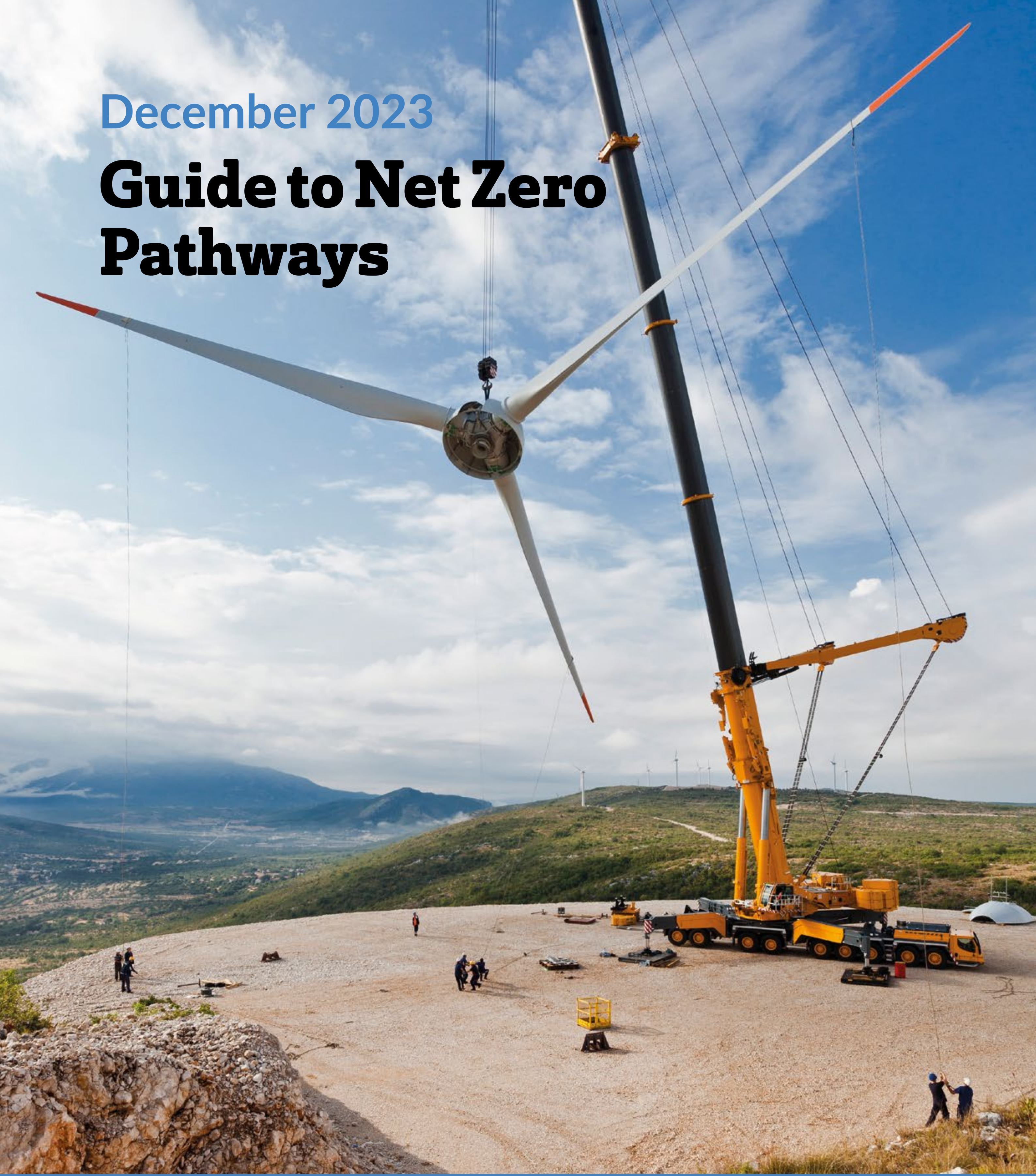
December 2023

Guide to Net Zero Pathways



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A FORWARD LOOK AT SUSTAINABILITY

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The pensions industry has a key role to play in the crucial task of retooling the entire global economy to a net zero future. It is at the same time both a significant asset owner and is also charged with securing a sustainable and secure future for the tens of millions of members it serves.

Mitigating the impact of the now inevitable changes to the climate, and accelerating the transition to a low carbon economy is essential if we are to preserve our way of life. It is an immense challenge but there is no denying that the UK pensions sector has rolled up its sleeves and played its part so far.

Not surprisingly given the scale of the challenge, the solutions are complex, wide-ranging and fast evolving. For pension schemes, the reporting requirements, through now obligatory Task Force on Climate-Related Financial Disclosures (TCFD) reports, require detailed scrutiny of the emissions currently being made and the scenarios the investments in them imply.

The way the pensions industry looks at net zero and sustainability is rapidly evolving. While a ‘low carbon’ approach may superficially seem like the way forward, a more nuanced approach is required. It is easy to dump a few heavy carbon stocks and slash a scheme’s tonnes of carbon per pound invested ratio. But straightforward divestment does nothing for the just transition to a greener world. Planting windmills in the sea requires a lot of concrete and steel, and is carbon intensive – a simplistic approach simply doesn’t work.

Newer ways of looking at net zero pathways involve a forward-looking rather than backward-looking approach, understanding the part industries and the companies within them are playing in building the sustainable future we all need.

This guide shares best thinking from across the sector and beyond, explaining and simplifying some of the very complex issues that pension schemes face in managing the transition to net zero.

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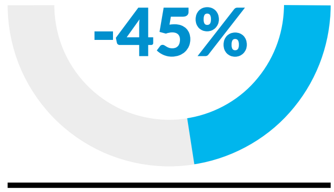
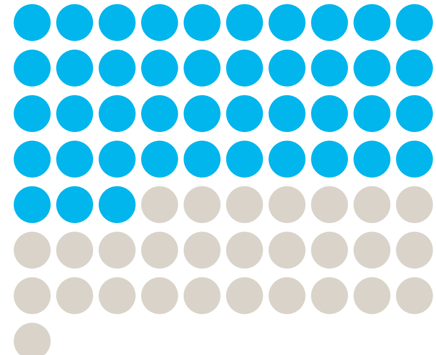
NET ZERO IN NUMBERS

increase in emissions by 2030 compared to 2010 based on available national action plans

Source: DWP (2022): Call for evidence



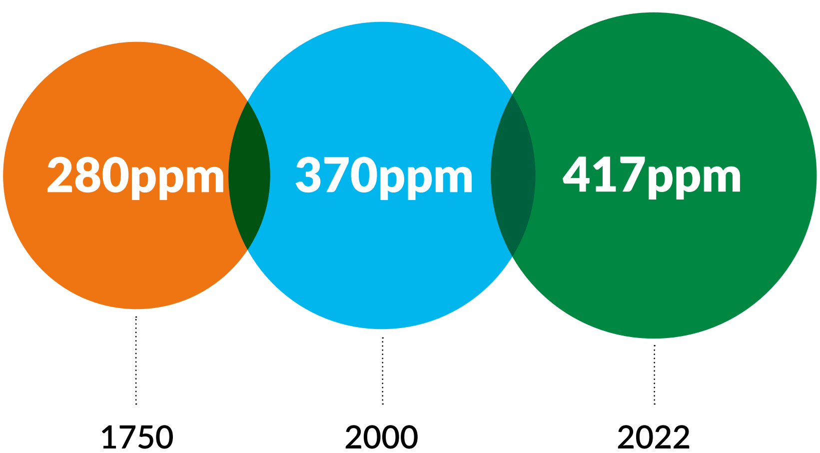
reduction in emissions needed by 2030 from 2010 levels to keep warming to no more than 1.5 degrees celsius

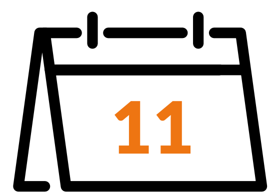


43 out of 71

TCFD reports published that have set a formal net zero target

Carbon dioxide concentration in atmosphere parts per million (ppm)

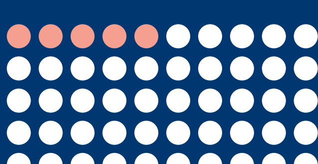




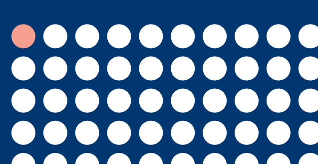
number of consecutive years that carbon dioxide levels in atmosphere have now increased

Source: National Oceanic and Atmospheric Administration - US Dept of Commerce 2023

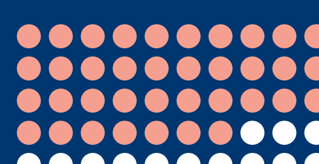
NET ZERO ENDPOINTS



5 schemes
targeting net zero by 2040



1 scheme
targeting net zero by 2045



37 schemes
targeting net zero by 2050

Source: TPR

Net Zero Asset-Owner Alliance

86 members

$11 trillion AUM

Net Zero Asset Managers Initiative

315 signatories

$59 trillion AUM

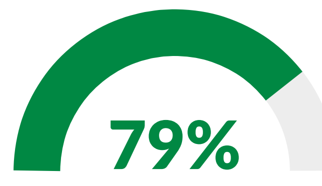
Science Based Targets Initiative (SBTi)

4,230

companies and financial institutions committed to science-based targets

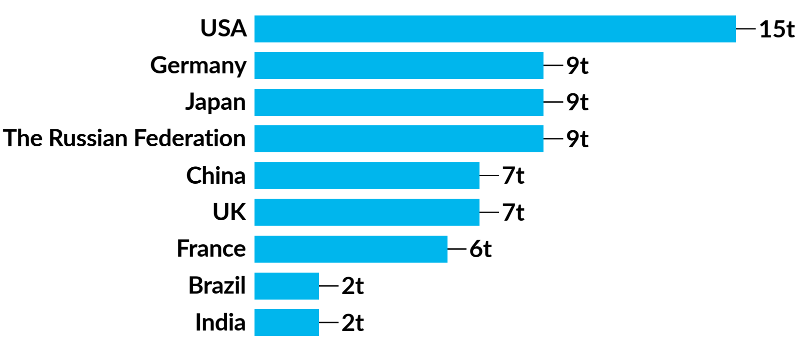
2,079

companies and financial institutions had targets externally validated



of all companies with science-based targets were 1.5°C-aligned for scopes 1 and 2 by the end of 2022.

Greenhouse gas emission in 2020 from leading economies: (consumption-based tonnes of CO_2 per capita, adjusted for trade)



Source: Global Carbon Project

£450bn

value of pension assets invested that now have explicit net zero target

18m pension savers

in schemes with explicit net zero target

Advisers – are you comfortable a 2030 50% decarbonisation target won't impact returns?

74% **26%**

Advisers – are you comfortable a 2050 decarbonisation target won't impact returns?

85% **15%**

Source: Corporate Adviser

WHY IMPLEMENT A NET ZERO PATHWAY?

There are numerous reasons why a workplace pension scheme would implement a net zero pathway for the investments it holds – risk mitigation, reflecting members' wishes, corporate social responsibility and the desire to play a part in the realignment of the global economy.

While current regulations do not require pension schemes to commit to net zero goals, they are now obliged to disclose information setting out the steps they are taking to assess and manage climate risk, and how this might impact investments for members.

Regulatory requirements

Information on a pension scheme's approach to climate risks is published in the Statement of Investment Principles and, if appropriate, its Task Force on Climate-Related Financial Disclosures (TCFD) report.

The TCFD report contains a range of metrics which over time should evidence the steps being taken to decarbonise portfolios, and plot progress towards net zero targets. This will highlight changes in investment strategy — for example, new investments into climate solutions, and tilts skewing investments away from companies with poor environmental, social and governance (ESG) records.

Pension schemes may also in future have to make similar disclosures regarding their approach to and management of nature-related investment risks through a report that reflects progress towards the goals of the Task Force on Nature-Related Financial Disclosures (TNFD). This covers actions on issues such as biodiversity and deforestation, which are both key aspects in helping the economy meet net zero goals.

There is no regulatory requirement to publish a TNFD report yet, but plans exist to integrate TCFD and TNFD reporting within a wider Sustainability Disclosure Regime, bringing UK legislation closer to EU regulations. Further guidance on TNFD reporting is expected in 2024.

TCFD REPORTS – WHO COMPLETES A REPORT

Trust-based schemes

- October 2021 – schemes with assets of £5bn+
- October 2022 – schemes with assets of £1bn+
- Once within scope, schemes have seven months from their scheme end date to publish their TCFD report. Reports must be updated every three years
- No date has yet been set for when smaller trust-based schemes will be obliged to publish this information

Contract-based schemes

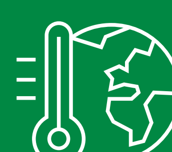
- January 2022 – FCA-regulated asset owners with £5bn+ AUM required to make TCFD disclosure at both an entity level and product or portfolio level

TCFD reports: what they contain

- **Governance:** The internal processes and controls in place giving oversight around climate-related risks and opportunities

- **Risk Management:** Details of processes used to identify, assess and manage climate-related risks

- **Metrics and Targets:** Schemes can reference a range of different metrics to demonstrate current exposure to climate risk and how this will be managed over time



- **Strategy:** The impact of climate-related risks and opportunities on the scheme. Includes analysis of how the scheme's investments, assets and liabilities will perform in different global warming scenarios

USING TRANSITION PLANS TO DELIVER NET ZERO PATHWAYS

The new best practice Disclosure Framework for climate transition plans give schemes and trustees guidance on how to implement their net zero pathways

Ben Caldecott and Kate Levick, co-heads, Transition Plan Taskforce Secretariat

As pension schemes and their trustees tackle the challenge of transitioning the assets in their schemes to a net zero pathway, they can now see that the Transition Plan Taskforce (TPT), first announced by the UK at COP26, has launched its best practice Disclosure Framework for climate transition plans.

This delivers on the mandate set by the UK Government at COP26 to lead on creating the gold standard for credible and robust transition plans and is a major international leadership step for the UK.

The TPT's work has already attracted a high level of interest from other jurisdictions, and we are very proud of the momentum the Taskforce has created, and how it has contributed to the shaping of common global norms on what constitutes a credible, high-quality transition plan.

Transition plans are critical for climate action. They are core to the fundamental transformation in business and finance that is required for the transition to net zero and for delivering a climate resilient future. Robust plans will support the flow of the significant amounts of capital that is required across the real economy to enable these changes. The TPT Disclosure Framework can support pension schemes both as preparers and users of transition plans, to support the decarbonisation of the pension system.

These new resources complement, and build on, the global baseline of disclosures developed by the International Sustainability Standards Board (ISSB) and draw on the work of the Glasgow Financial Alliance for Net Zero (GFANZ). The TPT is actively supporting efforts to build consensus around international norms to avoid fragmentation of standards.

In the UK, listed issuers are already required by the UK Financial Conduct Authority (FCA) to make transition plan disclosures on a comply-or-explain basis, with the first companies reporting at the end of December 2023.

In August, the FCA further signalled its intention to consult on strengthening its requirements for transition plan disclosures in line with the TPT Disclosure Framework, alongside its consultation on implementing UK-endorsed ISSB Standards. These new requirements are anticipated to come into force for accounting periods from January 2025.

The UK government also committed to consulting on introducing requirements for the UK's largest companies to disclose their transition plans if they have them. This consultation, expected in the fourth quarter of 2023, will ensure consistency in disclosure requirements for both listed and large private companies.

Additional guidance for preparers and users of climate transition plans is published alongside the sector-neutral Disclosure Framework, including:

- Implementation guidance, allowing firms to explore the disclosure recommendations in more detail and understand the transition planning cycle
- High-level sectoral guidance across 40 sectors to complement the main Disclosure Framework, including for asset owners and asset managers
- Technical comparison between the Disclosure Framework and ISSB, ESRS and TCFD
- A report on legal considerations for companies preparing reports using the Disclosure Framework

Further sector-specific guidance will be published in draft for consultation for the sectors: asset management, asset ownership, banking, electric utilities and power generators, food and agriculture, metals and mining, and oil and gas.

As co-heads of the Transition Plan Taskforce Secretariat, we urge all companies to set their ambitions high, and to take a strategic and rounded approach to their transition plan which should explain how it will meet climate targets, manage climate-related risks, and respond and contribute to the economy-wide climate transition.

Transition plans are also welcomed by financial institutions, shareholders and consumer groups as a way to tackle un-evidenced green claims. Research in early 2023 showed just how few companies had a credible plan in place, despite many having made visible pledges and commitments.

To achieve a fundamental transformation of our economy towards a sustainable future requires every organisation to play its part. We therefore call on all companies to get started with their transition plan today.

The Transition Plan Taskforce has made available a set of resources to help companies to build their transition plan which you can find at our website at www.transitiontaskforce.net ■

DELIVERING THE PENSIONS PEOPLE WANT

Pensions have a key role to play in decarbonising the global economy

Huw Davies, senior finance adviser, Make My Money Matter

"We all know that climate action is urgently needed; only last month the UN Secretary General said that "humanity has opened the gates of hell" with a projected 2.8 degrees of warming if nothing changes. All the Earth's warning lights are flashing red, and surely none of us wants to retire into a world on fire – but this is a real possibility for younger pension savers today.

The good news is that the pension industry, along with all financial institutions, can play a crucial role in tackling the climate and nature emergency. It has the power to shift investee companies through stewardship, advocate for regulatory and government action on climate, and make positive investment decisions. In the UK alone there are trillions of pounds in pensions which can contribute to a safer, greener, and more prosperous future rather than fuelling chaos. This is important for pension funds, pension savers, and their employers.

Firstly, for investors, this global transition to a clean economy represents opportunity, the biggest commercial opportunity of our time according to Mark Carney. And on the other hand, inaction raises climate risk which creates a threat to financial performance as well as our future. Climate risk is investment risk, and climate solutions represent investment opportunity.

Secondly, for pension savers this is important because they want a pension that doesn't destroy the planet whilst generating returns, for example the majority of people think their pension shouldn't invest in companies contributing to deforestation.

And thirdly, this is important for employers because they often decide which pension to offer to their staff. A company which has set sustainability goals and is working hard to reduce its impact could find that its choice of pension is undermining these efforts; research shows that the carbon emissions financed by typical FTSE100 company pensions are 7 times higher than the reported Scopes 1-2 operational emissions of those companies. Businesses of all sizes should be considering whether their financial arrangements align to their sustainability aims, because their staff will. Many employees, especially younger ones, now want and expect greener pensions.

IN THE UK ALONE THERE ARE TRILLIONS OF POUNDS IN PENSIONS WHICH CAN CONTRIBUTE TO A SAFER, GREENER, AND MORE PROSPEROUS FUTURE

So, given the importance of pension climate action, what is needed? It's great to see that many pension funds have set net zero targets in recent years, and increasing numbers are developing implementation plans, but what matters now is real action. Here are just a few key points which we believe are crucial for a good transition plan that has real world impact:

- **Commit to 1.5 degrees** – Align with the Paris goal in order to limit the worst of climate change and potential tipping points
- **Set targets, measure, and disclose** – Short and medium-term targets for emissions (including halving emissions by 2030) are needed, using credible methodologies, across all sectors and asset classes. These should be disclosed for transparency and accountability
- **Ambitious climate solutions plans** – A huge scale-up in investment for climate and nature solutions is needed around the world. A net zero plan should set out bold ambitions to take advantage of this opportunity
- **Phase out fossil fuels** – Publish clear targets to end investments in coal, and set red lines on new oil and gas expansion
- **Eliminate deforestation** – Publicly commit to tackle deforestation, map exposure, and set effective policies
- **Robust stewardship** - Use your power to drive change, including using votes, advocacy, and exclusions/divestment where necessary

This is a complex task, but the pension industry has a vital opportunity to step up in the face of our biggest collective challenge, and individuals and businesses are expecting more from their pension funds. So far steps have been taken, by some providers more than others, but greater action is needed across the board. Make My Money Matter will be measuring, ranking, and communicating climate action progress, and we hope in 2024 to see a race to the top on pension climate plans so that all pension savers in the UK have a pension that builds a liveable world they can retire into. ■

TRUSTEE RESPONSIBILITIES

In order to fulfil their TCFD reporting obligations trustees are required to carry out the following specific activities 'as far as they are able'. This regulatory caveat is important, as it acknowledges the difficulties trustees currently face getting reliable data in many areas.

Under TCFD reporting trustees must:

- Undertake scenario analysis taking into account the potential impact of climate change on the scheme's assets and liabilities
- Obtain Scope 1, Scope 2 and Scope 3 greenhouse gas emissions for the assets within their scheme. This information should be used to give an indication of the scheme's exposure to climate-related risk, using their chosen metric. Trustees do not have to obtain Scope 3 emissions data for their first TCFD report
- Measure the performance of the scheme against the target they have set in relation to one of their selected metrics.

Understanding climate-related risks

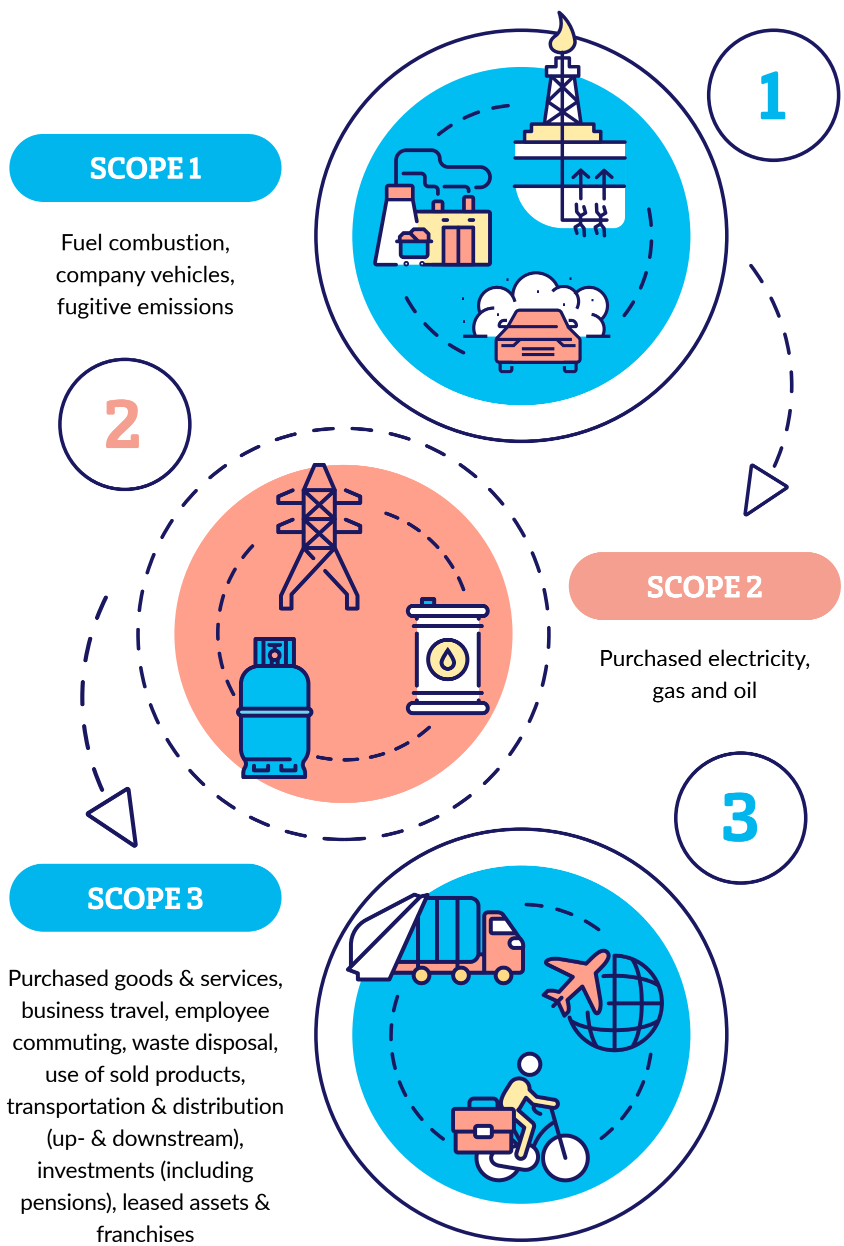
The TCFD recommendations divide climate-related risks into two categories:

Physical Risks: Includes an assessment of direct damage to assets and destabilising impacts from supply change disruption resulting from climate change. This includes risks such as a rise in sea level, flooding and the destruction of biodiversity, as well as the disruption caused by single catastrophic events and longer-term changes to climate patterns. Other potential impacts of physical changes in climate include wider social disruption, mass displacement, environmental-driven migration and social unrest

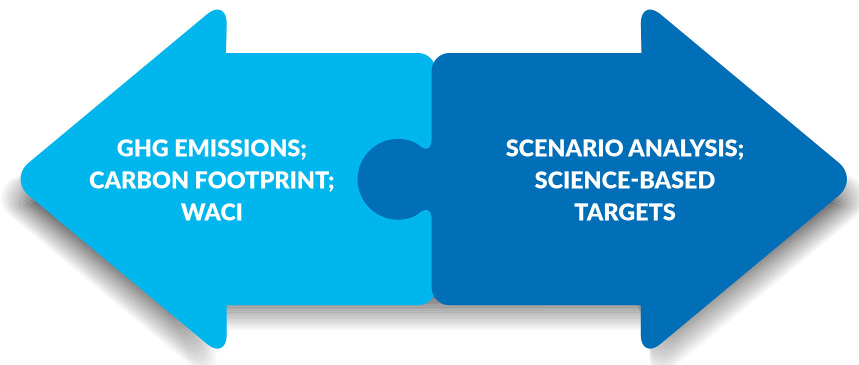
Transition risks: Includes policy, legal, technology, market and reputitional risk factors that are likely to emerge as a result of climate change

SCOPE 1, 2 AND 3 EMISSIONS

Greenhouse gas emissions are categorised into three groups or 'scopes' by the most widely-used international accounting tool, the Greenhouse Gas (GHG) Protocol. Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company. Scope 3 includes all other indirect emissions that occur in a company's value chain.



METRICS AND DATA
– UNDERSTANDING TODAY, PLANNING FOR TOMORROW



Effective implementation of net zero pathways involves both an understanding of the extent of the carbon emissions caused by a scheme's assets today and also the way they are positioned to support progress towards a net-zero future.

Schemes can cut the carbon emissions from their portfolios relatively easily by simply selling out of highly polluting industries and moving into lower carbon stocks such as technology firms – without doing anything to support progress to a lower carbon future.

Industry thinking is moving towards a pragmatic approach which also acknowledges that the transition to a net-zero world will require carbon-intensive activities in the coming decades. This both forward- and backward-looking approach involves benchmarking emissions today and tracking them year by year, while at the same time analysing the extent to which the assets held will in future eradicate or significantly reduce their emissions, or contribute materially to decarbonisation across the economy more generally.

Measuring today's carbon emissions

There is no single industry-wide metric for the measurement of the carbon intensity of assets held within portfolios. A number of metrics are used to calculate the greenhouse gases that a pension scheme is effectively funding. These metrics should, over time, help track a scheme's progress towards net zero goals.

Regulators do not currently prescribe which metrics should be used although the Department for Work and Pensions (DWP) does make recommendations in its guidance. Trustees choosing a different metric to those recommended by the DWP are required to stipulate why they are doing so.

All these metrics are in their infancy and rely on trustees having an accurate picture of the Scope 1, Scope 2 and Scope 3 greenhouse gas emissions generated by the companies and countries they invest in, through equity, bond, real estate, infrastructure and private market portfolio holdings.

Currently, there are a number of gaps in this data, and it is widely acknowledged that different entities are recording this information differently. This could lead to a significant re-basing of these figures at a future date, particularly as reporting of Scope 3 emissions becomes more commonplace.

QUALITY OF DATA

A major challenge facing pension schemes is the quality and accuracy of available climate-related data on underlying investments.

Trustees, investment advisers and asset managers need to understand the parts of their portfolio for which high quality emissions data is available, and where significant data gaps remain. This is important to review on a regular basis as schemes progress their journey towards net zero — as more granular and accurate data can alter the carbon footprint of the scheme, potentially making it appear as though emissions have risen, even though decarbonisation steps have been taken.

In order to address this schemes are encouraged to publish information about data quality, detailing the proportion of their portfolio for which they hold high quality data for Scope 1 and 2 emissions, and in future what proportion of the portfolio publishes high quality data regarding Scope 3 emissions.

When assessing the quality of data available, schemes are encouraged to disclose what proportion of their portfolio meets the following criteria:

- Emissions data is reported and externally verified
- Emissions data is reported
- Emissions data is estimated
- Emissions data is not available

Climate-related data on emissions currently comes from a range of sources, including information published directly by companies, and by external data providers such as MSCI or S&P Truscot — both of which cover published climate data by listed companies. This results higher quality data being available for equity and corporate bond markets.

There are far fewer data providers covering private markets and property which can lead to data gaps when it comes to these asst classes.

CARBON METRICS

Trustees are required to report one absolute emissions metric and one emissions intensity metric in their TCFD report. The DWP recommends using total/absolute GHG emissions for the former and Carbon Footprint for the latter.

Total GHG Emissions:
A specific metric used to calculate the emissions financed by a portfolio or pension scheme. To calculate this trustees need to know the total emissions for each asset within their portfolio, and what proportion of that asset the scheme finances.

Currently, this will be difficult to calculate for certain asset classes, so trustees can limit the reporting of this metric to specific sections of a DC or DB portfolio where data is more robust. This can help identify GHG 'hotspots' within the portfolio where decarbonisation efforts need to be focused. This figure is normally expressed in tonnes of carbon dioxide (tCO2e). The larger the portfolio, the large the emissions figures is likely to be.

Carbon Footprint:
TPR's recommended measure of carbon intensity of schemes. This takes the total GHG emissions figure, and weights it relative to the size of the underlying investments. This figures is expressed in tonnes of carbon dioxide emitted per £1m invested (tCO2e/£m). The figure used to determine the value of the investments is the Enterprise Value Including Cash (EVIC) figure. This means that if a value of a company goes up — for example BP or Shell shares double, but their emissions remain the same — their emissions figure would reduce.

Trustees need to report the emissions in tonnes of GHG emission for each £1m of scheme's assets for which they are reporting. This can be for parts of the portfolio, where data is not available for the entirety of it. This figure can assist trustees in identifying carbon-intense sections of their portfolio, a priority for strategic re-allocation or engagement to minimise climate-related risks and plot a pathway to net zero. It should also enable some degree of comparison between different entities.

Weighted Average Carbon Intensity:
An optional way to measure carbon intensity is WACI, which shows the carbon intensity of the underlying investments, relative to the revenue generated by these entities, rather than the investment value of the company itself. It is an effective way for comparing companies within sectors.

SOVEREIGN DEBT

There are additional issues when it comes to assessing the emissions data of sovereign bonds — be it UK government gilts, US treasury notes and so on, as the emissions intensity of these assets is often calculated on a different basis to that of equities and corporate bonds.

Governments, unlike corporations, don't have a 'enterprise value' so calculations will typically look at total emissions of the goods and services produced in that national economy, and then rate this against the country's revenue or GDP. This makes these assets look significantly more carbon intense than listed equities and bonds - often by a big factor.

For example TCFD reports show that the Carbon Footprint calculations for many bond and equity portfolios typically range from 70 to 100 tCO2e/£m (for Scope 1 and 2 emissions) while sovereign debt is in the region of 1,300 to 1,800 tCO2e/£m — although this does include estimates from Scope 3 emissions.

Pension schemes admit that this methodology means there is a degree of 'double counting' with emissions attributed to both the sovereign country and the companies operating in that economy. which may also be held as investments in other parts of the portfolio.

FORWARD-LOOKING METRICS

Climate value at risk metrics (climate VaR)

These metrics provide forward-looking valuation assessments to measure climate-related risks and opportunities in a portfolio over different time horizons. One of the most common ways to measure this has been scenario analysis methodology.

Scenario analysis

This approach analyses the potential consequences for a portfolio resulting from specified increase in global temperature. Schemes has significant leeway in the scenarios they choose to use and their definition of short, medium and long-term. But regulation states trustees must provide analysis for at least two future scenarios — with one scenario covering a global average temperature rise of between 1.5 and 2 degrees C above pre-industrial industrial levels.

Trustees also need to project how the portfolio might be impacted by different transition scenarios in each of these cases:

- An orderly/ measured transition - where climate policies are adopted early, as companies and sovereign states meet their stated net zero commitments in accordance with the Paris Agreement
- A disorderly transition - here overall net zero goals are met, but action on climate change happens much later, resulting in the need for sharper emission reductions, alongside increased transition and physical risks
- A 'hot house' world - this assumes current net zero policies are not met, emissions continue to rise and climate goals are missed

Criticisms of scenario analysis methodology

There have been criticism of the way some pension schemes are currently modelling this scenario analysis. A number of published TCFD reports indicate only 'minimal impact' on member portfolios even with significant temperature rises, and in

FOUNDATIONS FOR SCIENCE-BASED NET-ZERO TARGET SETTING IN THE FINANCIAL SECTOR

Following COP26 a swathe of pension companies, asset managers, banks and insurers set net zero targets. But there has been criticisms that relatively little progress has been made since then – and there is a lack of standardisations to evaluate and validate these pledges. This can limit the ability of financial institutions to drive the decarbonisation of the real economy that is necessary if global temperature rises will be limited to 1.5 degrees C above pre-industrial levels.

In response to this the SBTi will launch a Net-Zero Standard for financial institutions to help move this process forward and provide greater clarity on how financial companies are meeting this goals. This is expected to launch early in 2024.

some cases the impact of a disorderly transition is less than a more orderly move towards a net zero world.

The Institute of and Faculty of Actuaries and the environmental think tank Carbon Tracker have questioned the validity of this analysis, with both organisations criticising the 'flawed' economic models underpinning these calculations. These models, some of which were devised in the 1990s, show economic growth continuing, even if global temperature rise by 7 degrees C — well beyond the limits set out by the Paris Agreement. The IFoA points out that these economic models fail to take into account the threat of 'tipping points'. They also appear to ignore or underplay warnings from climate scientist of the potential systemic economic consequences of global temperature rises.

The Pensions Regulator (TPR) has flagged its concerns about the integrity of some climate scenario analyses, and has urged trustees and their advisers to think carefully about the narratives applied to the scenarios used. TPR says that models used will continue to evolve and it welcomes industry-wide initiatives to devise analysis that addresses a fuller range of real-world risks and uncertainties.

Portfolio alignment metrics

These metrics compare the alignment of the scheme's portfolio to the climate change goal of limiting the increase in average temperatures to 1.5 degrees C. These include binary target measurements, benchmark performance models or implied temperature rise (ITR) models.

Trustees must initially use a binary target and review their approach as methodologies develop.

Science Based Targets

The Science Basted Targets Initiative (SBTi) is a framework set up to help private companies to set out a clearly-defined path to reduce emissions in line with Paris Agreement goals. The initiative is a partnership between the Carbon Disclosure Project (CPD) the United National Global Compact, World Resources Initiative (WRI) and the World Wide Fund for Nature (WWF).

Around 4,000 businesses are now signed up to this global initiative. To sign up, companies set targets to reduce emissions, which have to be validated by the SBTi board. Companies must then report annually on progress made.

Using Science Based Targets

Pension schemes can use this data to indicate likely emission reduction across their portfolio by disclosing the proportion of companies they invest in that have committed to following science-based targets. This forward-looking metric can give an indication of the extent to which a scheme is likely to see a reduction in carbon emissions over the next 10 years. This contrasts with Carbon Footprint and WACI metrics which take a backward look. Schemes that currently have relatively high exposure to sectors with high emissions, for example mining, oil and gas companies, will look worse than peers under Carbon Footprint and WACI metrics. If these high emitters stick to stringent reduction targets, they will help drive meaningful emission reductions. SBTi can show which schemes are best placed to drive significant change in transitioning towards a lower carbon economy.

THE SCIENCE BASTED TARGETS INITIATIVE (SBTI) IS A FRAMEWORK SET UP TO HELP PRIVATE COMPANIES TO SET OUT A CLEARLY-DEFINED PATH TO REDUCE EMISSIONS IN LINE WITH PARIS AGREEMENT GOALS

NET ZERO STARTING POINT

The target for the global economy to reach net zero greenhouse gas emissions is 2050. This target was set out in the Paris Agreement in 2015, as being necessary to limit global warming to well below 2 degrees and as close as possible to 1.5 degrees above pre-industrial levels. The UK Government legislated to meet this target in June 2019 - leadign to many UK companies and pension schemes setting their own 2050 or sooner net zero goals.

The UK government has set its own interim targets to reduce emissions. Published data shows that greenhouse gas emissions have fallen by 48% between 1990 and 2022 domestically, although several heavily polluting industries ceased operating in the UK during this period.

Most pension schemes have set their own interim targets and all master trusts and GPPs state an ambition to halve emission by 2030. But not all schemes are using the same starting point from which to measure this reduction. Many schemes are using 2019 as their starting date - with a number of dates in that year being used. Other providers are using later dates, while some have yet to set a date. A further complication is that some start dates may have been just before the Covid pandemic, where the economic lockdown caused a significant reducion in GHG emissions.

It may be that estimates of GHG or CO2 emissions for this start date get revised in future, particularly as carbon accounting and the collecting of Scope 3 data becomes more advanced.

IMPLEMENTING A NET ZERO PATHWAY

There are a number of organisations offering an agreed framework, practical support and advice for pension companies looking to reduce emissions and chart a pathway towards net zero.

Institutional Investors Group on Climate Change (IIGCC)

A European membership body for asset owners and asset managers, providing guidance, frameworks, tools and support to help members integrate management of climate relative risks and opportunities into their investment processes. It currently has 400-plus members in 27 countries which represent $65 trillion in assets.

Net-Zero Asset Owner Alliance

A global body for international asset owners that are committed to supporting net zero goals, that has been set up in through the UN Environmental Programme Finance Initiative (UNEP FI) and the UN-convened Principles for Responsible Investment (PRI).

Asset owners pay a fee to join the NZAOA and have to commit to its objectives - which will include setting net zero targets in line with the group's protocols and reporting on progress towards its goals. It is focused on peer exchange and collective action via engagement, with a target setting protocol. All members' targets are evaluated anonymously by a peer review group, which categorises them in accordance with a traffic light system, showing progress to date. It currently has just less than 80 members.

Science Based Targets Initiative (SBTi)

This initiative also focuses on organisations setting net zero targets and reporting progress made towards these goals but it is not a membership organisation. The SBTi is focused on independent assessment and validation of targets against selected methods and criteria.

It focuses on quantitative targets for investment and lending portfolios.

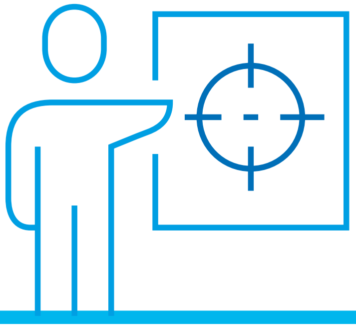
Transition Plan Taskforce Framework

A UK framework that is being designed to help private companies develop robust credible and consistent plans that will help them transition towards a low carbon economy.

This will include details on short- medium- and long-term actions that are required in order to meet net zero goals.

Sector specific guidance, including for pensions and financial services, is expected to be published next year which will cover a range of issues across implementing a strategy, engagement issues, relevant metrics and targets and governance.

Both the SBTi and NZAOA are seen as complimentary target-setting frameworks and many organisations will join both NZAOA members are encouraged to submit their targets to SBTi for external validation, although this is not automatical due to methodology differences



THE ROLE OF STEWARDSHIP

Influencing the behaviour of carbon-intensive corporates is one of the most important areas of net zero pathway implementation. Institutional investors such as pension funds can apply pressure to investee companies to adapt the way they operate towards more sustainable practices. Engagement can be through meetings, voting rights, and filing and supporting shareholder resolutions. By working together, through sector-wide initiatives, pension schemes and other institutional investors can apply pressure to polluting companies more effectively.

Where pension schemes hold funds run by asset managers, rather than holding assets directly themselves, a key element of stewardship involves applying pressure to asset managers to get them to pressurise investee companies.

THE PATHWAY TO NET ZERO – FOLLOW THE NORTH STAR

Net zero strategies are moving away from mechanistic annual reductions towards forward-looking measures

Edwin Whitehead, director, sustainable investment, Redington

The momentum of institutional capital pledging to reach net zero is growing. A great deal of energy has been spent determining target net zero dates, annual decarbonisation rates, and smooth glide paths. But for the less well-resourced and those yet to start this journey, which path is right?

Net zero is how we aim to limit global temperature increases. At some point in the future, the goal is that there will be no net increase of carbon dioxide into the atmosphere. To achieve this, we must fundamentally change how we travel, produce energy, food, and goods, whilst also enhancing our diverse natural environment, which absorbs carbon and protects us from zoonotic disease. Net zero is challenging, complex, and not cost free. But it is the North Star – the one we use to navigate forthcoming challenges.

Why are investors setting net zero goals? For those who see ownership of carbon-emitting investments as excessively risky or perhaps morally wrong – they may be on a pathway of planned divestment; mechanistically reducing portfolio emissions. Here, a portfolio's net zero pathway may be agnostic of real-world events, and its ambition can be scaled accordingly with tracking-error tolerance.

There is a different approach: align a portfolio's objective with contributing to real-world goals. Why do this? Because climate risk is hard to diversify away from. Paradoxically this can make the question of a net zero pathway easier and harder. It is easier in so far as the ambition is to follow the North Star – aim for the c.2050 net zero pathway informed by science. Where it gets more challenging is in the implementation.

What to measure?

Carbon footprints of portfolios are based on 'financed emissions', i.e., dividing a company's emissions by the proportion of a company's capital structure financed by the investor. Often it is carbon footprints where net-zero pathways are set. "Halved by 2030" or ">7% annual fall" are commonplace.

However, this metric is fundamentally volatile and backward-looking. Volatility in the financial inputs can dominate. Carbon footprints have whipsawed year-on-year: the Covid pandemic reducing footprints, the post-lockdown recovery and war in Ukraine increasing them. All the while, global emissions have gone up.

Our clients are moving their focus away from the importance of annual reductions and instead looking towards forward-looking measures. Understanding the transition-readiness of portfolio companies gives greater insight into the pathway an investor is on, and where action is needed to reach the right one.

What actions to take?

Portfolio emissions are likely concentrated in a small number of high emitters. Understanding where the concentration is, how aligned with net zero the constituents are, and the actions being taken to engage them should be a priority. Asset managers must engage to set credible transition plans and have a clear policy on the managed phase out of fossil fuel use, starting with coal.

If stewardship is to be an effective tool in delivering net zero, it needs to have teeth. Asset owners can send clear signals to asset managers. 2023 saw low levels of shareholder support for climate-related resolutions at AGMs. This was especially true at several US banks, where shareholders called for financing new fossil fuel expansion to cease. Asset managers should be held accountable for their net zero engagement, and asset owners should be willing to escalate – switching to a more progressive manager if expectations are not met.

The global investment required under a net zero pathway is significant – £3.9 trillion a year according to the International Energy Agency. This presents asset owners with ample investment opportunities. These must be executed in a risk-balanced way, with the recognition that some solutions may increase portfolio emissions. Transition investments like green steel or green cement, for example, may mean financing emissions today, to avoid them in the future.

Asset allocators face meaningful challenges when setting net zero pathways. For those who wish to contribute towards the global transition, it's time to start deploying your tools: identify concentration of emissions, focus on direction of travel and be comfortable with annual volatility; deploy engagement resources effectively and escalate accordingly; allocate to solutions.

This may seem an oversimplification, and it is – issues such as biodiversity and nature are complex. However, all those wishing to follow the North Star must start their journey somewhere - these considerations can help you set off on the right footing. ■

TALKING TO PENSION SCHEME MEMBERS ABOUT CLIMATE AND NET ZERO

Is there such thing as a member-friendly TCFD summary? Asking members to help create one can give you some clues

Caroline Hopper, lead consultant, Quietroom

"Showing members how their pension can tackle climate change is a proven way to help them engage with their money. It can make them feel more positive about their pension, and increase trust in their scheme.

So does that mean members want to read a 70-page Task Force on Climate Related Disclosures (TCFD) report? No, it does not.

But can we use some of the information in TCFD reports to engage members? For anyone seeking to create the ideal TCFD summary, user testing shows that snippets of a climate report can bring pensions to life for members.

Help members make the connection between their pension and climate

There are two things members need to know before you can talk about the climate impact of their pension. Firstly that their money is invested – in things like companies and buildings. The second point is that those investments create emissions. You need to cover these in what one member described to us as 'a logical order so I could build my knowledge as I went on'.

Members who are clued up on climate change have often never made the connection between their pension and climate. So showing examples of how climate change could affect their investments is very powerful. One example we used is showing how flooding could damage a shopping centre they invest in.

This shows why reducing investment emissions is good for their pot as well as the planet. 'It's good it focuses on climate but reassures you you'll still get growth,' is one bit of feedback we have received.

Members also respond positively to metrics, seeing annual measurements of targets as demonstrating openness.

Give investment examples to bring their plan to life

Almost all members we speak to say the most interesting information is the examples of what their money is investing in, making their pension investments exciting and real, and building confidence and trust.

Include examples if the scheme engages with heavy polluters. We expected a mixed reaction when we did this, but the response was overwhelmingly positive.

Offer members next steps

Some members may not want to take further action. But for those that are more engaged, when it comes to next steps there are three clear winners:

1. Seeing the companies they invest in
2. Calculating their personal carbon footprint
3. Tracking progress on engaging with companies

It's time to talk to your members about climate

Most members have multiple pots. If members hear from one scheme about climate plans and not another, they assume the latter doesn't have a strategy.

We often hear that schemes don't want to talk to members about climate for fear of knee-jerk reactions, especially if emissions metrics go up in the short term. But members appreciate the necessary long-term thinking on climate. ■

MEMBERS WHO ARE CLUED UP ON CLIMATE CHANGE HAVE OFTEN NEVER MADE THE CONNECTION BETWEEN THEIR PENSION AND CLIMATE. SO SHOWING EXAMPLES OF HOW CLIMATE CHANGE COULD AFFECT THEIR INVESTMENTS IS VERY POWERFUL

Include targets and metrics for transparency

If you expect users to skim over the 2050 goal and interim targets you would be wrong. Our research has shown that members see net zero targets as ambitious, bold and demonstrative of long-term thinking, which is perceived positively.

Q&A

SUPPORTING THE JUST TRANSITION

» **Dr Stephen Porter** responsible investment lead, Scottish Widows

As financial stewards, pension schemes have a critical role to play in the journey to net zero. But wider societal and environmental factors should not be overlooked in the transition towards a low carbon economy.

What is meant by a Just Transition?

When we talk about sustainable development, or the journey to net zero, the focus is invariably on the future. We want to ensure that actions taken today don't damage the environment for future generations. Thinking about a 'Just Transition' helps us to also focus on the present, and consider the impact today of steps we are taking to tackle climate change. It is important we reach net zero goals, but this needs to be done in ways that don't disadvantage particular groups in society. The Just Transition reminds us that this process is not an abstract economic construct but impacts people and places – be they oil and gas workers in Aberdeen or the specific challenges facing communities across the global south. Much of the discussions around 'ESG' relate to the environment - the 'E' in this acronym. The Just Transition ensures that societal issues, the 'S', are not overlooked.

How can pension providers support the Just Transition?

Pension schemes and asset owners have an important role to play but they can only move as fast as the underlying economy. For this to happen we need clear, long-term direction from global governments, to incentivise companies to decarbonise, and penalise those that fail to take the issue seriously.

While government can set the framework, action has to come from corporates, and the financial system that funds them. As big asset owners, pension schemes need to be active and responsible stewards, providing finance to help companies change business models and adapt to a lower carbon economy, while also allocating capital to companies that are helping deliver solutions, new ideas and new ways of doing business that support a Just Transition.

What role does divestment play?

A pension can simply sell out of fossil fuels, but while this might lower the scheme's carbon footprint, ownership simply passes to someone else so it may not be effective in reducing real world emissions.

However, divestment has a role to play alongside stewardship. At Scottish Widows we now don't invest in firms whose revenues are primarily from thermal coal and tar sands extraction. These activities need to stop if we are to tackle climate change.

Much of the focus to date around divestment and stewardship has been on equities. But there is also now focus on the role schemes play as fixed income investors, particularly with maturing corporate debt. Many companies will be looking for these financial arrangements to roll over, so there is a lever there for large investors to start a conversation about sustainability goals, and link this to future financing commitments.

What role does protecting nature play in the Just Transition?

This is a key part of the Just Transition, and something that pension schemes will need to look at in future, through the Taskforce on Nature-related Financial Disclosures (TNFD). There is a lot of talk about biodiversity, but this is effectively another word for 'nature' – a term we think is better understood by most pension members.

This encompasses a range of issues, from deforestation, land and marine pollution, desertification and habitat loss. Measuring this is more complex: there isn't a single metric that shows a company's, or pension scheme's positive or negative impact on the natural world in the way that there is with carbon emissions. But taking a more proactive approach to nature does help when it comes to tackling climate change. Cross-industry groups and supra-national organisations can help pension schemes take a more holistic look at these challenges.

How important are 2030 net zero targets?

2050 can seem a long-way off so it is important to have shorter-term targets to monitor progress towards net zero goals. But pension schemes also must not lose sight of the longer-term view. There is often too much short-termism within the financial services industry, particularly in relation to investment returns. Rather than be caught up in quarterly performance figures we want to encourage managers to consider investments through this long-term lens and consider potential returns outlook over at least a 10- or 20-year period. On these timescales it is not hard to see that companies that are adapting to a low carbon economy are better placed to prosper, not only delivering returns for our members but helping build a world that they can retire into. ■

SCOTTISH WIDOWS

GREENWASHING

Corporate 'greenwashing' is an ongoing issue, with concerns that some companies are exaggerating or making misleading claims about their environmental credentials.

Within the pension and investment sphere there are concerns that firms are using 'green' labels and ESG-terminology to market funds or schemes which may not differ significantly from standard funds when it comes to overall carbon emissions or wider environmental impact.

There is growing concern about greenwashing, with a recent poll of DC pension consultants stating this is a serious problem within the investment and pension arena. There are concerns that this is being compounded by the proliferation of different standards and regulatory bodies, which can be used to give firms a degree of environmental credibility, without necessarily following stringent guidelines. There is also considerable confusion among pension professionals as well as pension savers about the way some investment and pension providers use key ESG and sustainability terms.

This isn't just on the radar of investment consultants and professionals. The government is in the process of producing its own Green Taxonomy, with the explicit aim of addressing this issue.

Green Taxonomy

The UK is currently in the process of setting up its own Green Taxonomy, which is essentially a classification system that will be used to define whether an investment is sustainable or not.

One of the main drivers for establishing a green taxonomy is to boost investor and business understanding and to ensure there is a robust way to measure investment and pension companies 'green' marketing claims.

The FCA has published four fund labels for sustainable funds - Sustainability Impact, Sustainability Focus, Sustainability Improvers and Sustainability Mixed Goals.

This classification system will provide companies, investors and policymakers with definitions for a range of sustainable activities. As it currently stands there are plans for the taxonomy to cover six key areas:

- Climate change mitigation
- Climate change adaptation
- The sustainable use and protection of water and marine resources
- The transition to a circular economy
- Pollution prevention and control
- The protection and restoration of biodiversity

There will be technical screening criteria for each of these areas through the government's new Sustainable Disclosure Framework that will oversee this. This will effectively subsume the current TCFD and in-coming TNFD requirements, and will see individual corporations plus pension and investment firms disclosing information against a whole range of sustainable criteria to give a more robust and detailed view of the green credentials of different investment products.

There has been some delay to the implementation process of the Green Taxonomy. An update is expected later this year on the green finance strategy but further consultation is not expected until at least 2024, with implementation unlikely before the next General Election.

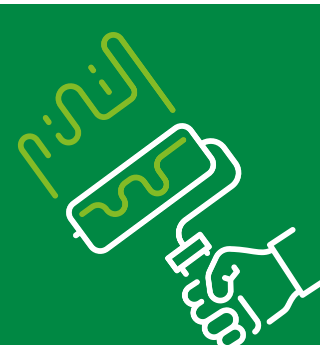
EU regulation

The EU has been leading the way on green regulation. Its Sustainable Financial Disclosures Regulation (SFDR) requires managers to assess and disclose how sustainability risks are considered in their investment process.

Under this disclosure regime financial products are classed as either Article 6, Article 8 or Article 9. As part of this process they must disclose how they consider investment decisions that might result in a negative environmental impact — know as Principal Adverse Impact (PIAs). Unlike the UK's Sustainable Disclosure Regime, this EU regulation is now up and running.

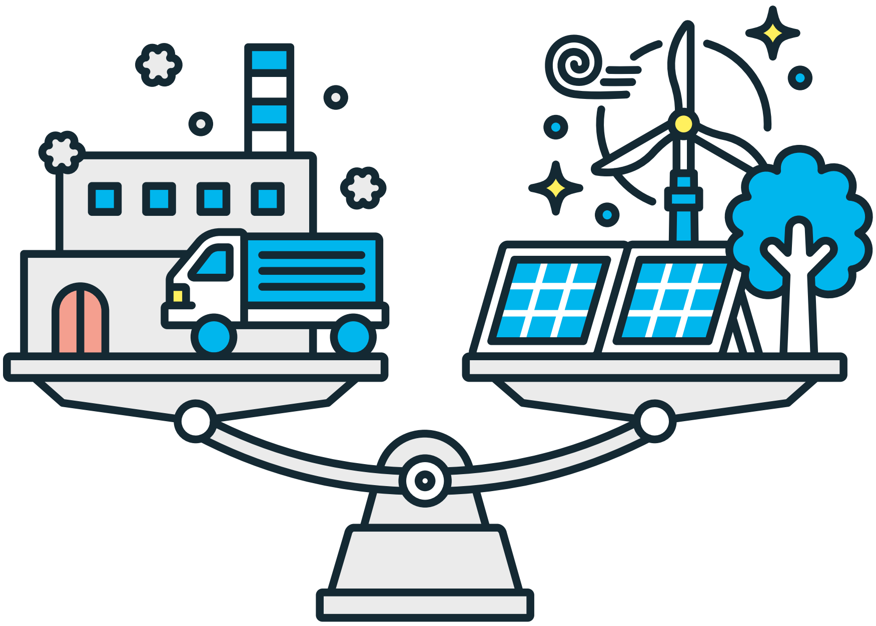
- **Article 6 funds** – do not have a sustainable investment objective
- **Article 8 funds** – should promote environmental or social characteristics and have good governance practices
- **Article 9 funds** – have a sustainable investment objective and should make a positive impact on society or the environment and have a non-financial objective at its core

This is part of the wider EU Taxonomy Regulation - a classification framework to determine whether economic activities are environmentally sustainable. It follows the same six environmental objectives that are included within the UK's Green Taxonomy.



BAN ON 'CARBON NEUTRAL' CLAIMS

In 2022 the EU banned companies describing their products as 'carbon neutral' or 'climate neutral' or saying they have a positive environmental impact if they are using offsets. Climate campaigners lobbied for this ban, arguing these terms were misleading consumers and essentially providing a 'fig leaf' through which they can conceal their ongoing pollution. Any companies selling products or service into the EU will be affected by this legislation.
The ban was passed under the Empowering Consumers for the Green Transition (ECGT) directive.



CARBON OFFSETS

A carbon offset is a reduction in greenhouse gas emissions or an extraction of carbon from the atmosphere that compensates for emissions made elsewhere.

A carbon offset credit is a certified instrument that represents the reduction of a metric tonne of CO2, or other greenhouse gases. Offset credits can be retired by the purchaser to reduce their overall greenhouse gas tally.

There is debate within the industry as to the role carbon offsetting should take when it comes to meeting net zero goals.

Some environmental groups say offsetting is not a credible solution to the climate emergency, and will not change the behaviour of the big polluters or result in a significant reduction in real world emissions.

The contrary view is that it is unrealistic to ever expect to be 100 per cent net zero without some offsetting, and these offsets are likely to play an important part, particularly as schemes get closer to their net zero goals. But with so much of the economy now committed to net zero pathways, and with the high brand premium of association with innovative solutions to the climate crisis, demand for carbon offsets looks set to soar.

Key to this debate is the of concept of 'additionality'. Some carbon reductions would happen anyway — for example wind farms that generate energy in a profitable manner. For a carbon offset project to have 'additionality' it must only be possible because of the carbon offset that is being paid for. There is an argument that firms or organisations looking to offset carbon emissions should only be using credits that have this additionally.

As well as being additional, carbon offsets should be permanent. This is to avoid situations such as where trees are planted as a carbon offset, and then burn down because of wildfires, returning their captured carbon to the atmosphere, thereby erasing the offset.

The carbon offset market is in its infancy and steps are being taken to measure and improve the quality of carbon offsets as global demand for these instruments soars.

A number of organisations monitor and verify such offset schemes. Projects can apply to get a Verified Carbon Standard (VCS) mark, while the Climate Community and Biodiversity Association awards a triple, double or single gold rating to qualifying projects.

CARBON CAPTURE AND STORAGE

Carbon capture involves trapping the CO2 made from burning fossil fuels and then storing it in a way that will not damage the environment or contribute to global temperature rises.
CO2 is captured where it is produced - typically iron and steel factories, before transporting it to storage.

This is seen as one of the key ways that the world may be able to mitigate climate change and meet net zero targets, but at present the technology around this is in its infancy, and the process remains highly costly.
One variant is direct air capture (DAC) which aims to take CO2 out of the atmosphere - this is also known as carbon dioxide removal (CDR).

As well as the expense of capturing and storing this carbon - there are several other potential downsides, not least the fact that the transportation of captured and compressed carbon requires special designed infrastructure and pipes that and expensive to build and can result in higher emissions. There may also be unknown impacts of storage over the long term.

It is currently estimated that carbon capture and storage costs range from \$15 to \$130 per metric tonne of CO2, while the costs for direct air capture range from \$100 to \$345 per tonne of C02.

OPINION

STEWARDSHIP: WHY ENGAGEMENT AND ACTION ARE THE KEY TO RESPONSIBLE INVESTMENT

» **Shipra Gupta** investments stewardship lead, Scottish Widows

Stewardship is central to delivering investment and doing business in a responsible way. It helps us as an industry transition to a more sustainable future, and produces better long-term outcomes for customers, clients, our society, and the wider economy.

At Scottish Widows, we are proud of our signatory status to the Financial Reporting Council's (FRC) 2020 Stewardship Code. Our approach supports our climate action plan designed within the Paris Aligned Investment Initiative Net Zero Investment Framework (NZIF), and is based on three core pillars:

- Engagement with, and oversight of, investment managers
- Engagement with companies
- Engagement with industry and policy makers.

Through this approach we aim to consider stewardship through both a micro and macro lens,

At a micro level, our engagement with investment managers and companies is a critical aspect of our policy. We expect all our investment managers to achieve signatory status with the UK 2020 Stewardship Code or their in-country equivalent. By 2024, our expectation is that all our Tier 2, as well as our Tier 3 managers, will be code signatories.

Owning our responsibility

As an asset owner, we recognise our power and responsibility to effect change. Our stewardship approach is an evolving policy, adapting to reflect emerging ESG risks and maximise impact.

In 2022, for example, we included human rights as a new social theme and broadened our environmental focus to add biodiversity and deforestation. Our engagement with investment managers, companies and industry, and our voting guidelines, cover all sub-themes of our extended policy, which are:

Climate and environment – climate remains a core focus for us. We recognise that a successful transition to net zero will support better outcomes for customers and society, and the risks and opportunities that climate change presents for companies and those that invest in them. It's also an issue our customers care deeply about. Our focus includes making a Just Transition integral to engagement on climate.

We've also extended this focus to include biodiversity and deforestation. This recognises that nature degradation is one of the greatest threats we face.

Human rights – this is a new theme based on the United Nations Guiding Principles on Business and Human Rights. These cover human rights impacts, working conditions and decent, fair, or living wage compensation.

Cognitive diversity on boards – we believe that diversity and inclusivity lead to better long-term value creation, and that cognitive diversity is a key element within that.

Driving positive change

For us, stewardship is about more than policy documents. It's about putting words into action. Through engaging directly with investee companies, we are driving positive change. In 2023, for example, we engaged directly with Volkswagen after it was added to the 2022 list of United Nations Global Compact violators in relation to operations in its Chinese supply chain. Volkswagen was able to assure us that it had risk management processes in place.

We also engage with our appointed investment managers to embed our core themes to deepen our influence on voting. This helps ensure our stewardship activity is aligned with and builds on the work of our investment managers. It also allows us to take a stand where we feel this is appropriate, even overriding decisions by our appointed investment managers.

In 2022, for example, we directed our vote in support of a special shareholder resolution for Sainsbury's to commit to paying all its workers the living wage by July 2023. This went against how our investment manager voted.

Delivering better outcomes

In 2023, we directed a number of votes on management and shareholder resolutions in several of our top 300 holdings related to our stewardship policy. At a macro level, stewardship is about driving progress through industry-wide collaboration and policy advocacy. Our material collaborations include the Occupational Pensions Stewardship Council, Institutional Investors Group on Climate Change, UK Sustainable Investment and Finance Association, and the Association of British Insurers.

A key contribution has been in facilitating client-directed voting in pooled funds through the Department of Works & Pensions' Taskforce on Pension Scheme Voting Implementation, and engagement with our managers. Partnerships and collaborations are key to supporting the greening of the real economy in a just way, and to driving effective regulation.

Please take a look at our most recent Responsible Investment and Stewardship Report – https://adviser.scottishwidows.co.uk/assets/literature/docs/61026.pdf. ■

SCOTTISH WIDOWS

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