ACCOUNTING FOR SUSTAINABILITY

ALIGNING TO A NET ZERO PATHWAY

TOP TIPS FOR PENSION SCHEME TRUSTEES

THE PRINCE OF WALES'S CHARITABLE FUND

NET ZERO

CONTENTS

About this document

This 'top tips' guide is written for pension scheme chairs and trustees to provide you with peer-tested, practical actions to align your pension scheme(s) with a net zero pathway. The guide also lays out why transitioning to a net zero pension scheme is compatible with upholding your fiduciary duty to act in the best interests of your members.

While this guide is UK focused, the tips are widely applicable to asset owners globally (subject to local regulatory frameworks), including pension schemes, sovereign wealth funds and family offices.

This guide:

- Defines what net zero means in the context of pension schemes
- Highlights the challenges and opportunities to consider when planning a net zero transition strategy
- Provides some top tips compiled from chairs and trustees who are on a net zero journey

NB: Details on investment strategies presented in this guide are for informational and illustrative purposes only and do not constitute professional advice.

In this context, the term 'net zero' refers to an approach where the amount of greenhouse gas (GHG) emissions put into the atmosphere is the same as the amount that is removed. The scientific community has underlined that global emissions must be reduced to net zero by 2050 to meet the ambition set out within the Paris Agreement, notably to limit global temperature increases to 1.5°C above pre-industrial levels. Organizations, including pension funds, are setting their own net zero targets to contribute to this global goal. A net zero ambition set by a pension fund should focus on achieving two objectives, as recommended by the Institutional Investors Group on Climate Change (IIGCC)[1]:

1. Decarbonizing investment portfolios in a way that is consistent with achieving global net zero GHG emissions by 2050.
2. Increasing investment in the range of 'climate solutions' needed to meet that goal (eg renewable energy, low carbon buildings and energy efficient technologies).

1. IIGCC, Net Zero Investment Framework 1.5°C, Implementation Guide

FOREWORD

Foreword by Guy Opperman, UK Minister for Pensions and Financial Inclusion

Climate change is the defining issue of our age and my job as Pensions Minister is to ensure that we incorporate the path to net zero and the battle against climate change into every aspect of our UK Pensions. So I congratulate Accounting for Sustainability and the Asset Owners Network for producing such an excellent short guide for trustees on net zero. I am enthused by the guide's desire for proper assessment of asset managers and consultants.

I am also pleased to see the importance accepted of the need to speak with and listen to scheme members. Trustees and Local Government Pension Scheme governance bodies who reach out to their savers will build engagement and understanding. They will make better decisions and communicate them more clearly. Those who adopt a siege mentality will fail.

I hope you get the opportunity to learn from each other with the "war stories" of trustees in this helpful guide. They will be invaluable as you take steps to net zero. I have been proud to introduce ESG investing into our pensions, whereby you must make every investment decision, as well as every stewardship decision, take climate change into account. Likewise the Task Force on Climate-Related Financial Disclosures (TCFD) provides a revolutionary framework – I am proud to say that we are the first G7 country to mandate TCFD-aligned disclosures for occupational pension schemes.

Government can do a lot, but we can only do so much. It is good to work with organizations like Accounting for Sustainability and the many other engaged and committed organizations and individuals who will help make a net zero financial system a reality.

FOREWORD

Climate change presents a significant financial risk factor to asset owners and investors. With a value of US$50 trillion (OECD, 2020), global pension assets can substantively fund solutions to the climate crisis or accelerate it.

From a traditional risk and return perspective, it now unquestionably falls within a trustee's fiduciary duty to consider and integrate climate impacts into investment decisions, recognizing that our ability to provide long-term, risk-adjusted returns to our members is threatened by the impact of climate change both now and in the future. This aligns with direction of global pensions regulation while simultaneously addressing the wider, moral and member-led imperative to do so.

Increasingly, pension scheme members are questioning how and where their pension savings are invested. They are becoming more aware of their personal carbon footprints and choices, extending to their personal financial choices. And environmental and social consciousness has heightened as we emerge from the Covid-19 pandemic.

As the trustees and stewards of these US$50 trillion global pension assets, we have the member mandate, responsibility and opportunity to respond. Our investment decisions will materially impact global efforts to limit temperature increases to 1.5°C above pre-industrial levels, in line with the aspirations of the Paris Agreement. As a global community and as individual pension funds, we are an essential instrument to financing the transition to a net zero global economy, driving capital towards positive outcomes, including building climate resilience, being a catalyst for innovation and opportunity and leveraging our influence across the investment chain.

This guide sets out the practical steps that chairs and trustees can take to set their schemes on a course towards net zero, thus mitigating the environmentally, socially and economically destructive impacts of climate change. As trustees, we need to be able to hold up a mirror and be satisfied that we are doing enough. There is no Planet B.

Foreword by Emma Howard Boyd CBE, Chair of the Environment Agency and Russell Picot, Chair of the HSBC Bank (UK) Pension Scheme – co-chairs of A4S's Asset Owners Network

INTRODUCTION

Failure to act on climate change represents an existential risk to society and the global economy. The World Economic Forum's Global Risks Report 2021[2] places climate action failure in the top two risks by likelihood and by impact over the next 10 years, with extreme weather the top risk by likelihood. The Paris Agreement, adopted by world leaders in 2015, aims to keep global heating to well below 2°C above pre-industrial levels by 2100 and to strive for a maximum 1.5°C rise in global average temperatures. We have already seen global warming of about 1.2°C[3] with global average temperatures now at levels unprecedented in at least the past 12,000 years and affecting living conditions in many parts of the world. Left unchecked, the global temperature increase by the end of this century is estimated to be between 2.7°C and 3.1°C.[4]

In 2019, the Intergovernmental Panel on Climate Change released a report underlining the importance of keeping the rise in global average emissions to below 1.5°C to avoid the worst impacts of global heating. The report estimated that to achieve this goal, global GHG emissions need to halve by 2030, reach net zero around mid-century and be negative during the second half of the century.[5]

Climate change is already starting to have profound impacts on ecosystems, health, infrastructure and the economy. Many countries and businesses have started to respond, recognizing the need to put strategies in place to align with a limit of 1.5°C, and making net zero emissions commitments. Achieving net zero will require substantial investment and transition of the whole economy. New technologies and jobs will be needed to reduce energy use, eliminate emissions and restore land. This transition presents unique challenges and opportunities, particularly in regions that have urgent development needs today.

While the exact outcome is uncertain, it is foreseeable that some combination of these trends will occur. This decade is set to be a critical period of change.

"Addressing climate change is in the world's interest, but increasingly pension funds recognize that it's in their interest because climate risk is investment risk. The scale of stranded assets is only starting to be appreciated. And not thinking about terminal value in a world on the road to net zero could well prove terminal for some portfolios."

Mark Carney, United Nations Special Envoy for Climate Action and Finance, at Make My Money Matter's Net Zero Pension Summit, June 2021

2. World Economic Forum, The Global Risks Report 2021
3. World Meteorological Organization, State of the Global Climate 2020
4. Climate Action Tracker, Temperatures
5. Intergovernmental Panel on Climate Change (IPCC), Global Warming of 1.5°C

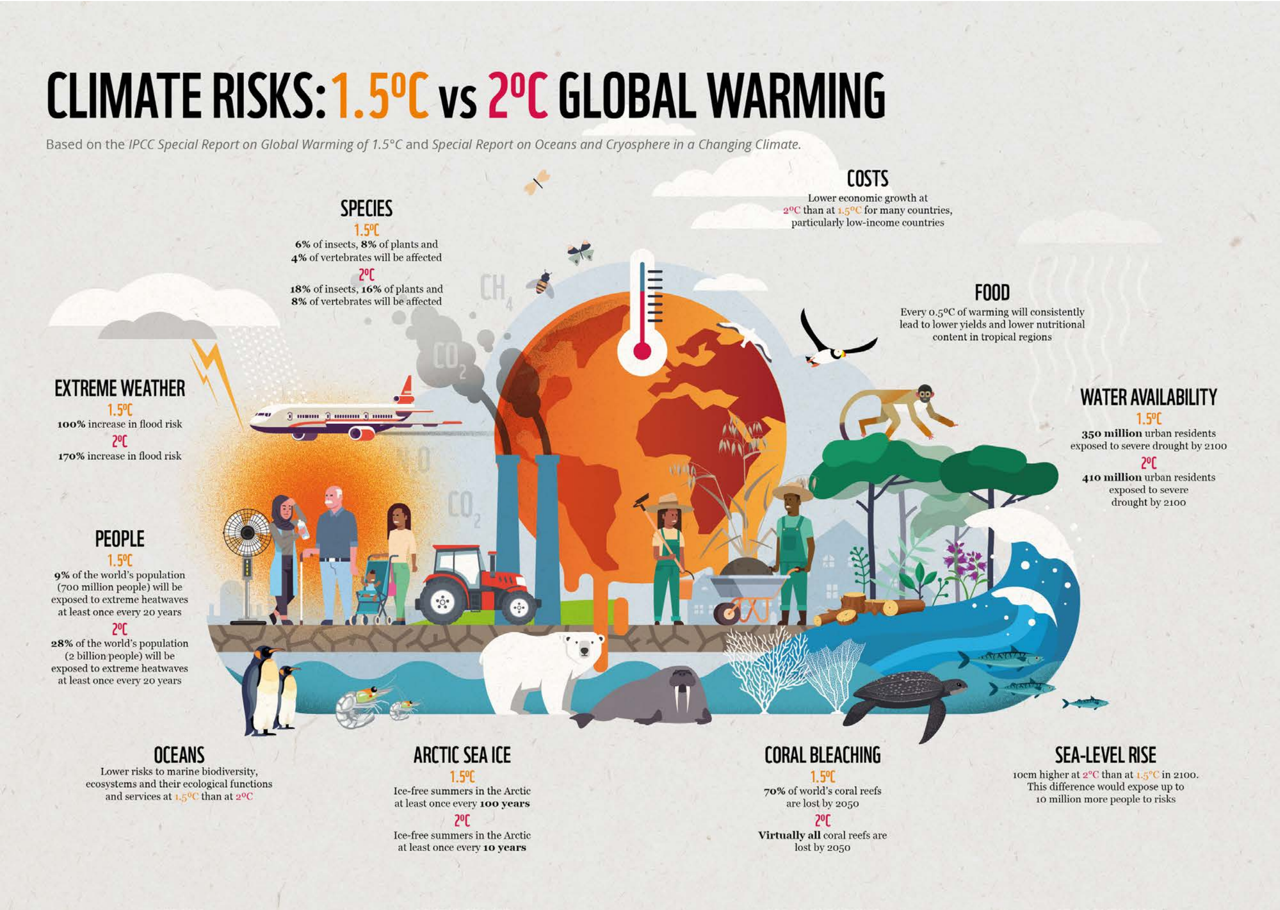

Figure 1: Comparison of climate risks between a 1.5°C and 2°C warming projection, (Source: WWF and Clean Canvas)

What are the risks to pension schemes?

Whether equity or debt, your investments carry extensive, diverse and complex exposure to climate outcomes. There are two key risks of climate change to your underlying investments, enhancing in severity as time progresses:

- Physical risks as a result of extreme weather (eg damage to buildings and infrastructure) which can halt supply chains and/or close operations in vulnerable locations.
- Transition risks that could result in GHG intensive businesses (or those slow to respond to the net zero transition) suffering from reduced demand, obsolescence and/or high regulatory overheads.

Both types of risk may result in significant business disruption, 'stranded assets' and a resultant devaluation of the investment. For defined benefit (DB) schemes they could also affect the prospects of the sponsor. Litigation risk is also something that needs to be factored into investment decisions, from multiple angles including: scheme compliance with the current and future pension regulations; potential litigation faced by investee companies failing to mitigate, adapt or disclose; and potential ligitation against pensions themselves.

It is therefore prudent for trustees to consider a range of responses, including steering their scheme investment and funding strategies – as well as their stewardship activities – towards net zero alignment, protecting savers' money from the potential economic shocks of climate change, and leveraging investment opportunities created by the global transition to a net zero economy.

Some companies are increasingly aware and committed to supporting alignment of their pension schemes with environmentally positive outcomes, as are the trustees, executives and advisers who govern, develop and manage these schemes. Indeed, some trustees have identified a net zero transition as a commercial advantage, for example, Andrew Warwick-Thompson, Chair, Scottish Widows Master Trust said: "When an employer or trustees go through an exercise to identify a master trust, we have found that environmental, social and governance (ESG) factors are key considerations in their selection criteria. There is a commercial component for master trusts adopting net zero ambitions."

Trustees are motivated by the need for scheme resilience for the benefit of members. Many forecasted impacts of climate change are likely to fall within the term horizons of the scheme's liability profile. Some physical risks are already starting to be felt by businesses and economies. Even if your scheme is not affected in the short term by physical risks from climate change, it may be affected by transition risks in the short term as government policies change in response to national net zero commitments, including a focus on accelerating the transition as part of Covid-19 recovery plans.

> "It's not only about the future, climate change is affecting asset prices today and we need to stay ahead of evolving regulation."
> **Nest** [6]

In your role as chair or trustee, it is important to consider how climate change interacts with fiduciary duty. Legal consensus now largely supports the position that consideration of ESG factors forms part of fiduciary duty.[7] This has moved a long way from the traditional view that ESG issues might undermine fiduciary duty.

What are the opportunities for pension schemes?

There will be multiple opportunities for pension schemes as the global economy transitions to net zero. Capital can be directed to new technologies, business models and asset classes.

The Environment Agency Pension Fund (EAPF) has created an 'Opportunity Fund' to invest directly in opportunities offering strong financial and sustainable credentials. This has enabled the EAPF to take on more calculated risks, with more doors being opened to newer asset classes and investments to fund climate solutions than perhaps the Fund would have previously seen.

The EAPF's pensions committee gets regular training on climate and ESG topics and exposure to a wide range of experts on this issue. With increased knowledge, the EAPF found it easier to set targets, be more ambitious with their goals and achieve a cultural and mindset shift, the impact of which is felt more widely across the Fund.

What is a net zero pension?

The Science Based Targets initiative (SBTi) defines what it means to reach net zero emissions for private sector organizations, "achieving a state in which the activities within the value chain of an organization result in no net impact on the climate from GHG emissions".[8] For pension schemes, this predominantly means the emissions emanating from your investments. These emissions are often known as portfolio emissions, and it is the management of these emissions that require a strategy to meet net zero.

Your ability to achieve a net zero aligned pension relies heavily on the ability of your underlying investee companies (and their industries and geographies) to reduce their emissions accordingly. As trustees, you have a significant role to play in stewarding underlying businesses to become climate resilient and to remain financially viable and investible in the future. Your ability to engage actively with your investee companies is a powerful lever to exert significant influence across the investment chain.

The SBTi advises a net zero transition pathway is just as important as the net zero outcome because it can be engineered to solve wider sustainability issues (such as reversing biodiversity loss or eradicating poverty). A transition pathway will also allow you to monitor progress and adjust your plans if need be. A well-planned net zero transition will not only help you check that you are on track to reduce risks to your scheme brought on by climate change, it also implies reduced GHG emissions while simultaneously addressing (or at least not compromising) wider sustainability goals.

At the top of the investment chain, asset owners such as pension schemes, are highly exposed to the risks of an unsustainable future. They are, however, also powerfully positioned to influence a more sustainable outcome, for example by:

- Recognizing and driving capital towards the best ideas and enterprises
- Being a catalyst for innovation, opportunity and dynamism
- Helping to finance the transition to a net zero and climate resilient global economy
- Leveraging influence down the investment chain, through to investee companies
- Directly influencing corporate behaviour to achieve climate targets

6. A4S and Nest, practical example – Delivering a net zero investment strategy
7. Law Commission, Fiduciary Duties of Investment Intermediaries
8. Science Based Targets initiative, Business Ambition for 1.5°C Commitment Letter

The regulatory landscape for net zero and climate change mitigation (as of June 2021)

Regulation to support net zero is becoming increasingly prevalent across multiple industries and jurisdictions. We have referenced the UK regulatory landscape below as an indicative example of how the global regulatory landscape will unfold over the next few years.

UK pension schemes
The UK was the first major economy to legislate for a net zero target. This has led to changes in regulations and policies affecting many different parts of the UK market. For pensions, section 124 of the Pension Schemes Act 2021 sets out requirements on climate change governance and reporting. This regulation lays the foundations for pension schemes actively to account for the risks and opportunities that climate change and the transition to a net zero economy will inevitably trigger. As trustees, you will be required to consider climate change in more depth than you have probably done to date. This will include:

- Assessing scheme resilience in different climate scenarios
- Identifying climate-related metrics such as your scheme's carbon footprint
- Setting climate-related targets
- Reporting on this to members and the regulator

An outline of the minimum requirements that a UK pension scheme must currently comply with, or needs to start processes in order to comply with near-term regulations, as set out in the UK Pension Schemes Act 2021, can be found here.

While there are no specific regulatory requirements around carbon or GHG neutrality or 'going net zero', pension schemes will, by virtue of their compliance with the regulations designed to manage climate risk, be driven to consider the GHG emissions of their investment portfolios and underlying investee companies.

Pension schemes in other jurisdictions
New Zealand has also taken increased steps to mandate the consideration of climate change in pension investments. It is possible that other jurisdictions will follow, in particular where the country has made a commitment to net zero. At present, this includes the following countries, most of which have committed to net zero by 2050:

- Legally binding: Denmark, France, Hungary, New Zealand, Sweden (2045)
- Under proposed legislation: Canada, Chile, EU, Fiji, South Korea and Spain
- In policy document: 20 countries including China (2060), Germany, Japan and South Africa[9]

Net zero pension initiatives

Trustees would be forgiven for not knowing which initiatives they should consult due to the high number of initiatives, collaborations, frameworks and proposed standards. Helpfully, the Principles for Responsible Investment (PRI) and the London Stock Exchange Group have published 'The investor guide to climate collaboration: from COP26 to net zero'. This is a comprehensive guide to the collaborative initiatives, frameworks and tools which "investors can use to structure action on climate change, and develop consensus on best practice".[10] It provides a review of the eight leading global investor initiatives, as well as an overview of the key frameworks and tools to address climate risk and support alignment with climate goals.

In addition, you may also wish to stay abreast of campaigns such as Make My Money Matter and Count Us In, which are engaging your members directly on sustainable pensions and net zero.

9. Energy & Climate Intelligence Unit, Net zero emissions race
10. Principles of Responsible Investment (PRI), The investor guide to climate collaboration: from COP26 to net zero

TOP TIPS FOR CHAIRS AND TRUSTEES ON ALIGNING TO A NET ZERO PATHWAY

1. **Define the business case and frame your approach**
2. **Identify and embed objectives and milestones into your established processes**
3. **Establish from the outset, methods to measure and report on your progress**
4. **Assess and secure your net zero 'enablers'**
5. **Engage, engage, engage**

TOP TIP ONE - DEFINE THE BUSINESS CASE AND FRAME YOUR APPROACH

Build your evidence base

Robust evidence supports plans for a net zero pathway. Sources could include research articles and reports, proprietary data or peer experience. For example, Nest spoke to large insurance companies, gaining insights around the pricing of climate risk, something that the insurance industry had been doing this for years.[11]

Translate evidence into your scheme's risk register

Climate change is likely to rank high on a scheme's risk register and should be part of a DB scheme's plans on integrated risk management. Your risk mitigation response will help frame your net zero investment transition. This also helps gain board consensus, as evidence-based risk analysis is difficult to challenge.

> "Documenting climate change into our risk register made things smoother from a member and sponsor engagement perspective. Addressing climate risk gives members better risk adjusted returns over time. Mitigating climate risk also protects members against transition risks."
>
> **Andrew Warwick-Thompson, Chair, Scottish Widows Master Trust.**

Leverage your sponsor's position

A pension scheme's alignment with its sponsor's own net zero ambition can be a key enabler of success, while recognizing you may have differing legal and financial duties. You can leverage sponsor resources to measure and monitor progress and create a joined-up approach to member/employee engagement. A4S's Top Tips for Sponsors of Pension Schemes provides additional advice for sponsors on engaging with their pension trustees and their members.

Collaborate across teams

Provide a dedicated space and time to develop and deliver net zero plans (eg create a working group comprising sustainability, risk and investment specialists from the scheme, its sponsor and external advisors).

Set out your intent

Be clear on goals and ambitions when communicating to key stakeholders. Your 'why' for net zero could be based on several motivations, so it might be useful to create a consistent narrative for trustees to use when communicating this intent, whether internally, with members or with media.

11. A4S and Nest, practical example – Delivering a net zero investment strategy

TOP TIP TWO - IDENTIFY AND EMBED OBJECTIVES AND MILESTONES INTO YOUR ESTABLISHED PROCESSES

Many schemes who have commenced their net zero journey perceive it as an evolution of their existing ESG practice (alongside emerging TCFD regulation). Net zero complements these existing initiatives by requiring your scheme to identify a realistic transition plan to net zero, with clear interim milestones that all stakeholders can understand and deliver on.

Review and, where necessary, update your investment beliefs

Your investment beliefs are a bridge between your high level net zero ambition and the practical decision making that will be required to achieve this goal. They should be reflective of the threat that climate change poses to your ability to deliver on your fiduciary duty.

> "Our first net zero step was to update our Investment Beliefs Statement. This statement provides a North Star against which trustees and their managers can appraise each and every investment decision, from both a traditional and net zero risk/return perspective."
>
> **Tegs Harding, Trustee, Atos UK Pension Scheme**

Be detailed, not vague

There is a growing trend to announce net zero 'target years' with a level of competitiveness. This means that sometimes the details of the net zero pathway take a backseat. Determining from the outset the path to GHG reduction, your approach to stewardship and more challenging, potentially controversial areas such as divestment and carbon offsetting, as well as which milestones need to be achieved by when to determine success, will enable a clearer understanding of your stakeholders' roles in achieving this goal. The IIGCC's Net Zero Investment Strategy outlines key areas to be addressed, such as: setting direction and portfolio structure, shifting alignment of assets and market engagement. For example, Nest sets out a net zero investment strategy that includes specific commitments within: asset allocation; fund manager selection and monitoring; and stewardship and public policy.

Agree scheme-specific objectives

Objectives should be reflective of the specific characteristics of the scheme (eg set up, size and jurisdiction). For example, owing to the prior winding down of the coal mining industry in the region, a key objective of South Yorkshire Pensions Authority's (SYPA) net zero ambition was to ensure support for any local industries and communities impacted by the global transition to a net zero economy. Therefore, the scheme requires investee companies to provide clear plans on how they will account for the communities who may experience impacts such as a loss of jobs.

The IIGCC urges transparency on the pathways and scenarios used as the basis for net zero objectives and target setting. Documenting assumptions and limitations and being clear on rationale for decision making is considered good practice in selecting scheme-specific objectives. This also provides a strong governance audit trail.

Consider aligning your default fund as a near-term action

Defined contribution (DC) schemes can find that focusing on the default fund can be an effective immediate step within their net zero strategy. After announcing their net zero ambition in 2020, Nest reallocated all of their developed market equity allocation in the default fund to climate-aware strategies (ie tilting towards companies mitigating and adapting to climate change). This represented £5.5 billion of members' money and 45% of their entire portfolio, therefore having an immediate effect on the default funds in which more than nine million of their members remain.

Make key decisions early

Tackling the 'elephants in the room' while establishing your approach means that you are able to focus quickly on delivering your net zero strategy. However, some decisions will be challenging to make, often impeded by a lack of substantial data or evidence, or considered controversial. Bringing in external experts and peers who have gone through similar decision-making processes, as well as setting aside enough time to debate with fellow trustees, will help you to come to a considered decision. This will likely include deciding on your approach to divestment and use (or not) of carbon offsetting. We have explored these debates in more detail at the end of this guide.

TOP TIP THREE - ESTABLISH FROM THE OUTSET, METHODS TO MEASURE AND REPORT ON YOUR PROGRESS

Use existing initiatives to help inform your strategy

Many industry-wide collaborative opportunities and frameworks exist, providing 'best practice' and advice. However, notwithstanding TCFD, none are yet established as the industry gold standard. It is therefore important to connect to many initiatives and industry groups, (see net zero pension initiatives section for further details), to provide you with opportunities to test different net zero approaches.

> "As an active member of the IIGCC, we found the new framework gave us the chance to test net zero strategies in our portfolios, as well as access to a large network of determined asset owners and managers."
>
> **Denise Le Gal, Chair, Brunel Pension Partnership**

Understanding around climate risk, net zero strategies and how to respond is developing constantly so having systems in place to stay up to date will help you to maintain a front-footed approach. For example, taking part in consultations, such as the current (at time of publication) public consultation by the TCFD on proposed guidances on climate-related metrics, targets and transition plans, and measuring portfolio alignment[12], will help you to stay in touch with the latest methodology while providing you with the opportunity to input into such developments.

Leverage peer experience

Sometimes the best first step is to reach out to peers who may have valuable experience to share, including lessons learnt, how to approach more challenging aspects and their own 'top tips'.

For example, an area which is often seen as daunting and a costly process is scenario analysis. The BBC Pension Trust saw the scenario analysis process as a critical first step in addressing the impact of climate change on their investment strategy, which in turn helped inform their approach to other areas such as governance and risk management. A key top tip from the scheme's trustees is to "simply get started on what you can. Don't get tied up in an overly complex analysis, and go from there. It's not only the data that comes out of scenario analysis that is useful. For us, much of the value comes from the discussions with trustees, consultants and asset managers that have been sparked by the annual scenario analysis process and its results."[13]

A4S's Asset Owners Network allows you to discuss with fellow chair trustees the steps they have taken, challenges faced and solutions used. A4S's bank of case studies provides examples of practical steps pension schemes have taken on net zero and other aspects of ESG integration.

Define what success looks like

It is important to document an agreed understanding of what success looks like to your scheme and its key stakeholders, including service providers. This would include measurable criteria to be tracked to monitor progress. In setting targets for asset class performance in reducing GHG emissions, Atos UK Pension Scheme trustees forecast that reduction performance was likely to be on a 'J curve' rather than linear improvement. Acknowledging and anticipating asset class-specific trends meant that target setting and monitoring could be designed accordingly and expectations could be managed better. The managers of Aviva's My Future DC default fund suggest it may be more appropriate to undertake annual reviews of climate performance over more regular reports to avoid the volatile nature of short-term tracked climate metrics.

> "Using the TCFD framework alongside IIGCC's Net Zero Investment Framework (NZIF) has worked well. The former provides guidance on targets and metrics, the latter provides practical guidance on how to meet those targets. The NZIF also breaks down different approaches to net zero transition by asset class, meaning you don't have to invent your own methodologies to do this."
>
> **George Graham, Director, South Yorkshire Pension Authority**

12. TCFD public consultation: June 7 – July 7 2021 https://www.fsb-tcfd.org/publications/
13. A4S and BBC Pension Trust, Practical Example – Our Approach to Scenario Analysis

TOP TIP FOUR – ASSESS AND SECURE YOUR NET ZERO 'ENABLERS'

Asset managers

It is important to establish early on whether managers can provide the necessary reporting data to set and monitor progress against your net zero strategy, as frequently as needed. It may also be helpful to set and agree climate-related objectives with them, as relevant to your scheme.

For example, when the in-house investment team of the Scottish Widows Master Trust (SWMT) sought new externally managed funds, it used three key criteria on which to base its selection of fund manager:

1. Manager's disclosure in line with the TCFD recommendations
2. Manager's own net zero alignment
3. Manager's signatory status of the UK Stewardship Code and relevant experience

The benefit of selecting fund managers who are reporting against the TCFD recommendations is consistency, making trustees' lives easier as they do not have to harmonize disparate data from multiple fund managers. Being a signatory of the UK Stewardship Code can be one indication that the manager has some baseline understanding of and commitment to investment stewardship, and this could be supplemented by understanding the strength of the manager's voting policies on climate and the percentage of shareholder resolutions supported on climate change. Selecting a manager that has its own net zero ambition will also put significant emphasis on stewardship activities.

Net zero climate scorecards

Tailored at an asset class level, this can be used as part of your mandate objectives with your asset managers. Metrics could include:

- Carbon footprinting
- Forward-looking climate metrics
- Stewardship and advocacy activities
- Internal climate change knowledge and training
- Exposure to transition investments, such as investments that provide low-carbon solutions

When undertaking annual manager performance reviews, the BT Pension Scheme uses a net zero scorecard to benchmark their asset managers against their expectations, and as a tool to ensure that the trustees and asset managers stay on target.

Investment consultants

Whether tendering for new providers or assessing existing ones, using specific criteria to compare investment consultants can help identify what attributes are the most important for you as you transition to a net zero pathway.

The Investment Consultants Sustainability Working Group's Guide for assessing climate competency of Investment Consultants sets out five themes against which trustees should expect their investment consultants to demonstrate climate competency, with examples of positive and best practice indicators included against each:

1. Firm-wide climate expertise and commitment
2. Individual consultant climate expertise
3. Tools and software, eg have a climate metrics database and use widely available methodology to asses client risk
4. Thought leadership and policy advocacy
5. Assessment of investment managers and engagement with them

In assessing their existing investment consultant's suitability to advise on Atos UK Pension Scheme's net zero pathway, the trustees cross-examined their consultant by challenging how they would assess investments across different asset classes, different methodologies and different GHG emission calculations. In response, the consultant provided examples of how this aggregation could be resolved, providing the trustees with confidence in their consultants's suitability to continue with them on their net zero journey.

The A4S Pension Scheme ESG Maturity Map provides recommendations to help you engage with your investment consultants and asset managers and align their activities with your net zero strategy.

Pooling partners

Schemes who use pooling partners may have limited scope and autonomy to make decisions without cross-scheme consensus. However, some have found ways to work with their pooling partners on their own net zero ambition. South Yorkshire Pensions Authority (SYPA) is part of a pool of 11 local government funds and led a campaign to drive net zero consensus across the pool in 2019. The pool members voted against formal net zero alignment. In late 2020, SYPA continued with its own plans and set its own scheme target to achieve net zero emissions by 2030. It also continued direct conversations with their pooling partner – Border to Coast – and other schemes from other pools which helped to build the evidence base. Since then, Border to Coast has started the process of formalizing their own net zero commitment, including changes to their equity fund management to reflect this.

TOP TIP FIVE – ENGAGE, ENGAGE AND ENGAGE

Be an active shareholder

Engage the companies you are invested in, using your influence to bring about real change.

The Church of England Pension Scheme engages companies through a combination of face-to-face meetings and written communications. Being transparent around expectations enables a relationship built on trust to be developed with management. A timescale for action is set and an escalation process is in place for when concerns are not adequately addressed. Divestment is a final resort. Collaborating with other asset owners through participation in global engagement initiatives like Climate Action 100+ means your voice can be amplified, leveraging many times over your assets under management.

In engaging its investee companies on net zero transition plans, Alecta uses climate stress testing on its current portfolio against a 1.5°C warming scenario. It then acts to understand a company's net zero potential and support its path to reach that target. The trustees ensure the company has a credible plan, clear milestones (which are being met) and engaged leadership. They use climate stress testing as a framework to monitor progress.

Talking openly about experiences as an active shareholder can encourage and provide confidence for peers to take a similar approach. The A4S Pension Scheme ESG Maturity Map provides recommendations on what best practice investment stewardship looks like for trustees.

Speak to your members

Communicating with your members about your net zero transition is increasingly crucial, and a two-way dialogue with your members is also a way to develop stronger engagement.

Engaging members on climate change is not always a simple exercise and you may take a different approach to other schemes in relation to how and when to communicate, depending on your members. Some tried-and-tested approaches include using digital communications, using relatable language, planning for responses, bringing members' money alive with case studies and using communication experts, where appropriate.

Member engagement can help you to:

- Understand member views and preferences, which can help inform your investment and stewardship strategies
- Prioritize where and how to deploy communications
- Support engagement with investee companies, demonstrating member views in company AGM voting

"Deciding to embark on a net zero pathway was influenced by several factors. Member desire for their pension to have a net zero target was extremely high and this helped motivate us to undertake a detailed analysis of the financial and legal implications of such a decision. The results of which provided us with a strong case to commit to a net zero target of 2045, which we announced early 2021."

Robert Gould, Chair, Environment Agency Pension Fund

"Rolling out a digital app for members will provide us with a new level of granularity and coverage in respect of their views across several topics, including ESG. We hope these member views will support trustee decision making in the future, as we gain insight into what our members really want."

Andrew Warwick-Thompson, Chair, Scottish Widows Master Trust

ADDITIONAL INFORMATION

- **Using the Institutional Investors Group on Climate Change's (IIGCC's) Net Zero Investment Framework (NZIF)**
- **The debate over divestment**
- **Carbon offsetting**
- **The A4S ESG Toolkit for Pension Chairs and Trustees**

USING THE INSTITUTIONAL INVESTORS GROUP ON CLIMATE CHANGE'S (IIGCC'S) NET ZERO INVESTMENT FRAMEWORK (NZIF)

by Denise Le Gal, Chair, Brunel Pension Partnership

The Paris Agreement set the targets and tone for global action on climate change mitigation, but it did not stipulate practical steps for asset owners or investment managers to take. The IIGCC has addressed this by providing an achievable and common framework for European-based investors to both understand and use.[14]

With IIGCC members currently representing more than US$39 trillion in assets, it is a group that could enable systemic change. Brunel Pension Partnership shares the IIGCC's urgent desire to see this framework come to life, which is why we collaborated with them by providing test data, to help develop and launch the framework.

Testing five of our investment funds (worth a combined £1.3 trillion) brought to life our level of current net zero alignment. We also discovered that net zero alignment actually offered significant benefits over a business-as-usual approach to investment. The obvious examples here are lower exposure to carbon-related risk and benefiting from the inevitable transition to a net zero economy by being ahead of the investment curve.

The NZIF's implementation guide is being delivered by four investor networks (IIGCC in Europe, Ceres in North America, the Investor Group on Climate Change in Australia and the Asia Investment Group on Climate Change in Asia). Therefore, the pursuit for a globally aligned solution is embedded into the IIGCC's approach. Additionally, the IIGCC is working with the Net Zero Asset Owner Alliance, with further alignment on net zero plans in the pipeline.

Pension schemes choosing to adopt the NZIF are putting their head above the parapet. The framework makes it possible to score performance against peers in a way we have never been able to do before. This means that asset owners and investment managers who have not signed up will increasingly stand out.

14. IIGCC, Net Zero Investment Framework 1.5°C Implementation Guide

THE DEBATE OVER DIVESTMENT

Decarbonizing investment portfolios to achieve net zero GHG emissions by 2050 is a complicated and multifaceted challenge.

Divesting from carbon intensive investments may seem like the quickest route to achieving a net zero investment portfolio, but how effective is it?

Divestment raises the cost of capital for the investee company and reduces their ability to expand fossil fuel extraction projects, for example. Large divestments also increase the perceived risk of stock in the market, which can further increase the cost of capital. For divestment to have necessary impact, academics have identified that a critical mass of eight per cent of investors can create a tipping point to impact significantly the cost of capital.[15]

However, large waves of divestment could also present a risk to meeting global net zero targets. On selling the investment, it may be purchased by another asset owner who does not have the same investor influence or high standards of governance or ambition to achieve net zero as the present asset owner. While divestment can help your scheme to meet its net zero commitment, it could defeat the global objective of meeting net zero. Additionally, increasing cost of capital through divestment can make it difficult for fossil fuel companies to raise the capital required to transition to low carbon energy sources. Essentially, this is a strategic decision and warrants thorough research. The Bank of England's discussion paper, 'Options for greening the Bank of England's Corporate Bond Purchase Scheme'[16] provides a good framing of the options for investors around divestment and engagement, with illustrative examples of different divestment/stewardship outcomes.

The rapidly changing context is affecting the divestment debate constantly. As an example, two significant developments in May 2021, just before publishing this guide – the International Energy Agency (IEA) stating that "all investments in new oil and natural gas projects must stop from today in order for the global energy industry to achieve net zero carbon emissions by 2050,"[17] and the Dutch court ruling on Royal Dutch Shell to reduce its net carbon emissions by 45% by 2030 compared to 2019 levels[18] – have both underscored the potential 'stranded' nature of fossil fuel assets.

Some pension schemes are taking a more nuanced approach to developing a fossil fuel divestment strategy. For example, their stewardship policy will consider divesting when their engagement is unsuccessful, or where they consider a company to be progressing insufficiently or too slowly towards net zero alignment. This will take place after several escalation options have been explored, such as engaging collectively with other investors, voting against management or speaking up at annual general meetings (AGMs).

A challenge arises for schemes using pooled funds, given trustees have less discretion over divestment – instead they would need to invest in screened, low carbon or fossil fuel free funds. To help pooled schemes influence investee companies, a number have committed to net zero climate engagement through the Climate Action 100+ initiative. Asset owners who cannot directly engage have signed up as supporters and collaborate with pooling partners and asset managers to take collective action on net zero.

15. Toulouse School of Economics, The "Washing Machine": Investment Strategies and Corporate Behaviour with Socially Responsible Investors
16. Bank of England, Options for greening the Bank of England's Corporate Bond Purchase Scheme
17. International Energy Agency, Net Zero by 2025: A Roadmap for the Global Energy Sector
18. BBC, 'Shell: Netherlands court orders oil giant to cut emissions' (2021)

CARBON OFFSETTING

Carbon offsetting comes with a number of considerations. The debate on the ethics of carbon offsetting is complex and ranges across scientific, economic, political and philosophical dimensions. An argument against offsetting emphasizes that by doing so, the consumer is discharging their duty to mitigate their carbon emissions. There are also practical challenges, such as the ability to calculate accurately how much CO_2 is absorbed by young trees etc. Indeed, conscious of this, some regulators are leaning towards a requirement for reporting of real versus offset emissions. However, pension schemes are limited in their choice of mechanisms through which to reduce emissions, given the majority of their carbon footprint is derived from portfolio emissions, and appropriate offsetting can help channel much-needed finance into emissions reductions and removals.

The SBTi has recently supported carbon offsetting as a method to compensate or neutralize emissions during the transition to net zero and to maintain net zero where residual emissions exist at the transition end point. However, the SBTi emphasizes that carbon offsetting does not replace the need to reduce emissions in line with scientific recommendations. The Voluntary Carbon Markets Integrity Initiative is currently undertaking a consultative process to set out guidance on the appropriate use of offsetting in decarbonization strategies, and claims associated with these transactions. Future action should be informed by the outcomes of that process.

When selecting a method of carbon offsetting, there are many options available, and quality and effectiveness should be front of mind. The SBTi encourages wider sustainability considerations when approaching net zero, selecting carbon offset projects that are attentive to biodiversity and societal concerns (such as habitat restoration and renewable energy projects). A thorough due diligence exercise is always advised to understand the direct and indirect impacts of offset projects.

The SBTi emphasizes that carbon offsetting does not replace the need to reduce emissions in line with scientific recommendations.

THE A4S ESG TOOLKIT FOR PENSION CHAIRS AND TRUSTEES

A4S's ESG toolkit for Pension Chairs and Trustees contains resources designed specifically for pension scheme trustees. It contains:

1. **An ESG maturity map** with suggested steps that schemes can take to progress on their ESG integration journey

2. **Practical examples** of pension schemes to bring 'what good looks like' to life

3. **Guidance material** to highlight the practical steps, eg embedding ESG factors into different asset classes

You can use this toolkit as you develop your net zero plans, notably by:

- Workshopping the ESG maturity map with your Board (and consultants/fund managers). This process will help drive consensus on where you and your fellow trustees believe the scheme is on your ESG intergration journey. To achieve a net zero aligned pension scheme, the different elements within the ESG maturity map should be considered.

- Referring to the bank of case studies of pensions schemes – large and small – that have addressed different elements of a net zero transition plan, including the investment decisions and processes, stewardship, engaging asset managers, scenario analysis and target setting.

- Using the individual guidance materials to initiate deeper discussions with your executive office and consultants / fund managers.

- Refer to the third party resources listed to gain further insights into specific elements or to signpost your investment teams towards.

Explore the ESG toolkit for Pension Chairs and Trustees on our website.

ABOUT A4S

Our vision is a future where sustainable business is business as usual.

HRH The Prince of Wales established A4S in 2004 to work with the finance and accounting community to:

- Inspire finance leaders to adopt sustainable and resilient business models
- Transform financial decision making to reflect the opportunities and risks posed by the climate crisis and other environmental and social issues
- Scale up action to transition to a sustainable economy

A4S has three global networks:

- Chief Financial Officers (CFO) Leadership Network – CFOs from leading organizations seeking to transform finance and accounting
- Accounting Bodies Network (ABN) – members comprise approximately two-thirds of the world's accountants
- Asset Owners Network – pension fund chairs who integrate sustainability into investment decision making

A4S ASSET OWNERS NETWORK

The A4S Asset Owners Network is a grouping of pension fund chairs and trustees to discuss integrating sustainability into investment decision making. Click here to find out more.

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