Contract-based pensions and climate risk: Report and recommendations to the Financial Conduct Authority
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1 Introduction

1.1. This report is submitted by ClientEarth¹ and ShareAction². It concerns the risks posed to the financial system and, in particular, members of contract-based pension schemes (“Customers”), by climate change (“climate risk”).

1.2. ClientEarth and ShareAction have serious concerns that, because of a lack of detailed FCA guidance, providers of contract-based pension schemes (“Providers”) are not taking sufficient action to assess and manage climate risk and that, as a result, Customers whose savings they manage could face significant losses over the medium to long-term.

1.3. These concerns have been borne out by an evidence-gathering exercise seeking the views of 12 Providers³ with a total of more than 11 million workplace pension scheme members. We have also confirmed, as part of a review of the 2017 annual reports by independent governance committees (“IGCs”), that the majority of IGCs have not reported on any work being undertaken to manage the potential impact of climate risk on Customers’ investments.

1.4. The FCA should take urgent action to assess climate risk and issue guidance to the firms it regulates to ensure that Providers consider and, if necessary, take steps to manage climate risk and ensure the suitability of pension investment products. This should include the default funds in which some 90% of defined contribution pension savers’ investments are held. The FCA should also require IGCs to report on Providers’ policies on climate risk, in line with the Law Commission’s recommendations.

1.5. Providing clearer climate risk guidance to Providers would assist materially in ensuring better protection for Customers. Given the quantum of pension assets being invested, this would also assist the FCA with fulfilling its statutory duty to ensure the integrity and stability of financial markets as the UK seeks to transition to a lower carbon economy.

1.6. The FCA should demonstrate that it is taking the risks to the financial system posed by climate change seriously for the following reasons:

1.6.1. **Alignment with FCA objectives.** Since climate change poses risks to consumers and markets, integrating climate risk into the FCA’s supervisory approach maps with its statutory duties across both its strategic and operational objectives. In particular:

   a. **Addressing risks to consumers.** In determining whether consumers have access to appropriate levels of protection, the FCA must have regard to the differing degrees of risk involved in different types of investment, and the

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¹ ClientEarth is a non-profit environmental law organisation working to create pragmatic solutions to key environmental challenges such as climate change. It is a company limited by guarantee, registered in England and Wales, company number 02863827, registered charity number 1053988, registered office 10 Queen Street Place, London EC4R 1BE. ClientEarth also has a registered branch in Belgium, N° d’entreprise 0894.251.512, and with a registered foundation in Poland, Fundacja ClientEarth Poland, KRS 0000364218.

² Fairshare Educational Foundation (t/a ShareAction) is a charity that promotes Responsible Investment practices by institutional investors. Fairshare Educational Foundation is a company limited by guarantee, registered in England and Wales, company number 5013662, registered charity number 1117244, registered office 16 Crucifix Lane, London, SE1 3JW.

³ The 12 Providers contacted in this report are listed in the Appendix.
needs that Customers, as consumers, may have for the timely provision of information and advice that is accurate and fit for purpose. As a result of auto-enrolment legislation, increasing numbers of UK consumers have retirement savings held in contract-based pension arrangements. However, these consumers do not have the right to choose their own workplace pension product and require a higher degree of protection as they are often not well equipped to represent their own interests in a complex market, as the OFT found in its review of the market in 2013.⁴

b. **Addressing risks to markets.** The FCA must seek to ensure the integrity of the UK financial system, including its soundness, stability and resilience. There is substantial evidence that climate change is likely to have a significant effect on financial markets. This is not only a future risk but a current one, with as yet unrealised risks having the potential to cause short term economic shocks that will be relevant to all investors.

1.6.2. **Equivalence and maintaining competitiveness with EU.** The European Commission is looking at incorporating environment, social and governance ("ESG") factors into the mandate of supervisory authorities, to enable them to monitor how financial institutions identify, report, and address ESG risks. It will be important for the UK to have equivalence on this issue to ensure that London remains competitive as a leading financial centre.

1.6.3. **Global initiatives on climate-related financial reporting.** The Financial Stability Board’s Taskforce on Climate-related Financial Disclosures (“TCFD”) has published its recommendations for effective reporting on climate risks. The TCFD recommendations have been widely supported internationally, including by 6 of the Providers (or their corporate groups) contacted as part of this report. Use of the TCFD recommendations is expected to become the benchmark for investors required to comply with the disclosure requirements of France’s 2016 Energy Transition for Green Growth Law (Article 173). Calls for implementation of the recommendations in national reporting frameworks are growing – as evidenced most recently by the final report from the European Commission appointed High Level Expert Group on Sustainable Finance ("HLEG").

1.6.4. **Parity between FCA and TPR.** A coordinated and consistent approach to climate risk should apply to pension savings regardless of whether the pension is trust-based or contract-based. The Pensions Regulator (“TPR”) has already issued guidance on financial and non-financial ESG factors for trust-based pension schemes, confirming that trustees should take into account financially material ESG factors (climate change being an example highlighted in the guidance). Members of contract-based pension schemes deserve parity. As part of the pensions regulatory strategy recently announced by the FCA and TPR, the FCA should champion a coordinated approach that seeks to ensure that all pension savers receive the

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same information and protections with regards to the risks that climate change may pose to their retirement savings.\(^5\)

1.6.5. **Law Commission recommendations.** The Law Commission has recommended that the FCA issues guidance to Providers in line with TPR guidance, and that it amends its rules to require IGCs to report on ESG factors and stewardship.\(^6\)

1.6.6. **Pension providers want guidance.** Many of the pension providers we spoke to said that they would welcome additional guidance from the FCA on how to manage climate risk and two of the Providers have formally confirmed this by endorsing our request for additional guidance.

1.7. If the FCA does not act on this issue it risks failing to meet its own duties to protect consumers and the integrity of the UK financial system, as well as falling behind other regulators both in the UK and abroad.

### 2 What is climate risk?

2.1. Climate change poses potentially significant financial risks to the global economy, including to Providers and their Customers. The Bank of England has divided these risks into two broad categories: physical risks and transition risks.

2.2. **Physical risks** arise from the direct physical impacts of climate change. These may be driven by specific events, including increased severity of extreme weather events, or by longer-term shifts in climate patterns, including sea level rise or chronic heat waves. The financial impacts of these risks could include losses from damage to assets and supply chain disruption; reductions or disruption to production capacity; increased operating and input costs; and increased insurance premiums.

2.3. **Transition risks** arise from the transition to a low-carbon economy. Extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change are well underway. They are already having financial impacts. Policy changes and new regulation are driving write-offs and balance sheet impairments; disruptive technology is creating new competitive pressures; and consumer demand for low-carbon and sustainable products is shifting markets.

2.4. These risks have the potential to wipe considerable value from investment portfolios if they are not adequately mitigated against. All UN member states have committed to the 2015 Paris Agreement, binding them to keeping global temperature increases to below 2°C above pre-industrial levels, with the aim of limiting increases to 1.5°C.\(^7\) The Cambridge Institute of Sustainability Leadership has predicted that a 2°C temperature increase will result in global GDP increasing by 4.5% between 2015 and 2050, while in circumstances

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6 [https://www.lawcom.gov.uk/project/pension-funds-and-social-investment/](https://www.lawcom.gov.uk/project/pension-funds-and-social-investment/)
where no significant actions are taken to mitigate the effects of climate change, global GDP will decrease by 16% over the same period.\(^8\)

3 Why is climate risk relevant to contract-based pension schemes?

3.1. Climate risk is relevant to all investors. It is a particular risk to pension schemes given the long-term investment horizons of most pension members.

3.2. Russell Picot, special adviser to the TCFD, noted recently that “climate risk is present in every investment portfolio [he] can think of”.\(^9\) The HLEG final report stated that pension funds’ long-term investment policies make their assets potentially more exposed to long-term risks compared with other institutions.\(^10\) TPR guidance published in 2016 agrees that the financial impacts of climate risk could be significant for pension schemes:

“... most investments in DC schemes are long-term and are therefore exposed to the longer-term financial risks. These potentially include risks relating to factors such as climate change... These risks could be financially significant, both over the short and longer-term.”\(^11\)

3.3. There are clear parallels between the duties of Providers under the FCA Handbook (for example, the Principles for Business (PRIN) and Conduct of Business Sourcebook (COBS) rules) and those of trustees of trust-based pension schemes. This is confirmed by a joint statement made by TPR and the FCA which stated that "The FCA expects pension providers to ensure that customers are treated fairly [Principle 6] in the same way that the Pensions Regulator expects trustees to act in the best interests of their scheme members".\(^12\)

3.4. This parity was also reinforced by the FCA when it stated, ahead of the introduction of IGCs, that it believes “existing FCA rules and principles provide fiduciary-like protections” for members of contract-based schemes and that it was “confident that IGCs will be able to act independently and effectively in the interests of scheme members”.\(^13\)

3.5. The duty of pension trustees to act in the best interests of their members in the context of climate risk was the subject of a legal opinion given by Keith Bryant QC and James Rickards in November 2016. According to Mr Bryant QC and Mr Rickards:

“Any factor that is financially material can and must be taken into account, whether or not it would ordinarily be described as an ESG factor ... if the risks associated with climate change are financially material to a particular investment decision then it is clear, we think,

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\(^8\) https://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/unhedgeable-risk
\(^12\) https://www.fca.org.uk/publication/finalised-guidance/workplace-defined-contribution-pensions-guide.pdf
\(^13\) https://www.fca.org.uk/publication/policy/ps15-03.pdf
3.6. The Law Commission’s 2014 guidance\textsuperscript{15} makes it clear that trustees should take into account any factor which is financially material when investing beneficiaries’ savings. Climate risk will almost certainly be a financially material factor for most investment portfolios and should therefore be considered by Providers when making investments on behalf of Customers.

3.7. There is no reason why pension members whose pension arrangements are overseen by the FCA are not exposed to the same risks as those pension members whose arrangements are overseen by TPR. Climate change is recognised by TPR as a risk to pension scheme members; the same risk should also be recognised by the FCA. Parity of regulation is an important principle recognised by regulators generally and this parity should extend to climate risk.

3.8. Providers have been slow to accept that their duties to Customers to manage risk and return extend to a consideration of climate risk. Our experience of engaging with Providers indicates that this may be for a number of reasons, including:

3.8.1. a misconception of climate change and environmental factors as merely ethical or non-financial in nature (i.e. not to be considered as part of a scheme’s investment strategy for their default funds, but possibly to be addressed by offering some form of alternative fund choice);

3.8.2. a tendency towards short-termism in UK capital markets (recognised by the Kay Review in 2012);\textsuperscript{16}

3.8.3. concern that additional costs of reflecting climate risk could reduce investors’ net returns; and

3.8.4. lack of demand from clients (i.e. Customers’ employers) for new climate-tilted products.

3.9. There are similar issues across Europe: responses received to the European Commission’s 2016 public consultation on long-term and sustainable investment\textsuperscript{17} emphasised that:

3.9.1. When investment decisions are made in a short time frame, investors do not consider the majority of ESG issues to be financially material.

\textsuperscript{15} http://content.tfl.gov.uk/law-commission-guidance.pdf
\textsuperscript{17} http://ec.europa.eu/information_society/newsroom/image/document/2016-44/feedback_final_pc_30068_en_19173.pdf
3.9.2. Internal governance arrangements of institutional investors should be better aligned with the interests of beneficiaries and thus contribute to an increased focus on long-term risks and opportunities.

4 The FCA’s current approach to climate risk

4.1. The FCA’s operational objectives are to secure an appropriate degree of protection for consumers (which includes Customers); to protect and enhance the integrity of the UK financial system; and to promote effective competition in the interests of consumers. We are aware that the FCA takes a risk-based approach to fulfilling these objectives: in particular, it identifies and assesses risks to consumers, firms and the financial markets, and makes evidence-based policies to help change behaviour. The FCA has recognised in its 2017/2018 business plan that climate change could pose a threat to its ability to meet its objectives. In particular, the business plan refers to the financial implications of extreme weather events for the insurance industry. Given the FCA’s awareness of this aspect of climate risk, we would be interested in understanding what steps the FCA has taken to assess climate risk more generally and whether the FCA has investigated the possible impacts of climate risk on other financial sectors.

4.2. The FCA stated in the government’s interim response to the Law Commission’s 2017 recommendations on social pensions that it “agrees with the Law Commission that it is important to evaluate long term risks to an investment that is to be held for the long term, in particular when making investment decisions for default investment strategies and in the selection of ‘chosen funds’ offered to members of defined contribution workplace pension schemes.”

4.3. However, in April 2017, when ClientEarth wrote to the FCA setting out the importance of regulator intervention in relation to climate risk and contract-based pensions, the FCA responded that “it is not clear to us that there is a need to provide more specific guidance on climate change, or the impact it may have on longer term investment performance, to the firms we regulate”. In this context, it suggested that TPR’s guidance to trustees to consider longer-term financial risks such as climate change “reflects the specific role that trustees perform in relation to trust-based pensions”.

4.4. We disagree that TPR was addressing a point specific to trust-based pensions. The guidance from TPR was developed to address a failure on the part of many trustees, highlighted by the Law Commission, to understand that ESG factors, including climate risk, can be financially material. The guidance was therefore necessary to correct the misunderstanding that climate risk is an ethical issue and not a potentially material financial risk. Our work shows that this misunderstanding is not limited to those working in the trust-based pensions sector but repeated across other financial sectors, encompassing many of the firms and markets regulated by the FCA.

4.5. In the same response to ClientEarth, the FCA referred to its 2013 guidance on the Responsibilities of Providers and Distributors for the Fair Treatment of Customers ("RPPD") as placing an expectation on firms to consider climate risk. While the RPPD reiterates some of the FCA's mandatory requirements to consider risks and communicate with customers, it makes no reference to the need to consider specific risks, including climate risk, and therefore does not provide sufficient information or assistance to firms on how they should be approaching climate risk. In fact, this response merely serves to support our view that the FCA is not taking appropriate action to communicate with Providers on the need to consider climate risk. If the FCA's position is indeed that firms "should, where appropriate, take climate change into consideration", as set out in its written response, then it has a duty to make this expectation clear to firms, including Providers.

4.6. We are aware that 'climate change and sustainability' was one of eight themes discussed in the context of future risks to the financial services industry at the FCA's Future Horizons Conference in 2017. The Future Horizons report published after the event makes the following observation:

"It was noted at the conference that climate change is currently not a high priority for some in finance, largely because its impact lies beyond the current business and political cycle. In fifteen years, it may no longer be possible to ignore it. Policy makers may need to understand the implications and ensure that the transition to a low-carbon and resilient economy is as orderly, timely and efficient as possible. They may also have to recognise the indirect impacts, such as parts of the world being uninsurable."

4.7. The Future Horizons report also refers to an expert paper commissioned by the FCA. The paper, authored by Nick Robins from the UN Environment Programme, highlights two false assumptions that may hinder appropriate responses to climate risk. The first is that disruption caused by climate change is 'distant in time' and the second is that climate change 'has limited implications for financial authorities'. The expert paper makes clear that:

4.7.1. Asset prices are already being influenced by climate risk and could shift further in the near future (challenging the assumption that the transition to a zero-carbon, resilient future is distant in time and marginal in impact to the financial system).

4.7.2. Financial policymakers are starting to work through the implications of climate change for their core prudential and market development goals – and this trend is set to become the norm (challenging the assumption that there is a limited role for action in the financial system, and that reforms in the real economy are sufficient to ensure an orderly transition).

4.8. We feel that there is a clear disconnect between (i) the FCA's acknowledgement of the potential financial risks of climate change, (ii) the FCA's position that Providers have 'fiduciary-like' responsibilities towards investors, and (iii) the FCA's failure to provide guidance to Providers on how they should account for climate risk. The FCA should clarify its position with regards to climate risk and provide clear guidance to firms on how this risk should be considered and communicated to Customers, for example through IGC reports.
4.9. One way that the FCA could begin to do this is through use of the Adaptation Reporting Power ("ARP"). The ARP is a process for organisations to report on the progress they are making in adapting to climate change. It was established by the Climate Change Act 2008 and operates on a five yearly cycle. Two rounds of ARP reporting have taken place to date and the next round of reporting under the ARP will take place from 2018. Under the ARP, reporting authorities prepare an assessment of the impact of climate change on the organisation’s functions and its proposals and policies for adapting. The ARP could be a key tool to enable the FCA to fully assess the impact of climate change on its organisation and the firms it regulates.

4.10. There is precedent for financial sector reporting under the ARP; in 2015, as part of the second round of reporting, the PRA prepared a report into the impact of climate change on the UK insurance sector. Preparing an adaptation report would provide a framework for the FCA to engage with stakeholders on climate change risk assessment, and review the resilience of the firms it regulates to climate change. While it is Defra that has the power to require reporting authorities to prepare a report, the FCA could begin preparations for reporting under the ARP by opening dialogue with the Bank of England team responsible for the PRA report or even by engaging directly with Defra to express its interest in adaptation reporting.

5 Our findings - Provider practice on climate risk

5.1. It is clear from our work that Providers are not considering climate risk to the necessary extent (if at all) in their management of pension assets and the pension products they are offering. This raises serious and broader concerns about the way in which Providers deal with emerging risks within the financial markets. The FCA’s approach of expecting firms to take climate risk into consideration as a result of general, non-specific guidance is not working. It is therefore our view that the FCA needs to act to address a potential blind-spot in how Providers manage risk.

5.2. This lack of action on climate risk should be a key concern for the FCA, which has responsibility for securing “an appropriate degree of protection” for over 4.8 million active Customers through its oversight of contract-based DC pensions.\(^2\) The importance of Providers’ duties to manage risks, including climate risk, and to ensure the suitability of investment products is particularly marked given that some 90% of DC savers invest through their pension scheme’s default fund (which has been chosen for them) and therefore do not have (or have not exercised) the option to take a more active approach to managing climate risk.\(^2\)

6 Our findings - Correspondence with Providers

6.1. In 2017, ClientEarth sent letters to 12 Providers. The Providers were chosen as a cross-section of the UK contract-based pension provider market and include many of the market leaders. Copies of the letters were also sent to those Providers’ IGCs. In these letters, we described the financial risks and opportunities associated with climate change, and asked

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\(^2\) http://www.plsa.co.uk/PolicyandResearch/Research/Annual-Survey.aspx
a number of questions about how each Provider was managing climate risk on behalf of Customers.

6.2. We received substantive written responses from six Providers (Aegon, Aviva, Legal & General, Scottish Widows, Standard Life and Zurich), and had meetings with four of these Providers (Aviva, Legal & General, Standard Life and Zurich). We had a meeting with a further Provider (Virgin Money) and discussed the questions contained in our letter in person.

6.3. We received a short response from Prudential, which did not address any of our questions but referred us to the website of M&G, as the investment arm of Prudential Group, which manages a significant proportion of the investments of Prudential’s Customers. This response highlighted a further issue that some Providers consider delegation of day-to-day investment decisions to entail a corresponding delegation of their responsibility to manage risk at a strategic level.

6.4. We received no response from Fidelity, Old Mutual, Royal London or Phoenix Life.

6.5. In particular, we asked Providers the following questions in relation to their contract-based schemes:

a. Whether they had undertaken a strategic review of investments through a climate change lens, including integrating climate change into its investment beliefs and policies.

Although the Providers from whom we received substantive responses accepted that climate change is a key issue affecting the companies they invest in, climate change has not generally been reflected in the investment beliefs and policies relevant to their pensions business due to, in summary, continuing uncertainty on the energy transition, inconsistent reporting and concerns over data.

One Provider had conducted an analysis of investment risks related to climate change and drawn the conclusion that “climate change will have a financial impact over the long term on the companies that we invest in. However, due to significant uncertainty on what actions will be taken by government to combat climate change and how the energy transition will occur, as well as a lack of data and reporting standards, our ability to manage climate investment risk is limited.” (Aegon)

One Provider, however, said that “as a major global investor it has a fundamental interest in ensuring that shareholder value is not eroded by a company’s failure to manage its impact on its natural and social environment. It has policies on ESG issues (including a standalone policy on climate change) and seeks to identify social, governance and environmental risks (including climate change) that can affect the company’s valuation. [The Provider] then works with [investee companies] to ensure they build a more sustainable model which will be of longer term benefit to all shareholders “ (Legal & General)
b. **Whether they had a policy with set targets, timelines and monitoring which addressed the investment risks and opportunities associated with climate change.**

Amongst the Providers with whom we met and/or who responded substantively to us there was a clear lack of climate change policies which could be monitored or evaluated for success. There was just one Provider who had integrated clear timelines and targets into their engagement strategy and quantitatively monitored progress through a proprietary scoring tool - companies that did not meet minimum expectations were divested and, in funds that cannot divest, a vote was cast against the chairman.

One Provider stated it had targets in place but these were limited to real estate investments (i.e. 10% reduction in global like-for-like energy consumption over five years from a 2011/12 baseline). (Standard Life)

The Provider with a clear policy stated it “has publicly committed through its “Climate Impact Pledge” to addressing climate change by engaging with the largest companies in the world who hold the key to meeting the Paris target. Through the pledge [the Provider] has identified six sectors exposed to climate change and/or have a key role to play in the transition to a low carbon economy. [The Provider] then rigorously measures how the largest companies in those sectors are transitioning to a low carbon economy through the use of score cards, encouraging them to improve their rank and will consider disinvestment or voting against the reappointment of the chairman where the company has not improved its response to climate change.” (Legal & General)

c. **Whether they had measured the exposure to climate change risks and opportunities of the funds, including default funds, they offered to Customers.**

Responses to this question were wide-ranging and some Providers (such as Virgin Money) highlighted that the cost of retail funds was often prioritised over other factors. Some Providers indicated that they are simply waiting for the constituency of relevant indexes to change over time to include more companies in low-carbon sectors. Other Providers are waiting for clearly defined standards of reporting. Some are beginning to look at climate change risks for the funds they offer to Customers.

One Provider stated this is something they are considering “as part of the wider piece of work underway”. (Standard Life)

Another Provider acknowledged that a substantial proportion of their default funds are invested in passive index trackers and that this presented a challenge for addressing climate risk. (Zurich)

According to another Provider, the index purchased via passive funds will, “by default ... raise the allocation of companies not exposed to climate risk, as their weighting in the index naturally rises”. (Aegon)

Another Provider said “this is an area in which the industry has yet to define common standards for reporting”. (Scottish Widows)
d. Whether they had set themselves targets to reduce the carbon intensity of existing assets and increase exposure to the low-carbon economy.

Only one of the Providers that we received substantive responses from and/or met with responded to this question in the affirmative but even then the targets did not currently apply to assets of Customers invested in their default funds.

The Provider commented that “the most impactful way to reduce carbon intensity is through the choice of assets in the fund and that its “climate-tilted” fund…provides reduced exposure to the risks associated with the transition to the low carbon economy whilst increasing exposure to the opportunities that arise. Additionally [the Provider’s] “Climate Impact Pledge” will impact the fund assets over time.” (Legal & General)

e. Whether the Providers’ funds, including default funds, offered climate protection (that is to say addressed the investment risks associated with climate change by decreasing exposure to high carbon companies that are not transitioning their business models to a low-carbon economy and increasing exposure to companies that are likely to benefit from that transition).

Only one of the Providers that we received substantive responses from and/or met with responded to this question in the affirmative but even then the climate protection did not apply to the default funds available to Customers.

According to one Provider, this “would add cost to our default funds and reduce investors’ net returns. However, [the Provider’s] default funds are resilient to climate change to the extent that companies at risk of climate change may well see their weightings decline over time, while the weightings of new industries reflecting climate opportunity increase their size, profitability and market capitalisation”. (Aegon)

Another Provider said that the approach adopted so far “has been one of engagement with companies for whom climate change represents a significant risk rather than decreasing exposure in the first instance - unless they believe there is likely to be a material financial impact in the foreseeable future, in which case they would take action to protect the interests of investors”. (Standard Life)

Another Provider said that their default funds were “entirely index-driven” explaining that this didn’t currently provide scope to offer climate protection and that ethical funds currently available are usually more expensive compared to a traditional market-capitalisation weighted index-tracker leading to a “potential drag on returns for customers”. (Aviva)

Just one Provider told us about “a specific “climate-tilted fund”…which explicitly incorporates ESG considerations into the fund strategy.” The Provider told us that the “climate-tilted” fund is available as an option to all DC members but is not currently available as a default fund for contract-based schemes although the Provider “intends to launch a “climate-tilted” multi-asset fund which could be offered as a default fund for contract-based schemes in 2018.” (Legal & General)
f. Whether they provided information to customers addressing the risks and opportunities associated with climate change and the impact that these might have on customers' saving.

Only one of the Providers that we received substantive responses from and/or met with responded to this question in the affirmative and even then they acknowledged the need to develop their communications further for retail default pension fund members.

That Provider said that “it is bringing climate change issues to the attention of its clients through seminars and publications and has ongoing dialogue with DC user groups...on climate change”. The Provider is “developing its [information] offering further for retail default pension fund members”. (Legal & General)

g. Whether they carried out robust engagement with companies with set targets, timelines and monitoring to bring about positive change in the carbon intensity of their businesses and ensure they are alive to the risks and opportunities associated with the transition to a low-carbon economy.

Some Providers that we received substantive responses from and/or met with appear to be carrying out robust engagement with investee companies although it remains to be seen whether this engagement is impactful, either resulting in positive change or divestment.

Two of the Providers stated they carry out engagement with companies on ESG or “sustainable and ethical” investment. (Standard Life and Aegon)

Another Provider stated that it “carries out robust involvement with investee companies on climate change….and [will use] their vote or disinvest from companies who fail to meet their minimum expectations.” (Legal & General)

One Provider had “made a conscious choice not to pursue responsible investment through a divestment and exclusions approach”. (Zurich)

7 Summary of our findings - Providers

7.1. Through these responses and meetings, we have built a picture of how Providers are dealing with climate risk on behalf of Customers. The findings of particular relevance to the FCA are that:

a. In many cases there is a disconnect between a Provider’s group stance on climate risk (publishing strong policies and external strategies on investment of the Provider’s assets) and its consideration in the provision of pensions for its Customers. This is particularly surprising where contract-based pensions are provided by insurance companies, whose catastrophe and/or general insurance arm has already developed a view on the wide-ranging risks and opportunities associated with climate risk. Yet, this disconnect and, for some, a complete failure to consider climate risk in respect of
the provision of contract-based pensions was acknowledged in a number of face-to-face meetings.

b. Many Providers were not able to tell us how they were dealing with climate risk in respect of their contract-based pension schemes and have not considered the effects of climate risk for strategic asset allocation in their product design and offering.

c. Where default funds are passive index tracker funds, Providers had not always considered whether the fund was vulnerable to climate risk, sometimes citing an inability to make investment/disinvestment choices in an index-tracker fund. Investment via index-trackers should be no excuse for failing to manage climate risk; there are a range of steps that Providers can take to reduce passive exposure to climate risks such as active stewardship policies and selection of products that track climate risk-weighted indices.

d. Faced with insufficient/unclear regulatory guidance, most Providers are reluctant to develop climate-aware products and solutions unless there is sufficient client demand. The client in this scenario is usually the employer that chooses the products, rather than the Customer who bears the risk of investments. It is therefore perhaps unsurprising that Providers are seeing little demand from employers for these kinds of products.

e. Some Providers told us that they are concerned that the regulatory focus on low fees is leading to clients (usually the employer making the purchase decision for the auto-enrolment platform) choosing passive index-tracker default funds (most of which do not reflect climate-risk) rather than funds which take into account climate risk and which may be financially beneficial, not only in the medium to long-term, but also in the short-term.

8 Our findings - Independent Governance Committees

8.1. In 2015, the FCA required Providers to set up IGCs to address poor consumer outcomes in contract-based pensions. An IGC is intended to have oversight of the Provider’s work, assessing whether the provider is offering value for money to its Customers. At the outset, the FCA stated its intention to conduct a review of the effectiveness of IGCs in 2017, two years after their inception. However, in May 2017, the FCA announced that it was indefinitely delaying this review. In light of the FCA’s announcement, ShareAction undertook a review of IGC annual reports published in 2017.

8.2. ShareAction based its review solely on the annual reports published by IGCs in 2017. It did not proactively seek further information from other webpages unless such a link was included within the 2017 report or from the IGCs directly. This approach was chosen because the annual report is the material an interested Customer is most likely to access for information on the IGC. It also represents the most comprehensive public document on the IGCs’ activities.
8.3. It is clear that the FCA intended these reports to be scrutinised. In its policy statement on the final rules for IGCs the FCA said: “The publication of IGC annual reports should increase transparency and encourage comparison between schemes provided by different firms. In addition, it will enable interested scheme members, employers and consumer groups to scrutinise an IGC’s work and the provider’s response to any concerns raised or recommendations made.”

9 Summary of our findings - Independent Governance Committees

9.1. Only two of the 16 IGCs we reviewed reported any information on the Providers’ approach to climate risk.

9.2. One IGC (Aviva) gives a clear explanation of ESG. It says that the Provider takes ESG and Responsible Investment “very seriously in how and where they invest your money” and that they have seen “good evidence of this”. However, no further detail is given of the scheme’s approach to ESG. We would like to see evidence of how the IGC has challenged the Provider to demonstrate its ESG and stewardship policies, and how these have been implemented in real terms.

9.3. A further IGC (Legal & General) states that the IGC has reviewed what actions the Provider is taking on ESG issues. The IGC sets out the subjects covered, including their approach to active governance, how they attempt to raise market standards, company engagement and voting activities, addressing climate change, views on executive remuneration and the Provider’s current engagement focus. A link is given to the Provider’s corporate responsibility report. However, this report covers the Provider’s group activities in general, rather than the approach to long-term risk management taken in relation to the specific funds discussed in the IGC report. It would be more effective if it were linked to the members’ money under management.

9.4. Three IGCs (Abbey Life, Fidelity and Prudential) do not mention the Provider’s specific approach to long-term factors but do consider investment performance from a long-term perspective. For example, the Prudential IGC does not mention ESG but specifically uses what it considers to be the most appropriate long-term measure of investment returns (backed by Professors Lynda Gratton and Andrew Scott and used by NEST).

10 Recommendations

10.1. For the reasons set out above, we recommend that the FCA:

10.1.1. Engages with other UK financial regulators to ensure a co-ordinated approach to regulation and guidance on climate risk. In particular, the FCA should capitalise on the opportunity to develop a pensions regulatory strategy with TPR that recognises

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the importance of a forward-thinking and harmonised approach to climate risk over the next 5 to 10 years;

10.1.2. As recommended by the Law Commission in June 2017, amends COBS 19.5 to require IGCs to report on the Provider’s policies in relation to:

a. Evaluating risks to an investment in the long-term, including risks relating to sustainability arising from corporate governance or environmental or social impact (this could be achieved by following the TCFD recommendations).

b. Considering and responding to Customers’ ethical and other concerns.

c. The Provider’s policy (if any) on stewardship.

10.1.3. As recommended by the Law Commission in June 2017, issues guidance for contract-based pension providers on financial and non-financial factors that they should consider when making investment decisions, to follow the guidance given by TPR in its guide on investment governance. This could include a recommendation that using current industry best practice - such as the TCFD recommendations - is an effective way to assess longer-term financial risks;

10.1.4. Proactively secures the opportunity to prepare a report into the adaptation of FCA-regulated firms and markets to climate risk as part of the third round of ARP reporting; and

10.1.5. Carries out an assessment of the impact of climate risk on the firms and markets it oversees. This could include engaging with firms to understand firm-level consideration of climate risk and its associated opportunities, and could be conducted as part of reporting under the ARP.

11 Endorsements

11.1. The Providers listed below endorse the view that it would be helpful to the Providers and to the market generally for the FCA to provide further guidance on the management of climate risk:

a. Legal & General Investment Management

b. Scottish Widows

11.2. When providing the endorsement above Legal & General Investment Management commented, in support of the recommendations at 10.1.1, 10.1.2 and 10.1.3, that they “want to provide the same offering to all pension members regardless of whether the member’s pension is provided through a trust or is contract-based”, emphasising the need for a coordinated and consistent approach on regulation and guidance on climate risk from TPR and the FCA. This supports our view that, whilst there is a different financial regulator
protecting Customers’ pension savings than those saving through trust-based schemes, they should be treated with parity when it comes to climate risk issues.

12 Next steps

12.1. We request a meeting within two months of the date of this report to discuss the matters we have raised. Please provide us with some suggested times by 9 March 2018 so that we may be able to coordinate relevant diaries.

12.2. From ClientEarth, please contact Alice Garton (Company and Financial Project Lead) at agarton@clientearth.org and Joanne Etherton (Pensions Lawyer) at jetherton@clientearth.org. From ShareAction, please contact Rachel Haworth (Policy Officer) at rachel.haworth@shareaction.org.
Appendix

The Providers contacted regarding this report are listed below. Where we have named the parent company this should also be taken to refer to the asset management arm of that business, if applicable.

Aegon
Aviva
Fidelity
Legal & General
Old Mutual
Phoenix Life
Prudential
Royal London
Scottish Widows
Standard Life
Virgin Money
Zurich
ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw. We are activist lawyers working at the interface of law, science and policy. Using the power of the law, we develop legal strategies and tools to address major environmental issues.

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