cardano

Climate and investment reporting:

Setting expectations and empowering savers – consultation on policy, regulations and guidance

22 December 2021

Introduction

We welcome DWP's leadership on sustainability, in the UK, and globally.

In our experience, the introduction of TCFD reporting requirements is widely welcomed, not just in letter, but in spirit[1]. Trustees – and their advisers – are working to address climate change-related risks and opportunities in investment decision-making, better protecting their savers from the financial implications of climate change.

We also welcome the DWP's latest consultation, 'Climate and investment reporting: setting expectations and empowering savers', the introduction of alignment metrics and stewardship-related disclosure.

We believe alignment and carbon footprint metrics are two sides of the same coin. Climate change is now a widely established and socialised concept within financial markets – both as a financial risk, due to transition and climate-related risks, and, increasingly, an investment imperative, because the way in which we direct capital will support (or hinder) climate targets.

At Cardano, we've taken a step back, and considered the behaviours that we believe regulation should incentivise, in particular, such that investors can maximise real-world sustainability impact.

When we invest, we consider two lenses:

1. Risk and return, which includes sustainability-related risks and opportunities
2. Influence, which includes real-world sustainability impact

We believe that this is a view that is increasingly shared by institutional investors[2].

In our experience, there remains little clarity on what is meant by influence and real-world sustainability impact, nor how to measure it. Consequently, we have developed a 'model of influence'. This comprises of three key areas of influence, based on how direct an impact these actions have.

Model of influence – tier one

The first tier of influence includes:

- Supplying new capital, debt or equity to a company or government, where this has an environmental or social objective

[1] https://www.pensions-expert.com/Special-Features/Trustees-embrace-the-spirit-of-TCFD-not-just-the-letter
[2] For example:
- Freshfields / PRI's Legal Framework for Impact: https://www.unpri.org/policy/a-legal-framework-for-impact
- Impact Investing Institute and Pensions for Purpose impact principles: https://www.impactinvest.org.uk/publications/impact-investing-four-good-governance-principles-for-pensions/

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- Collaborative company engagement on sustainability-related topics, for example through the Climate Action 100+ initiative
- Engaging with public policymaking to create a more sustainable economy, for example engaging to decarbonise the electricity grid or rollout electric vehicles

Tier two

The second tier encompasses two key elements:

- Engaging with companies as an individual investor on sustainability-related topics – this is less impactful than collaborative engagement, but nevertheless has an impact
- Incorporating climate change-related tilts and bespoke mandates, as part of a scheme's investment approach

Tier three

The third tier of influence to achieve real-world sustainability impact is one many institutional investors are already doing. That is integrating ESG factors into buying and selling of securities.

Our model of influence informs our response to the consultation. We set out our views in response to the questions below.

For questions regarding this consultation response, please email w.martindale@cardano.com.

Alignment

Q1.

Yes, we agree, however, we echo the response prepared by the Institutional Investors Group on Climate Change (IIGCC)[3].

The alignment metric should include a number of forward-looking indicators to provide a more holistic view of alignment potential for assets in high impact sectors, including:

1. Short- and medium-term emissions reduction targets. We believe disclosures should introduce Scope 3 as soon as reasonably possible.
2. Capital expenditure, so as to understand a company's likely future alignment with decarbonisation goals.
3. A credible, science-based decarbonisation strategy, with published KPIs, is in place to achieve targets (in addition to any high-level commitments).

In particular, of the three above, we believe capital expenditure disclosure is important[4]. We want to incentivise investment in companies that are transitioning their business models to decarbonise, including in hard to abate sectors, such as energy, industry, utilities, and mining. The risk is that pension funds allocate to companies that are "already low carbon" (a reflection more of the industry and sector, for example, technology) than the quality of the decarbonisation strategy. The behaviours we want to incentivise here are allocations to companies investing in credible, science-based decarbonisation strategies.

[3] https://www.iigcc.org/

[4] Considering capital expenditure is also consistent with how we review sponsor exposure to climate change-related risks and opportunities: https://www.cardano.co.uk/advisory-services/covenant-and-sustainability-services/esg-and-sustainability-integration/

We do think Implied Temperature Rise metrics are compelling in their simplicity, however, as we noted when TCFD consulted earlier this year, there is a risk that ITR introduces 'model arbitrage' risks, where clients find it challenging to scrutinise black-box methodologies and assumptions (it may also focus asset manager investment in modelling, versus, say, stewardship).

We also would welcome a clearer link to the proposed UK taxonomy.

Q2.

We agree with the proposed scope of pension fund.

We, however, note the timing mismatch in disclosure between asset managers regulated by the FCA and pension funds regulated by the TPR. We will continue to engage the FCA to bring forward TCFD reporting requirements for asset managers in line with that of pension funds.

While the mismatch exists, we believe the TPR should provide some flexibility in disclosure.

Q3.

Yes, we agree.

Q4.

We welcome reference to 1.5 degrees (as opposed to previous language on 'below 2 degrees').

We welcome application of an alignment metric disclosure to listed equity and bonds. We note that there remain unresolved challenges in non-listed asset classes and sovereigns. As such, in non-listed asset classes, we believe Trustees should disclose as 'far as able to'.

Q5 and Q6.

No answer.

Stewardship

Q7.

We welcome the introduction of a voting template, and we believe PLSA is the right starting point.

We have two further comments, based on our model of influence.

1. We believe pension funds should be able to understand, and be encouraged to input into, upcoming votes. Asset managers should disclose their voting principles, to provide pension funds with insight into what they might expect in votes, including approach to escalation, as well as voting guidelines, which explain how voting activities are conducted in line with the principles.

   In our experience, there is currently a mismatch between voting principles and actual votes cast. As such, we would welcome more transparency on how votes are cast, in order to close this gap, for example, guidelines to help us understand the circumstances that would lead an asset manager to vote against management in the case of climate laggards.

2. Asset managers should disclose their approach to 'collaborative engagement', which (for many reasons) is more efficient and effective than individual engagement. Asset managers should also be transparent about their engagement strategy for climate change, for example, is it focused on

high risk sectors, highest emitters, or targeting different greenhouse gases (carbon dioxide or methane).

Q8. to Q12.

Yes, we welcome the DWP's proposals.

In general, we favour statutory, rather than non-statutory guidance. We believe statutory raises standards, levels the playing field, rewards first-movers and creates efficiencies.

Q13. and Q14.

In general, we find the financial and non-financial distinction unhelpful.

We also note that sustainability is inherently forward-looking, while both fiduciary law, and the way in which the investment industry tends to review investment performance, is inherently backward looking. Non-financial may mean limited historic evidence of financial materiality, rather than non-financial.

Instead, we favour the two lenses, set out in our model of influence above:

1. Risk and return, which includes sustainability-related risks and opportunities
2. Influence, which includes real-world sustainability impact

The two-stage test for "non-financial" factors does not work. In practice, few members tend to engage and consensus decision-making is not possible.

This is compounded with conflicting legal views, which in turn favours status quo bias.

As such, we believe the DWP should more clearly enable the second of our two lenses, real-world sustainability impact. For example, we believe that there is opportunity in the Pensions Act for wording similar to Article 172 of the Companies Act[5]. In particular, to clarify that Trustees can consider the (sustainability) outcomes of investment activity, and that this is consistent with returns (particularly for long-term DC funds, where savers may be drawing their pension 50 years from now) consistent with what Freshfields calls "ultimate ends 'investing for sustainability impact'"[6].

We believe that trustees should set out and communicate to members the pension fund's real-world sustainability impact objectives, alongside financial objectives, in the context of considering what is in the best interests of the beneficiaries. In that process, they may but are not necessarily expected to seek input from members. They may also consider the nature of the member base and what they as trustees believe are in the best interests of those members' "ultimate ends".

Q15.

See response to Q7.

[5] https://www.legislation.gov.uk/ukpga/2006/46/section/172
[6] See Freshfields / PRI's Legal Framework for Impact: https://www.unpri.org/policy/a-legal-framework-for-impact