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Submitted to **Aligning your pension scheme with the TCFD recommendations: a consultation on guidance**
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Introduction

1 What is your name?

Name:
Sarah Woodfield

2 What is your email address?

Email:
sarah.woodfield@theia.org

3 What is your organisation?

Organisation:
Investment Association: The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

4 What do you like about the guidance? / What is most useful?

Answer:
The risks associated with the impact of climate change could result in a significant loss of value in pension scheme investments. This will ultimately impact on pension scheme beneficiaries who rely on their pension for their retirement income. Pension scheme members are increasingly alert to the risks to their investments and are rightly setting high expectations of how pension funds and the investment managers that invest on their behalf are managing this risk. As long-term investors, pension funds are also well positioned to benefit significantly from opportunities relating to a sustainable and low carbon transition, and from assets that support adaptation and mitigation efforts.

The IA is supportive of this timely guidance which will help pension funds to report in line with TCFD. Proactively identifying and managing climate related risks and opportunities and communicating how they are being managed to clients and their end beneficiaries is a priority for the investment industry. The IA outlined TCFD adoption as one of four key expectations for FTSE listed companies in 2020 and welcome the expectation set out in the Government's Green Finance Strategy for adoption by asset owners and issuers by 2022.

For disclosure to be meaningful, we must think about its dissemination along the full length of the investment chain. Pension funds need quality disclosures from their investment managers, who in turn need quality disclosures from investee companies. We are working with our members to help them to develop a full set of TCFD disclosures, including a calculation of carbon foot-printing. We are also helping our members work towards disclosing the Paris-alignment of their portfolios.

In calling for proactive TCFD adoption, the IA recognises that asset owners, investment managers and companies are on a journey to understand and manage the impact of climate change on their business models and investment strategies. Further collaboration is needed to identify the best methodologies to quantify and manage the risks and opportunities associated with climate change. We are working with our own members to understand and build on the development of methodologies to date to ensure meaningful disclosures for clients.

We therefore welcome attempts to share knowledge and best practice to support asset owners and managers take these first steps. The IA is keen to work with the DWP and other stakeholders to further progress this work.

Amongst other asset owners, pension funds set the tone for the responsible allocation of capital across the investment chain. Strong signals from pension funds, accompanied by robust TCFD disclosures from companies, will reinforce the mandate that investment managers have to effectively manage the financial impact of climate change on behalf of clients. The awareness of climate risk, and the effective integration of it into their investment approach, is critical to supporting long-term returns for pension savers.

The quick start guide is a welcome starting point that will be valuable for schemes at the start of this journey, including for smaller schemes who will need to take a proportionate approach. We welcome a tailored approach to promoting this guidance depending on the audience.

5 What don't you like about the guidance? / What needs improving the most?

Answer:

There are a number of areas where this guidance should be strengthened and some areas where this guidance could be unhelpful or misleading, which we set out below.

Regulatory clarity

The Government needs to further clarify how this guidance fits into the wider regulatory package that is focused on Environmental, Social and Government issues, including the Pension Schemes Bill and forthcoming secondary regulations, recent regulatory changes relating to SIP documentation, and regulations which may be implemented by the UK Government under the EU's sustainable finance strategy.

Regulatory clarification should address the appropriate scope of this guidance. There may be a number of smaller schemes who do not have the resource or expertise to address this guidance comprehensively and who should be encouraged to take a proportionate approach to managing the impact of climate change. It will also be important to clarify the expected timing of pension scheme disclosures on a voluntary and mandatory basis, recognising that the quality of pension funds' own disclosures are dependent on their managers' and in turn the quality of investee companies. Any mandatory regulation should be sequenced appropriately, starting with investee companies.

The impact of climate change on investment strategies

The guidance appears to provide a regulatory steer on how climate change should impact investment strategies. It should be revised to ensure that it does not give a regulatory steer towards specific investment strategies. Trustees should incorporate climate related risks and opportunities in their assessment of how their investment strategy helps them to achieve their beneficiaries' investment objectives.

The guidance should emphasise that financial considerations of climate change are not just in relation to downside risk management (though this is also critical). As long-term investors, pension funds are also well positioned to benefit significantly from opportunities relating to a low carbon transition, and from assets that support adaptation and mitigation efforts.

The role of stewardship

The guidance needs to reflect the shift in emphasis in the new Stewardship Code towards outcomes, over and above policies and processes, recognising that Stewardship is much wider than voting and applies beyond listed equity and into other asset classes.

The questions for investment managers provided in Appendix II should be more focused and proportionate. It is important to encourage trustees to prioritise targeted questions that reveal how a managers' approach helps meet their investment objectives and beliefs. This long list of questions risks overwhelming or incentivising trustees to adopt a 'tick box approach' to manager assessment, which does not meaningfully inform selection and oversight decisions.

Policy changes required to achieve net zero.

Finally, pension funds, investment managers and companies need clarity from government on the sector specific policy interventions they intend to make to transition to a net-zero economy in an orderly fashion. Early policy signals help investors to price externalities into their valuations effectively and minimises the risk of market instability as a result of cliff edge policy decisions. It is important for all market participants to receive clear and well timed notice of policy decisions to allow them to process and adapt to policy changes.

6 Is the current structure helpful?

Answer:
Yes.

7 Does this guidance provide schemes with everything they need to:a) manage climate risksb) disclose in line with the TCFD recommendations?

Answer:

8 Have we missed anything?

Answer:

9 Part I - Please provide any comments on "Introduction - Understanding climate change as a financial risk"

Answer:
This guidance clearly explains how climate change is caused by green-house gas emissions, why governments around the world have signed up to the Paris Agreement and dispels any myths about the causes of global warming. Paragraphs 12 and 13 may benefit from some simplification to ensure these technicalities are as accessible as possible, with further links to more scientific explanations where appropriate.

The guidance clearly highlights the important distinction between transition and physical risks. The guidance does not engage directly with liability risks. While these risks could be understood as part and parcel of the transition risks outlined, it would be helpful to explicitly discuss how litigation and insurance claims could originate and the implications for asset owners and investment managers. Litigation may compromise the value of the assets pension funds are invested in, their employer fund covenants and may even be directed towards pension funds and investment managers if they cannot demonstrate that they have taken climate risk into account.

Under paragraph 20, it will be helpful for this guidance to illustrate the kinds of policy interventions that the UK Government is planning to undertake to reach net zero carbon emissions by 2050. This will help pension funds to better understand the nature of the risks associated with an insufficient policy response and the extent to which they will need to factor in potential financial instability resulting from cliff-edge policy decisions. It is also helpful to set out how the policy interventions of individual jurisdictions may not be sufficient to tackle this complex global problem and the role the UK Government will play in supporting other jurisdictions to make progress towards the Paris Agreement (as a part of its role in hosting COP26). As pension funds invest in assets and companies all over the world trustees should understand the risks associated with an inadequate policy response from different jurisdictions and not only from the UK.

This section could be improved by exploring in more detail how climate risks will manifest in the short- to medium-term, expanding on the physical risks that companies are likely to face, their financial impact and expanding on how these risks will manifest in different asset classes. While trustees must consider these risks with respect to the time horizons of their beneficiaries, the risk itself is not only a long-term issue and may impact on investment returns in the short, medium and long term.

Throughout the guidance, the fossil fuel industry is used repeatedly as an example high risk sector. As one of the largest producers of greenhouse gas emissions, we recognise the importance of focusing trustees' minds on the risks associated with this sector and the vast array of companies whose products and services are dependent on this energy source. Given this interdependence trustees should be encouraged to consider the effectiveness of different investment strategies. However, we would also stress the need to explore and emphasise the vast range of risks and opportunities associated with other industries. Trustees should recognise that the pervasive and complex nature of these risks mean that it is not always immediately apparent which direct or indirect impacts are financially material for which companies. It is for this reason that the IA has asked all listed companies to undertake a systematic risk assessment which considers the impact of climate change on their products and services, operating model, assets and financial position, supply chain, as well as on their key stakeholders, employees and customer base.

10 Part I - Please provide any comments on "The legal requirements on pension trustees"

Answer:
This section clearly outlines pension fund trustees' current legal duties with respect to climate change. It will be helpful to outline clearly how this guidance will interact with the incoming Pension Schemes Bill and any secondary legislation that results. There is currently a lack of clarity as to what extent, if at all, this guidance might later be put on a statutory footing, or whether there will be additional statutory guidance to supplement this voluntary guidance.

Regulatory clarification should address the appropriate scope of this guidance. There may be a number of smaller schemes who do not have the resource or expertise to address this guidance comprehensively and who should be encouraged to take a proportionate approach to managing the impact of climate change. It will also be important to clarify the expected timing of pension scheme disclosures on a voluntary and mandatory basis, recognising that the quality of pension funds' own disclosures are dependent on their managers' and in turn the quality of investee companies. Any mandatory regulation should be sequenced appropriately, starting with investee companies.

11 Part I - Please provide any comments on "The TCFD Recommendations"

Answer:
This section clearly and helpfully explains the background to TCFD. It should also refer to the wider initiative to introduce TCFD for other elements of the investment chain, including investment managers and issuers. Coherent disclosures across the investment chain will help to drive up standards and the effective management of climate risk across the market.

12 Part II - Please provide any comments on "Defining climate-related investment beliefs"

Answer:
This section helpfully illustrates how schemes can consider climate related risks and opportunities when developing their investment beliefs. It is written in places as though trustees will be developing their beliefs anew, whereas most schemes will need to assess and revise their current set of beliefs to ensure they fully consider climate related risks and opportunities.

These beliefs may relate to making the most of investment opportunities, as well as managing risks, for example under paragraph 63: "Clarifying the trustees' convictions around the balance between engagement, voting and/or divestment as appropriate tools to manage climate-related risks". When developing their beliefs, trustees should also consider the role of allocation towards assets that are geared towards benefiting from a low carbon transition, adaptation and mitigation, and not only divestment away from assets that are most exposed to risks.

13 Part II - Please provide any comments on "Climate-related risks in investment strategy and manager selection"

Answer:
There are a number of areas where this section could be strengthened and where we are concerned that it could be interpreted as giving a regulatory steer towards certain investment strategies.

As presently written, this section reads as though trustees are developing their investment approach anew. Instead, most pension funds have pre-existing mandates, where they will need to place more emphasis on understanding the approach taken to addressing risk in their existing mandates and fund selection, reviewing whether these are still fit for purpose. As a result of this review they may need to update their mandates, renegotiating relationships with existing managers, and retendering contracts where this is not possible. It is important therefore for schemes to engage with their managers and refer to dedicated resources to this issue, to develop a full view of how their managers' approach may be aligned with their investment beliefs. Pension schemes may wish to coordinate this process with a wider review of how they take into account a broader range of Environmental, Social and Governance issues.

All actors are on a journey to integrate climate risk into the investment process and to demonstrate this through more quality TCFD disclosures. Investment managers are working at pace to develop meaningful disclosures for their clients. The quality of these will be determined in part by the disclosures made by investee companies. Key to success will be for pension funds and investment managers to have early, two-way conversations about their expectations on the management of climate risk and their reporting requirements, so that these can be properly embedded into their systems and processes. This clear communication will help managers to exert influence over investee companies to improve the quality of their disclosures and risk management in turn.

We have some concerns about the evidence base for some of the guidance in this section (in particular in sections 78-80), and would caution against language that could be perceived as a regulatory steer towards certain investment strategies:

• "Replacing existing asset managers and/or investing in new priority areas using
emerging taxonomies as the basis" – it is very unclear what is meant by this suggestion and this point should be expanded on.

• This section states that “growth assets are generally expected to be more sensitive to climate-related risks than matching assets”. We recommend this suggestion is removed as it is not clear that the singular source referenced leads to this conclusion. This statement could be interpreted as giving an inappropriate regulatory steer towards matching assets for reasons other than those that such assets are typically used for by a pension scheme. This steer is particularly concerning given the cost of carbon is not yet accurately priced into the real economy, therefore there is a risk that this kind of statement disincentives investment in new technologies which may help facilitate a sustainable transition. Trustees need to make their own assessment about the relative level of risk and return they target to meet their beneficiaries’ investment objectives.
• We would caution against any expression of preference for index or active based strategies in relation to the management of climate risk.

Investment managers should offer appropriate choice, in consultation with their clients, on the investment strategies they develop for different investment objectives and ESG or sustainability related preferences. The responsible investment characteristics of different products and strategies should be appropriately communicated to prospective clients, including the approach to managing climate related risks and opportunities. Following the publication of our Responsible Investment Framework, the IA has been supporting our members to establish best practice in fund level communication of responsible investment characteristics. Pension funds will need to ensure that their objectives and investment beliefs are reflected in their approach to manager selection, their contractual arrangements, and ongoing oversight and performance assessment.

14 Part II - Please provide any comments on “Stewardship on climate issues”

Answer:
Climate change is a key stewardship priority for investment managers. The influence that investors can exercise through the rights and responsibilities they have as investors in different asset classes, will make a critical difference to how investee companies transition to a more sustainable pathway. For this reason, the IA set out climate change as a key stewardship priority for 2020.

The guidance rightly calls for pension funds to “hold their asset managers to account in relation to their engagement activities and voting record on climate issues”. This section should better reflect a number of changes in emphasis in the revised UK Stewardship Code and ensure that trustees’ are informed about the wide variety of ways in which stewardship is exercised beyond voting, so they can make informed decisions about their managers’ approach to stewardship and climate change.

Stewardship is wider than voting

Stewardship is much wider than voting behaviour and incorporates upfront due diligence, ongoing research and monitoring, engagement voting and a variety of escalation tools, including buy and sell decisions for active managers. The recent developments in the UK Stewardship Code make a significant shift in emphasis away from signatories only making disclosures about their voting policies towards making clear disclosure about the outcomes of their stewardship activities.

Stewardship in different asset classes

Stewardship does not just relate to listed equities, where there are significant rights and responsibilities which give rise to the opportunity to vote at companies’ AGMs. The new Stewardship Code is clear that stewardship applies to a range of asset classes and investment strategies. Climate change will have a significant financial impact on infrastructure, real estate, debt and private markets. Investors can have significant influence on these assets according to their ownership rights and the long-term characteristic of these investments. Pension funds should assess the different ways stewardship is exercised in this broader range of asset classes.

Climate change as a voting issue

Climate change is currently not an explicit voting issue – there is no specific resolution dedicated to climate change in company law. Shareholders may hold companies to account on their management of climate risk through voting against a number of resolutions and will often use the resolutions on director re-election, or their report and accounts. Investors will take a view on which resolution will be most effective depending on the nature of their concern on the companies’ management of climate risk.

Requisitioned resolutions also provide an opportunity to vote on these matters, though historically the use of this tool in the UK has been relatively limited. Climate Action 100 and other similar collective initiatives have had success with requisitioned resolutions in recent years and we hope to see more targeted resolutions emerging that indicate shareholder concern over how companies’ are reflecting climate risk in their business strategy balanced with appropriate division of responsibility between shareholders as the bearers of risk capital and company management who are responsible for protecting shareholder interests.

Investors typically see a vote against as an escalation tool – they will deploy this where their engagement with companies has not produced the desired results. Effective stewardship relies on building long-term relationships with the investee company. Often investors don’t need to escalate concerns to a vote because they are satisfied as a result of their engagement with the company that the management is effecting change. Where voting and other forms of escalation have been ineffective, active managers may choose to sell an investment if they can no longer justify the relative level of risk and return. Voting behaviour alone therefore is not a good proxy for the effectiveness of stewardship and this guidance should encourage pension funds to consider their expectations on a wider range of stewardship activities.

The role of stewardship in responding to systemic risks

An important emphasis in the new Stewardship Code is on collaborative engagement and responding to systemic risks such as climate change. IA members take their role as stewards seriously and will take action to collaborate with other investors where they are not getting the change they desire and will also engage with policy makers and regulators to promote the integrity of the market as a whole. Policy makers play a key role in taking the steps necessary to reduce green-house gas emissions, as such investors in their role as stewards will be engaging with policy makers to promote an orderly transition.

Governments play a key role in bringing negative externalities onto businesses’ balance sheets, for example, through effective carbon pricing and fiscal measures. These, in turn, help investors to price externalities into their valuations effectively. It is important for market participants to receive clear and early

notice of policy decisions to allow them to process and adapt to policy changes.

Suggested improvements

It would be helpful if this section further explored the voting process at the AGM, the general company engagement process and how climate risk can be addressed through these engagement activities. In particular, it is important to stress the role that shareholders play in supporting companies through their engagement activities to make capital allocation decisions that will enable them to make sustainable transition to a Paris-aligned world. Pension funds will need to be aware that this support may result in significant capital expenditure including:

• Capital expenditure on infrastructure and operations to manage physical risks,
• Changes to their business structure, including acquisitions or disposals to transition the business -model, and
• Investment in research and development to develop new products and services.

Stewardship outcomes

A key benefit of the new Stewardship Code's focus on outcomes, rather than only on voting and engagement approaches or policies, is that it steers away from 'greenwashing'. Investment managers should provide pension funds with information about what changes their stewardship activities have achieved on climate change rather than only what activities they have undertaken. It is important for mangers to distinguish the specific contributions to these outcomes where possible to avoid 'free-riding' behaviour. It is important for this guidance to encourage pension funds to focus on these outcomes (and not just on activities and voting policies), as these outcomes ultimately contribute to long-term value for pension scheme beneficiaries. Pension fund should be alert to 'greenwashing' and encourage their investment managers to be clear about their specific contribution to the outcomes achieved.

While stewardship plays an important role in promoting a sustainable transition, it is not a silver bullet in taking action against climate change. Stewardship can help to minimise or make risk justifiable, but ultimately it is the responsibility of company management to ensure their underlying business model is viable in the long-term. Through their role as stewards, investors can assess whether companies are taking the right steps and this will inform their approach to investment and further engagement.

15 Part II - Please provide any comments on "Additional points for DB schemes"

Answer:

DB Schemes will need to understand their sponsors' capital allocation plans to ensure their business model and strategy are fit for purpose in a Paris aligned world or under varying degrees of global warming. This may have implications for covenant and funding plans. Trustees will need to note the significant strain that Covid-19 is placing on company balance sheets and how they will need to prioritise their capital allocation plans to ensure they remain viable in the short and longer term.

16 Part II - Please provide any comments on "Reporting and member communications"

Answer:

17 Part III - Please provide any comments on "Scenario analysis"

Answer:

This guidance should refer to the work undertaken by the Climate Financial Risk Forum, this comprehensive guidance has been produced in collaboration with different participants in the investment chain and it is important that government guidance is joined up.

Pension funds should recognise that a degree of caution is needed around the availability of meaningful metrics and targets in relation to climate change. The IA has been working with the CFRF and our members to support progress in this area, however the quality of this data depends in part on the availability of data from investee companies and there is not yet regulatory requirements for investee companies to report in line with TCFD.

Metrics and targets in relation to carbon intensity need to be understood in the context of risk-adjusted return. Some portfolios with relatively high carbon intensities may be targeting growth potential in relation to the low carbon transition. Pension schemes need to assess metrics on carbon intensity in the context of their own investment beliefs and objectives.

Forecasts and scenario analysis are an important aspect of TCFD which underpins a robust risk management process. These forecasts need to be updated regularly to reflect evolving policy responses, emissions and global warming data. Pension schemes need to be encouraged to consider this information as a part of a risk management process, recognising that the product of forecasting exercises may result in single numbers associated with some figure of error. Taken by themselves these figures may be misleading, as they reflect a wide range of possible outcomes.

This guidance needs to be clear about the pros and cons of different methodologies and ensure there are appropriate health warnings as to their interpretation.

18 Part III - Please provide any comments on "Metrics and Targets"

Answer:

19 Part III - Please provide any comments on the appendices

Answer:

The questions for managers provided in Appendix II should be more focused and proportionate. Trustees should prioritise targeted questions that reveal whether a managers' approach helps meet their investment objectives and beliefs. This long list of questions risks overwhelming or incentivising trustees to adopt a 'tick box approach' to manager assessment, which does not meaningfully inform selection and oversight decisions. These questions are not targeted at different

investment strategies and asset classes and therefore will not generate meaningful answers for many pension schemes. We strongly recommend the development of a list of 10 focused questions that are designed to stimulate an effective conversation between pension funds and their managers.

We also have a number of concerns with specific questions, which reflect some of the concerns with the guidance raised above.

Question 5: This question should be removed. Trustees should make their own assessment of their asset manager's approach to climate change, based on publicly available information and engagement with their managers about how their approach is aligned with their investment objectives.

Engagement and voting sections: these questions relate to the managers' overall approach to voting and stewardship and not specifically to climate change. Trustees should be provided with ample material on their manager's broader approach to stewardship via their SRD II disclosures, Stewardship Code signatory statements and bespoke reporting. Trustees should explore their manager's approach to stewardship in addition to and beyond voting in listed equities. Questions should be targeted to better understand the outcomes of stewardship, and not just policies and processes. Voting on climate change issues can be targeted at a wide range of resolutions and not only against the chair of the company. Question 11 therefore will give a misleading indication of the effectiveness of the manager's stewardship activities.

We also have concerns that the questions on risk management do not reflect on the data and methodological challenges that pension funds, investors and companies are working at pace to address.

Trustees need to think beyond risks and also about their investment portfolio in terms of the availability of climate related opportunities– this emphasis is not reflected in this list of questions.

20 Please provide any comments on the Quick start guide

Answer:
This Quick start guide should be promoted as a helpful starting point for many trustees.

21 Case Studies - We would welcome any case studies on TCFD-aligned disclosure and integration of climate-related risk assessment and management into decision making and reporting. Please provide an overview of any case studies you wish to submit below.

Answer: