Summary
• Sustainable investing is growing exponentially but pension professionals need to keep pace with the different regulations such as TCFD, SDR and TNFD, and initiatives.
• Sustainability is not just about metrics and analysis but also engagement and accountability.
• Data remains the biggest challenge in compliance but various working groups are trying to develop standardised solutions.

A changing landscape

Lynn Strongin Dodds explores the many recent developments within sustainable investing

Although responsible investing is topping the investment agenda, it can be difficult to keep pace with the rapidly changing landscape. Pension professionals not only have to be aware of the regulations coming down the pipeline but also stewardship requirements, as well as the various initiatives and investment strategies entering the market.

Regulations

Over the past three to four years, pension funds have been subject to increased levels of regulation that has pushed the decision-making emphasis on climate change and wider ESG factors higher up the agenda," says Hymans Robertson head of responsible investment, Simon Jones. "The Task Force on Climate-related Disclosures (TCFD) for private sector schemes, which will also apply to local pension funds in due course, has helped to focus the industry on tackling climate change."

He adds, that "alongside this, the UK Stewardship Code has helped to raise stewardship standards for our industry. There are a diverse range of issues and what was best practice in the past can't be assumed to represent best practice today. The approach to addressing these requirements will vary from those leading the way to those that are treating these rules as a compliance activity. We strongly advocate a positive, but proportionate response to these requirements."

Mercer partner, Brian Henderson, echoes these sentiments. "Some are doing better than others," he adds. "There are a lot of late-to-the-party evangelists and they need to be assessing what action to take. Some of these funds have a lot of buy in while others are still trying to pin down a sustainable agenda. There are many things to think about such as Sustainable Disclosure Requirements, Sustainable Development Goals, governance, policies, direct investments and stewardships but the Task Force on Climate Related Disclosures has focused the mind for many."

Introduced four years ago by the Financial Stability Board, the TCFD aims to improve and increase reporting of climate-related financial information. The UK government plans to introduce mandatory climate-related disclosures in line with the TCFD recommendations across the economy by 2025, with many of the requirements in place by 2023.

In the meantime, the Financial Conduct Authority (FCA) is consulting on whether to extend the regulation to asset managers, life insurers and FCA-regulated pension providers. In addition, UK pension schemes and financial service firms will also be required to disclose their risks and opportunities from, and impact on, the climate and environment through implementing integrated SDRs. These were announced by Chancellor of the Exchequer, Rishi Sunak, in July, as part of the UK government's efforts to bolster the country's green credentials.

While it is not clear how these requirements will interact with the TCFD, the finer details of what will be required are expected to be published before COP26 in November. The bottom line though is that pension funds will

have to shine a much brighter light on their carbon footprint. "The aim is to create a carbon flight path and to incrementally take the carbon out of the portfolio," says Redington head of stewardship and sustainable investment strategy, Paul Lee. "While many see this as a compliance exercise, we hope it will lead to a better conversation and trigger different investment decision making."

Preparations

It is not surprising that there are different levels of preparations. As Barnett Waddngham policy and strategy lead, Amanda Latham, points out smaller schemes are struggling more than their larger brethren because of constrained resources and time. "We are past the tipping point and in 2022, all schemes will need to implement an effective system of governance including considering ESG and climate change in their investments, while the largest are already embedding TCFD recommendations to take into account all the risks and opportunities from climate change," she adds.

One of the biggest issues for funds of all sizes will be complying with Scope 3 greenhouse gas emissions (GHG) – which is measuring the indirect emissions throughout the value chain. These are sometimes the greatest share of a carbon footprint, covering emissions associated with business travel, procurement, production of inputs, use of outputs, waste and water. Scope 1 and 2 – direct and direct emissions, respectively, are more straightforward.

"Scope 3 is troublesome because of its link to net-zero commitments and even with the best endeavours, there are gaps in hard data to help with predictions," says Henderson. "It is based on the science and the science in some cases is not there yet. There is also a gap between action and policy."

Lee agrees that "the data for Scope 3 is shockingly bad. It is inconsistent and very difficult to get to grips with because the whole point is that it focuses on emissions that are not in the company's control such as supply chains. There is also a risk of double counting which is a problem that needs to be addressed".

Overall, data is one of the greatest challenges in ESG investing, according to Mercer senior investment consultant and ACA investment committee chair, Vanessa Hodge. "It is difficult to get consistent available data that is credible," she adds. "However, I do think this should not be a distraction and that people should not wait before taking action."

This is not just for the current rules being implemented but also those waiting in the wings such as The Taskforce on Nature-related Financial Disclosures (TNFD) which is based on the TCFD but focuses on the risks connected to the natural world. Market participants note that gathering data on biodiversity is more difficult and fragmented than for the environment where information is more established.

The TNFD framework, which is set for 2023, also aims to align with the United Nations Convention on Biodiversity's (CBD) draft Global Biodiversity Framework. As with the TCFD, the industry will be waiting to see how the UK government will incorporate this into their SDR framework.

In the meantime, Hodge believes in general the starting point for pensions is to evaluate their portfolios today and how they will develop. "It is not black and white," she says. "It is important to look at the whole picture and not base decisions on a snapshot in time. Pensions trustees need to understand what their exposures are, how they will evolve over time and then ensure their investments are aligned with their investment beliefs and objectives."

The strategy should not only rely on metrics and analytics but also engagement. Market participants see the recently revamped, more stringent UK Stewardship Code, as one step in the right direction. However, ShareAction and the All-Party Parliamentary Group believe that the UK pension funds should be following the Scandinavian approach and exerting influence as well as increasing accountability. To that end it proposed a Responsible Investment Bill, which would increase directors' accountability for their investment decisions, allowing beneficiaries of investment schemes to seek judicial redress.

UK ShareAction policy manager, Rachel Howarth, says: "We would like pension funds to adopt a broader definition of sustainability. It is not just about the few extra percentage of return but also looking at the overall quality of life. For example, in the EU Taxonomy, this is something that the double materiality requirement addresses. It not only takes into account investment risk but also risk to society and environment."

Due to Brexit, the taxonomy will only apply to UK asset managers selling their products to European investors. However, the has been actively involved with regional and international working groups as well as with the International Financial Reporting Standards (IFRS) Foundation in setting up the International Sustainability Standards Board (ISSB). The aim is to establish a single set of norms regarding the disclosure of financially material sustainability information by corporates and financial institutions within a globally accepted framework.

A recent report from Fitch Ratings notes that the "large-scale adoption of IFRS, their familiarity and widely accepted credibility makes the expected ISSB launch a significant event that could facilitate widespread and consistent sustainability disclosures across sectors, although their efficacy would depend on ISSB standards' final form and their implementation by regional and national authorities".

Written by Lynn Strongin Dodds, a freelance journalist