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Pension scheme investments and climate change

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Summary

Occupational pension schemes in the UK hold almost £2 trillion in assets. The Government says that this makes them "the largest single group of institutional investors in the UK, with significant influence over the flow of investments in the economy." Coupled with their long-term investment horizons, this means they are both particularly susceptible to the impacts of climate change and "uniquely placed to invest in the financial opportunities that are emerging, and will continue to emerge, to drive us towards a lower carbon economy."

In recent years, the Government has introduced significant new requirements on pension scheme trustees to improve their governance with respect to the effects of climate change and show how they have taken the risks and opportunities associated with it into account in their investments. These changes followed a report of the Law Commission in 2014 which clarified that trustees should take into account factors which are financially material to the performance of an investment and recommended changes to regulations to reflect this.

The Government went on to make changes to the regulations governing occupational pension scheme investments. The effect was to require trustees of pension schemes with more than 100 members, from 1 October 2019, to specify in their Statement of Investment Principles (SIP) their policies in relation to financial material considerations, including those relating to climate change. From 1 October 2020, they were required to produce an implementation statement explaining how they have followed and acted upon the policies set out in their statement.

In November 2021, the UK and Italy will host the international UN climate change conference (COP26) in Glasgow. Key aims of this conference include agreeing a way to take forward the 2016 Paris Agreement on climate change, and all countries committing to reaching net zero emissions as soon as possible. One of its goals is to mobilise finance.

In advance of the conference, the Government introduced what it described as "world leading regulations." The Climate Change Governance and Reporting Regulations 2021 require larger occupational pension schemes and authorised master trusts to set climate-related targets from October 2021. Trustees will be required to undertake governance activities relating to each of the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) and report annually on it. The Government says this will

make the UK the first economy to mandate TCFD reporting for its pensions sector.

In a report on Pension Stewardship and COP26, published on 30 September 2021, the Work and Pensions Select Committee called on the UK Government to use November's Glasgow conference to secure international commitments on global harmonisation of climate-related financial disclosures. Recommendations included:

- The UK should play an active role in encouraging and facilitating other economies to require pension scheme trustees to fully consider and disclose their climate-related financial risks and opportunities, as set out in the Pension Schemes Act 2021.
- The Pensions Regulator should report annually on the progress made in consolidating schemes, given evidence that larger pension schemes are usually better placed to meet the costs of making green investments.
- The Government should continue to support the development of products, such as green gilts, to mitigate the risk of a "green asset bubble" in the short-term.
- The Government should set out a UK climate roadmap to provide greater certainty for pension schemes and other investors, particularly for those investing in long-term investments such as infrastructure.
- The DWP should set out what specific steps it is taking to ensure that its policies do not incentivise divestment over good stewardship—while making clear that schemes could nevertheless consider divestment when there is no other option.

A separate Commons Library Briefing paper looks at the rules applying to Local Government Pension Scheme investments, CBP 7309, October 2021.

1 Introduction

In November 2021, the UK and Italy will host the international UN climate change conference (COP26) in Glasgow. Key aims of this conference include agreeing a way to take forward the 2016 Paris Agreement on climate change, and all countries committing to reaching net zero emissions as soon as possible. More information is available in the Library Briefing on COP26: the international climate change conference, Glasgow, UK and in the Library pages on climate change.

Occupational pension schemes in the UK hold almost £2 trillion in assets; this is equivalent to 85% of UK GDP.[1] This makes them the largest single group of institutional investors in the UK. The Government explains that, coupled with their long-term investment horizons this means "they are particularly susceptible to the impacts of climate change in the next 5, 10 and 30 years." On the other hand, it also means they are "uniquely placed to invest in the financial opportunities that are emerging, and will continue to emerge, to drive us towards a lower carbon economy."[2]

Trustees need to take account of physical, transition and litigation risks associated with climate change:

> 4. Climate change risks manifest themselves in the form of physical and transition risks, as well as related risks such as litigation risks. All pension schemes are exposed to these climate-related risks. As with interest rate risk, inflation risk, insolvency risk etc., trustees of occupational pension schemes are bound by their fiduciary duty to act to protect their beneficiaries against risk and deliver them a return on their savings.
>
> 5. The UK is a signatory of the Paris Agreement. In 2019, the Government wrote into law the target of achieving net-zero greenhouse gas emissions by 2050.
>
> 6. Trustees of pension schemes need to take into account the risks that are associated with this transition and the investment opportunities that are available to them. The emergence of transition risks and opportunities will inevitably impact the viability of current investments but will also require schemes to set out a strategy – to have a plan – to enable them to navigate the transition

[1] PPF Purple Book 2020, Figure 4.2; The Pensions Regulator, DC trust scheme return data 2020 – 2021 (Data tables file 3) [Underlying data £1,700.6 bn + £87.5 bn = £1,788.1 bn]

[2] Impact Assessment on Climate Change Risk – Governance and Disclosure (TCFD) Proposals, January 2021, p5

to ensure they deliver their members a sustainable retirement income, protected effectively against climate change risks. [3]

Investment approaches to climate change can take various forms:

- **Divestment/negative screening** - Excluding specific companies/sectors associated with specific activities or sustainability risks, whether through index, rules-based or active funds.
- **Tilted funds** - Strategies that increase portfolio exposure to companies with higher ESG [environmental, social and governance] ratings on behaviour relating to climate change.
- **Voting** - Voting in a way that supports positive behaviour in relation to climate change, either directly or via an asset manager.
- **Engagement** - Engaging with companies on climate change, either directly or via an asset manager, working with other investors, creating and sustaining momentum. [4]

1.1 The statutory and regulatory framework

Different legal frameworks apply to investments in:

- **Contract-based schemes**, where an employer appoints a pension provider, often an insurance company, to run the scheme. The scheme members will sign a contract with the provider, who will make the majority of decisions about the way the scheme is run. The main types are Group Personal Pensions, Group Self-Invested Personal Pensions, Group Stakeholder Pensions.
- **Trust-based schemes**, which are sponsored by an employer but managed by a board of trustees who have full responsibility for the management, administration and investment of the plan and a fiduciary duty is to act in the interests of members. Trust-based schemes can be either: **defined benefit -** in which the member builds entitlement to pension benefits based on fixed factors such as salary and length of service; or **defined contribution** – in which an individual builds up a fund based on contributions and investment returns.

Although different rules apply, the Department for Work and Pensions and the Financial Conduct Authority say that the outcome for pension savers is

3 Ibid
4 PPI, Engaging with ESG: climate change, Feb 2021, figure 1.4

intended to be the same whether a scheme is trust-based or contract-based. [5]

Trust-based schemes

According to the Law Commission, the legal duties of the trustees of occupational pension schemes derive from at least three sources:

- **The trust deed** for the scheme, which trustees should look at to understand the purpose of the investment power they have been given and how they can use it to promote the purpose of the trust.
- **The pensions legislation,** in particular, section 33 to 36A and 40 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378) (the 'investment regulations').
- **Judge-made duties,** that attach to the exercise of a power, duties of care and fiduciary duties. Among other things the courts require trustees to consider the right issues. In particular, they should: i) act for the proper purpose; ii) take into account all relevant considerations, and ignore irrelevant ones; iii) take advice; and iv) not "fetter their discretion", by applying a pre-existing judgement. [6]

The Pensions Regulator has produced guidance on investments for defined benefit pension schemes (updated September 2019) and trust-based defined contribution schemes (updated July 2019).

Trustees are not the only actors involved in the investment approach to climate change. Others include asset managers, to whom trustees delegate the day-to-day decision making on investments; the companies they invest, which may be assessed using climate change metrics or analytic tools; and advisers and consultants, who often play a key role in investment decision-making. [7]

Contract-based schemes

Contract-based pension schemes are regulated investments under the Financial Services and Markets Act 2000. Rules set by the Financial Conduct Authority include a requirement on workplace contract-based schemes to have an independent governance committee (ICG) to provide governance oversight. ICGs have a duty to assess the ongoing value for scheme members which includes assessing a scheme's default investment strategy, whether they have a clear statement of aims and objectives and are designed and executed in the interests of scheme members. Factors the ICG should assess and report on include the firm's policy in relation to ESG (environmental and

5 Pension Fund and Social Investment. Summary, Law Commission, 2017, para 1.33

6 Pension trustees' duty in setting an investment strategy. Guidance from the Law Commission, July 2014, para 1.7-1.11

7 PPI, Engaging with ESG: climate change, Feb 2021

social governance considerations), the adequacy and quality of its policy in relation to non-financial matters in its investment strategy, and the adequacy and quality of the firm's policy (if any) in relation to stewardship. [8]

[8] Conduct of Business sourcebook (COBS 19), FCA, chapter 19, para 19.5.5

2 How policy has developed

2.1 Law Commission - fiduciary duties (2014)

A Review of UK Equity Markets and Long-Term Decision Making by John Kay in 2012, identified widespread concern about how fiduciary duties were interpreted in the context of investment. In particular, some stakeholders felt that their fiduciary duties required them to maximise returns over a short-time scale, precluding consideration of long-term factors which might impact on company performance. They were also unclear how fiduciary duties applied in the investment chain. The review recommended that the Law Commission should be asked to review the concept of fiduciary duty as it applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers. [9]

In March 2013, the Government asked the Law Commission to examine the fiduciary duties of investment intermediaries. A central concern was how far pension scheme trustees may (or must) consider interests beyond the maximisation of financial return, such as questions of environmental and social impact, and the ethical views of their beneficiaries. [10]

In its 2014 report, [11] the Law Commission explained that the primary aim of an investment strategy was "to secure the best realistic return over the long term, given the need to control for risks." [12]

There was a key distinction between financial factors (relevant to trustee's primary investment duty of balancing returns against risks) and non-financial factors motivated by other concerns (such as improving members' quality of life or showing disapproval of certain industries). [13]

Taking account of financial factors in investment decisions involves trustees balancing returns against risks. Trustees may take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as (ESG) factors:

> These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a

9 The Kay Review of UK Equity Markets and Long-term Decision Making, Final Report, July 2012, p13, recommendation 9
10 Pension trustees' duty in setting an investment strategy, Law Commission, July 2014, para 1.3
11 Fiduciary duties of investment intermediaries, Law Commission, July 2014
12 Pension trustees' duty in setting an investment strategy, Law Commission, July 2014
13 Ibid, para 1.13-4

> company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action. [14]

"Non-financial factors" are those motivated by other concerns, such as improving members' quality of life or showing disapproval of certain industries. To illustrate the distinction with financial factors, the Law Commission gave the following example:

> Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor. [15]

The Law Commission said trustees should always take financially material factors into account. They could take account of non-financial factors if two tests were met:

> **Financial factors**
>
> 1.42 In pensions, the primary purpose of the investment power given to trustees is to secure the best realistic return over the long term, given the need to control for risks. Trustees of DB and DC schemes should always take into account financially material factors when making investment decisions.
>
> 1.43 In this context, issues of social impact should be taken into account where they help trustees assess the long-term financial risks of a particular investment; for example, where a company's negative social or environmental impact could affect its long-term sustainability and financial returns.
>
> **Non-financial factors**
>
> 1.44 In some limited circumstances, the trustees of a scheme may go further than this. They may favour investments with a positive impact or avoid investments with a negative impact. However, for trustees to take account of non-financial factors when setting investment strategies and making investment decisions, they must apply two tests, taken from the case law: (1) trustees should have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund. [16]

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[14] Ibid

[15] Ibid, para 1.23-4

[16] Pension funds and social investment, Summary, July 2017

In a further report published in 2017, the Law Commission said the existing law was flexible enough to allow investment for social purposes. The barriers were mostly "structural and behavioural rather than legal or regulatory." [17]

The Law Commission made recommendations (in 2014, updated in 2017) for changes in the law to reduce barriers to social investment:

- **For trust-based pensions**, the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations) should be amended in the following ways:
  - The reference to 'social, environmental or ethical considerations' should be amended to ensure that it accurately reflects the distinction between financial factors and non-financial factors.
  - There should be a requirement that the statement of investment principles (SIP) produced by trustees should state trustees' policy (if any) on stewardship.
- **For contract-based pensions**, the Financial Conduct Authority (FCA) should require schemes' Independent Governance Committees to report on a firm's policies in relation to:
  - evaluating the long-term risks of an investment, including relating to corporate governance or environmental or social impact;
  - considering members' ethical and other concerns; and
  - stewardship.
- The FCA should issue guidance for contract-based pension providers on financial and non-financial factors, to follow the guidance for trust-based schemes given by The Pensions Regulator. [18]

2.2 Changes to the investment regulations

The Government welcomed the Law Commission's explanation that incorporating social impact into investment decision-making could deliver competitive risk-adjusted returns where that was the investment objective. [19]

[17] Pension funds and social investment: summary, Law Commission, June 2017
[18] Pension funds and social investment. The Government's interim response, December 2017
[19] Pension funds and social investment: the government's interim response, December 2017

It consulted on several of the Law Commission's proposed changes to the investment regulations in January 2015, but at that stage concluded there was not a compelling case for change. Guidance from the Pensions Regulator would support trustees in understanding their responsibilities in taking investment decisions. [20]

In June 2018, the Government launched a further consultation on changes to the investment regulations in June 2018. These regulations already required trustees of a trust-based occupational pension scheme with at least 100 members to prepare a Statement of Investment Principles (SIP), review it at least every three years and without delay after any significant change in investment policy. [21] The consultation proposed changes to what would need to be included in a SIP and how it should be publicised. [22] In September 2018, the Government said it would proceed as proposed, with some modifications. [23] The Law Commission welcomed the proposed changes, which it had first considered as part of its 2014 report on Fiduciary Duties. [24]

Under the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (SI 2018/998), schemes that are required to produce a SIP (because they have more than 100 members) must include in it:

- From October 2019, their policies in relation to financially material considerations (including ESG considerations, such as climate change) and how those considerations are taken into account in investment decisions. They must also explain their policy in relation to the exercise of voting rights and engagement activities in respect of the investments.
- From October 2020, how they incentivise their asset manager to act in line with the trustees' policies and the extent to which members' views on non-financial matters are taken into account in realisation of investments.

Trustees of schemes of at least 100 members offering money purchase benefits are also required to make their SIP publicly available free of charge on a website. [25]

[20] Consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries', DWP, February 2015

[21] Occupational Pension Schemes (Investment Regulations) 2005 (SI 2005/3378), reg 2; Pensions Act 1995, s35

[22] Consultation on clarifying and strengthening trustees' investment duties. The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018, June 2018

[23] Consultation on clarifying and strengthening trustee's investment duties. Government response, September 2018, p9

[24] Law Commission website – pension funds and social investment (viewed September 2021)

[25] The Pensions Regulator, Managing DC benefits/investment governance/statement of investment principles, Updated July 2019

2.3 Climate-related Financial Disclosures

In December 2015, at the COP21 Paris Climate Change Conference, Mark Carney, then Governor of the Bank of England and chair of the Financial Stability Board announced the establishment of the Taskforce on Climate-related Financial Disclosures (TFCD) under the chair of Michael R. Bloomberg, UN Secretary-General's Special Envoy for Cities and Climate Change and former Mayor of New York. The taskforce was asked to make recommendations for consistent company disclosures that would promote better informed decisions by financial market participants and allow them to understand and better manage climate-related risks. [26] The recommendations of its 2017 report focused on four key areas: [27]

> **Governance:** The organization's governance around climate-related risks and opportunities
>
> **Strategy:** The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.
>
> **Risk Management:** The processes used by the organization to assess and manage climate-related risks.
>
> **Metrics and Targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities. [28]

These were supported by eleven recommended disclosures: [29]

[26] FSB to establish Taskforce on climate-related financial Disclosures, 4 December 2015
[27] Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017
[28] Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017; Pensions Climate Risk Industry Group, Aligning your pension schemes with the TFCD guidance, March 2020
[29] Pensions Climate Risk Industry Group, Aligning your pension schemes with the TFCD guidance, March 2020, p28

Governance	Strategy	Risk-management	Metrics and targets
a) Describe the board's oversight of climate-related risks and opportunities	a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long-term.	a) Describe the organisation's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.	b) Describe the organisation's processes for managing climate-related risks	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas emissions, and the related risks.
	c) Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.	c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

For pension schemes, the intention was that the increased transparency encouraged through the TCFD recommendations would "lead to decision-useful information and therefore better-informed decision-making on climate-related financial risks." By applying the TCFD recommendations and making the recommended disclosures, pension scheme trustees would be "better placed to properly assess and understand what climate change actually means for their particular scheme – and will be better equipped to make decisions that ensure the best outcomes for pension scheme members." [30]

The Government formally endorsed the TCFD recommendations in September 2017, describing it as "the most widely-adopted way in which organisations were managing and reporting climate risk." [31] Its July 2019 Green Finance Strategy set an expectation for "all listed companies and large asset owners to be disclosing in line with the TCFD recommendations by 2022." [32] HM

[30] Ibid, p25

[31] See also, HM Government Green Finance Strategy July 2019; FCA, PRA, FRC and TPR, Joint statement on climate change, July 2019

[32] HM Government, Green Finance Strategy, July 2019

Treasury published a Roadmap towards mandatory climate-related financial disclosures in November 2020.

For more on the background see Green finance: Mobilising investment for green growth, Commons Library Insight, June 2020.

Pension Schemes Act 2021

Section 124 of the Pension Schemes Act 2021 allows the Secretary of State to make regulations to secure effective governance of occupational pension schemes with respect to the effects of climate change; requiring information regarding the effects of climate change on the scheme to be published and ensuring compliance with these requirements. [33]

The provisions were not included in the Bill when it was first introduced in the House of Lords on 7 January 2020. [34] Instead, the Government introduced an amendment at Committee stage in the House of Lords on 26 February. It explained that, building on the expectation announced in its Green Finance Strategy that all large asset owners would be expected to report on how they addressed climate change risk in line TCFD by 2022, it was taking powers to require occupational pension schemes to manage the effects of climate change effectively as a financial risk to their investments and to report publicly on how they have done so. [35]

For more on the background see Pension Schemes Bill 2019-21, Commons Library Briefing Paper CBP 8693, January 2021.

Consultation on aligning pension schemes with TCFD recommendations

In March 2020, the Pensions Climate Risk Industry Group launched a consultation on guidance for aligning pension schemes with the TCFD recommendations. [36] Pensions Minister, Guy Opperman, welcomed the consultation, saying that while he was proposing to take powers in the Pension Schemes Bill to require TCFD reporting, schemes did not need to wait for this in order to start actively managing their exposure to climate change in line with the TCFD recommendations. [37]

The consultation noted that several of the TCFD disclosures aligned to existing requirements, including those for disclosure of trustees' policies on climate change and effective governance, including consideration of ESG factors. TCFD disclosures were likely to assist trustees in demonstrating they were taking account of financially material factors and in meeting the legal

[33] DWP, Taking action on climate risk: improving governance and reporting by occupational pension schemes, August 2020, para 40

[34] Pension Schemes Act 2021/stages, UK Parliament website

[35] HL Deb 26 February 2020 c156GC

[36] Aligning your pension scheme with the TCFD recommendations, Pensions Climate Risk Industry Group, March 2020

[37] Ibid Ministerial foreword

requirements on considering climate-related risks. It would also be a useful lens for trustees of DC schemes as they compiled their statement on how they had implemented the policies in the SIP. [38]

The Pensions Climate Risk Industry Group explained that TCFD could be applied to consideration and action on climate risk at every stage of the investment journey:

- **Setting investment beliefs -** under TCFD, they should formalise and document their governance policies, including roles, in relation to climate change.
- **Considering climate risks in setting investment strategies, reviewing and reporting -** under TCFD, trustees should document how they identify and assess the materiality of climate-related risks and opportunities, document the main risks and opportunities for each time horizon and their potential impact, and explain their assessment of their scheme's resilience to different scenarios, including relevant metrics. They should also identify, document and disclose how climate issues are included in their consultants' objectives, and in the selection, review and monitoring of asset managers.
- **Stewardship -** under TCFD, trustees should document and disclose their own stewardship policies, report on how they have followed them, and hold investee companies to account on doing TCFD.
- **Trustees of defined benefit (DB) schemes** - should identify and assess the materiality of climate-related risks and opportunities to their sponsoring employer, the main risks and opportunities for each time horizon and their assessment of their employer's resilience to different scenarios.
- The outcome of the trustees' TCFD review should be **reported and communicated to scheme members**. [39]

Requirement to align with Paris Agreement objectives

Although at Committee stage in February, responding to arguments from opposition and backbench MPs, the Government had said it did not think the industry was ready to be required to align with the Paris objectives, [40] at Report Stage on 30 June, it amended clause 124 to require trustees to "explicitly consider climate change goals, including the Paris Agreement temperature goal." [41] Work and Pensions Minister, Baroness Stedmann-Scott, explained that the Government's amendments would:

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[38] Ibid, p29

[39] TCFD for trustees of pension schemes – quick start guide, July 2021

[40] HL Deb 26 February 2020 c156GC

[41] HL Deb 30 June 2020 c625

- Make it explicit that regulations may require scheme trustees and managers to take account of the different ways in which the climate might change and the steps that might be taken because of those changes.
- Allow regulations to be made requiring trustees to adopt prescribed assumptions about achievement of the Paris Agreement goal and other climate change goals, or the steps that may be taken to achieve them.
- Ensure that trustees and managers could be required to publish information relating to the assessments they make by reference to the Paris Agreement goal or other climate change goals under Section 41A. This would include publication of the contribution of schemes' assets to climate change.

The Government intended to "begin with large schemes and then consider costs and benefits carefully before we extend any requirements to smaller schemes." [42]

In Second Reading debate in the House of Commons on 7 October 2020, Work and Pensions Secretary, Therese Coffey, said this would put the UK "among the very first countries in the world to put climate change reporting for pension funds into law." The Financial Conduct Authority planned to consult on corresponding climate-related financial disclosures for personal pension schemes and to finalise the rules by the end of 2021. That would mean that by 2022, both occupational and personal pension schemes would be subject to TCFD reporting requirements. [43]

Debate on mandatory net zero targets

At Report Stage of the Pension Schemes Bill on 16 November 2020, Shadow Work and Pensions Secretary, Jonathan Reynolds, moved an amendment that would enable regulations to:

> mandate occupational pension schemes to develop a strategy for ensuring that their investments and stewardship activities are aligning with the Paris agreement goals, and include an objective of achieving net-zero greenhouse gas emissions by 2050 or sooner. [44]

He said this would not "enforce or mandate pension funds to be net zero" but rather "ensure that they have an investment strategy, including a stewardship strategy, that is consistent with those objectives." [45] The amendment had been developed and backed by a whole host of organisations across the public and private sectors. [46] Responding, Mr Opperman said it was the wrong way forward. It would "direct investment,

[42] Ibid c626
[43] HC Deb 7 October 2020 c909-12
[44] HC Deb 16 November 2020 c60 and c107-8
[45] Ibid c71
[46] Ibid c108

breach fiduciary duties and lead to divestment and negative outcomes." [47] The Opposition amendment was defeated on division by 356 to 256 votes. [48]

The Pension Schemes Act 2021 received Royal Assent on 11 February 2021. Regulations to implement the new requirements, starting with the largest schemes, came into effect in October 2021, as discussed below.

Consultation on policy proposals – August 2020

In August 2020, DWP launched a consultation on policy proposals to:

- Require trustees of larger occupational pension schemes (£5 billion or more in assets) authorised master trusts and collective money purchase schemes to have effective arrangements for the assessment and management of climate risks and opportunities from October 2021; and
- Report on these in line with the TCFD recommendations by the end of 2022.

For schemes with more than £1 billion in assets, the governance requirements would apply from October 2022 and the reporting requirements by the end of 2023. This would mean that more than 75% of assets and 80% of members would be in schemes subject to the requirements. [49] The Government would take stock in 2024 and consult more widely before extending the requirements to schemes with under £1 billion in assets, taking account of the quality of climate risk governance and associated disclosures carried out to date, and the current and future costs of compliance. [50]

Consultation on draft regulations and statutory guidance – January 2021

The Government consulted in January 2021 on draft regulations and statutory guidance. [51] Guidance of the Pensions Climate Risk Industry Group, consulted on in March 2020, was published in final form on the same day. [52]

The draft regulations [53] would require trustees of schemes in scope to:

[47] Ibid c112

[48] Ibid c131

[49] DWP, Taking action on climate risk – improving governance and reporting by occupational pension schemes, August 2020, Ministerial foreword; chapter 1, summary of proposals

[50] Ibid

[51] Taking action on climate risk: improving governance and reporting by occupational pension schemes, DWP, January 2021; Governance and reporting of climate change risk. Guidance for trustees of occupational pension schemes. Consultation version, DWP, January 2021

[52] Aligning your pension scheme with the Task-Force on Climate-Related Financial Disclosures Recommendations, Pensions Climate Risk Industry Group, January 2021

[53] Draft Occupational Pension Schemes: Climate Change (Governance and Reporting) Regulations 2021; Draft Occupational Pension Schemes: Climate Change (Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021

- implement climate change governance measures and produce a TCFD report containing associated disclosures; and
- publish their TCFD report on a publicly available website, accessible free of charge.

In addition, there was consultation on statutory guidance to which trustees would be required to have regard when meeting requirements under the regulations. [54] The Government published its response to the consultation in June 2021. [55]

Regulations

The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations were debated in the House of Lords on 5 July 2021. Work and Pensions Minister, Baroness Stedmann-Scott explained that the regulations would require larger occupational pension schemes (and authorised master trusts and collective money purchase schemes) to disclose in line with TFCD recommendations:

> This includes requirements relating to governance, strategy and risk management as well as requirements to select and calculate climate-related metrics and to set and measure performance against targets.
>
> Trustees will be required to meet these climate change governance requirements, which underpin the recommendations of the TCFD, and to report on how they have done so in line with the task force's recommendations. Details of steps that should be taken to meet the requirements are included in the statutory guidance to which trustees must have regard. The regulations also confer compliance powers on the Pensions Regulator to enforce the new requirements.
>
> Among other requirements, trustees will need to report on the risks that affect their portfolio, on how their investment strategy—and, in the case of defined benefit schemes, their funding strategy—would respond to different temperature rise scenarios, which will include consideration of the strength of the employer covenant, on the emissions attributable to their assets, their emissions intensity and their performance against targets that trustees have set. [56]

The requirements would be rolled out in stages:

- Trustees of schemes with £5 billion or more in relevant assets and all authorised master trusts and collective money purchase schemes would

[54] Governance and reporting of climate change risk. Guidance for trustees of occupational pension schemes. Consultation version, January 2021

[55] Government response: Taking action on climate risk: improving governance and reporting by occupational pension schemes, DWP June 2021

[56] HL Deb 5 July 2021 c257GC

be required to meet the governance requirements from 1 October 2021 and to produce and publish climate risk disclosures within seven months of their scheme year end.

- Schemes with at least £1 billion in relevant assets, would have to meet the same requirements from 1 October 2022. From that date, the regulations would apply to more than 70% of pension assets and more than 80% of pension members.
- The Government had committed to review the effectiveness of the regulations and statutory guidance in 2023, at which point it would assess whether the regulations remain appropriate and whether they should be extended to smaller schemes. [57]

The regulations would require trustees to conduct scenario analysis, to set targets and measure performance against them. They would be required to do this "as far as they are able", taking all steps reasonable and proportionate in the circumstances. The activities would rely on data from other participants in the investment chain. The Minister emphasised that trustees retained primacy in investment decisions, whether in the targets they set or in investment decisions. It was "not for the Government to direct trustees to sell or buy certain assets, and these proposals do not create any expectation that schemes must divest or invest in a given way." [58]

The effects of the regulations would be "significant and transformative":

> By the end of 2023, the risks and opportunities climate change poses to £1.33 trillion-worth of pension savings will be assessed and published for all to see. Critically, this develops a system of accountability that we have never had before, and trustees will be required to show how climate change is likely to affect their portfolio. To conclude, these measures cement the UK's leadership in green finance. We were the first major economy to pass a net-zero emissions law, and now these measures on climate change risk and pensions are the first of their kind globally. [59]

Labour Peer, Baroness Sherlock, raised concerns about the adequacy of the data that would be available to trustees, given the FCA was currently consulting on proposals to introduce TCFD requirements for asset managers and others, with responses requested by September 2021. She asked whether trustees would be able to rely on an "FCA quality stamp as a reliable and acceptable source of data." [60]

In response, Baroness Stedman-Scott said a significant portion of mandatory requirements would be in place by 2023:

[57] Ibid
[58] Ibid c258
[59] Ibid
[60] Ibid c262

> The Government have already announced their intention to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023. This will produce regulatory alignment through the investment chain, which will capture asset managers, workplace personal pension schemes, UK-registered large private companies, insurance companies and banks by the end of 2023. This will increase the flow of data, which is vital for trustees to embed effective climate risk governance. [61]

As regards the delay in extending the requirements to smaller schemes, she said the Government did not wish to impose "disproportionate burdens" on trustees and that trustees did not need statutory requirements to begin meaningful action. [62]

The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (SI 2021/839) and The Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021 (SI 2021/857) come into force on 1 October 2021.

The Pensions Regulator is responsible for monitoring and enforcing compliance with the requirements. [63] In June 2021, it consulted in its proposed regulatory approach. [64]

Financial Conduct Authority

The FCA published rules on climate-related disclosure for the most prominent listed commercial companies in December 2020, aligned with the recommendations of the Taskforce on Climate-related Financial Disclosures. [65] In July 2021, it consulted on proposals to extend these rules to issuers of standard equity shares and to introduce TCFD disclosure requirements for asset managers, life insurers and pension providers regulated by it. [66]

[61] Ibid c264
[62] Ibid c265
[63] SI 2021/839 Part 3
[64] Climate-related governance and reporting consultation, TPR, July 2021
[65] PS20/17: Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations, FCA, 21 December 2020
[66] FCA, Climate change and sustainable finance, Updated 20 July 2021

3 Issues

Recent reports indicate a number of areas where more work is needed, with some differences of opinion on the best approach.

In the report of its inquiry on Pension Stewardship and COP26 published on 30 September 2021, the Work and Pensions Select Committee called on the UK Government to use November's Glasgow conference to secure international commitments on global harmonisation of climate-related financial disclosures and made recommendations on reporting standards, pension scheme governance and investment and stewardship.

3.1 Divestment and stewardship

The Law Commission explained that:

- Divestment or negative screening refers to "the use of ethical, social and governance (ESG) factors to exclude investment in particular companies or sectors, such as tobacco companies or pesticide manufacturers."
- Stewardship involves engaging with companies on how they operate. It aims to promote the long-term success of companies in such a way that protects and enhances the value that accrues to the ultimate beneficiary of an investment. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. [67]

The Government says its policies are designed to encourage stewardship rather than divestment:

> 16.Whilst engaged members and civil society groups have an important role in facilitating scrutiny, these measures are not intended to give any support to campaign groups calling for blanket divestment from certain assets. Government continues to believe this would be the wrong approach – engagement with high carbon companies, when done effectively, can reduce the climate risk to which the scheme is exposed. At the same time, stewarding these firms to set a plan for the transition can have a greater impact on

[67] Fiduciary duties of investment intermediaries, Law Commission, July 2014

> climate change than simply selling assets to others who might not hold investee firms to account. [68]

Some organisations argue for divestment – for example, from fossil fuels, as a powerful way of sending a signal to companies and the Government where public priorities should lie. [69] A report published in February 2021 by campaign groups Friends of the Earth and Platform argues that it is not a binary choice: "a vocal decision to divest must be viewed as a highly successful form of engagement in itself." They argue for fossil fuel divestment as the "foundation upon which an effective climate policy can be built", adding that "complete Paris alignment requires cross-portfolio action by investors, divesting from the worst offenders and engaging with companies that can change." They argue that it is also in accordance with fiduciary duties given that "the transition away from fossil fuels is a question not of 'if' but of 'when.'" [70]

In its report on Pension Stewardship and COP26, the Work and Pensions Select Committee said it supported the Government's approach:

> Divestment remains a fallback strategy for pension schemes with investments in assets which are unable to reduce their contribution to climate change or where a good stewardship approach has failed. Nevertheless, widespread divestment by pension schemes is unlikely to have the required impact on the real economy's contribution to climate change. Encouraging behaviour change in companies through good stewardship is more likely to be an effective approach to help the real economy transition to net zero. We welcome the Minister's clear statement that divestment should be a last resort. We recommend that the Department set out, in response to its report, what specific steps it is taking to ensure that its policies do not incentivise divestment over good stewardship—while making clear that schemes could nevertheless consider divestment when there is no other option. [71]

3.2 Targets

Targets can provide trustees with clarity and a framework for their work on climate change as well as helping to engage scheme members. [72]

Some have called the Government to mandate specific targets and/or plans, for example, regarding net zero. The Work and Pensions Committee explains

[68] Taking action on climate risk: improving governance and reporting by occupational pension schemes. Policy consultation response, DWP, January 2020

[69] Friends of the Earth website, Divestment and climate (viewed 6 October 2021)

[70] Divesting to protect our pensions and the planet, Platform, Friends of the Earth England Wales and Northern Ireland and Friends of the Earth Scotland, February 2021, p34-5 and chapter 2

[71] Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 72

[72] Oral taken on 30 June 2021, HC (2021-22) 238, Q 22 and 23 [Morten Nilsson]

that this can be interpreted in several different ways. These include, the scheme only investing in net zero assets, its portfolio being net zero aligned, or its investments being consistent with a national net zero approach.[73]

In December 2020, the Advisory Group on Finance for the Climate Change Committee recommended making net zero targets and plans mandatory for financial institutions:

> Building on the overall financial system goal outlined in Recommendation 1 and the positive momentum shown by leading financial institutions, the government should introduce a mandatory requirement for all financial institutions to introduce net-zero targets and plans for how these are to be achieved. These should be delivered through five-yearly interim net-zero goals, matching the UK carbon budgets, with annual reporting of progress. This builds on the proposal by the Climate Financial Risk Forum's Innovation working group for regulated financial institutions to publish 'capital allocation statements' for climate change. An explicit net-zero commitment would help to ensure that financial flows are consistent with the Paris Agreement and would show clear UK leadership. From this, the UK could support an evolution of the TCFD framework to more explicitly include net zero alignment alongside risk and opportunity.[74]

In July 2021, IPPR's Environmental Justice Commission recommended that the Government should "set a legal requirement for the 'default' defined contribution funds to be net zero aligned by 2030 at the latest." It argued that this would accelerate and expand innovation in green consumer finance.[75]

Some witnesses to the Work and Pensions Committee were concerned that mandatory targets could have unintended consequences. The UK Sustainable Finance and Investment Association preferred a voluntary approach, saying mandatory net zero requirements "could lead to a kneejerk divestment away from the parts of the economy that, from a macroeconomic perspective, need to rapidly transition to providing the goods and services of a net zero economy."[76] The Pension and Lifetime Savings Association and Association of British Insurers preferred a voluntary approach, allowing pension schemes and providers to set appropriate targets.[77]

Aviva said that while disclosure was very important, there was a "growing consensus that climate transition plans were the necessary next step":

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73 Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 36

74 The road to net zero finance, A report prepared by the Advisory Group on Finance for the UK's Climate Change Committee, December 2020, Recommendation 8

75 IPPR, Environmental Justice Commission – Full report, Part 2, July 2021, p69. See also oral evidence taken on HC (2021/22) 238, 14 July 2021, Q28 and 34; See also Ibid Q17; see also Q34

76 PSC001, June 2021; Oral taken on 30 June 2021, HC (2021-22) 238 Q4

77 PSC0020, June 2021; PSC008 June 2021, para 5

> Critically, we would like to see mandated climate transition plans for major financial institutions at least. That was a recommendation from the Climate Change Committee.
>
> All the disclosure stuff, and TCFD being mandated, is great—disclosure is really important—but I can weigh myself as many times as I like, but if I do not have a plan to eat better and exercise more, I am not going to get very far with my diet.
>
> We are not saying that Governments have to tell us how we do it; we are saying they have to require us to do it and mandate the publication of transition plans with net zero targets that are science based and map your business plan and your capital expenditure to your stated commitments. That way, we can understand what these companies are doing and continue to invest in companies that might be brown today but have good plans to be green tomorrow. That is the big win. [78]

The Government's approach is to require trustees to set and disclose targets and to measure performance against them:

> Trustees will also have to set a target for the scheme in relation to one of the metrics they have selected to calculate. In each scheme year they will be required to measure performance against the target and, taking into account that performance, determine whether it should be retained or replaced. There is no requirement that the scheme must meet the target set, but trustees will have to report their metrics and performance against their target in their published TCFD Report for that scheme year. Statutory Guidance, published in draft alongside the draft Regulations, offers more detail [...] It is up to trustees to decide, in line with their fiduciary duty, which targets to set.

It does not propose to mandate net zero targets:

> DWP has **not** mandated trustees to set net zero targets. To do so could put trustees in a difficult legal position where they are at risk of breaching their fiduciary duties, particularly if the net zero target is contrary to the scheme beneficiaries' best interests. There is also a significant risk that such mandatory targets would trigger divestment from higher carbon firms which are in the process of transitioning to Net Zero. Pension savers would continue to experience the impacts of polluting firms, whilst their trustees would be unable to hold them to account. [79]

The Government also points the progress that has been made with a voluntary approach to targets:

[78] PSC0025 June 2021; Oral evidence to the Work and Pensions Select Committee, 30 June 2021, Q34

[79] Taking action on climate change: governance and reporting by occupational pension schemes, DWP, August 2020, p75; PSC00022, June 2021; Oral evidence taken on 14 July 2021 HC (2021/22) 238, Q48

> […] a number of the larger DB schemes have made voluntary net zero commitments, but some of the mature DB schemes are less likely to set those kinds of targets because they do not expect to be operating by 2050. On the DC side, there has been significant progress. Certainly with voluntary net zero targets, we now see about 85% of DC savers are in a scheme with a net zero target. [80]

The Association of Pensions Lawyers stressed the importance of trustees remaining focused on their fiduciary duty:

> As the law currently stands, it is not the trustees' role to contribute to setting and/or delivering on COP26 targets or otherwise lobby asset managers in pursuit of an agenda beyond their above stated legal obligations. In practice, an increasing number of trustees have set Net Zero ambitions for their scheme's investments. However, this is because they believe such an approach is financially beneficial to the scheme and will usually be part of a wider scheme strategy to mitigate climate-related risks and take account of climate-related opportunities in the best financial interests of the Scheme. [81]

The Work and Pensions Select Committee recommended that the Pensions Regulator define "net zero alignment" as it did not have a single clear definition. It also recommended "that the Government consult on the case for mandating that these default options should align to UK Government climate goals." [82]

3.3 Information to support decision-making

Scope of TCFD requirements

In debate on regulations in July 2021, Labour Peer, Baroness Sherlock, raised concerns about the adequacy of the data that would be available to trustees, given that the FCA was currently consulting on proposals to introduce TCFD requirements for asset managers and others, with responses requested by September 2021. [83] In response, Baroness Stedman-Scott said a significant portion of mandatory requirements would be in place by the end of 2023:

> The Government have already announced their intention to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023. This will produce regulatory alignment through the investment chain, which will capture asset managers, workplace personal

[80] Ibid, Q42

[81] PSC0019 June 2021

[82] Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 42-5

[83] HL Deb 5 July 2021 c262GC

> pension schemes, UK-registered large private companies, insurance companies and banks by the end of 2023. This will increase the flow of data, which is vital for trustees to embed effective climate risk governance. [84]

In its evidence to the Work and Pensions Select Committee, the Pensions and Lifetime Savings Association (PLSA) said expressed concerns about the practicalities of the TCFD requirements on trustees in the early years, given that they would be “dependent on asset managers and companies for this data, the majority of which will not be required in law to provide by the time schemes require it.” Success would depend on the full investment chain, including fund managers and companies, reporting to a similar standard. Nonetheless, it welcomed the Government’s ambition and believed that, in the long-term, it would result in a “much more comprehensive picture of how UK’s pension investments are at risk from or impacting climate change.” [85] NEST agreed, saying:

> Like many other pension schemes, we invest through external fund managers and ask them to provide the relevant metrics to meet our disclosure requirements. But we have found that some investment managers do not fully understand the disclosure requirements for pension schemes and are not able to provide the data we are requesting at the moment, let alone the new proposals. We believe that mandatory disclosures across the economy will be crucial to improve the situation and welcome the forthcoming consultation by the FCA on TCFD-aligned rules for asset managers. [86]

Both organisations also stressed the importance of having consistent international standards. NEST said “a common international standard for climate change disclosure should be a key focus at COP26. The TCFD framework was most useful for pension schemes as it focused on the financial impacts of climate change. However, it had faced challenges “due to the lack of coverage and inconsistent methodologies for collecting data across different asset classes. Consistent disclosure requirements across the global economy would help to overcome these challenges.” [87]

DWP said that “given the international diversification of pension scheme investments, it is in the interests of UK pension schemes for the UK Government to work with other jurisdictions to improve take-up of mandatory climate risk reporting.” [88]

[84] Ibid c264
[85] PSC0020, June 2021
[86] PSC0013 June 2013
[87] PSC0013 June 2013
[88] PSC0022, June 2021

The Work and Pensions Select Committee recommended that the Government aim to "secure international commitments to work towards the global harmonisation of climate-related reporting standards at COP26." [89]

3.4 Green taxonomy

The need for a "green taxonomy" (a common framework for determining which activities can be defined as environmentally sustainable) was mentioned by a number of witnesses to the Work and Pensions Committee. Tony Burden of Make My Money Work said:

> That definition—that taxonomy—is key. What is green? [...] Different bits of industry will lobby for their own interests. That is why you need a balanced approach across all this. Ultimately, consumers need to know whether their pension is green or not, and how they know that it is. [90]

Morten Nilsson of the BT Pension Fund agreed it was "critical to get this green taxonomy right so that we have a standardised way of thinking about all this, but it is important that that is done on a scientific basis and it is not too purist, so that we find a way of avoiding greenwashing but we also have a chance to invest in these browner assets that are turning green." [91]

Mark Fawcett of NEST said achieving consistency internationally would be important, "to make sure we are talking a common language, with reduced risk of greenwashing and so on." [92]

In November 2020, Chancellor of the Exchequer, Rishi Sunak, announced the establishment of an advisory group to work on this:

> The UK will also implement a green taxonomy – a common framework for determining which activities can be defined as environmentally sustainable – which will improve understanding of the impact of firms' activities and investments on the environment and support our transition to a sustainable economy. The UK taxonomy will take the scientific metrics in the EU taxonomy as its basis and a UK Green Technical Advisory Group will be established to review these metrics to ensure they are right for the UK market. And to support and benefit from the development of common international standards on taxonomies, the UK also intends to join the International Platform on Sustainable Finance. [93]

89 Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 17
90 Oral evidence taken on 30 June 2021, HC (2021/22) 238, Q13
91 Ibid Q27
92 Ibid Q30
93 HM Treasury, Chancellor sets out ambition for future of UK financial services, November 2020

Information about the Green Technical Advisory Group, including its terms of reference, is on the Green Finance Institute website.

In his evidence to the Work and Pensions Committee on 14 July 2021, Pensions Minister, Guy Opperman said this was work in progress:

> One of the big challenges going ahead is going to be how it is you have certain international standards. This is why TCFD works so well, because it is an international standard that we are then applying in government and is relatively easy for us to do. Other things, like green taxonomy, are going to be harder because different organisations—the American, the EU, the UK—have slightly different priorities and are at different stages of development. [94]

The Chancellor had "committed to legislate for the first set of technical screening criteria, which essentially sets out the detail of when economic activities make substantial contributions to environmental objectives, by 2023." [95]

The Work and Pensions Select Committee recommended that the green taxonomy developed by the UK Government should, as far as possible, align with international standards, whilst also reflecting the UK context. [96]

3.5 The need for a joined-up approach

In evidence to the Work and Pensions Committee, the Pensions Policy Institute has called for "a more joined-up approach across the industry, from government, regulators, industry bodies and third parties such as consultants and asset managers, will be needed to drive forward progress." [97]

James Alexander of the UK Sustainable Finance Association called for the Government to outline what the UK's 2050 net zero economy would look like:

> One of the key parts of that is for the Government to outline what the 2050 net zero economy of the UK actually looks like. How do we travel? How do we heat our homes? These fundamental questions of how we live in a net zero world do not yet have answers. The Government need to work rapidly to start helping us answer some of those questions so that we can shape investments in that direction and start reinforcing how that economy might look through the investments that we make. [98]

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[94] Oral evidence taken on 14 July 2021, HC (2021/22), Q56
[95] Ibid [Pete Searle]
[96] Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 28
[97] PSC0018, June 2021
[98] Oral evidence taken on 30 June 2021 HC (2021/22) 238, Q6

Aviva said the Government's net zero strategy provided an opportunity to "develop a clear policy framework to drive net-zero across the real economy, signalling the steps and timescales by which they will be met." [99]

In July 2021, in response to the Treasury Select Committee's recommendation that the Government should set out in its net zero strategy who was responsible for "delivering net zero, coordinating the roles of different departments, and ensuring that the UK remains on track to meet its net zero target in a cost-effective way," the Government said the Department for Business, Energy and Industrial Strategy led work on the Government's overall strategy and would be publishing the net zero strategy in the Autumn. [100] On Tuesday 21 September 2021, BEIS Minister Greg Hands said the net zero strategy would be published ahead of COP26. [101]

The Work and Pensions Select Committee said recommended that "the Government set out a UK climate roadmap—including sector specific pathways for meeting the Paris Agreement goals—to provide greater certainty for pension schemes and other investors, particularly for those investing in in long-term investments such as infrastructure." [102]

3.6 Climate-related investment products

The PLSA said in July 2021 that it did not believe that there are currently enough suitable products to enable pension funds to make climate conscious investments. Although as the economy transitioned, it was likely that opportunities would increase but at present "many schemes feel that the scale and volume of appropriate products is lacking." This imbalance in supply and demand is driving up costs, therefore creating some less attractive options, given the need to ensure value for money for underlying savers. It welcomed the UK Government's confirmation of the first issuance of a UK green bond later this year. [103]

DWP said schemes took a "variety of approaches to managing climate risk to their beneficiaries, using a wide variety of products." It was not aware of a shortage of suitable products, although trustees did report challenges distinguishing products which most effectively meet their needs. This was why the Government had announced its intention to make climate risk reporting mandatory across the whole economy. [104]

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[99] PSC0011 June 2021

[100] Net Zero and the Future of Green Finance: Responses to the Committee's Thirteenth Report of Session 2019-21, 15 July 2021

[101] HC Deb 21 September 2021 c140

[102] Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 58

[103] PSC0020, June 2021

[104] PSC0022, June 2021

The Work and Pensions Select Committee said it was important that the Government continued to support the development of products such as green gilts to mitigate the "risk of a "green asset bubble" in the short term, as the market for these products develops.[105]

3.7 Trustee capability

The TFCD regulations include a requirement for trustees to have "a sufficient degree of knowledge and understanding of the principles relating to the identification, assessment and management of climate change risks and opportunities in respect of occupational pension schemes, to enable them to properly exercise their functions and implement the proposed underlying activities and disclosure requirements effectively."[106]

The Pensions Policy Institute has stressed the challenges for trustees given the speed at which policy and regulatory changes relating to climate change were occurring:

> Although regulation has strongly encouraged trustees, providers and Independent Governance Committees (IGCs) to become more informed on ESG risks, there are concerns that some schemes are still not engaging with these considerations in a meaningful way.[107]

Relatively rapid regulatory changes meant schemes would need to improve their knowledge and understanding. Schemes that were heavily reliant on asset managers for their investment strategy, would need to increase their engagement and monitoring of those managers in order to improve the effectiveness of investment strategies and mitigation of climate risks:

> Now that implementation statements are part of the regulatory requirements, there is a need for all trustees and providers, regardless of scheme size or type and the level of direct day-to-day involvement with ESG approaches to have a sufficient level of knowledge and understanding in order to best fulfil their role to effectively scrutinise external managers used by their scheme. There will need to be a greater focus on engagement and stewardship activities to ensure that companies across the board are making progress towards climate change goals.[108]

[105] Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 56

[106] The Occupational Pension Schemes (Climate Change and Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021 (SI 2021/857), Part 2; Governance and Disclosure (TCFD) requirements, Impact Assessment, DWP, January 2021

[107] PSC0018, June 2021; See also Engaging with ESG: climate change, PPI Feb 2021

[108] Ibid

Mark Fawcett of NEST also stressed the importance of stewardship capability to press the companies in which schemes invested to develop transition plans to a net zero economy. [109]

Pensions Minster, Guy Opperman, said that doing a detailed assessment of ESG and TCFD was particularly difficult for small schemes, which lacked "critical mass scale and expertise." The Government was therefore encouraging schemes to small schemes to consolidate:

> [...] there are relatively few schemes that are bigger than £5 billion in DC at the present stage. At the same stage, if you speak to the Australians and take evidence from international quarters, they would say that the appropriate size of DC should be at least £30 billion going forward. Clearly they have a much more developed market than we do, but certainly bigger is definitely better going forward. [110]

DWP consulted in September 2020 on new regulations to require trustees of schemes with less than £100 million in assets to "justify their continued existence via a new value for members assessment." Regulations come into force in Autumn 2021. [111] With a view to driving consolidation further, in June 2021, it issued a call for evidence "on the barriers and opportunities for greater consolidation of schemes with between £100 million and £5 billion of assets under management." It is currently analysing the feedback from this. [112]

The Work and Pensions Committee welcomed the encouragement for scheme consolidation and recommended that "the Pensions Regulator report annually on the progress made to consolidate schemes within its existing research and analysis publications." [113]

3.8 Monitoring the impact

In its evidence to the Work and Pensions Committee, Share Action said it was critical to be able to assess how far pension schemes were aligning their investments with UK climate goals:

> Climate change is a systemic challenge which individual investors will struggle to manage on a portfolio-by-portfolio basis. DWP states that it has explored the methodologies available for measuring the

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[109] Oral evidence taken on 30 June 2021, HC (2021/22) 238, Q25

[110] Oral evidence taken on 14 July 2021, HC (2021/22) 238, Q40-1

[111] Improving outcomes for members of defined contribution (DC) schemes, September 2020; The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (SI 2021/1070)

[112] Future of the DC pension market: the case for greater consolidation, DWP, June 2021

[113] Work and Pensions Committee, Pension stewardship and COP26, Fourth report of 2021-22, 30 September 2021, para 34

climate impacts of pension fund portfolios but concluded that more work is required before these can be implemented. We would encourage the Work and Pensions Committee to call on the DWP and the pensions industry to accelerate this work in line with the urgency and scale of the climate crisis. [114]

[114] PSC00024

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