Investment Consultants Sustainability Working Group (ICSWG)

Response to the Open Consultation on policy proposals from the Department for Work and pensions (DWP) on "Climate and Investment reporting: setting expectations and empowering savers – consultation on policy, regulations and guidance" published on 21 October 2021

One of the ICSWG objectives is to engage with the DWP and the broader investment industry to act as a force for a better understanding and appreciation of the climate risks and opportunities our clients face and to act as a catalyst for positive change which will result in better outcomes. The proposed regulations and statutory guidance are directly relevant to the ICSWG member firms, their respective clients and ultimate beneficiaries.

About the ICSWG

The ICSWG was established by its member investment consulting firms in the UK in order to engage with relevant stakeholders and give added power to asset owners and their ultimate beneficiaries in order to seek better sustainable investment outcomes and practices across the industry. As investment consultants, we each work closely with boards of trustees, asset managers, product providers, platform providers, regulators, non-governmental organisations and others. There are presently nineteen firms represented in the ICSWG. Member firms are likely to be responding to this Consultation in their direct capacities as well as part of this collective Group.

Our views on the Consultation

1. Measuring and reporting Paris alignment

1.1. Forward-looking metrics (Q1)

We support the introduction of a mandatory forward-looking metric, such as a portfolio alignment metric.

We believe a portfolio alignment metric will help pension trustees to focus on the transition to a low-carbon economy, rather than the backward-looking emissions metrics which can incentivise divestment from companies that most need capital investment to further the transition to net zero.

We would also like to note that forward looking metrics are not limited to portfolio alignment metrics only. For example, in line with its mandate to promote disclosure of the *financial* risks and opportunities from climate change, the TCFD also makes note of other forward-looking metrics, such as value at risk. A principles-based approach across a range of metrics would enable a holistic, balanced approach to trustees' investment decision making in relation to climate change (as discussed further in section 1.5).

1.2. Three types of portfolio alignment metrics (Q4)

We support the flexibility proposed by allowing trustees to choose from one of three types of portfolio alignment metrics. Acknowledging that best practice for the calculation of portfolio alignment metrics is evolving quickly, we believe it is important to provide this flexibility within the proposed statutory guidance. However, as highlighted in section 1.5 below, we would prefer to see even less prescription of the metrics.

Paragraph 160 of the proposed Statutory Guidance requires trustees to understand the basic methodological decisions and assumptions, which we agree is important. In particular, if the new statutory guidance recommends the benchmark divergence and implied temperature rise models (as proposed), we would like to see explicit reference in the guidance to the varied and evolving nature of these measures, and their potential shortcomings in terms of unintended consequences, complexity or lack of transparency around inputs and methodologies.

The approach of binary target measurements is also evolving and so again, if the new statutory guidance goes on to recommend this as an option, we suggest the statutory guidance is sufficiently flexible to allow for the evolving approaches to this. For example, the Net Zero Investment Framework developed by the Paris Aligned Investment Initiative categorises assets using a five-point maturity scale for alignment to a net zero pathway as opposed to the simpler binary approach.

1.3. Climate change goal

We note that the proposed amendments to the Climate Regulations and statutory guidance make explicit reference to *"limiting the increase in the global average temperature to 1.5 degrees Celsius above pre-industrial levels"*. Whilst we agree that this is a preferred objective, the IPCC's latest report finds that averaged over the next 20 years, global temperature is expected to reach or exceed 1.5°C of warming. Given this, we believe it would be preferable to change from specifying 1.5°C to a metric which shows the alignment of the scheme's assets with a defined climate warming scenario. A specific temperature may also restrict trustees from using some portfolio alignment measures.

We also note that the timing of the temperature goal is unclear. Standard expectations would be by 2100 but this is not covered in the proposals and the pathway to getting there is also not discussed – again alignment with a defined climate warming scenario could address this.

We note that the Financial Conduct Authority's new rules for disclosure of climate-related financial information (PS21-24) use a broader definition for the portfolio alignment to be reported by asset managers as far as reasonably practicable. We recommend a consistent definition is used to make it easier for trustees to obtain the data they need from their managers.

1.4. Additional climate change metrics

Whilst we broadly support the proposed guidance in relation to portfolio alignment metrics and the expansion of the list of recommended additional climate change metrics, we do not agree with the choice of metrics to include in the expanded list. We understand the DWP's preference for aligning the guidance with the TCFD's recommended cross-industry, climate-related metrics. However, these were chosen to be suitable for a broad range of companies and some are not particularly well suited to pension schemes. Moreover, some climate-related metrics that are important for pension schemes are not included in the list.

In relation to the proposed additional climate change metrics in paragraph 173, we recommend that DWP:

- removes the carbon price and remuneration metrics, which are more suited to individual portfolio companies than pension scheme trustees;
- provides more detail on some of the other metrics (exposure to physical risks, transition risks and climate-related opportunities) to make it clearer what it is intended to achieve; and
- includes some further metrics that are important for pension schemes (climate-related voting and engagement statistics, and climate risk management metrics such as the Transition Pathway Initiative's Management Quality scores).

More broadly, we recommend the DWP encourages trustees to adopt a number of forward-looking indicators to provide a more holistic view of alignment potential for assets in high impact sectors[1] including: short- and medium-term emissions reduction targets, capital expenditure and a credible decarbonisation strategy is in place to achieve targets.

1.5. Suitability of metrics (Q4)

The existing and proposed regulations and statutory guidance are prescriptive on the detail of the metrics. Although we welcome the flexibility proposed for the mandatory portfolio alignment metric (in terms of three types), this introduces further complexity and detail to the statutory guidance. In our view, given the evolving nature of best practice on climate-related metrics, a more robust approach would be less prescriptive on the detail.

[1] High impact sectors being defined as: oil and gas, electric utility, cement, real estate, metals and mining, chemicals, steel, food and beverages, paper and forest products, agricultural products and agriculture.

Instead, we believe it would be better to take a more principles-based approach; specifying several categories of climate metrics to capture the different nature of climate-related risks and opportunities which trustees face. For each prescribed category of metric, the selection of specific climate metrics would then be at trustees' discretion based on the best available science.

For example, the five climate metric "use cases" described by the Climate Financial Risk Forum[2] ("CFRF") – transition risks, physical risks, portfolio decarbonisation, mobilising transition finance and engagement – would provide a good framework for prescribing the categories of metrics in the amended Climate Regulations (although we note that measuring physical risk exposure is currently challenging).

Each type of metric has benefits and drawbacks, as well as important end uses. The statutory guidance should encourage trustees to adopt a range of metrics appropriate to their scheme's specific circumstances and capabilities. We would also encourage use of metrics which are actionable. For example, the alignment maturity scale described by the IIGCC's Net Zero Investment Framework[3] drives action because it highlights the parts of portfolios where action is required to be Paris Aligned.

In our view the advantages of this more principles-based approach would be:

- encouraging a more holistic approach to climate metrics by requiring trustees to consider the purpose for each category of metric and a range of options within that – as opposed to focusing on compliance with three very specific metrics;
- helping to move towards an industry-wide set of core metrics if the CFRF framework is adopted as the basis for the amended Climate Regulations; and
- providing a more future-proofed approach as climate science or market views on best practice change.

1.6. Timing and scope (Q2, Q3)

We agree with the proposed terms for introducing the amendments. Although we note that publication of the disclosures prescribed by the FCA for asset managers in PS21-24 will apply from 30 June 2023 at the earliest and the requirement to disclose portfolio alignment metrics is only required "as far as reasonably practical". Together these mean it may be difficult for trustees to calculate their portfolio alignment metric in the initial years of implementation.

[2] https://www.fca.org.uk/publication/corporate/climate-financial-risk-forum-guide-2021-data-metrics.pdf
[3] https://www.parisalignedinvestment.org/media/2021/03/PAII-Net-Zero-Investment-Framework_Implementation-Guide.pdf

2. Stewardship and the Implementation Statement

We welcome the DWP's consultation on this area. We believe that effective stewardship can be the most powerful function that the asset management industry performs but it is often placed at the bottom of asset owners' agendas given governance challenges. We also recognise the challenges of embedding stewardship as a key tool for pension trustees to improve investment returns and encourage long-term value creation for savers. These challenges include the limited resources from pension fund trustees that they can dedicate to this topic, the complexity of stewardship reporting that often has to be based on qualitative rather than quantitative assessment, and the ability of asset managers to provide trustees with decision-useful information.

While the industry is trying to find optimal ways to report on stewardship activities, we would like to highlight that excessive focus on reporting could potentially be at the detriment of real constructive engagement between trustees and asset managers and between asset managers and underlying businesses. The importance of allocating time and resources to having a high-quality constructive dialogue cannot be underestimated. For example, effective stewardship goes far beyond voting on shares and too much focus on voting reporting could potentially divert attention from more value additive activities, such as engagement with underlying businesses to drive change in the real-world economy. We would encourage any additional action by the DWP to be proportionate with the expected value of various reporting activities and ensure that reporting requirements serve first and foremost to incentivise the right type of behaviours that could lead to better real-world outcomes.

We also recognise that most implementation statements have been mostly compliance documents rather than useful communications by trustees to their members and beneficiaries. In our view, one of the main constraints on improving implementation statements is the quality of reporting on stewardship by fund managers who struggle to produce tailored stewardship reporting to their clients. Also, the inability of a number of fund managers to disclose 'significant votes' adds to pension fund trustees' challenge on implementation statements.

With a view to improving engagement reporting and bringing decision-useful information to help pension fund trustees evaluate their managers' stewardship capabilities but also to help the industry coalesce on engagement reporting best practice, the ICSWG has recently published our standardised guide for manager engagement reporting. We have had lots of helpful suggestions and feedback from fund managers who have appreciated that the guidance is designed to improve reporting around engagement, recognised a need and seen how it could be useful to have some common guidance on engagement reporting. We also note that like the earlier PLSA vote reporting templates, there are some segments of the industry that have tended to see this tool as an imposition on the market rather than an attempt to facilitate reporting along the lines that will enable pension schemes to deliver against their mission, beliefs and regulatory requirements.

We strongly welcome the alignment of the proposals with the principles of the Stewardship Code. It is positive if signatories can streamline their overall reporting burden by aligning their implementation statements with their Stewardship Code reports. We would also note that the ICSWG engagement reporting guide is aligned with the Stewardship Code and is complementary to the overall objective of raising the significance of stewardship in our industry.

We note that some of the proposals are intended as statutory guidance while others are likely to be non-statutory guidance. Where the proposals take the form of non-statutory guidance, we note that if DWP is seeking to improve standards across the market, non-statutory guidance is unlikely to prove the necessary catalyst for broad-based change. To achieve improvements in stewardship activities by trustees who have taken a minimum compliance approach to meeting their implementation statement requirements, the changes may not be enough to create a catalyst to change their approach.

Two additional aspects that we think it would be useful to address are:

- fund managers ‘pre-declaring votes’ to allow trustees to review and provide input to voting decisions; and
- disclosure and encouragement of ‘collaborative engagements’, especially related to climate change issues, which in our view are for many reasons more effective than voting.

In response to the individual questions:

2.1. DWP’s vote and engagement reporting templates (Q7)

We do not believe that the market is ready for DWP to create a vote reporting template. At the moment, a number of fund managers are not able to respond in a robust way to our clients’ requests based on a template. We believe that the PLSA template is sensible and would form the appropriate basis for any other formal regulatory template but at present we seem to face practical difficulties in getting necessary data from fund managers.

Similarly, we do not believe that the time is right for a DWP-imposed engagement reporting template. Naturally, we believe that the ICSWG guide for engagement reporting would form an appropriate basis for this type of a standard template, but fund managers’ ability to provide such reporting needs to be addressed first before pension trustees are asked to use these templates as a matter of course.

In addition, we positioned the ICSWG guide for engagement reporting as a guide of suggestions on metrics and case studies rather than a fixed template. Given the variety in fund managers’ approaches, it is not possible to get the perfect set of reporting questions in every situation. A fixed format compulsory engagement template would also be at odds with the spirit of the new UK Stewardship Code (which is proving successful in our view) – this is deliberately not prescriptive in exactly how different entities must communicate stewardship.

Lastly, we very much welcome the formation of the Occupational Pensions Stewardship Council by asset owners. ICSWG would be delighted to provide input to this group from the investment consulting perspective, if needed.

2.2. Cross-cutting proposals for the Guidance on Statements of Investment Principles and Implementation Statements (Q8)

We believe that these proposals are sensible and form an appropriate approach to encouraging enhanced Statements of Investment Principles and Implementation Statements. We note that while Statements of Investment Principles are in the form of non-statutory guidance, they will be no more than encouragement, which may only have limited impact on delivery of enhanced Implementation Statements across the market as a whole. We would also like to note that communications from pension trustees to their members would need a different communication style and would need to be shorter.

2.3. Guidance on stewardship policies and most significant votes (Q9)

We believe that this Guidance is sensible and forms an appropriate approach to encouraging enhanced Statements of Investment Principles and Implementation Statements. We note that while Statements of Investment Principles are in the form of non-statutory guidance, it will be no more than encouragement, which may only have limited impacts on delivery of enhanced Statements of Investment Principles across the market as a whole.

It is unclear if the proposal in the draft Guidance that *"…trustees must report all of the most significant votes within the IS itself, and should also report the considerations by which the trustees selected significant votes"* implies hands-on involvement from trustees in selecting significant votes versus, at the other end of the spectrum, trustees still ultimately having the option to decide to ask asset managers to identify significant votes in the context of their investment process. If the former, then we recommend considering the operational implications in the context of typical trustee bandwidth and investment arrangements. It may be useful to give examples to clarify how this might work in practice and permit some flexibility for trustees in implementation depending on their resources.

Some schemes currently use specialist boutique asset managers. We would not want a new vote reporting requirement to place such a high reporting burden on asset owners to discourage this. Doing so would reduce innovation and competition within the asset management industry. A pragmatic solution may be to allow trustees a level of prioritisation in reporting emphasis.

Given the assumed intention to encourage high quality stewardship activity, rather than solely driving greater reporting of certain votes to members, we see a case for asking trustees to report their process for overseeing (ie investigating and questioning) vote activity. Reviewing significant votes such as those provided by asset managers could be part of this, but guidance could also recommend use of additional analysis – not produced by asset managers – to identify areas (eg particular votes or topics) to investigate further.

2.4. Statutory Guidance on the information to be included in the Implementation Statement (Q10)

We regard this clarification as helpful and potentially removing one of the encouragements to boilerplate in Implementation Statements. It is helpful that this is proposed as statutory guidance.

2.5. Statutory Guidance on meeting the Implementation Statement requirements (Q11)

We regard this proposed change as a valuable small improvement to Implementation Statements. It is helpful that this is proposed as statutory guidance.

2.6. Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to investment strategy (Q12)

We believe that this Guidance is sensible and a further encouragement to pension schemes to require their fund managers explicitly to adhere to the standards and expectations set out in their Statements of Investment Principles. We note that not all fund managers have proven to readily accept requests from their clients formally to state that they will adhere to client Statement of Investment Principles.

We also note that where this Guidance is in the form of non-statutory guidance, it will be no more than encouragement, which may only have limited impacts on delivery of enhanced Statements of Investment Principles across the market as a whole.

2.7. Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to financial material considerations (Q13)

We believe that this Guidance is sensible and a further encouragement to pension schemes to consider ESG matters in the framing of investment decisions, tenders and monitoring.

We note that where this Guidance is in the form of non-statutory guidance it will be no more than encouragement, which may only have limited impacts on delivery of enhanced SIPs across the market as a whole.

2.8. Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to non-financial material considerations (Q14)

We consider the distinction of financial and non-financial factors in the guidance and in the underlying regulations to be unhelpful. As ICSWG pointed out in our joint response with the IFoA to the Law Commission's 14th Programme of Legal Reform earlier in 2021, the two-step process for non-financial factors creates barriers and complexity, leading fiduciaries to believe they do not need to consider some ESG risks. In the long run, many typically attributed non-financial factors within ESG frameworks can be considered to be financial factors. Many issues, including those relating to climate-change, will have both financial and non-financial aspects. Further, some issues that start out as non-financial (e.g. public criticism in relation to a particular industry or company) may become financial (e.g. where this translates into reputational damage or reduced customer demand). The distinction between financial and non-financial factors is therefore artificial. We believe that the trustees must have regard to the impact of their investments on the community and the environment, similar to the duty of a director of a company under Section 172 of the Companies Act 2006.

A recent report commissioned by the Generation Foundation, the UN's Principles for Responsible Investment and the UNEP-FI produced by Freshfields Druckhaus Deringer LLP ('Freshfields II'), concluded that this two-step test means that trustees would generally not be comfortable in taking account of so-called non-financial factors in the UK. In practice, the financial / non-financial distinction has created confusion on the part of pension trustees about requirements to consider the integration and management of climate and other ESG-related risks in their investment decisions.

Moreover, the two-stage test for non-financial factors does not seem workable in practice due to the difficulty in ascertaining the views of pension scheme members. Indeed, the Association of Pension Lawyers has expressed the view that there must essentially be unanimity of support among pension scheme members before non-financial factors are taken into account, other than in a tie-breaker situation. In practice, trustees are finding the regulatory framework is a barrier and few schemes are adopting a policy of taking account of members' views, despite growing calls for pension schemes to do so (for example, from campaigns such as Make My Money Matter).

2.9. Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to arrangements with asset managers (Q15)

We regard these clarifications as helpful in setting out how trustees best ensure the alignment of their requirements of asset managers with their stated policies and look to confirm that transaction costs and turnover are in line with expectations of the relevant strategy in the given market conditions.

We note that some of these proposals are in the form of non-statutory guidance, while others are proposed as statutory guidance. As stated previously, we believe that changes to the statutory guidance are more likely to deliver the broad-based change that DWP is seeking.

Conclusion

In conclusion, we reiterate from our previous responses to the DWP's consultations on climate regulations that we strongly support an orderly transition in line with the UK government's Net Zero commitment and view the proposals in this consultation as part of the overall strategy to make that happen. As such, the ICSWG wishes to state its full support to the DWP in their objectives. We look forward to further engagement and collaboration with the DWP in striving for a successful implementation of the TCFD guidelines.

The ICSWG supports the proposal to require a portfolio alignment metric in the amended Climate Regulations. However, we believe it would be preferable to be less prescriptive on the detail of the metrics and instead specify several categories of metric (with examples of specific metrics under each category) to be adopted.

The ICSWG also supports the additional guidance on stewardship and the Implementation Statement but urge the DWP to consider including more within the statutory guidance – rather than the non-statutory guidance – to achieve the policy intent. Taking a step back from the details of the proposals, we would prefer the focus of any new requirements to be on constructive engagement between trustees and asset managers and between asset managers and underlying businesses rather than compliance with prescriptive reporting.

The Investment Consultants Sustainability Working Group members:

- Aon
- Barnett Waddingham
- Bfinance
- Broadstone
- Buck
- Cambridge Associates
- Capita Pension Solutions
- Cardano
- Hymans Robertson
- ISIO
- LCP
- Mercer
- MJ Hudson Allenbridge
- Momentum Investment Solutions & Consulting
- Redington
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