from their investment managers, who in turn need quality disclosures from investee companies, the ultimate source of the data and information needed by their clients, including pension schemes. The IA continues to support our members in their capacity as stewards, to improve the quality and comprehensiveness of companies' climate disclosures – setting a clear expectation in our 2021 Shareholder Priorities, that UK listed companies should report in line with all four pillars of TCFD. For climate-related disclosures to be meaningful, they must be disseminated coherently along the full length of the investment chain.

39. UK pension schemes hold highly diversified and global portfolios. Across both DB and DC schemes in the UK, domestic equity exposure has fallen from around 75% of pension schemes' total equity holdings in the late 1990s to around a third of their total equity holdings today. At asset class level there has also been a move to greater diversification by UK pension schemes, particularly DB schemes, which now hold around 18% of their equity holdings in unquoted or private equity. DC schemes are also increasingly exploring making allocations to private markets and the IA is participating in joint work between HM Treasury, the Bank of England and the FCA on a Working Group on Productive Finance, which is looking at the key design features and regulatory framework needed to allow DC investors to invest directly in less liquid productive finance assets. Finally, DB schemes, driven by regulation and innovations in liability driven investment strategies, have moved heavily to increase their fixed income allocations over the last 15 years, with bond holdings increasing from 28% of DB assets in 2006 to 69% of total DB assets in 2020.

40. With such a diversified asset allocation across both geography and asset class, gaps in the existing coverage of TCFD reporting both in the UK and overseas mean data will be incomplete:

    a. Premium listed UK companies may choose to explain why they are not disclosing a TCFD report, although the FCA's clarification over the limited range of circumstances where an 'explain' approach is appropriate should partially mitigate this risk.

    b. As highlighted above, UK pension schemes have significant allocations to overseas investments that are not subject to any TCFD reporting.

    c. Given the significant allocation by pension schemes to bonds, more effort is needed to improve climate disclosures from bond issuers, both sovereign and corporate.

41. While forthcoming FCA rules for investment managers to facilitate client reporting under TCFD will provide helpful clarification to investment management firms and their clients, these rules will not change the fact that investors, including investment managers and pension schemes, remain reliant on the access and quality of information from the underlying investee companies.

42. The IA supports the proposals in the recent BEIS consultation on requiring mandatory climate-related financial disclosures for large public and private companies, which will help pension schemes assess the climate-related risks and opportunities faced by UK private companies held within their portfolios. We are pleased that the proposals in this consultation will see the UK Government demonstrating global leadership and delivering on the recommendation set out in the HM Treasury Asset Management Taskforce report, 'Investing with Purpose', to advance a legislative underpin, requiring both public and large private companies to make TCFD disclosures.

43. We recognise that TCFD reporting by pension schemes will be a new and challenging process, with which they will require significant support from their investment managers and other service providers. We urge DWP and TPR to take a pragmatic and proportionate approach to assessing pension schemes' compliance with their TCFD reporting obligations, focusing initially mainly on how schemes embed climate risk into their investment governance and decision-making structures. The quantitative elements of TCFD reporting are essential to informing better investment decisions, but it should be recognised that these elements of the framework will require more time to reach the requisite quality and will in any case only be helpful where they are decision-useful for schemes' investment processes and support trustees to develop effective governance of climate-related risks.

44. In that regard we welcome the DWP's inclusion of certain provisions in its TCFD regulations that recognise the data challenges faced by pension schemes and investment managers in this area. Notably: (i) giving trustees an additional year to source the scope 3 emissions attributable to their portfolios; and (ii) requiring trustees to produce scenario analyses, obtain data, calculate metrics, and set targets on an "as far as they are able" basis. In the short-to-medium-term these provisions will provide reassurance to trustees and investment managers that there is a recognition that time is needed for data quality to improve.

45. Regulators and governments around the world should also fast track international efforts to enhance and harmonise corporate reporting standards for sustainability, including those led by the International Organization of Securities Commissions

(IOSCO), Financial Stability Board (FSB), the International Financial Reporting Standards (IFRS) Foundation and the European Financial Reporting Advisor Group (EFRAG).

46. Investors support efforts from the IFRS Foundation to create a new International Sustainability Standards Board which will focus on enterprise value and the use of TCFD; utilising the five major global standard setters as building blocks. We also welcome IOSCO's statement that they will work with the IFRS and international regulators and consider endorsement of the SSB. We are keen to ensure that there is strong investor representation on the SSB to ensure the providers of capital and users of company reporting are represented in the standard setting process.

47. We back the commitment to meet the urgent need for comparability on climate reporting as this will be essential in supporting the further integration of climate risk into the investment process. We would also like to see urgent progress across the full range of sustainability issues and for the IFRS Foundation to set out a clear roadmap for addressing the full range of sustainability factors.

48. In the interim, the UK investment management industry encourages securities and other regulators around the world with responsibility for setting corporate reporting standards to fast-track the use of TCFD and SASB. We were encouraged by the UK's Financial Reporting Council's statement to this effect and the Securities and Exchange Commission's consideration of the role of global standardisation in their consultation on issuers climate disclosures.

June 2021