Tidal wave

Summary
- Three-quarters of UK pension schemes either have, or will have, net-zero plans in place by 2024.
- Extra regulation in response to net-zero ambitions will be introduced this year, but the burden of further compliance with rules will be too much for some smaller schemes.
- A lack of data and appropriate metrics is holding back some net-zero plans.

Increasing numbers of schemes are set to chase net-zero goals, but their pursuit is far from straightforward

Going net zero has become de rigeur for UK pension schemes in 2022. Big beasts such as The Marks & Spencer Pension Scheme and the Royal Mail Pension Plan have pledged to have sufficiently green portfolios by 2040 and 2050, respectively. Behind the headlines, the Pensions and Lifetime Savings Association (PLSA) released results of a survey in May stating that three quarters of UK pension schemes either have, or will have, net-zero plans in place by 2024.

"The journey to net zero is common to all of us, not just UK pension schemes," says Schroders head of UK sustainability, Claire Glennon. "The reality is that we now have over 130 countries and more than 90 per cent of the world's GDP associated with a net-

zero target. This momentum has turned decarbonisation into the investment theme of the century."

This tidal wave of change is now so strong that very few trustees are not mindful of its importance. The only segments of pension provision not paying it much attention are DB funds who are close to executing the final stages of their endgames. In their case, careful monitoring of greenhouse gas (GHG) emissions become impractical distractions, rather than worthy pursuits.

"We find the larger schemes in both DC and DB are focused on net zero," says LCP partner and lead investment adviser, Dan Mikulskis. "Even a DB scheme with a 10-year plan to endgame will often find net zero relevant due to the level of change and impact likely happening over the next decade, and the fact that the corporate bond portfolio – which DB schemes tend to invest more in towards their endgame – feature higher exposures to global utility companies, who are often running and expanding their fleets of coal-fired power stations and hence are among the most critical companies for net zero."

Regulation-led?

From October, new measures from the Department for Work and Pensions (DWP) to supposedly "propel" pension net-zero journeys will add further regulatory demands on scheme trustees. The government estimates that more than 80 per cent of UK pension scheme members will therefore be invested in schemes who will be required to publish how their investments support the Paris Agreement climate goal of limiting global warming to 1.5 degrees Celsius above pre-industrial levels.

The new rules, added to a pile of already burdensome red tape, could, conversely, accelerate net-zero objectives, suggests Mercer partner and director of consulting, Brian Henderson. "Once you get past the £1 billion-plus funds to the next layer down, there will come a point

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where the governance of doing all this is too much," predicts Henderson. "And that's where we'll start to see even more consolidation in the DC space." Smaller schemes who will simply throw in the towel and go into master trusts, will then place their members into giant schemes that will no doubt already have firm net-zero aspirations in place.

For Mikulskis, additional regulation in this area is merely a reflection of popular opinion. "The interesting thing about net zero is that it is not really regulation-led," he argues. "TCFD *[the Taskforce on Climate-related Financial Disclosures]* is regulation, but that is distinctly different to net zero. Net zero is really an entirely voluntary, bottom-up industry initiative, which is one of the things that makes it powerful."

The data gap

Despite groundswell support and subsequent scheme action, there are some clear issues involved in decarbonisation, the most obvious of which is a lack of appropriate data. "If you're going to put a target date in then, you need the data to be able to draw a line in the sand," says Henderson. "And if you don't have all the data, then you're guessing really."

This gap has led to questions over which investments schemes are actually assessing for their net-zero targets. In some cases, schemes may end up only focusing on a narrow segment of a portfolio and ignoring the "hard stuff", as Henderson puts it, such as government bonds. As Mikulskis explains, in the context of most of the net-zero frameworks, sovereign debt is often placed out of scope due to the need to hold government bonds for hedging purposes and the limited engagement impact that investors can have in practice. "But if a large part of a portfolio is held in gilts this feels unsatisfactory," he admits.

Other asset classes bring different difficulties. In private markets, for example, the right data to enable monitoring of a net-zero strategies is not as commonly available, although there are some notable bright spots. "For example, in real estate and infrastructure, where we have found coverage and data

to be surprisingly reasonable in some cases," says Mikulskis.

Mikulskis also highlights that there is a good argument that emerging market assets ought not to be held to the same strict net-zero standards as those in developed markets. When twinned with the fact that some large economies clearly falling well short of international net-zero targets, trustees may be faced with a decision between limiting their opportunity set or softening their portfolio targets.

Asset assessment has now been further complicated by the inclusion of Scope 3 emissions, which widen the carbon emission net considerably, to the say the least. "Very few trustees or pension schemes will have access to their Scope 3 emissions," says Henderson. He is far from alone in his concerns. At the PLSA Investment Conference in May this year, AXA Investment Managers senior solutions strategist, Bruno Bamberger, warned that Scope 3 emissions could "blow decarbonisation targets out of the water" in the near future.

It is also clear that some managers are still lagging behind when it comes to the adoption of some of the basic, widely available data frameworks for assessing alignment of companies with net-zero, such as the science-based targets initiative and the Transition Pathway Initiative.

On a more positive note, the general decarbonisation data gap is getting closer to being breached, argues Mikulskis. "There are now several well-established frameworks that pension schemes and other asset owners can draw on, so they can be confident in getting to a robust, credible and serious plan without needing to reinvent the wheel," he says. "A year or so ago this was greenfields' new territory, now it's pretty well-trodden ground."

Another encouraging trend born out of decarbonisation efforts has been a push into sustainable investments. A recent institutional investor study by Schroders found that 68 per cent of UK institutions are keen to find new opportunities where they can invest in assets that address energy transition needs across the globe. "This is consistent with the conversations we have been having with clients and a view we support; investment in areas such as renewable infrastructure, thereby supporting the energy transition coupled with the potential for stable inflation-linked returns is proving attractive for both UK pension and insurance investors," says Glennon.

Looking in the right place

In essence, decarbonisation means identifying a point in time by which the net GHG emissions of all companies they are invested in will be zero, with net being the operative word. In May, Sackers published a report called G*etting to net zero: A spotlight on the role of pension trustees,* which says that adopting a net-zero target does not necessarily mean that trustees can only invest in businesses which have achieved "GHG neutrality" themselves. "The key is that the net emissions of the portfolio are balanced so, in the future, GHG intensive businesses may still be held as long as those emissions can be offset elsewhere by carbon capture, or other emerging technologies."

This is where having the right metrics becomes crucial. In a case study included in the report, HSBC chief investment officer and pension scheme executive, Brain Kilpatrick, admits finding the correct measuring tools and benchmarks to be a challenge. He reveals that the bank is keeping "an open mind" and pushing managers to report against metrics that are "independent and overseen with academic rigour".

Glennon concedes the same point, adding that how to report and what to invest in are also challenges. "This is where we as asset managers and fiduciaries of our clients' money have a responsibility to help and support clients in this transition whilst also help them deliver for their members."

But perhaps schemes are looking in the wrong place for help, suggests Henderson. "Is the governance and trustee knowledge and understanding of this ever going to be at the level of a climate specialist?" he asks. "I could argue climate is all about energy. Therefore, you need to understand what the new transition of energy looks like.

"Now, is that the job of someone with a BA in finance, or a chemical or mechanical engineer?"