Two steps forward, one step back?

Amid market uncertainty and rising inflation, Sophie Smith considers whether pension schemes' focus on climate could be slipping, or whether a renewed focus could be on the horizon

Summary
- A number of pension schemes made net-zero commitments in recent years, yet many remain in the internal discussion phase, with a clear lag effect between commitment and action.
- Recent market volatility saw the immediate focus shift away from climate considerations, although it has also further reinforced the need to confront ESG-related issues.
- New climate-related regulation has also proven helpful for many schemes, and whilst industry research has revealed flaws in this area, industry experts have stressed the need for patience.

In recent years, the focus on environmental, social and governance (ESG) factors has surged, as campaigning efforts placed growing pressure on the pensions industry, and businesses more widely, to consider their climate change impact.

And this renewed focus has been particularly pronounced amid the annual UN Climate Change Conference, bringing with it a string of climate-related announcements and commitments, as well as heightened public scrutiny.

COP26, for instance, saw CEOs of Nordic and UK pension funds announce a collective commitment to invest $130 billion in clean energy and climate investments by 2030, whilst protestors made their voices heard on the key topics being discussed by policy makers inside.

This trend towards responsible investment has been one of the strongest the investment industry has seen in decades, according to Hargreaves Lansdown lead ESG analyst, Dominic Rowles, as governments and companies alike search for ways to reduce carbon emissions to have less of a negative impact on the environment and society.

"Those left behind could face a media backlash, regulatory issues or even a customer boycott," he warns. "Ultimately, this could impact their prospects and their prices."

Yet the impact of many of these commitments has yet to be seen. Premier Miton head of responsible investing, Helene Winch, points out that whilst much of the work around net-zero commitments has prompted increased flows into sustainable and ESG-labelled funds, there is a huge amount of pension scheme capital that remains invested in

high carbon producing assets.

Pensions for Purpose chair and founder, Karen Shackleton, also confirms that despite several pension schemes publicly declaring net-zero goals by 2050, or earlier, the majority are either at the stage of discussing it, agreeing on interim goals internally and mapping their journey, or working towards net zero without setting specific public goals.

And in recent months, updates around climate progress seemed to have slowed, particularly as attention was diverted amid the gilt market volatility following the mini-Budget.

This is perhaps unsurprising, as Rowles says that the past year has been a challenging time for investors around the world, explaining that "crippling" inflation, the cost-of-living crisis, and the repercussions of Russia's invasion of Ukraine have created an environment of uncertainty and volatility.

This in turn, according to Van Lanschot Kempen head of client advice, Arif Saad, has diverted the conversation away from net zero and sustainability.

In particular, Winch says that the war in Ukraine and the subsequent oil price shock has meant many portfolios with a focus on investing in low carbon or 'net-zero' companies have underperformed their benchmarks.

"This, quite rightly, will always raise questions as part of a pension scheme's fiduciary responsibility," she continues. "The challenge will be around whether it is in the best interest of a scheme and its members in terms of pure financial returns to follow a portfolio investing in rapidly decarbonising companies."

Yet Winch argues that the long-term climate benefits of this approach are "clear and well documented".

Building momentum amid the storm

And whilst recent attentions may have shifted immediate focus, Saad argues that the long-term commitments and momentum that have built up over the past few years mean that the direction of travel is clear.

Recent challenges may have also renewed focus in some areas, as Franklin Templeton head of UK institutional, Dean Heaney, says that while the Russian invasion of Ukraine and focus on access to affordable energy in the cost-of-living crisis has presented immediate concerns, it also added to the recognition that science and economics are accelerating the shift to a low-carbon economy.

Equally, whilst the autumn market volatility may have seen a renewed focus on liquidity requirements and diverted immediate focus away from climate efforts, Heaney notes that, for those pensions schemes now closer to buyout following the funding improvements triggered by this market volatility, "we see greater focus from bulk annuity providers to ensure these commitments continue for the life of the pension".

Echoing this, Legal & General Investment Management head of client solutions, Laura Brown, says that the next five to 10 years will be critical, both in terms of the journey to net zero for DB schemes moving towards full funding and, potentially, buyout, suggesting that managing downside risks over this time period is very important.

Creating the framework

Industry experts have also recently raised concerns around the regulatory focus in this area, with particular concerns around the limited mention of ESG in The Pensions Regulator's (TPR) DB Funding Code and the proposed value for money framework.

Yet, Janus Henderson director of institutional DC, Dave Whitehair, argues that the regulatory focus is "clear", highlighting TPR's new ESG compliance campaign as re-enforcement of this.

The campaign *[further details on page 16]* aims to ensure trustees are meeting their ESG reporting duties, with a regulatory initiative to check if trustees are sharing ESG data planned for spring.

Despite a continued focus on ESG, however, TPR's initial analysis has not proved promising, with initial analysis of the statement of investment principles (SIP) and implementation statement (IS) data provided through 2022 revealing that a number of schemes did not provide valid website addresses of the SIP and IS statements.

Industry research has revealed similar trends, with analysis from Pensions for Purpose revealing that the majority of schemes are not yet using Task Force on Climate-related Financial Disclosures (TCFD) reporting to inform and drive their climate investment strategy.

However, discussing the research further, Shackleton reveals that some schemes did say that the output from their TCFD report corroborated decisions that the trustees had already taken and that it was helpful.

Smart Pension investment proposition manager, Fiona Smith, agrees, explaining that the master trust found the increased climate reporting

requirements helpful in supporting its overall net-zero strategy and targets.

"The processes and work undertaken to report these disclosures have allowed us to further develop our policies, processes and beliefs for managing climate-related risks and opportunities," she says. "We have gained a better understanding of the greenhouse gas emissions associated with our investments, the current data limitations, and areas for improvement and further development. These are important considerations that feed into the setting of our investment strategy and any future changes to our strategy that we make."

Whitehair also reveals that many DC schemes have made changes to their investment design already, explaining that this might not apply across the complete default offering.

Instead, he says that the growth phase, and in particular equity investing, has been the core focus given the availability of data, investment solutions and the fact that it is where the majority of member assets are invested.

Data, data, data

"The main concern over data quality and data coverage is nervousness about making investment decisions that may prove to be less than optimal in years to come as data improved," Shackleton explains. "Other funds told us that this was the first time they had been obligated to report, and that they would be more likely to use their reporting to drive decision-making as and when trend data became available."

Indeed, Winch says that "patience is very much key in this area", explaining that climate reporting can take time to deliver accurate data and results.

In particular, Whitehair explains that many schemes are using this first data cut as an input into the process of forming their collective views and beliefs on sustainability and climate change specifically before implementing changes.

Saad also notes that while many of TCFD requirements currently only apply to the largest pension schemes, over time this will apply to a larger percentage.

"The impact on how money is allocated and the climate transition effort will truly be seen when, firstly, there are multiple years to compare against each other and, secondly, targets are set that need to be complied," he continues. "The latter is likely to be more controversial if dictated to investors, but may be required if the goals set are to be achieved."

Adding to this, Redington global head of sustainable investment, Anastasia Guha, says there are things trustees can do before making an allocation decision.

"Progressives find a way," she states. "There are many sensible things you can do to protect your scheme from the risks arising from sustainability issues. We need to stop getting analysis paralysis."

Ramping up the regulation

Pressure seems set to build further, as Winch says that the update to the UK green finance strategy alongside the new government department of energy security and net zero could potentially be a "game changer" for the UK and its pensions sector, if it focuses in on encouraging the low carbon sector and supports the required investment in related jobs.

Proactive industry backing for climate efforts has also grown, as Shackleton says that "the pension funds we work with are already maintaining their focus on climate considerations, with or without that additional regulatory or reporting obligation".

This trend can be seen across the industry more broadly, as the Financial Reporting Council recently revealed that a raft of UK pension schemes had become signatories to the UK Stewardship Code, taking the total number of signatories to 254, up from 235 in September 2022.

Despite these improvements, Guha warns that the financial sector cannot change the world by itself or shoulder the decarbonisation of the global economy alone, it must be a joint effort with global policymakers taking the lead.

"We need to start thinking more about decarbonising the world rather than decarbonising portfolios," she continues, querying how it will work if schemes have got a portfolio that's already heavily decarbonised when the world is headed to 2.7 degrees.

"Essentially, it's greenwashing if it makes no difference in the real world. Also post the war in Ukraine and energy firms doing very well – questions about fiduciary duty are arising again. It's a pretty tricky conundrum, especially because a lot of the schemes who went first decarbonised by tilting out of high emitting sectors, so they're essentially losing money by not being in the sector at all. The lesson is that you really have to take a strategic, long-term approach."

Written by Sophie Smith