THE INVESTMENT ASSOCIATION

DWP: Taking action on climate risk: improving governance and reporting by occupational pension schemes.

Investment Association Response

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Executive Summary

We welcome the opportunity to respond to this consultation on 'Taking action on climate risk: improving governance and reporting by occupational pension schemes.

The risks associated with the impact of climate change could result in a significant loss of value in pension scheme investments. This will ultimately impact on pension scheme beneficiaries who rely on their pension for their retirement income. Pension scheme members are increasingly alert to the risks to their investments and are rightly setting high expectations of how pension funds and the investment managers that invest on their behalf are managing this risk. As long-term investors, pension funds are also well positioned to benefit significantly from opportunities relating to a sustainable and low carbon transition, and from assets that support adaptation and mitigation efforts.

Amongst other asset owners, pension funds set the tone for the responsible allocation of capital across the investment chain. Strong signals from pension funds, accompanied by robust TCFD disclosures from companies, support investment managers to manage material climate risks on behalf of clients. The awareness of climate risk, and the effective integration of this risk into investment managers' investment approach is critical to supporting long-term returns for pension savers. **The investment industry therefore welcomes the expectation that large asset owners should report in line with TCFD by 2022, and we are committed as an industry to work with our clients to meet this expectation.** However, we have a number of concerns with the approach proposed in this consultation, which we outline in this response.

For climate-related disclosures to be meaningful, they must be disseminated coherently along the full length of the investment chain. Pension funds need quality, meaningful and comparable disclosures from their investment managers, who in turn need quality disclosures from investee companies, both public and private. It is this point of disclosure coherence which is the focus of our outstanding concerns with the DWP's proposals and **we recommend that the DWP continues to work closely with the FCA, BEIS and other government departments as well as the investment industry to ensure the coherence of the information flows between investee companies, investment managers and asset owners when finalising its expectations of pension funds**. We welcome the commitment to this effect in the recent exchange of letters between Christopher Woolard and Guy Opperman.

We recognise that the urgency and systemic nature of the risks posed by climate change have prompted government departments to act quickly to enhance climate disclosures by different parts of the investment chain at the earliest available legislative opportunities. Asset owners, investment managers and companies are on a journey to understand and manage the impact of climate change on their business models and investment strategies. Methodologies for climate disclosures are evolving rapidly. We support the argument that seeking perfectly comprehensive disclosures shouldn't inhibit all actors to start making disclosures as soon as possible. Nevertheless, given the interdependence of these disclosures by different actors, it is essential to future proof the regulatory arrangements to ensure that they do not create divergent expectations or inadvertently encourage a tick box or short-term approach.

Coherent expectations on companies

At the time of consulting on these proposals, the FCA will have just concluded their consultation (CP20/3) on enhancing issuer disclosures by introducing new listing rule requirements for premium listed companies to report in line with TCFD on a comply or explain basis. We encourage DWP to consider the points raised in tandem with this response.

In our response to CP20/3 **we call for the FCA to implement their recommendations on a mandatory basis for commercial companies with a premium listing, and to extend their requirements to standard listed commercial companies on a comply or explain basis. Outside of this consultation, we are also recommending to BEIS that the UK Government introduces a legislative underpin which will require all large UK incorporated private and public companies to report in line with TCFD**.

It is only by achieving comprehensive reporting from investee companies that asset managers will be able to gather the relevant information to report quality information to pension funds to facilitate their own TCFD disclosures, noting in particular that this will need to cover the full range of assets and not just listed equities. Currently there is a disconnect between the mandatory basis of the proposals by the DWP and the comply or explain approach and the scope proposed by the FCA. We encourage the DWP to carefully consider the application of the proposed regulations to a wider range of asset classes, considering the limited data availability beyond listed equities.

There is also a disconnect in the expectation that pension funds should report on and assess their managers on climate targets (including emissions and non-emissions-based targets) on a *quarterly* basis, given investee companies will report to the market key climate-related disclosures in their annual report and accounts on an *annual* basis. We are concerned that this expectation is not only impractical but may also introduce a short-term approach in financial markets in relation to climate metrics and targets.

In terms of practical considerations, investee company annual reports and accounts are the basis on which investment managers report to their clients on emissions and non-emissions related metrics and targets. It is critical that material climate-related disclosures are included in the annual report and accounts, as these will have been subject to the appropriate levels of governance and third-party assurance. It is rare for companies to make disclosures on a quarterly basis on other issues and more regular reporting involves added collection and assurance costs which ultimately percolate through to the end saver.

We are also concerned that this expectation will introduce a short-term approach in financial markets in relation to climate metrics and targets. Investors discourage investee companies from producing quarterly reports as this incentivises short-term management behaviour, which can undermine a focus on long-term value creation. The expectation of assessment against emission reductions targets on a quarterly basis may further drive behaviour to ‘reduce emissions at all costs’ in contradiction with the Government’s stated support for *“collaboration with business, as opposed to divestment as the most effective means of holding companies to account on climate change”*. This undermines the long-term investment approaches which are needed to counter climate-related risks.

It is important to note that many investee companies will need to make some big, long-term decisions about their business model and strategies to ensure that they are viable in a decarbonised economy and are contributing to Paris alignment. Pension funds need to be aware that this may involve significant capital expenditure including:

- Capital expenditure on infrastructure and operations to manage physical risks
- Changes to their business structure, including acquisitions or disposals to transition the business-model; and
- Investment in research and development to develop new products and services.

Pension funds, as providers of long-term capital are well-placed to support investee companies as they undertake this transition. These are significant structural changes which will not take place overnight. There is a danger that by focusing on short-term decarbonisation wins, this long-term structural change is discouraged.

We therefore strongly recommend that the DWP amends its expectation that “underlying data for metrics and targets are obtained and calculated, and performance against target is measured, at least quarterly” to an annual basis.

Even on an annual basis, emissions data can be significantly volatile, driven in part by economic cycles but also the varying sector and asset class characteristics of a fund. It is important therefore for trustees to be supported to assess yearly data implications for decarbonisation trajectories within the context of their overall approach to strategic asset allocation.

Coherent expectations on investors

In these proposals there is a significant degree of optionality in the metrics and targets that pension funds could be expected to report on. Different pension funds will be selecting different metrics and targets for their managers to report to them which will result in managers producing differing sets of metrics and targets for their clients within the same fund – this is not a proportionate approach.

The availability of much of this data will depend on the ability of investment managers to aggregate the data available from investee companies, which again relies on investee companies producing a consistent set of data with comparable underlying methodologies. Given CP20/3 does not mandate any particular metrics or targets, and only applies to listed equities, there is no guarantee that the metrics and targets pension funds choose to report on will be available from investee companies.

While the quality of this data is improving significantly in listed equities, data availability in the wider range of asset classes such as private companies, corporate debt, and real assets, which constitute a significant proportion of pension funds' portfolios, is severely lacking.

Where data does not exist, or is patchy, there are a range of data providers that are filling this gap, however with outstanding concerns about the quality of the underlying data, a significant amount of governance and oversight is required to make this meaningful.

We stated in our response to CP20/3 that there needs to be greater levels of comparability between the data provided from investee companies. TCFD's 2019 Status Report found that 42% of issuers considered that there was a lack of standardised metrics for their industry. Investors have similarly voiced concerns that the metrics and targets pillar require improvements. This is particularly the case within individual sectors. Without sector-specific metrics, the comparability of the data, and therefore its utility, is reduced. We therefore encourage the development of sector-specific standardised metrics and encourage the FCA to signal their support for alternative sustainability disclosure frameworks which complement and support TCFD. Specifically, investors support greater adoption of SASB, which has the strength of featuring less optionality on key climate-related metrics than TCFD as well as a sector-based materiality lens.

We do not think this level of optionality is a proportionate approach and would instead encourage DWP to narrow the set of disclosures. We would encourage DWP to focus on a narrower range of disclosures in statutory guidance, building on the work the Climate Financial Risk Forum has done in this area. **The IA is willing to work with the DWP, the FCA and other stakeholders to support the development of a template for a narrower range of disclosures**.

A recent example where differing regulatory requirements on different parts of the investment chain have led to differing disclosures is the approach taken to implementing the Shareholder Rights Directive II by the FCA and DWP. This has resulted in some confusion in the market and misaligned expectations, for example relating to the treatment of "most significant votes" and the extension of parts of the Directive to cover corporate debt within its scope by one part of the investment chain only. We encourage the FCA, DWP and others to continue to work closely together to provide consistency across the investment chain.

As set out in recent correspondence with the Pensions Minister, the FCA has signalled that they will consult on enhancing investment managers' climate related disclosures in their capacity as regulated firms in early 2021 and we look forward to engaging with these proposals. Without specific recommendations at this stage, it is challenging to assess the extent to which DWP's proposals will be coherent with any forthcoming regulatory expectations of investment managers.

It will be important to consider the interaction between DWP's proposals and investments managers' disclosures at a firm or entity level and portfolio or fund level disclosures.

The IA will support its members to develop a full set of entity level TCFD disclosures in the 2021/22 reporting round. Many of our members are already disclosing in line with TCFD in their capacity as listed issuers. This effort is currently primarily concentrated on firm level disclosures. TCFD guidance is clear that each of strategy, risk management and metrics and targets have relevance for product level disclosures and we are supporting our members to consider what a meaningful approach to these fund level disclosures mean in practice. At the same time, firms are currently focusing their attention on implementation of the incoming Sustainable Finance Disclosure Regulation (SFDR) requirements, to ensure that their clients have meaningful and robust sustainability disclosures in line with SFDR at a fund level. It is important to note that this product level disclosure is highly reliant on the availability of data from investee companies.

Through its regulatory approach, the DWP must not inadvertently set unachievable expectations on the fund level disclosures from asset managers to their clients. Specifically, **the DWP should continue to work closely with the FCA to consider their anticipated regulatory approach to investment managers' enhanced climate-related disclosures, before finalising any expectations of pension funds that would require fund specific reporting by investment managers.**

Methodological challenges

IA members commit to working with their pension fund clients to help them meet their own climate-related disclosure requirements. This includes helping them find solutions to issues on data quality and consistency, including questions of standardisation and accessibility of data and information.

This consultation notes that the DWP will consult on requiring pension funds to disclose the Implied Temperature Rating (ITR) of their portfolios or some other indicators of Paris alignment in the near future. It is important that investment managers work to empower clients to make informed decisions on the extent to which their investments are contributing to the Paris alignment. Our members are committed to continue to work with their pension scheme clients as expectations develop. Nevertheless, there are significant methodological challenges to introducing such an expectation at this stage that must be worked through before this is endorsed by regulators. Implied Temperature Ratings are dependent on the availability of emissions data, which as we have noted above can be very volatile and dependent on the quality of underlying data from investee companies. In recent years, there has been most progress in the availability of data from high-emitting sectors in listed equities. While the investment industry is putting significant resource into addressing these methodological challenges, there is significant progress to be made before these indicators can be used reliably and consistently by pension fund trustees.

Further collaboration is needed to identify the best methodologies to quantify and manage the risks and opportunities associated with climate change. We are working with our own members to understand and build on the development of methodologies to date to ensure meaningful disclosures for clients. We welcome continuing to work with Government Departments to address these challenges, building in particular on the work of the Climate Financial Risk Forum.

It is also important to note that it is not sufficient for financial participants to monitor the Implied Temperature Ratings of assets to achieve Paris Alignment. This kind of transparency and accountability plays an important role in supporting investors to manage climate risks, but further policy intervention is needed to reduce emissions; the Implied Temperature Rating of investment portfolios will broadly mirror global policy action.

It is critical that governments around the world provide clear and actionable signals on the nature and speed of the transition as soon as possible. Action today helps minimise financial stability risks arising from stranded assets and cliff edge policy decisions at a future date. Clear policy signalling from the Government gives companies clarity about their own transition risks, enabling them to improve their reporting on them and adapt their business models accordingly. This in turn helps investment managers engage with these companies more effectively to help support them in making the capital allocation decisions necessary to transition. This policy signalling also provides the requisite clarity to allow investment managers to price assets effectively for the long-term benefit of their clients.

Concluding remarks

The urgency of climate change demands that all actors play their part in contributing to a more sustainable economy. Greater transparency is needed across the financial system to enable stakeholders, including investors, to assess the impact that individual companies have on climate change and how they are responding to Government ambitions to be net zero by 2050.

Asset owners, investment managers and companies are on a journey to understand and manage the impact of climate change on their business models and investment strategies. **We ask the UK Government to be joined up in its approach to supporting different market participants on this journey.**