Institute and Faculty of Actuaries

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DWP consultation: Climate and investment reporting: setting expectations and empowering savers

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

- We support encouraging fiduciaries to collect metrics on their scheme's Paris-alignment. However, we believe the proposed metric may be poorly understood and would encourage the DWP, or TPR, to provide more guidance to improve trustee understanding of the benefits and weaknesses of the targets, including the impact that shifts in the underlying assumptions may have on the metrics.

- We also believe it is appropriate to require trustees to seek appropriate advice before reporting on the fourth metric, and suggest that the new requirements are reviewed before they are extended to smaller, arguably less sophisticated, schemes.

- We recommend that the DWP encourages pension funds to use the fourth metric to reflect their active stewardship activities other than divestment. This will encourage active stewardship, reduce the risk of creating investment bubbles and increase the likelihood of producing real-world reductions in emissions.

- We have concerns about the potential misunderstanding and misuses that might arise from the use of implied temperature rises and set out details of our concerns in Appendix 1. The use of alignment metrics may detract attention from engagement in the real economy and active stewardship of assets. It particular, there is a risk of fiduciaries conflating progress in their portfolio with progress in the real economy.

- We feel it would be imprudent, and due to the sub-optimal risk/return we believe it would conflict with fiduciary duty, for trustees to seek alignment with a scenario that science is indicating is not achievable. If using implied temperature rises, we recommend a portfolio alignment metric of 2.0 degrees instead of 1.5 degrees, with disclosure if using a temperature above 2 degrees.

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The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the DWP's consultation on climate and investment reporting: setting expectations and empowering savers. As for any IFoA response, we have considered the DWP's proposals from an independent, public interest perspective. This response has been drafted by the IFoA's Sustainability Board, with input from its Pensions Board and Finance & Investment Board. We have included as an appendix some additional notes compiled by the Sustainability Board on the limitations and potential abuses of portfolio alignment tools.

Should you wish to discuss any of the points raised in this submission in more detail please contact Caroline Winchester, Policy Manager, (caroline.winchester@actuaries.org.uk)

Chapter 1: Measuring and Reporting Paris Alignment

Q1. We propose to amend the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 to require trustees of schemes in scope to measure and report their scheme's Paris-alignment by adding a requirement for them to select and calculate a portfolio alignment metric and to report on that metric in their TCFD report. Do you agree with this policy proposal?

1. We believe that good fiduciary practice would consider the alignment of investment portfolios with the Paris Agreement, although noting that divestment or spinning off high-emitting assets does not necessarily also improve global alignment with the Paris Agreement. (Recent examples include the spinning-off of Thungala Coal from Anglo American plc, which has resulted in Thungala as a stand-alone company seeking to produce more profit by producing more coal, and thus increasing overall emissions).

2. The core challenges are the availability of data, the development of suitable metrics and differentiation between portfolio and economic contexts. Furthermore, "point-in-time" metrics (such as carbon footprint at 31/12/20XY), which are only calculated based on holdings at one date, are particularly susceptible to greenwashing and window-dressing.

3. Our preference is to focus on metrics that indicate investment risks, which best aligns with fiduciary duties and global alignment with the Paris Agreement, building on the efforts of scenario analysis. However, these too suffer from lack of data and historical evidence to base assessments on. We also prefer measures that reflect stewardship activities and real-economy changes to underlying holdings, such as 'change in carbon footprint for longer-term holdings'. These are less susceptible to window-dressing and can reflect real-economy impact rather than point-in-time exposures.

4. Our comments on the specific metrics given in the statutory guidance are given below. In principle, we believe it is good for fiduciaries to collect these metrics. However, we believe there also needs to be sufficient education to understand these metrics, their benefits and their weaknesses. In particular, we believe these are only suitable as targets for trustees with a sophisticated understanding of the underlying assumptions and methodological approaches.

5. Given this, we recommend that:

    a. The DWP explicitly requires only trustees of large schemes to use portfolio alignment metrics as targets, even if it also chooses to encourage adoption by smaller sophisticated schemes

   b. The DWP ensures trustees using these as targets have adequate knowledge, for example by requiring trustees to confirm their understanding of the benefits and weaknesses of the targets, including the impact that shifts in the underlying assumptions may have on the metrics.

6. There is a broader question of what the DWP, and broader ministerial policy, is seeking to achieve with the fourth metric. By focusing on portfolio alignment, there is a meaningful risk that this encourages widespread disinvestment activity by pension trustees – as it is simpler to report a more aligned portfolio arrived at through divestment, than to align portfolios by engaging with the complexities and stewardship of the transition.

7. This could have a number of unintended consequences, including weaker engagement with higher emitting companies, thus reducing (or reversing) their incentives to reduce real-economy emissions, ultimately with a negative impact on climate change.

8. It may also encourage crowding into "low-carbon" companies, creating investment bubbles and ultimately disappointing investment returns and poorer outcomes for pension scheme members. This could also undermine the overarching policy objective and the Minister's view that pension scheme trustees will find opportunities in green investments.

9. We therefore recommend that the DWP encourages pension funds to use the fourth metric to reflect their active stewardship activities other than divestment. This will encourage active stewardship, reduce the risk of creating investment bubbles and increase the likelihood of supporting real-world reductions in emissions.

10. Please see our response to Q4 and Appendix 1 for further detail.

Q2. We propose that:

(a) trustees who are subject to the requirements in Part 1 of the Schedule to the Climate Change Governance and Reporting Regulations on or after 1 October 2022 (including trustees to whom the requirements are re-applied in accordance with regulation 3(4), 4(4) or 5(4)) will be required to select, calculate and report on a portfolio-alignment metric and to publish the findings in their TCFD report within 7 months of the relevant scheme year end date in the same way as they are for other metrics. This will apply to:

- trustees of a trust scheme which had relevant assets equal to, or exceeding, £5 billion on their first scheme year end date which falls on or after 1st March 2020, and who remain subject to the requirements in Part 1 of the Schedule on 1 October 2022
- trustees of a trust scheme which has relevant assets equal to, or exceeding, £1 billion on a scheme year end date which falls on or after 1st March 2021
- trustees of all authorised master trusts and authorised collective defined contribution schemes

After 1 October 2022

(b) trustees will cease to be subject to the requirements to select, calculate and report on a portfolio alignment metric in accordance with regulations 3(4), 4(3), 4(5), 5(3) and 5(5) of the Climate Change Governance and Reporting Regulations, in the same way as they would be for other metrics:

- trustees of a scheme with relevant assets of less than £500 million on a scheme year end date which falls after 1 October 2022 will cease to be subject to the requirements to select and calculate a portfolio alignment metric with immediate effect, but must still report on their selected portfolio alignment metric in their TCFD report for the scheme year which has just ended, unless the relevant assets on the scheme year end date were zero
- trustees of an authorised scheme which ceases to be authorised after 1 October 2022 (a "formerly authorised scheme") and which had relevant assets of less than £500 million on the scheme year end date immediately preceding the scheme year in which authorisation ceased, will cease to be subject to the requirements to select, calculate and report on a portfolio alignment metric with immediate effect
- trustees of a formerly authorised scheme which has relevant assets of less than £500m on a scheme year end date after authorisation ceased, will cease to be subject to the requirements to select and calculate a portfolio alignment metric with immediate effect, but must still report on their selected portfolio alignment metric in their TCFD report for the scheme year which has just ended, unless the relevant assets on the scheme year end date were zero

Do you agree with these policy proposals?

11. Yes, subject to our comments in response to the other questions, it makes sense to align with other Climate Change reporting timelines.

Q3. We propose to incorporate the requirements to measure and report a portfolio-alignment metric into the existing Climate Change Governance and Reporting Regulations so that the requirements are subject to the same disclosure and enforcement provisions as the other metrics requirements.

Do you agree with this policy proposal?

12. It makes sense to make the requirements subject to the same disclosure and enforcement provisions as the other metrics requirements. However, we are concerned about the explicit reference to 1.5 degrees warming for the alignment metric. Whilst this is simple and aligns to the broader COP26 goal of "keeping 1.5 degrees alive", there is evidence that this is highly unlikely:

   - If all countries meet their long-term net-zero promises, the "best case" is that global warming will rise to around 1.8C (with an uncertainty range of 1.4C to 2.6C) by 2100[1].
   - The IPPC AR6 report says the world will pass 1.5C somewhere between 2030 and 2035[2].
   - IEA estimates of actions required for a net zero trajectory by 2050 require an end to coal mining development and new oil field exploration[3]. Yet, this is not yet policy within the more enlightened governments such as the UK, let alone the more recalcitrant ones.

13. An attempt to invest in scenarios that don't occur cannot be expected to provide robust risk/returns and thus conflicts with fiduciary duty. Furthermore, data providers such as MSCI estimate that only 10% of listed companies have operations that are compliant with a 1.5 degrees scenario[4]. This is not a large enough number for all pension schemes to create robust, diversified portfolios, and as such is liable to create bubbles if the pension industry tried to do so en masse.

14. It may not be the DWP's intention to encourage trustees to invest in line with 1.5 degrees. It would seem perverse to require the regulatory reporting of a metric, which is calibrated at a level which the government does not consistently advise all its regulated funds to achieve. Furthermore, having such a metric would certainly create pressures both internally from members, and externally from activists and the press, to align with such a metric. From experience, not all such advocates have an understanding of the broader fiduciary duties that trustees face, creating reputational issues and taking up trustee time and resources to manage mistaken challenges, and potentially damaging confidence in pension schemes.

15. We therefore recommend removing the reference to 1.5 degrees and changing the wording of the "portfolio alignment metric" from

    "portfolio alignment metric" means a metric which gives the alignment of the scheme's assets with the climate change goal of limiting the increase in the global average temperature to 1.5 degrees Celsius above pre-industrial levels.

    to:

    "portfolio alignment metric" means a metric which gives the alignment of the scheme's assets with the climate change goal of limiting the increase in the global average temperature to 2.0 degrees Celsius above pre-industrial levels, as defined in the Paris Agreement, or the best reasonable warming case that the trustees believe possible (disclosing where this is different from 2.0 degrees).

16. With this approach followed throughout the regulations and guidance, the trustees would need to disclose their metric including its temperature increase. Whilst we wish there were currently more robust climate policies in place, there is a robust intellectual argument that a temperature above 1.5 degrees is still aligned with the Paris Agreement and globally achievable. We feel it would be imprudent, and due to the sub-optimal risk/return we believe it would conflict with fiduciary duty, for trustees to seek alignment with a scenario that science is indicating is not achievable.

[1] https://www.carbonbrief.org/analysis-do-cop26-promises-keep-global-warming-below-2c.
[2] https://www.carbonbrief.org/analysis-what-the-new-ipcc-report-says-about-when-world-may-pass-1-5c-and-2c
[3] https://www.iea.org/reports/net-zero-by-2050
[4] https://www.msci.com/www/blog-posts/the-implied-temperature-rise-of/02891497341

Q.4 (a) Do you have any comments on the draft amendments to the Regulations?
(b) Do you have any comments on the draft amendments to the Statutory Guidance?

Please include in your answer any comments you have on whether you consider that they meet the policy intent stated in this chapter.

We particularly welcome comments on the definition of "portfolio alignment metric" and whether respondents think it reflects the policy intent?

17. (a) Please see our response to Q1.

18. (b) We have concerns about the potential misunderstanding and misuses that might arise from portfolio alignment metrics.

19. In brief, we would recommend fiduciaries start with the simpler alignment metrics such as binary target measurements based on percentage of aligned investments to particular alignment criteria. Whilst simplistic, their visible simplicity avoids a trap of over-reliance on hidden assumptions and the need to understand how varying the assumptions may vary the analysis and outcome.

20. On one technical point of detail, we would assume that the Transition Pathway Quality Score would qualify as a suitable portfolio alignment score. Strictly speaking, we would not see this as a binary target nor a benchmark divergence measure. We would appreciate direct confirmation that the Transition Pathway Initiative Quality Score is suitable. We recommend the guidance wording is slightly expanded to make this clear, for example:

21. "Binary target and alignment score measurements – these tools measure the alignment of a portfolio with a given climate outcome. Binary targets typically base these on the percentage of investments in a portfolio that (a) have declared net zero/Paris-aligned targets and (b) are already net zero/Paris aligned. Science Based Targets initiative's (SBTi) Portfolio Coverage Tool for Financial Institutions is an open source example of a tool that tracks the percentage of companies in a portfolio that have declared net zero/Paris aligned targets.

22. Alignment score measurements apply a similar approach typically creating a rating score to reflect the degree of alignment of an underlying investment. The Transition Pathway Initiative Quality Score is an example which rates the degree and quality to which the business strategy of the underlying investment aligns with the Paris Agreement.

23. The case for the visible simplicity of these alignment metrics contrasts with implied temperature metrics where the output appears simple but the complexity is hidden (see details in 23 below). In Appendix I, we expand on the potential pitfalls and misunderstandings that can arise in implied temperature rise metrics.

24. The power of the metrics is that they provide an answer that seems consistent with a future global temperature and thus a powerful and apparently intuitive communication tool. However, we think that it is this very power and apparent intuition that can lead to misunderstandings and misuse. In practice, almost all the assumptions, uncertainties and unknowns remain hidden – and there is considerable effort and sophistication required to understand these.

25. Areas that remain hidden include:

- Uncertainties of an economy in 30 years' time (2050). By comparison, 30 years ago there was no Facebook, Google, Netflix or Amazon. There is simply no way of addressing the uncertainties of an economy 30 years in the future, and widely variable unknowns in doing so.

- The actual pathway to future net zero and especially the required pattern of decarbonisation to 2030 and beyond. A specific policy approach will need to be assumed, but in practice the actual pathway will vary.
- New technologies and approaches will emerge. For example, the scaling up of Carbon Capture Usage and Storage could massively influence future pathways.
- The calculation of, and translation to, a temperature metric itself is subject to wide uncertainties. This may or may not vary between different approaches.

26. Whilst we comment on the innovation and efforts that are being undertaken to develop these metrics, the reality is that they are in their infancy. We are still developing the techniques and have no experience of how they may be practically used and applied within a portfolio, nor the degree to which they will be stable or variable in their calibration.

27. We believe phasing expectations on reporting of the metrics would be sensible, as trustees may struggle to validate or justify the reasonableness of the figure, unlike more universally monitored metrics such as investment returns and expenses.

28. Understanding the assumptions can also be complicated by potentially proprietary elements within the methodology. We expand on these in Appendix I.

29. We have concerns about the potential misunderstanding and misuses that might arise from the use of implied temperature rises. In brief, we recommend:

    - Encouraging those new to alignment metrics to engage with simpler metrics at first or alongside ITR (implied temperature rise) metrics.
    - That those seeking to use implied temperature rise metrics only do so after they have received advice and training on the hidden assumptions (ideally the advice would also be in writing and regulations should set this expectation).
    - Encouraging the providers and reporters of ITR metrics to provide transparency in their underlying assumptions and in particular how varying different assumptions impacts the outputs.
    - Discouraging the use of ITR as the target measure for all but the most sophisticated fiduciaries due to the need to understand the influences of the hidden assumptions (eg. by requiring appropriate advice to have been obtained and taken into account).
    - Monitoring the broad adoption of ITR metrics with the risk to financial stability (Minsky moments) if investments start crowding into a narrow set of scenarios which inevitably will not be the exact future economic and policy pathway.

30. Finally, we are concerned that the use of alignment metrics may detract attention from engagement in the real economy and active stewardship of assets. It particular, there is a risk of fiduciaries conflating progress in their portfolio with progress in the real economy.

31. This risk is mitigated by the emphasis and focus the DWP is also putting on Stewardship. However, this should remain a high point of concern for both the DWP and TPR. We would encourage the regulators to maintain a far greater emphasis and communication on engagement and stewardship responsibilities to make a real economy difference over the focus on alignment metrics.

Q5. Do you have any comments on the new regulatory burdens to business and benefits of requiring schemes to measure and report their Paris alignment?

32. While we welcome the increasing professionalisation of the largest trust-based pension schemes, it would be disproportionate to drive Member Nominated Trustees and also company executives off trustee boards through disproportionate requirements for other, smaller schemes. We consider that a great burden is being placed on part of the industry least able to bear it. There should be a greater focus on advisers, investment managers and service providers, although we recognise that this is a matter for the FCA and others.

Q6. Do you have
a. any comments on the impact of our proposals on protected groups and/or how any negative effects may be mitigated
b. any evidence on existing provision made by trustees in response to requests for information in alternative accessible formats
c. any other comments about any of our proposals

33. No comment.

Chapter 2: Stewardship and the Implementation Statement

Q7. Should DWP include a vote reporting template in its implementation statement guidance which trustees are expected to use? If so, should such a template be based on the PLSA's vote reporting template? What changes, if any, would be needed to the PLSA template if it were to be adopted?

What are your views on the adoption of an engagement reporting template? Should it be separate from any vote reporting template or integrated with it, so that – in relation to equities – both voting and engagement activities are described for the same set of assets?

34. We support the goal of integrating reporting on voting and engagement and note that this is also something the FRC are looking for in their review of stewardship reporting. The DWP should continue to work with the FRC and encourage greater take-up of the Code among pension schemes.

35. We do not consider a template to be a helpful approach at this point in time for disclosure of voting and engagement activities. There is not yet a clear set of metrics particularly for engagement activities and given the variety in fund managers' approaches, it is not possible to get the perfect set of reporting questions in every situation. That said, some tailorable but non-mandatory examples published by TPR or DWP may be helpful in avoiding each adviser having to reinvent the wheel.

36. We do think a template is likely to be helpful for smaller schemes, however it is important that this does not become prescriptive. Indeed, we think there is a potential conflict to those looking to align with the Stewardship Code 2020 which is deliberately not prescriptive in how different entities should communicate stewardship. The guidance should specifically encourage larger schemes, and those aligning to the Stewardship Code 2020, to develop their own formats. It should specifically permit and encourage the use of reporting formats used for a scheme's Stewardship Code reporting. This will reduce the risk that a template would stifle both innovation and effective reporting of activities.

37. For smaller schemes that may welcome a template, we consider the ICSWG engagement reporting guide and the PLSA voting template as helpful starting points.

Q8. Do you have any comments on our cross-cutting proposals for the Guidance on Statements of Investment Principles and Implementation Statements, in particular that:

(a) they are written for members?
(b) the Guidance reiterates that these are trustees' statements, not their consultants'?
(c) Implementation Statements should set out how the approach taken was in savers' interests?
(d) trustees should be able to include material from voluntary disclosures, such as Stewardship Code reporting, as long as they meet the requirements in the Regulations?

38. a) Agree these should be written for members, however this has not previously been the case. The significant requirements for the content of SIPs means that they are currently generally written for a professional audience. Some easement on content would be required to achieve general comprehensibility for members, which would be a good thing.

39. b) Agree these are trustees' statements. However, paragraph 20 of the guidance could be better phrased to make it clearer that trustees should reflect on and formulate their investment beliefs and stewardship priorities *before* generating their statements. We are concerned many trustees are not sufficiently knowledgeable or confident to form their own views directly, hence their reliance on their consultants in this area.

40. c) Agree. However, trustees may need further education and guidance on concepts such as universal ownership and systemic risks and help to note the difference between long term and short term (financial) interests.

41. d) Agree.

Q9 (a) Do you have any comments on our proposed Guidance on stewardship policies?
(b) Do you have any comments on our proposed Guidance on most significant votes?

42. It could be confusing to have statutory and non-statutory guidance in the same document.

43. We agree with clarifying that stewardship includes engagement with the managers themselves.

44. We suggest more emphasis on reflecting on and formulating investment beliefs and stewardship priorities *before* selecting or reviewing asset managers.

45. A more principles-based approach for larger schemes may be more useful than the level of prescription provided in the guidance.

Q10. Do you have any comments on our proposed Statutory Guidance on the information to be included in the Implementation Statement with regard the requirements under the Disclosure Regulations, Schedule 3, paragraph 30(1)(f)(i)-(iv)?

46. Generally for the Implementation Statement – if 'should' and 'should consider' are used in Statutory Guidance, there should be some indication as to the circumstances in which it is permitted to 'not'. Generally we would expect to see the use of 'must' in statutory guidance and 'should' in non-statutory guidance.

Q11. Do you have any comments on our proposed Statutory Guidance on meeting the Implementation Statement requirements in the Disclosure Regulations relating to choosing investments?

47. No comment.

Q12. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to investment strategy?

48. No comment.

Q13. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to financially material considerations (including ESG and climate change)?

49. No comment.

Q14. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to non-financial matters?

50. We consider the distinction of financial and non-financial factors in the guidance and in the underlying regulations to be unhelpful. As IFoA pointed out in our joint response with the ICSWG to the Law Commission's 14th Programme of Legal Reform earlier in 2021, the two-step process for non-financial factors creates barriers and complexity, leading fiduciaries to believe they do not need to consider some ESG risks. In the long run, many typically attributed non-financial factors within ESG frameworks can be considered to be financial factors.

51. Many issues, including those relating to climate-change, will have both financial and non-financial aspects. Further, some issues that start out as non-financial (e.g. public criticism in relation to a particular industry or company) may become financial (e.g. where this translates into reputational damage or reduced customer demand). The distinction between financial and non-financial factors is therefore artificial. We believe that the trustees must have regard to the impact of their investments on the community and the environment, similar to the duty of a director of a company under Section 172 of the Companies Act 2006.

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

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

54. We also consider that more reference could be made to universal ownership. If the basic expectation is that all trustees have to consider themselves to be universal asset owners, DWP should consider how they influence trustees to understand this position, potentially through the trustee knowledge and understanding framework.

Q15. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to arrangements with asset managers?

55. No comment.

Appendix 1 – The limitations and potential abuses of portfolio alignment tools

This note sets out our concerns with the use of portfolio alignment metrics.

Summary

- A single portfolio alignment metric is readily abused and manipulated
- A single standardised underlying future scenario is a poor information source
- provides insufficient information to make sound longer-term decisions
- increases "unknown unknowns" that policymakers and decision-makers face
- leads to bad outcomes, reputational damage, and facilitates abusive behaviour

What issues are likely to arise? And why are they problematic?

Several issues can arise – and have been proven in the past to arise – when a single metric is used. We outline some of these below, and note that the use of 2 or 3 complimentary metrics can mitigate several of these (noticeably those numbered 3, 4 and 5):

1. Poor reliability of calculation results
Makes greenwashing easy to do and hard to detect

- Immediate data gaps means results are not reliable for making short-term decisions
- Requires long-term assumptions which are subject to great uncertainty and almost certainly will turn out materially inaccurate
- Requires very detailed assumptions, making results and calculations difficult to explain

2. Results are almost certain to mislead voters, if not politicians too
Can result in significant reputational downside for policymakers

- Calculations focused on one future outcome mislead as there are many potential futures.
- The pathway to that future – or any other – is unknowable
- Mitigating this requires modelling to country and economic sector level

Possible way forward: global regulators agree model and parameters to use
Possible solution: can show 3 different scenarios and pathways

3. Highly likely to lead to counterproductive actions
And unintentionally encourages actions that less effectively address climate change risks and increase unmanaged exposures to them:

- Encourages reduced activities due to false comfort if the metric is good
- Encourages engagement with the metric rather than with the real economy
- Encourages inadequate preparation for risks, as it does not reflect related risks which need separate preparations, e.g. physical risk and biodiversity loss

4. Unintentionally forces investors to focus on parts of a portfolio with greater data availability:

- This is a significant problem if parts of a portfolio with poor data coverage contain bigger emitters (e.g. private equity vs listed equity)

5. **Unintentionally encourages firms to focus on improving metric in cheapest way – but real-world carbon emission reductions are what matter:**
    - Firms will manipulate portfolios and select data to flatter their metric if this is cheaper than taking emission-reducing actions
    - Will disincentivise investment in solutions that don't positively affect the metric
    - Using an apparently simpler metric does not alter the complexity of the challenge facing trustees, nor the need to engage in active stewardship and increase overall efforts and ambition.
    - The financial systems risk remains. There remain risks across the system of crowding-in capital on weak assumptions i.e. creating overvaluations leading to underperformance and risk of crashes. This is particularly true if there are small numbers of data providers and a lack of scrutiny of assumptions. It also follows if the target of 1.5 degrees is misaligned with reality.
    - And there is also the risk of complacency
        - A 1.5-degree portfolio doesn't mean 1.5 degrees will happen
        - It does not necessarily remove risk (especially if leads to overvaluations)
        - It misses physical risk.

6. **Communication and potential misunderstandings of what an ITR portfolio of X degrees means. It does not mean:**
    - That the portfolio will be the best - or perform the best - in an X degree scenario.
    - That holding this portfolio makes X degrees more likely - or indeed that everyone holding this portfolio would lead to X degrees.
    - That holding companies that are better-aligned means that trustees have reduced risk, and that they will outperform the broader market in a rapid transition world.

7. **ITR is an alignment metric highlighting the potentiality of risk and measures a correlated factor, but is not a direct measure of investment risk:**

For an individual investment, the degree and profile of alignment indicate potential risks. However, the amount of risk is almost certainly peer and sector-related as well as market-price and pathway dependent. Therefore at a portfolio level, it fails to aggregate, as summing the alignments fails to sum the risk impacts. So whilst it may be a risk indicator, it would then not be a financial metric at the portfolio level.

The challenge for trustees is that fiduciary duty requires them to give primacy to financial factors. Secondary, non-financial, factors can only be considered if:

1. They don't materially reduce the ability to reach financial goals and security (difficult to show for material if the scheme is currently underfunded)

2. They are clearly aligned with members' views and preferences (ok for cancer research and tobacco; unproven for climate risks)

Considering ITR as an alignment metric that is not a risk metric, then:

1. Seeking to manage portfolio alignment needs to pass one of the two non-financial factor tests. Otherwise, the DWP is asking trustees to report on something they should not manage.

2. If setting a target alignment metric, the trustees need to be able to articulate how this fits with their fiduciary duty.

A way through this conundrum would be for the trustees to assert a belief that better-aligned portfolios will provide better risk-adjusted outperformance. Subject to having confidence in the metrics, that is not an unreasonable belief. This would lead to the conclusion that trustees could only use alignment metrics targets in the context of their fiduciary duties if:

1. They had an explicit belief that portfolio alignment provides better risk-adjusted outperformance or

2. They could meet one of the two tests for non-financial factors

And finally, to note for DWP, this means it would be reasonable for trustees to believe that portfolio alignment is not a risk metric and not an indicator for better risk-adjusted outperformance. If required to report such a metric, they would be entitled to state that they believed the portfolio alignment metric had no bearing on their fiduciary responsibilities to the scheme.

Should you want to discuss any of the points raised please contact Caroline Winchester, IFoA Policy Manager (caroline.winchester@actuaries.org.uk).