PRI RESPONSE TO THE ENVIRONMENTAL AUDIT COMMITTEE'S CALL FOR EVIDENCE ON POSSIBLE FUTURE INQUIRIES

ABOUT THE PRI

1. The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI is now a not-for-profit company with over 3,000 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US $90 trillion in assets under management. 461 of these signatories, representing $9 trillion, are based in the United Kingdom.

2. The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

3. The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

4. For any questions regarding this submission or the PRI's UK policy work more broadly, please contact Emmet McNamee at emmet.mcnamee@unpri.org.

SUMMARY OF THE PRI'S POSITION

5. The PRI is grateful for the opportunity to submit evidence to the Committee. The PRI has identified three key areas where future inquiries by the Committee could be particularly impactful. Two fall within the proposed topics already identified by the Committee, while the third is an important component of the UK's broader approach to decarbonisation.

6. **Pension schemes**: building on work previously done by this Committee during its 2018 Green Finance Inquiry, the Committee should inspect the structure of the pension system and

practices of large pension schemes relating to climate change, focusing in particular on contract-based pension schemes and master trusts.

7. The other two suggested areas relate to decarbonisation of the real economy, which is an increasing focus of sustainable finance practitioners.[1] These areas have been prioritised on the basis that (a) they are among the highest-emitting sectors of the UK economy, (b) there has only been limited government progress on cutting emissions to date, and (c) there is a potential role for private finance to support decarbonisation.

8. **Afforestation**: given limited progress to date on hitting afforestation targets, the Committee should scrutinise the adequacy of current government plans in this area and their compatibility with wider environmental goals, such as on biodiversity.

9. **Transport**: the shift to electric vehicles will require a significant change in consumer behaviour. The Committee should scrutinise whether adequate planning and policy incentives are in place to smooth this transition.

DETAILED SUBMISSION

PENSIONS

10. Climate change is a source of long-term financial risk to pension savers. Markets today have not adequately priced in the near-term policy response to climate change.[2] This leaves portfolios exposed to significant risk and investors need to act now to protect and enhance value.

11. It is also recognised that pension funds and private finance more generally have a significant role to play in supporting the transition to a low carbon economy. Making private financial flows consistent with this transition was an explicit provision of the Paris Agreement, and private finance will be a major theme of the upcoming COP 26.[3] Initiatives convened by the PRI and partners such as the Net Zero Asset Owner Alliance[4] and ClimateAction100+[5] demonstrate of how investors such as pension funds can take a leading role in the transition.

12. Evidence suggests, however, that most pension funds are not currently equipped for the significant economic changes posed by decarbonisation. Research by The Pensions Regulator suggests that only 20% of pension funds take climate change into account when

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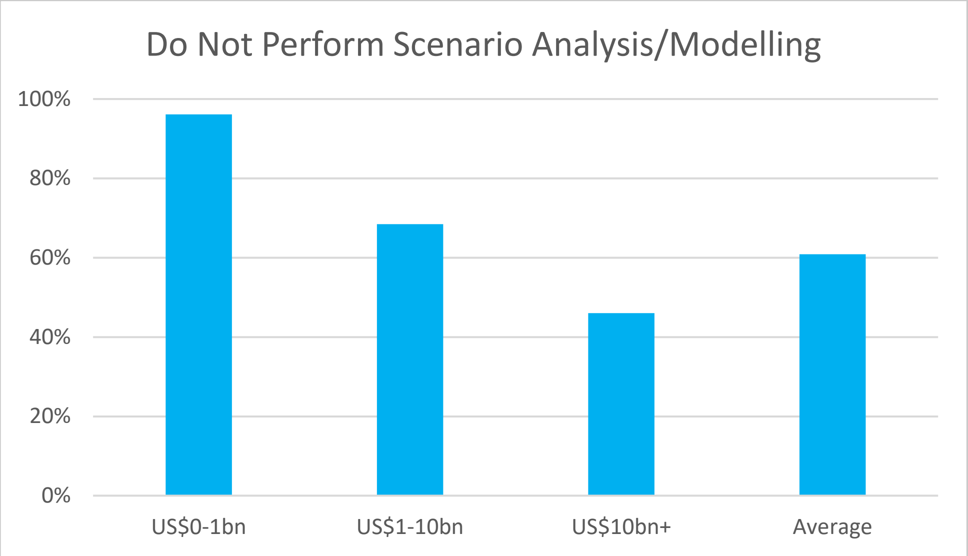
[1] https://d8g8t13e9vf2o.cloudfront.net/Uploads/c/j/u/pripolicywhitepapertakingstockfinal_335442.pdf
[2] https://www.unpri.org/esg-issues/environmental-issues/climate-change/inevitable-policy-response
[3] https://www.bankofengland.co.uk/news/2020/february/cop26-private-finance-agenda-launched
[4] https://www.unepfi.org/net-zero-alliance/
[5] http://www.climateaction100.org/

considering their investment approach.[6] Even among PRI signatories, who have committed to responsible investment principles, Figure 1 shows a robust approach to ESG issues through scenario analysis is lacking, particularly among smaller schemes.

Figure 1 – Global pension signatories undertaking scenario analysis or modelling of future ESG trends[7]



13. There have been some welcome policy measures in the past year to increase pension trustee attention to these issues. The amended Investment Regulations came into force in October 2019, requiring trustees to set out how they take account of material ESG issues. During the same month the Pensions Minister wrote to 50 of the largest pension funds in the UK to understand the actions they were taking on these issues. Amendments to the Pensions Bill published in February would require pensions to report against the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).

14. Regulations implemented thus far have had a limited effect on funds' behaviour. A study by UKSIF found that that two thirds of trustees had not complied with the requirement to publish their policies. Among those who had published their SIPs, policies were mostly vague and trustees committed to few concrete actions.[8] A separate survey by the Society of Pension Professionals found that only 2% of respondents felt that the regulatory changes had led to a material change to the portfolio of a majority of their clients.[9]

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[6] https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/new-figures-show-why-small-schemes-must-quit-the-market
[7] Indicator SG 13.1, PRI Reporting Framework 2018. While figures refer to global signatories, they are closely correlated with UK pension fund performance.
[8] https://uksif.org/2020/02/06/uksif-flags-pension-scheme-transparency-noncompliance/
[9] https://the-spp.co.uk/wp-content/uploads/2020/01/SPP-ESG-report-paper-FINAL-January-2020.pdf

15. The PRI recommends that, following on from the work of the 2018 Green Finance Inquiry, the Committee focuses once more on the preparedness of pension funds for climate change, whether these funds are aligned with the UK's climate goals and the sustainability preferences of their beneficiaries. Such efforts should concentrate in particular on master trusts and contract-based schemes,

16. Of the 38 authorised master trusts, only 10 appear to hold any funds that employ an ESG screening or tilting process within their default strategies. This is concerning considering almost 100% of Master Trust members are in their provider's default fund.[10]

17. Regarding contract-based schemes, the PRI has previously found that differences in the regulatory regimes between trust- and contract-based schemes could lead to worse outcomes for savers under the latter regime.[11] In particular, the Independent Governance Committees which oversee these schemes may be less likely to challenge the investment practices of the pension provider.

18. The vast majority of auto-enrolment pension savers are enrolled into a master trust or a contract-based pension scheme.[12] Given these savers' generally low levels of engagement with their pension, adequate protections and accountability are key. This has led legislators in New Zealand, for example, to ban providers from investing default members' money in fossil fuel production.[13]

19. The Committee could inspect how the pension system more broadly supports adequate action on climate change. Despite recent improvements, the UK's pension system remains highly fragmented, which the PRI has found reduces the likelihood of pensions schemes adhering to responsible investment practices and increases reliance on a variety of intermediaries, not all of which are aligned with the long-term investment horizons of pension beneficiaries.

AFFORESTATION

20. While the UK's focus should continue to be on decarbonisation, the Committee could also include the government's sequestration efforts through afforestation in its future work, where the UK is currently falling behind.

21. In the recent Budget the UK government pledged to plant 30,000 hectares of trees over the next five years.

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[10] PPI briefing note 108, September 2018
[11] https://d8g8t13e9vf2o.cloudfront.net/Uploads/e/v/l/priletterigcsandcontractpensions_783269.pdf
[12] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/automatic-enrolment-commentary-analysis-2019.ashx
[13] https://www.interest.co.nz/kiwisaver/103845/game-changing-kiwisaver-rule-changes-see-default-kiwisaver-funds-switched

22. It is clear that this target is far below what is required. The Committee on Climate Change estimated that afforestation of at least 30,000-32,000 hectares per year to 2050 is required, or up to 50,000 in a high ambition scenario.[14]

23. This concern is compounded by a failure to meet existing afforestation targets, consistent with an 80% reduction in emissions by 2050 rather than the current commitment to net zero; tree-planting has averaged less than 10,000 hectares in the past 5 years.

24. Greater consideration needs to be given to the role that private finance can play in supporting the UK's afforestation efforts. The Committee on Climate Change has suggested that an emissions trading scheme for forestry could incentivise private actors to establish and maintain forests to increase carbon storage, while Forestry Investment Zones trialled in Cumbria seeks to enable more private investment into the planting of large-scale productive forestry. This Committee could explore the viability of both of these options.

25. Furthermore, there is a risk that focusing solely on the number of trees to be planted might distort incentives towards quantity over quality in tree-planting.[15] "The right tree in the right place" is a prerequisite for government policy in this area.[16] There is a need for effective oversight to ensure biodiversity and to create opportunities for other forms of landscape-based sequestration.

TRANSPORT

26. Another potential focus area for the Committee could be the government's plans to accelerate uptake of electric vehicles.

27. Road transportation is the highest emitting sector in the UK, with one of the lowest rates of progress: greenhouse gas emissions from this sector have fallen just 2% since 1990.[17]

28. The government's recent commitment to bring forward the ban on selling new petrol, diesel or hybrid cars to 2035 at the latest is a welcome development. However, given current low rates of market penetration for sustainable vehicles – the market share of electric cars and vans was 2.5% in 2018 – a more detailed plan is needed for how this significant shift in consumer behaviour will be achieved.

29. Intermediate penetration targets, such as a quarter of new car sales to be zero emissions by 2025, will be necessary to ensure the smooth development of the electric vehicle sector.

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[14] https://www.theccc.org.uk/publication/land-use-policies-for-a-net-zero-uk/
[15] https://policyexchange.org.uk/wp-content/uploads/2019/12/BIGGER-BETTER-FORESTS.pdf
[16] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/878265/ncc-nature-based-interventions.pdf
[17] https://www.theccc.org.uk/publication/net-zero-the-uks-contribution-to-stopping-global-warming/

These targets can modulate the demand-side incentives that government provide; these are important given that electric vehicles are not projected to reach cost-parity until the mid-2020s (or longer with a prolonged oil price slump).

30. Charging and refuelling infrastructure will require over £1 billion in investment per year to 2030. While most will be privately funded, public funding will be needed for remote and sparsely-populated regions. Consideration should also be given to expanding the role of private finance through initiatives such as the Charging Infrastructure Investment Fund.