Pie crust promises

Summary
- Pension trustees must consider a range of factors, including the definition of net zero and their motivation, when setting a net-zero timeline.
- Climate objectives are becoming a more common criteria in tender processes, with providers playing a key role in achieving operational net-zero goals.
- There are concerns over the unintended consequences of setting a net-zero commitment, including around DB endgame planning and creating a global transition.

As the number of pension schemes and providers committing to net zero grows, Sophie Smith looks at whether this will be a real catalyst for change, or whether these promises will be easily made, and easily broken

Over the past year, the number of pension schemes and providers making commitments to net zero has ballooned, with the Aviva Investors *Real Asset Study*, revealing that 67 per cent of all pension schemes now have some form of net-zero commitment in place, up from to 47 per cent in 2020.

However, there has also been an increasing focus on making sure that these commitments are genuinely robust and meaningful, with the details of these objectives facing growing scrutiny. So where should trustees start when selecting the ingredients for an appropriate climate objective?

Aviva Investors head of UK and multinational DB pensions, Matthew Graham, suggests that there are two main considerations for trustees, both of which influence the timeframe a scheme allows itself to fulfil its net-zero commitment.

"The first is the measure of net zero trustees are committing to, whether they focus on Scope 1 or Scope 2 emissions or take a wider view of the supply chain to include Scope 3 as well," he explains. "The deeper the ambition, the longer the timeframe will likely need to be as it requires working with a greater number of stakeholders and to source a much broader range of the right data.

"A second consideration is what approaches to achieving net zero are at the disposal of trustees. The shorter the timeframe, the fewer tools there are likely to be. A target of net zero by 2025 can only really be achieved by adopting an exclusion-based approach and, whilst this would address the net-zero ambition of the scheme, it doesn't address the wider net-zero needs of society or contribute to positive change."

Choosing the right recipe

Graham suggests that, in contrast, setting longer-term commitments can allow schemes to invest in activities and providers that are helping to accelerate, and benefit from, the transition to a low-carbon economy.

However, Mercer UK sustainability integration lead, Vanessa Hodge, argues

that focusing on a target that is very far in the future could come at the expense of delaying action today, arguing that this is "the important element".

"Trustees need to avoid carbon myopia and resist the temptation to focus solely on reducing carbon exposure," she says. "They must be mindful of their broader strategic investment objectives when setting out their net-zero commitment timeline, managing exposure to climate-related risks and taking advantage of transition opportunities."

Yet Hodge agrees that wholesale divestment would have "insignificant real-world impact", suggesting that a more impactful approach would be to contract with asset managers who will seek out and invest in the companies that will be part of the climate transition.

Barnett Waddingham associate and head of sustainable investment research, Eva Grace, meanwhile, argues that whilst timeline can be important, it may be "somewhat of a red herring".

"Companies are in control of their emissions, but pension schemes do not control the business strategies of the companies that they invest in, and therefore don't control their emissions," she says. "Therefore, if a pension scheme wants to be 'net zero' long in advance of global consensus (2050ish), then it could limit their investible universe."

Instead, Grace suggests that trustees consider the motivation behind their climate objective, explaining that if it is aiming to help the world achieve net zero, then it may want to invest in strategies that help fund the transition, and accept that their investments will have high emissions today, and in the medium term, as a result.

"The UK can only meet its net-zero target when the entire economy achieves net zero so there is merit in working collaboratively and supporting industry initiatives," she continues.

Adding to this, Hodge emphasises that climate change is a global issue, warning that trustees need a good

understanding of any unintended consequences of action taken as part of a decarbonisation strategy.

"As an example, looking at climate metrics in isolation may lead to the conclusion that removing an allocation to emerging markets is a quick way to reduce climate risk," she say. "This ignores the strategic reasons for investing in emerging markets and the need to support these regions to help with their transition away from fossil fuels."

"Trustees face a difficult question when it comes to choosing how they wield their considerable influence and assets," agrees Ross Trustees associate, James Fitzsimmons. "For example, should they engage with assets and funds that have not yet met their ESG goals and/or operate in sectors that create high levels of pollution, or exclude them? When considering a just and/or global transition, it does not seem to be acceptable to leave an area to fall behind."

However, Grace suggests that this is where investing in the transition itself can play a role, explaining that by providing funding to companies that are high emitters now, but have credible plans to reduce their emissions over time, investors can allow them time to have more of a chance at a just transition.

"Of course, there are some companies that will not survive this transition," she clarifies, "so it's about making sure your investment manager engages with their portfolio companies to identify and avoid these."

In addition to this, Sackers partner, Stuart O'Brien, draws attention to the practical implications of net-zero commitments, noting that trustees will also need to be mindful of their fiduciary duty when making such targets.

He says: "Broadly speaking, a trustee statement that it will pursue a net-zero strategy will still leave a wide discretion as to the methods by which the trustee will, in practice, decarbonise the scheme's investment portfolios in a way that is consistent with achieving global net-zero greenhouse gas emissions by 2050. In other words, the making of the commitment should not fetter the trustee's future investment discretion."

Appointing a like-minded sous-chef

However, the definition of net zero that a scheme decides upon could impact whether it will need to include its supply chain and if questions regarding the alignment of interests across different groups are needed, according to Graham.

"In this situation, schemes might consider working with providers that at least understand their net-zero

commitment or ambition and can help them to align better with those interests."

O'Brien also warns that trustees will need to consider whether they are setting mandates with managers that incorporate net-zero strategies in terms of scheme assets, or selecting third-party advisers and other providers that have their own net-zero commitments vis-à-vis their business operations. "In relation to the former, trustees need to bear in mind their fiduciary duties as set out above", he says, clarifying that they "probably have a lot more discretion in relation to the latter".

And Fitzsimmons says that it is becoming more common during tendering exercises for third-party service providers to highlight their own environmental targets and roadmaps for carbon neutrality.

"Fund managers in particular often lay out how their strategies and asset allocations are making a difference and are increasingly a deciding factor in trustees' selection criteria," he says, noting that administration and communication can also have a "huge impact" on member behaviours, particularly those in DC arrangements.

DB arrangements, meanwhile, may have other areas to consider when setting net-zero targets, as Hodge identifies climate risk management capabilities as a key criteria in the selection process for placing business with an insurer.

She says: "Trustees with a long-term objective to buyout should assess the climate-related risks in their investment strategy, and the exposure of the corporate sponsor to climate risks, to better understand the likelihood of the funding plan getting derailed by a climate shock event."

Avoiding a sour taste

Graham also argues that "it is right to ask whether the fiduciary duty of scheme trustees extends to ensuring that the net-zero path they put members on is upheld by the insurance company member liabilities are being transferred to".

And there may soon be regulatory requirement for this, as Fitzsimmons notes that the reporting framework laid out by the TCFD will require schemes to publicly report on the climate change risks associated with trustee decisions.

"The requirements will introduce new monitoring standards that will be embedded in virtually all key areas of scheme governance and will be at the forefront of trustees' minds when it comes to activities such as choosing an insurer responsible for providing members' pensions after a scheme has wound up," he states, suggesting that this increased reporting will help trustees better understand the challenges and implement successful strategies.

In the meantime, however, he warns: "Misaligned assets that experience unwanted volatility at the wrong point in time can be very problematic when purchasing annuities and will need to be carefully considered."

Indeed, Grace also raises concerns that having an ambitious net-zero commitment could limit the buyout provider options available to schemes.

"For example, if a pension scheme has a 2030 net-zero commitment, will it only be able to buyout with insurers who have a net-zero commitment of 2030 or sooner?" she queries. "This is a bit of a far-fetched example, but we do think that trustees should try to foresee any unintended consequences of their commitments.

"On the positive side, as insurers 'green' their portfolios, pension schemes with more sustainable investments may see closer buyout pricing alignment and be more attractive to insurers (particularly those schemes seeking in specie buyout transfer)."

This is echoed by Legal & General ESG investment manager, Matyas Horak, who explains that trustees pursuing a net-zero strategy should be helpful as they then own assets that an insurer would wish to hold.

He warns, however, that the 'in specie' transfer of assets could present a challenge, as insurers will not want to add high carbon-emission assets to their investments.

"Trustees would either need to sell these ahead of paying the premium across or would need to pay the insurer the transaction costs for selling the assets if the assets are transferred in specie," he continues. "There is clearly a wider risk to the pension scheme if the assets become 'stranded'."

K3 Advisory, managing director, Adam Davis, suggests that pension scheme trustees are increasingly considering insurers' positions regarding ESG factors, clarifying that the situation is "more complex and involves more thought" for full buyouts.

Despite this, Davis emphasises that, ultimately, buyout is about securing individual scheme members' benefits and making retirement provisions secure.

"Members shouldn't be penalised as a consequence of decisions made by the trustees or the scheme's sponsoring employer," he says. "If an insurer has concerns with the trustees' investment strategy then buyout is a neat way of solving it, as the scheme's assets will usually be sold and the insurer will then invest in line with their own ESG principles."

This is echoed by Rothesay head of investment strategy, David Land, who stresses the need to work with pension schemes to support them in their journey to secure members' benefits in full.

"If one scheme has a more carbon intense portfolio than another this wouldn't currently impact our decision to quote so long as the scheme met our liquidity criteria," he says.

"Our expectation is that shortly after taking on any pension scheme we would transition their portfolio/premium received to our target portfolio, and in this regard liquidity is our key requirement. Therefore, the key thing for trustees is to ensure that any assets they hold are liquid."