Environmental, Social and Governance (ESG) Report 2023

Pensions Management Institute

Knowledge

Pensions Management Institute
Moving pensions forward

Foreword

Tim Middleton
Director of Policy and External Affairs, PMI

The implementation of Environmental, Social and Governance (ESG) principles into the running of the UK's pension schemes has now become well established. To some extent, this has been driven by the requirement for pension schemes to comply with the Task Force on Climate-related Financial Disclosures (TCFD) reporting requirements, although it should be emphasised that there is far more to ESG than just considering the impact of climate change. Former Pensions Minister Guy Opperman was an enthusiastic proponent of ESG, and his successor Laura Trott took up the mantle during her period in office. It is worth reflecting on why ESG is so important for pension schemes and to assess what remains to be done.

We are now at a point where many pension schemes have integrated ESG factors into their investment decision-making processes. This involves considering ESG issues alongside traditional financial metrics when evaluating investment opportunities. In some cases, trustees work with their consultants to apply ESG screening to their investment portfolios. This involves excluding or including investments based on predefined ESG criteria. For example, trustees may choose to exclude companies involved in tobacco, weapons, or fossil fuels. Many trustees are also now more active in Corporate Governance. Trustees may now actively engage with companies in which they invest to encourage better ESG practices. This can include participating in shareholder votes on ESG-related issues and advocating for positive changes in corporate behaviour. There is an increasing emphasis on transparency and reporting regarding ESG practices. Pension schemes may disclose information about how they integrate ESG considerations, their voting practices, and the impact of ESG factors on their investment decisions. Crucially, trustees now understand that ESG is far more than a simple compliance exercise. Experience has shown that companies who have adopted an ethical approach to commercial activity are actually more profitable over the longer term, and that a commitment to ESG rewards trustees with a well-performing portfolio.

The PMI's 2023 ESG report is an invaluable aid to trustees seeking to develop a long-term commitment to ESG and its effective implementation. A range of high-profile organisations have provided expert insight into issues to consider and methods for ensuring that ESG plays a prominent role in trustee decisions. The experts who have contributed to this report bring a wealth of experience and expertise, and the range of contributors ensures that ESG is addressed in a thorough manner. There is also consideration to the direction that future developments might take. As new challenges for trustees arise - such as, for example, the implementation of the Mansion House Reforms – this is a crucial consideration.

As ESG continues to play an increasingly important part in the stewardship of the UK's pension schemes, it is vital that trustees have clear and effective guidance with regard to how their approach to governance needs to be adapted. This report will provide a perfect starting point.

BARNETT WADDINGHAM
beyond the expected

Climate modelling and management

This month marks my 35th anniversary in the pensions industry. I would avoid the urge to tell you all that things were very different in 1988... but as luck would have it, it's relevant to what I'd like to illustrate! Financial projections carried out using an assumed future investment return of 9% p.a., inflation assumed to be 5% p.a.. Laughable if you think what has happened over the last couple of decades. Not so far-fetched now though!

Pete Smith
Principal and Head of Sustainable Investment, Barnett Waddingham

Fast forward to today and although most everything is indeed different to when I started, I am once again wrestling with a situation that has parallels with 1988 - climate scenario modelling and management.

1988 saw a surge in the growth of money purchase arrangements and a desire to be able to illustrate what these might produce in the future. Which brings me to my point – what is the difference between an Illustration (as in a statutory money purchase illustration (SMPI)) and a Scenario (as in a climate scenario)? Which one carries the greater gravitas and suggestion of being accurate?

For what it is worth, my 35 years of experience has shown that the results of either are far from perfect. Whether those imperfections are data related or wider is a matter for discussion and debate. So too is whether they are imperfections or flaws. However, what I do believe is they are tools to encourage a response - and that response is greater engagement and action.

Illustration

In the case of SMPI, that response should be to pay greater attention to your savings and save more.

The basis for calculating the SMPI projection is set out in guidance, however, from a climate perspective, TCFD only sets the scene for the scenarios you should consider. How you decide the assumptions to use is a matter of subjectivity. I would argue that long-term climate assumptions are also very much a matter of speculation – they need to consider the risks associated with a transition to a low carbon economy, the physical risks associated with climate change and the impact that human behaviour will have on both.

All of this is speculation. Necessary speculation, but speculation all the same, although an argument could be made that there may be a better way to format it than a SMPI projection.

What should we do? When you get your annual SMPI do you believe the telephone number-sized fund projection contained in it, or do you think about what relative direction changes you may make in your investment strategy? Or do you simply ignore it on the grounds there is not a lot you can do about it? As a disclaimer, I don't advocate the latter, as good financial prudence starts by looking after your most important client - yourself.

Climate modelling and management

Climate scenarios

In the case of climate scenario analysis, the response to results should be to identify potential weaknesses in your investment strategy caused by climate change, before taking steps to address these.

When I think about climate scenarios, I am even more minded to think about the relative position i.e. this strategy vs potential others. I am not thinking about the speculated outcomes, but on the logic behind what these scenarios might look like in real life – I am thinking about the extent to which transition, physical and human behaviour might be interacting. I am engaged. I am thinking about action.

In both cases I am also thinking about 'how would my vision of the future look'. To me this is the key. Think about the specific story and what that might mean to you, your strategy and, most importantly, whether the actions you take will help move you in the right direction. Don't try and manipulate outcomes within a largely prescribed framework to suit your narrative. Instead think about the outcomes that worry you, or are opportunities for you, and focus your efforts on contrasting actions to address these.

In 1988 we had limited revaluation in deferment, unequal retirement ages, SSAP24 accounting, GMP, AVCs and used balanced managed funds (many from management firms no longer with us). The temperature was lower too. I leave you with the thought that a lot can happen in 35 years. To how many decimal places can you predict what will happen in the next 27 as we move towards 2050 and our global climate goals?

Better to work off a narrative then.

cardano

Cardano's 10-point plan for effective stewardship

Stewardship can be defined as the use of influence in pursuit of an outcome. Stewardship comprises engagement and voting, but also involves using these tools in tandem with each other as a form of escalation.

Greta Fearman
Senior Responsible Investment Officer, Cardano

While outcomes are difficult to attribute to a particular investor engagement (often results are a combination of consumer, NGO, employee, regulation, and shareholder input, as well as corporate board and management decisions), stewardship should prompt change and progress, where the company undertakes actions that it might not otherwise have done, or would have done but at a slower pace. We don't only want to point the finger at companies and criticise their behaviour but encourage actions to build resiliency and achieve long-term success.

Stewardship has evolved considerably in recent years. Unregulated and undefined, stewardship was often a bolt on, rather than core to the investment thesis. Meetings with companies were cordial, but unproductive.

For a few reasons this is changing. Investors of all types are becoming increasingly informed about the impacts their portfolio companies are having. They are expected as universal owners to address sustainability risks and create long-term portfolio value. Regulators have begun to introduce voluntary, and increasingly, mandatory stewardship disclosure requirements. Clients and savers have begun to expect more of their asset managers, with more and more attention being given to shareholder resolutions, particularly on climate change. Stewardship continues to evolve with a focus on achieving outcomes, collaborating to address systemic issues (acknowledging the limits to individual company engagements which address idiosyncratic risks) and engaging in public policy dialogues.

This holistic view is very much how we think of stewardship at Cardano. Here's our 10-point plan for achieving effective stewardship.

1. We are outcome-focused, with our activities underpinned by targets, including on deforestation and water, as well as climate change.
2. Stewardship is linked to the investment thesis. Where engagement is unsuccessful, this informs our investment decision-making. A recent example is IBM, where we have sought additional disclosures around surveillance, and protection of human rights.
3. We invest in innovation, such as our partnership with Satelligence, where we use satellite data to monitor deforestation, and bioacoustics, where we use the latest technologies to improve biodiversity monitoring and measurement.
4. We collaborate. We combine resources and share insights. We are part of several initiatives including Climate Action 100+ and ADVANCE, the human rights engagement program established by PRI. We co-lead on several companies, facilitating engagement between companies and other investors involved in the initiatives. We also consult with NGOs to help inform our views and deepen our dialogues. An example of this is multiple meetings we had with local Peruvian chapters of Oxfam and CooperAccion to understand the situation on the ground following an oil spill tied to Repsol. These discussions have given us a valuable local perspective.
5. We're transparent. We report our voting and engagement activities on a quarterly basis, publicly, on our website. We share details of cases and outcomes.

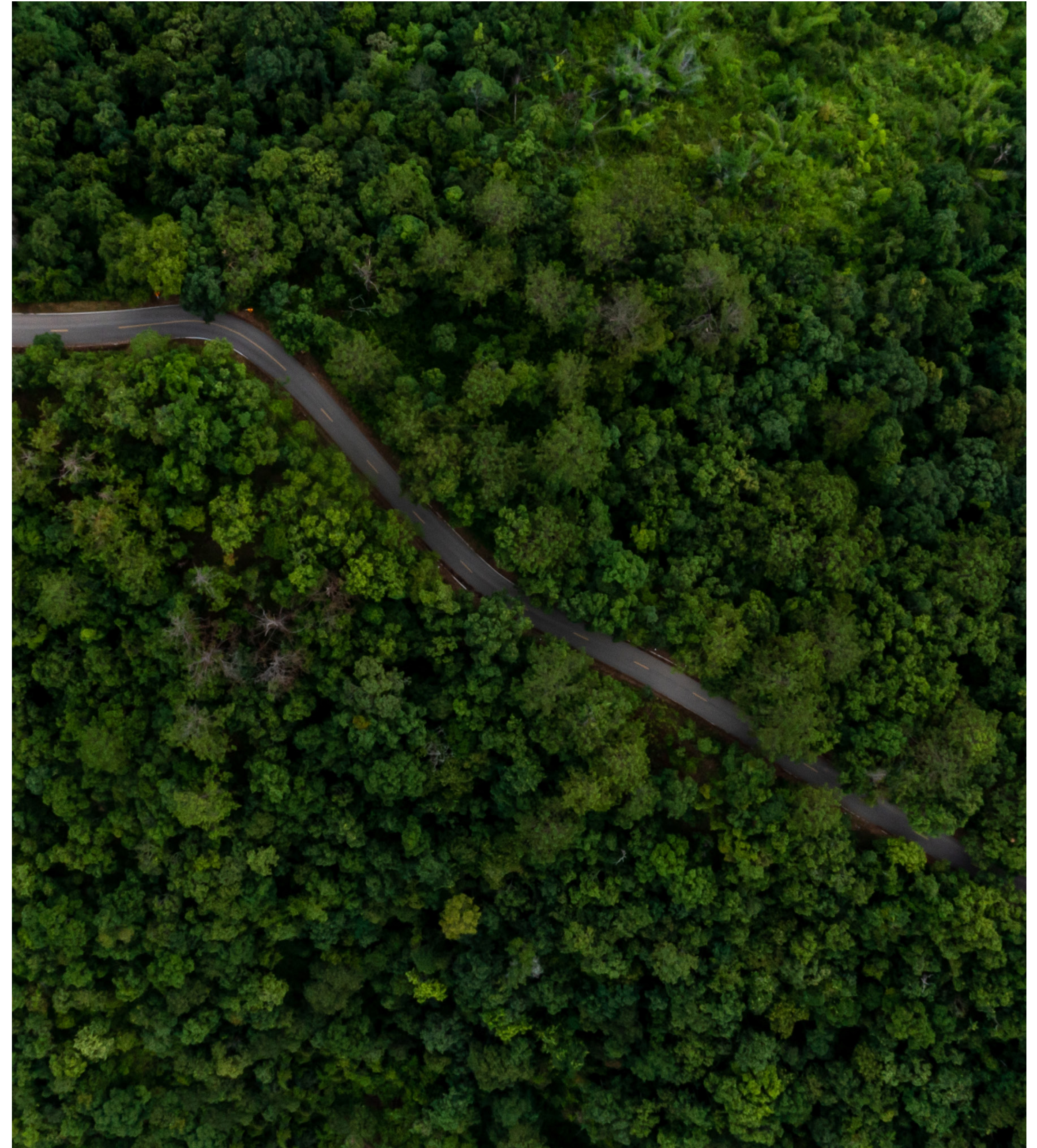
6. We use our vote consistently. Our goal is to vote at all shareholder meetings where we invest (there may be meetings, where, due to the company's jurisdiction this is not possible, but this is very much the minority). We will support resolutions on environmental and social issues consistent with our goals. Where we feel the company is not taking steps to address environmental and social risks, we will vote against direction re-elections.
7. We file resolutions. Recent examples include Amazon, Sainsbury's and Domino's. Where the company makes commitments that address the resolution, we withdraw it. This was the case with Domino's, which committed to undertake analysis and take action on its water-related risks.
8. We combine stewardship with other forms of influence, including working with stakeholders and policymakers. We've contributed to or provided feedback to a range of policy consultations, on TNFD, ISSB and Transition Plans Taskforce. We're a signatory to the UK stewardship code.
9. Where we invest externally, stewardship is an important part of the assessment process.
10. We're also a member of the PRI and Willis Towers Watson (WTW) stewardship resourcing working group and have responded to the group's questionnaire. We believe the industry would benefit from increased stewardship resourcing given the impact it can have.

Cardano's 10-point plan for effective stewardship

Knowing how and when to use escalation is essential to successful, impactful stewardship. Although just as important is developing a thorough understanding of the complexities of our engagement asks. We aim to have meaningful, solutions-oriented discussions by diving deep into topics and developing our knowledge of different sectors' transition pathways and how issues play out across value chains. An example of this is the collaborative engagement program we developed 'Satellite-based engagement towards zero deforestation'. Running into its third year, along with a group of global investors, we engage with companies that have palm oil and other commodities like soy and beef within their supply chains. The target companies include producers, traders, consumer goods companies and retailers. We support the engagements with satellite imagery of deforestation incidents, we develop our knowledge by speaking with companies across the value chain to understand the interactions, we learn about the role of regulation, the nuances of social implications, and the importance of financial incentives for suppliers. Building a deeper understanding of the topic enables us to have constructive dialogues with company boards and management and fosters open communication channels and willingness to work together.

Besides engagement, voting sends a message to company management to prioritise sustainable practices and to invest in adapting their business models to account for the sustainability transitions underway. Underlying our voting decisions is a detailed and comprehensive voting policy that we update annually. The policy serves as guiding principles for consistent and transparent voting decisions. Linked to voting is engagement with proxy voting advisors. Beyond ensuring that our own votes are cast in line with our custom policy, it's important to advocate for proxy advisors' default recommendations and advice to align with long-term decision making. Given the influence they have, encouraging them to strengthen their recommendations on sustainability topics should be part of an overall stewardship strategy to help move the market forward towards being more resilient.

We believe stewardship is the most important tool in the investor tool box in driving sustainability outcomes. We will continue to evolve our approach over time to remain effective.



Sackers

Impact Investment – how far can trustees go?

The regulatory landscape that pension scheme trustees must now navigate in relation to environmental, social and corporate governance (“ESG”) and climate change has developed considerably in recent years. Significantly enhanced obligations now apply to occupational schemes, particularly in relation to climate-related risks and opportunities. Although the Government remains at pains to point out that legislation does not tell trustees how to invest, in practice, new regulations have ushered in a new era of climate-related “governance”, and we are starting to see some changes in investment behaviour.

Stuart O’Brien
Partner, Sackers

Impact investment

The key outcome most often associated with investment is that of earning a financial return (adjusted for risks), but it is becoming increasingly hard to examine the risk/return attributes of an investment in isolation. Society and human existence depend on the sustainability of environmental, economic and social systems, some of which are under threat. The investment sector is intrinsically linked to these systems in order to generate financial returns. Instinctively, it feels that a narrow focus on the financial attributes of an investment, whilst ignoring the impact that this has on the wider economy and society, will be self-defeating. A company may itself suffer no harm from the external impact of its activities but, if those externalised impacts end up having a harmful effect on the rest of your investments or indeed your scheme beneficiaries, that will not be to an investor’s benefit.

The health of the planet, and its ecosystems, are part of a wider broader world goals. The financial world and our economy are intrinsically linked. Climate change, biodiversity and social impact issues, to name a few, certainly have an impact on the long-term macro-financial risks and performance of investments. It is for this reason that investors are starting to consider how to address these wider systemic issues in their investments. Here, however, the law may have some catching-up to do, with traditional articulations of trustee fiduciary duties still tending to focus more narrowly on each investment in question rather than its wider external impacts.

Fiduciary duty

Trustees might consider their fiduciary duties to be broadly:

i. to invest for the purposes of paying pensions (rather than for ulterior purposes),

ii. to take account of factors that are relevant to that purpose (which will usually be those factors which are financially material in nature), and

iii. to act prudently in doing so.

There is no doubt that trustees can consider ESG issues in their investment decision making where they have a financial impact on the investments in question. Indeed, we would advise that trustees are under a positive obligation to take such factors into account where they are material. The investment community has now largely bought into the idea that environmental considerations will be considered relevant factors because companies which harm the environment suffer from increased regulatory risk, while companies with sustainable business practices present a better long-term financial proposition.

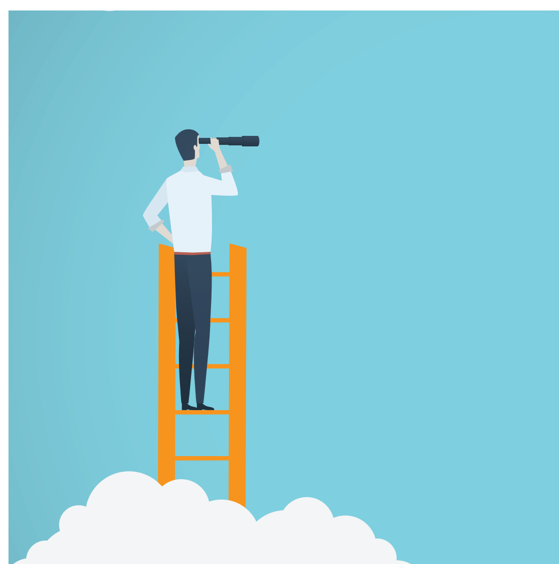
The law is more circumspect, however, when it comes to trustee investment decision making being motivated by a desire to further external purposes not directly connected to the pension scheme and the financial best interests of its beneficiaries. Traditionally, such external purposes might be considered “non-financial” in nature and therefore largely off limits as a relevant consideration for trustees. But things are not always that black and white, and in practice there may be an overlap. Many issues, especially those relating to climate change, will have both financial and non-financial aspects or, an issue that starts out as non-financial may over time become financial. Additionally, a company that has a positive impact on people and the planet may be able to demonstrate that these behaviours will also make it a better financial proposition than a company that has a negative impact. Trustees, or more likely their investment managers, will need to form their own views in each case but there are plenty who think that investments with positive external impact will align with, rather than be at odds with, an attractive risk-adjusted return.

But what about the wider external impact that companies have on societies and the environment where that can’t be shown to accrue in some positive way to the investment itself? And what about the company that “externalises its costs” in a way that will damage the environment or have negative social impact, even where this can’t be shown to have a detrimental effect on the company itself? Can trustees treat these as relevant factors in their investment decision making?

Impact Investment – how far can trustees go?

Unfortunately the law is not well developed on these harder questions, tending to require that any financial considerations in relation to an investment not be "too remote and insubstantial" in order for trustees to properly take it into account as a relevant factor. This might be considered a problem if trustees can't draw a direct link between their investment decisions, the corresponding impact on society or the environment and, in turn, that such impact will actually benefit the rest of its investments or its members. Put another way, if a trustee board decides to invest in a company that has a positive impact on society, how credible is it to think that such positive impact will really improve the financial performance of the scheme's other investments?

However, there could be scope for pension scheme trustees to consider these wider factors if they thought about their investment decisions as forming part of the collective action of institutional investors to invest for a wider positive impact. In practice, this is somewhat akin to recognising the game theory conundrum of the "prisoner's dilemma" (a game described in the mathematics context by Albert W Tucker in 1983).



The prisoners' dilemma

The classic prisoner's dilemma involves the arrest of two members of a gang of bank robbers, who are then interrogated in separate rooms. The authorities have no other witnesses, and it is only possible to prove the case against them if they can convince at least one of the robbers to betray his accomplice and testify to the crime.

Each bank robber is faced with the choice to cooperate with his accomplice and remain silent or to defect from the gang and testify for the prosecution.

- If they both co-operate and remain silent, the authorities can only convict them on a lesser charge resulting in one year in jail for each.
- If one testifies and the other does not, the one who testifies will go free and the other will get five years in jail.
- However, if both testify against the other, each will get two years in jail for being partly responsible for the robbery.

The paradox of the prisoner's dilemma is this: both robbers can minimise their combined jail time only if they both co-operate and stay silent, but the incentives that they each face separately will always drive them each to defect, resulting in the maximum combined jail time.

Perhaps we need to start thinking about pension trustee investment decisions in a similar way?

The incentives faced by each individual trustee board might induce them to invest only so far as it can be established that an individual investee company can "do well by doing good". But this alone may not be nearly enough to address the systemic risks we face. If we want pension trustees to be potential drivers of financial markets towards a better financial future for all of us then we need to think less narrowly about external impacts and, from a legal perspective, perhaps more imaginatively about what is and isn't a "relevant factor" when making an investment decision. Acting collectively may offer some hope and could make investors collectively better off by supporting financially those companies that might offer the wider economy the best chance of success whilst engaging robustly with companies that might otherwise drag the collective side down.

These are undeniably big and difficult questions that push against the boundaries of any conventional interpretation of trustee fiduciary duties, but it is these sorts of "bigger picture" questions that trustees, and the pensions advisory community, will need to tackle if we want a rising tide to lift all of the boats.

Schroders solutions

Why DB trustees should care about ESG and climate risks when close to buyout

Since the gilts crisis in late 2022, the average time for UK pension schemes to reach a sufficient level of funding to buyout their liabilities with an insurance company has reduced to c. 5 years[1]. This may lead some trustees to view ESG and climate risks as a lower priority given this short time horizon. However, traditional de-risking might give a false sense of security. Trustees must manage ESG and climate risks to prevent their journey from being derailed over the short to medium term.

Mike Rogers
Senior Strategist, Schroders Solutions

Caryl Embleton-Thirsk
Head of ESG, UK Client Solutions, Schroders Solutions

Trustees widely agree that ESG factors, including climate change, can be financially material to pension schemes. However, as time horizons shorten and other issues such as de-risking and securing benefits through buyout become priorities the importance of ESG factors may be underestimated.

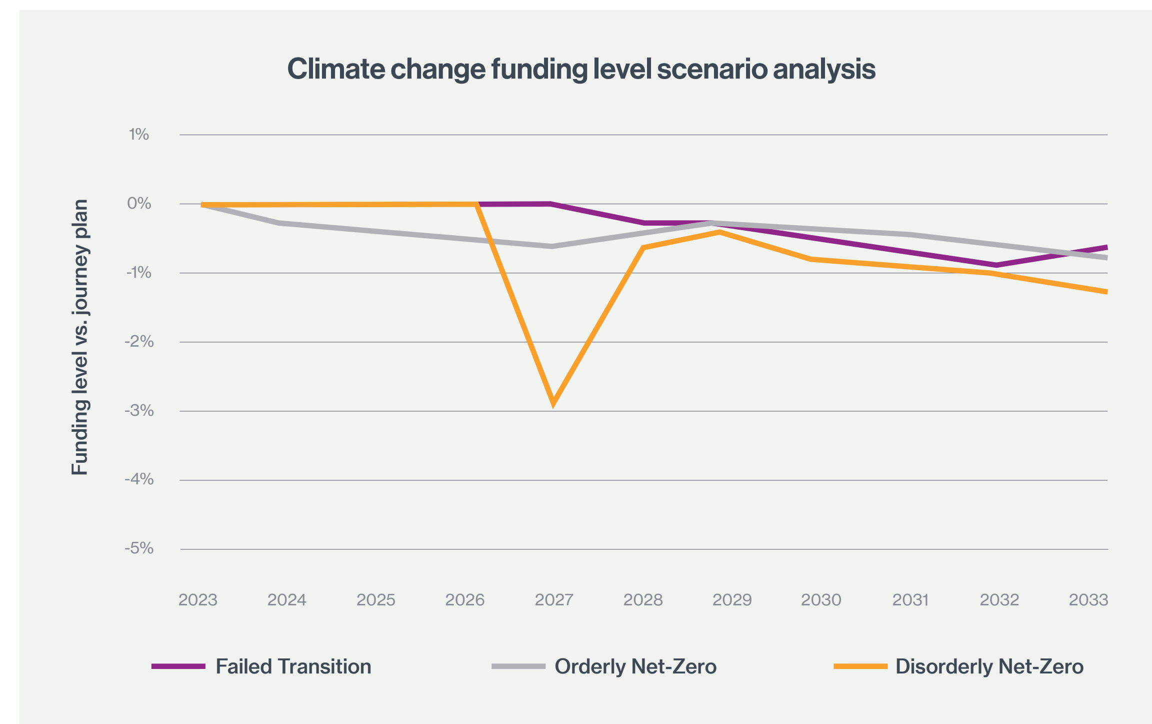
We challenge this thinking – a short time horizon can increase the impact of all risks, including ESG risks, because there is less time to repair any short-term losses. ESG and climate risks can also be proportionately more important for mature schemes given that traditional risks such as interest rates, inflation and market exposures will have been largely removed.

Will climate risk bite sooner, not later?

Climate risk can be split into physical and transition impacts. While physical climate risks refer to the direct consequences of climate change, transition risk refers to the impact of moving to a low-carbon world on businesses, economies, and markets. Transition risk is more immediate because markets are forward-looking and will respond quickly to changes in information. Transition risk might materialise gradually over time, or there could be sudden step changes.

In the chart overleaf, we show the potential impact of three climate change scenarios on a mature pension scheme targeting a buyout before 2030 with a "low risk"[2] investment strategy. Our analysis shows that even when traditional investment risks are low, a funding level reduction of 3% could occur within a year in a "disorderly transition" – where markets suffer a sudden fall in response to changes in climate change policy, regulation, or new information. In such a scenario, the pension scheme would fall well behind its journey plan, potentially delaying buyout for 3-6 years.

[1] Source: Barnett Waddingham DB End Gauge, 30 September 2023.
[2] "Low risk" investment strategy - 75% invested across LDI and Buy & Maintain Credit, 25% in diversified return seeking assets, fully liability hedged against inflation and interest rate risk.



Source:

Schroders Solutions, for illustrative purposes only.

Notes:

Failed Transition = Net zero not achieved, global warming reaches over 4 degrees above pre-industrial levels

Orderly Net-Zero transition = Paris goals met with global warming increase of 1.5 degrees above pre-industrial levels

Disorderly Net-Zero transition = sudden divestments required to align to the Paris Agreement leading to disruption to financial markets, with sudden repricing followed by stranded assets and sentiment shock

It's crucial to note that the impact in markets could happen at any point, especially as we approach 2030 and global decarbonisation targets are missed. The scenarios considered here are not 'worst-case', and some argue that many climate models understate the impact of climate risk[3]. Physical risks, typically modelled as impacting after the mid-2030s[4] are also building faster than anticipated, indicating that even mature schemes cannot ignore the potential for these risks to derail their plans.

[3] Institute and Faculty of Actuaries "The Emperor's New Climate Scenarios"
[4] Global temperatures set to reach new records in next five years | World Meteorological Organization (wmo.int)

Schroders solutions

Why DB trustees should care about ESG and climate risks when close to buyout

The dangers of derailment

A journey plan derailment could have significant implications. It may necessitate recourse back to the sponsor for additional funding, potentially at a time when the sponsor may also be facing financial challenges due to the same market conditions. It could also force the scheme to materially re-risk to make up for the shortfall, which could introduce new risks and further destabilise a scheme's financial position.

Additionally, a setback would likely occur at a time when a scheme is paying out significant amounts in pension payments, further straining its resources. The need to extend the timeframe for achieving the buyout could also introduce additional uncertainty and risk, as market conditions and regulatory requirements could change during the extended period.

In short, a significant climate event could disrupt the scheme's journey plan, creating a complex web of challenges that trustees would need to navigate to keep the scheme on track.

ESG considerations within buyout-aware portfolios

Climate risk, and more generally ESG risk, are key considerations in journey planning, even when traditional investment risks are low and well managed, for example, by using the Liability Driven Investment (LDI) and buy and maintain credit strategies that are common in cashflow driven investment and buyout-aware portfolios.

LDI

ESG considerations for trustees include:

Engagement, voting and exclusions: Whilst there is no scope to use voting as a lever for change for Gilts, the LDI manager has scope to influence through selection of counterparty banks and their role as a service user. Exclusions can also be applied within non-government cash holdings.

Investment approach: The investment universe in such a mandate is much more limited. Nevertheless, there are important decisions around the use of Green Gilts[5] and the investment profile of cash funds.

Buy and Maintain Credit

Within buy and maintain credit, managing the risk of default is key to investment outcomes, and ESG is critical to identify risk and financial materiality in both sectors and individual companies:

Engagement, voting and exclusions: The buy and maintain manager can continually engage with bond issuers across all its mandates. Although there is no scope to vote, there is much more scope for the investment manager to engage at the point of rolling or new issuance. Ultimately, the manager can exclude if engagement is unsuccessful (either for new issuance alone or for existing holdings).

Investment approach: Buy and maintain portfolios are designed with long-term pension liabilities in mind. Long-term corporate bond issuance is typically more concentrated in certain sectors (e.g. utilities), in turn resulting in more concentration of ESG risk. There is a much greater focus on the initial credit selection skills of the investment manager. Credit selection must also fully integrate sustainability, climate transition and manage sustainability concentration risks.

[5] A Green Gilt is a UK government bond whose proceeds are earmarked for projects that are aligned with the UK's environmental objectives.

ESG considerations when selecting an insurer.

ESG should remain a key consideration at the point of insurer selection. Trustees need to be mindful that their chosen insurer can take on responsibility for the payment of members' benefits many decades into the future. It may be natural to focus on price as the key factor in the choice of insurer, however, systemic risks such as climate change could affect an insurer's future financial strength and trustees are in a strong position to engage on ESG risk management. With the evidence pointing to increasing impacts from climate change hitting us earlier than expected, insurers may also increase premiums as they reappraise the scale and speed of the emergence climate change risk on their long-term investment portfolios.

Conclusion

In conclusion, it is crucial for DB trustees to recognise the significance of ESG and climate risks, even when nearing buyout. By incorporating these risks into their journey plans and insurer selection, trustees can safeguard the long-term sustainability of their pension schemes.

To achieve this, trustees should continuously evaluate ESG risks, integrate ESG considerations into investment strategies, ensure their fund managers are incorporating sustainability in security selection, and ensure their chosen insurer can manage long-term ESG risks. By taking these proactive steps, trustees can navigate the complexities of the endgame and secure a sustainable future for their pension schemes, even in the face of evolving ESG and climate challenges.

Important notice

Marketing material for professional clients only. The material is not intended to provide, and should not be relied on for accounting, legal or tax advice, or investment recommendations. Any reference to sectors/ countries/ stocks/ securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/ securities or adopt any investment strategy. The views and opinions contained herein are those of the individual to whom it is attributed and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. No Schroders entity accepts any liability for any error or omission in this material or for any resulting loss or damage (whether direct, indirect, consequential or otherwise).

The value of investments and any income generated may go down as well as up and is not guaranteed. An investor may not get back the amount originally invested. Past performance is not a guide to future performance. Changes in exchange rates may have an adverse effect on the value, price, or income of investments.

This document has been issued in October 2023 by Schroders Solutions, a division of Schroders IS Limited, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (Firm Reference No. 195028; registered in England and Wales No. 03359127) and is a subsidiary of Schroders PLC (registered in England and Wales No. 03909886), with its registered office at 1 London Wall Place, London, England, EC2Y 5AU.

SCOTTISH WIDOWS

An offsetting strategy for residual emissions

The climate imperative: There's no getting around it – the world is hotting up. Achieving net-zero greenhouse gas (GHG) emissions is not a 2050 or even a 2030 problem – it is one very much for today. On a global scale, GHG emissions continue to rise, not fall. What (more) can providers of capital do? We need thoughtful strategies to encourage the entities we invest in and/or finance to decarbonise. The use of carbon offsets against residual emissions should be an additional tool in the armoury.

Stephen Porter PhD, CFA
Responsible Investment Lead, Scottish Widows

CO_2 emissions are higher today than the pre-COVID peak. [1] We are already at 1.2°C of global warming, and even with the most optimistic of outcomes, we are on track for at least 1.8°C of warming, and possibly 2.3°C or more [2]. On our current trajectory, the remaining carbon budget available to *likely*[1] not exceed 1.5°C could be used up by 2030. [3] The latest UN Environment Programme (UNEP) report on the global emissions gap opined that, with global emissions still on a *rising* pathway and a lack of suitable policies, "(there) is no credible pathway to 1.5°C in place". [4]

We need rapid, large, and sustained investment in and financing of climate solutions to alter our current emissions and climate change trajectory and avoid the worst impacts of climate change. Sadly, this message is not new, and needed repeating yet again by the IPCC (Intergovernmental Panel on Climate Change) in their Synthesis Report for the sixth assessment review (AR6). [5]

To get onto a 1.5°C trajectory, GHG emissions in 2030 need to fall to about 25Gt CO_2e; a more than 50% decline from where we are today. Such a reduction was the equivalent to about 7% per year through 2030 when highlighted by UNEP's 2019 emissions gap report. For those starting today, that figure is now 11% per annum because global emissions continue to rise. Further delays to system-wide action until 2025 would mean annual GHG emissions reductions of over 15%. [6] And that only gets us halfway to net zero!

[1] 'likely' is the terminology used by the IPCC for probabilities of 66% or greater.

Acting as responsible investors and sustainable companies

The only way for the global investment 'market portfolio' to decarbonise is for the 'real economy' to decarbonise. Individual portfolio/fund decarbonisation is mere portfolio engineering – trading of carbon between market players – which has no impact on the total amount of carbon in the system.

One of the commitments of a responsible investor is to be active stewards of capital – to engage with investee companies (directly and indirectly, individually and collectively). The more rapidly our investments can decarbonise their operations and supply chains, the more rapidly our portfolio decarbonises. We should focus our efforts on reducing our own and our investee companies' emissions as far and rapidly as possible, before using carbon offsets for the remainder – the residual emissions.

The pathway to net zero is as important as actually getting there. Different companies and sectors will have different transition pathways, depending upon their starting points and realistic speeds of change. GHG emissions in some sectors and processes are unavoidable and/or very difficult to eliminate or reduce significantly (e.g., agriculture, aviation, cement manufacture). Value-chain emissions can also be difficult to mitigate or may even be necessary to deliver larger-scale emissions reductions by others (e.g., manufacture of renewable energy components).

These 'hard to abate' emissions are 'residual'. And we should only use offsets against this type of emission, but not as the oft-mooted 'last resort'. From an investors perspective 'hard to abate' emissions are those from the portfolio – our Scope 3, category 15, value chain emissions. [7] To achieve a 'net zero' state globally by the middle of the 21st century demands that we address 'residual' emissions now. They cannot be left as an 'afterthought' to be magicked away on the eve of 2050.

In a conceptually simple manner, we can see how offsets can be thoughtfully incorporated into mitigation activities today – we don't have to wait until 'tomorrow'. We employ the 'mitigation hierarchy'[2] in parallel as opposed to sequentially. Companies can do 'everything, everywhere' necessary to achieve the annual emissions reductions required to stay on their emissions reduction pathway. By so doing, they make the changes necessary to move away from 'business as usual', decarbonising the economy, and our portfolios at the same time.

[2] The mitigation hierarchy is typically denoted – in order of preference – as: prevent, reduce, remove, offset.

SCOTTISH WIDOWS

An offsetting strategy for residual emissions

Residuals offsetting strategy

Let's assume a baseline year of 2019, so we need to achieve 7% reductions in our financed emissions each year – the 1.5°C pathway. Our focus is on our investee companies, encouraging them via engagement to achieve the appropriate level of emissions reductions. They will follow the mitigation hierarchy in parallel – preventing, reducing, and removing. If the total of these three actions is less than what is needed to stay on the 1.5°C pathway, a corresponding volume of carbon offsets are purchased and retired. But the key is this is cumulative. In years where these three actions result in reductions greater than 'necessary' to stay on the pathway, this 'surplus' is banked for future periods. The quantity of offsets purchased and retired in a given fiscal year, is the difference of the cumulative total of reductions vs that of the pathway.

Crucially, however, we do not assume future periods will bring in greater reductions than required by the pathway – we are not 'betting' on future unknowns. In any given year, if there is a shortfall from actual accounted for emissions versus the quantity permitted by the pathway to that point in time, a corresponding quantity of offsets are purchased and retired. Any 'surplus' can be used in future time periods where the discrete annual reductions fall short of the pathway requirements, so the company stays on track and is not penalised for 'noise'.

Using some numbers to bring this concept to life:

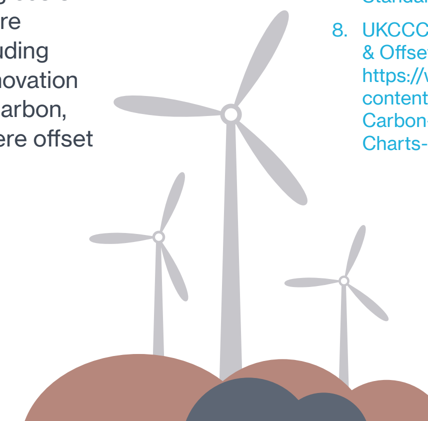
- an investee company determines it needs to achieve a 7% annual reduction in emissions to stay on the 1.5°C pathway.
- In year 1, its actions result in 5% fewer emissions than the year before (Year 0).
- It then purchases – and retires! – offsets equivalent to the remaining 2%.
- On the other hand, if Year 1 emissions were 8% versus Year 0, the 1% 'surplus' can be 'banked' for future periods where the annual target is not reached.

The same concept can be applied at the aggregate portfolio level. However, purchasing and retiring offsets is an immediate cost. How that cost will be absorbed is a major consideration of the strategy's viability as a portfolio overlay – it won't be universally suitable. But, if the underlying companies employ this or another strategy with a similar outcome, then our portfolios will automatically benefit from this real economy change.

A further consideration is the small size of the voluntary carbon market; in 2020 only 200Mt of offsets were recorded. [8] This is clearly insufficient to make much of a dent in the 50Gt of GHG emissions released into the atmosphere annually. With a restricted supply, increasing demand would put upward pressure on offset prices, raising costs for companies using them. However, there are also co-benefits from increased prices, including incentivising further corporate mitigation innovation by sending a market signal for the price of carbon, and higher capital flows to communities where offset projects are located.

References

1. H. Ritchie and M. Roser, "CO² and Greenhouse Gas Emissions," Our World in Data, 2023. [Online]. Available: https://ourworldindata.org/co2-and-greenhouse-gas-emissions.
2. Climate Action Tracker, "CAT Emissions Gap," 2022. [Online]. Available: https://climateactiontracker.org/global/cat-emissions-gaps/.
3. Carbon Brief, "Analysis: What the new IPCC report says about when the world may pass 1.5°C and 2°C," 2021. [Online]. Available: https://www.carbonbrief.org/analysis-what-the-new-ipcc-report-says-about-when-world-may-pass-1-5c-and-2c/.
4. UNEP, "Emissions Gap Report 2022," 2022. [Online]. Available: https://www.unep.org/resources/emissions-gap-report-2022.
5. IPCC, "AR6 Synthesis Report," 2023. [Online]. Available: https://www.ipcc.ch/report/ar6/syr/.
6. UNEP, "Emissions Gap Report 2019," 2020. [Online]. Available: https://www.unep.org/resources/emissions-gap-report-2019.
7. Greenhouse Gas Protocol, "Corporate Value Chain (Scope 3) Accounting and Reporting Standard," 2011. [Online]. Available: https://ghgprotocol.org/sites/default/files/standards/Corporate-Value-Chain-Accounting-Reporting-Standard_041613_2.pdf.
8. UKCCC, "Voluntary Carbon Markets & Offsets," 2023. [Online]. Available: https://www.theccc.org.uk/wp-content/uploads/2022/10/Voluntary-Carbon-Markets-and-Offsetting-Charts-and-data.xlsx.



TRAVERS SMITH

Putting stewardship into practice

Stewardship can be a tricky issue in pensions. Scheme investment chains are sophisticated, globalised and highly intermediated. On top of this, the law is widely framed, leaving trustees with a lot of flexibility, but arguably little specific direction, over what to do. This can make it hard to know where, or even whether, to start. In this article we explore the legal rationale for pension scheme stewardship, some challenges, and some pointers for putting it into practice.

Andy Lewis
Partner, Pensions,
Travers Smith

Henriika Hara
Partner, Financial Services & Markets,
Travers Smith

Jonathan Gilmour
Partner, Derivatives & Structured Products,
Travers Smith

Introducing stewardship

Why should trustees be proactive about stewardship? A definition helps us to answer this question. The Financial Reporting Council's UK Stewardship Code 2020 describes stewardship as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, environment and society". For trustees, two key points emerge from this:

- Stewardship's purpose is to create or preserve "long-term value" within an investment portfolio. This value-driven objective is well aligned with trustees' core 'mission', which is to invest scheme assets in order to provide members with their retirement benefits.
- Stewardship is not limited to environmental, social and governance ("ESG") matters. Considerations such as investee capital structures or financial performance are also valid stewardship themes, as investment legislation makes clear.

There are other legal prompts to look at stewardship too. *Reporting on Stewardship and Other Topics through the Statement of Investment Principles and the Implementation Statement* (2022) is Government statutory and non-statutory guidance for occupational pension schemes. There isn't space to summarise it here but it promotes detailed public disclosures around stewardship and, in effect, calls on trustees to publicly justify their approach. It is genuinely ambitious and wide-ranging. Indeed, the industry may not have fully appreciated its significance yet. Separately, schemes in scope for mandatory climate reporting are likely to need to cover climate-related stewardship activity in their annual climate governance reports.

In our view, this means stewardship is a legitimate part of the trustee investment toolkit and an important component of trustee legal duties.

Getting started

The 2020 UK Stewardship Code also gives practical examples of stewardship actions including: investment decision-making, actively monitoring service providers, engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights.

However, it's important to note that there is no requirement for trustees to practise stewardship across all issues at all times. Instead, a variety of sources recommend two key steps:

- Identify priority stewardship themes that are expected to have the greatest impact for the scheme's portfolio. As noted above, this could be financial topics such as investee leverage ratios or management incentivisation, but could also be climate change or modern slavery, for example.
- Develop clear processes for implementing stewardship. This will include both reporting packs from investment managers and an 'escalation strategy' of pre-agreed issues and triggers for different levels of stewardship intervention. These interventions can range from informal conversations and expressions of wishes from the trustees, to much stronger steps such exercising legal rights attaching to assets or, in extremis, disinvestment or termination of an appointment.

We acknowledge that stewardship experiences can vary between asset classes at present. In equities there is already a fairly well-developed reporting and voting ecosystem, though there is a lot of sectoral variation. In 2023, the Church of England Pension Fund disinvested from certain carbon-intensive equities, but only after a period of prior engagement with the companies around their climate transition. This is a real-life example of climate change as a stewardship theme and a connected escalation strategy being implemented gradually over time. Another example is NEST's climate change risk policy from December 2022, which details their climate stewardship and escalation approach.

Stewardship is possible outside equities but it will look and feel slightly different, as the box below outlines.

Putting stewardship into practice

Approaches to fixed income assets stewardship

The fixed income market has grown in importance, particularly as defined benefit schemes have shifted allocations away from equities in line with market trends and regulation. The market is evolving, and while fixed income investors are not the ultimate owners of companies, they nevertheless provide substantial amounts of capital and can therefore play an important role in promoting effective stewardship.

However, unlike equities, investors in fixed income assets do not automatically have a right to vote. Historically this has driven a slower uptake in effective stewardship in fixed income. This is now changing. Here are some different approaches that we have seen pension schemes use in this space:

i. *Only permitting investment in bonds which have a ESG score[1] among the top 80% of the respective sector;*

ii. *Sending annual letters to key issuers in the industry to highlight their investment approach and flag the relevant issuer's current ESG score;*

iii. *Reducing investable limits in a single issuer where the issuer has a poor ESG score;*

iv. *Declining to participate in a primary issuance where their credit analysis showed that the pricing of the new bond did not adequately compensate investors for the current ESG risks and broader credit risk;*

v. *Raising concerns in an initial engagement meeting and then providing feedback to the issuer where there has been insufficient progress on those matters to warrant further investment; and*

vi. *Including the above (as applicable) in investment documents to ensure that investment managers are contractually bound to comply with the relevant steps on behalf of the trustees.*

[1] ESG scores are a measure of how a company addresses ESG issues in its day-to-day operations. Key ratings agencies include Bloomberg and S&P, which use various criteria to evaluate whether a company is effectively managing ESG risks.

Working with managers

Whatever the asset class, it is often necessary to leverage investment manager services and experience in order to deliver stewardship activity on the ground. In this context, it's important for trustees to reflect upon their commercial relationship as the manager's client, and the environment the managers operate within, since these will influence the art of the possible. As always, the starting point is to ask questions.

In the UK, managers are required to publicly explain their commitment, if any, to the 2020 Stewardship Code. This may help may inform trustees of the stewardship exercised by their managers. Another sensible step is to scrutinise how effectively existing managers are plugged into their asset class(es) ecosystem for stewardship and how active they are within it. Case studies are helpful, but a consistent run of quantitative data is even better. The Association of Member Nominated Trustees voting red lines is one example of free template industry voting guidance that could be used for benchmarking, but others are available too. Specific to carbon-emissions related data, most UK managers are required to either make public disclosures or provide disclosures on investor request on climate-related matters under the framework of the Task Force on Climate-Related Financial Disclosures.

In an international context, access to information may be more challenging. There are some mandatory frameworks that require disclosures about stewardship, such as the EU Shareholders' Right Directive (specific to listed equities). But not all international asset managers are subject to requirements to provide information about stewardship, leaving this instead to a commercial negotiation between the trustee and the manager. Voluntary disclosures, such as where the manager is a signatory to the UN-supported Principles for Responsible Investment, may help. But early conversations are likely to be important to ascertain an asset manager's specific commitments and reporting, which in turn can help trustees when negotiating terms for a specific investment, including to set stewardship requirements.

Planning for accountability

Stewardship activities are publicly disclosable in various pension scheme documents including the annual implementation statement. This can create new accountability risks for trustees, including media repercussions for the scheme and potentially its sponsoring employers and a developing risk of member legal claims (sometimes backed by NGOs or activists). There are cost and reputation considerations even if such litigation ultimately fails, and this is a trend we are watching closely together with many schemes. In our view it makes sense to develop stewardship policies with trustee accountability in mind right from the outset.

Conclusions

Pension scheme stewardship is supported by law, strongly encouraged by guidance, and feasible in practice if planned thoughtfully and collaboratively. Above all, it's important to work actively, being realistic about what a scheme will do and when. Success depends on making sure trustees, advisers and managers are on the same page and committed to ensuring that planned activity is delivered.

Pensions Management Institute Contact Details:

Tel: +44 (0) 20 7247 1452

Registered office:

6th Floor,
9 Appold Street
London
EC2A 2AP

Pensions Management Institute

Moving pensions forward