Investment

Work and pensions committee call for evidence – Pension Stewardship and COP26

Nest's response

1 About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Unlike any other pension scheme in the UK, Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 890,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high quality, low cost pension scheme helping over 9.9 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £20,300 per year and nearly half our members are aged under 35 years old.

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We now occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.

Responsible investment and stewardship are built into the core of our investment strategy. We've created four responsible investment objectives to guide and prioritise our activities:

1. Better risk-adjusted returns: We want to target an improvement in ESG performance where there's evidence this can lower the risk we need to take to achieve a return.
2. Better functioning markets: We want to improve how markets operate and are regulated in jurisdictions where we invest.
3. Support long-term wealth creation: We want to encourage companies and markets we invest in to deliver sustainable and stable performance to support good returns for our members over many years.
4. Manage reputational risks: We want to protect Nest's reputation and grow trust with our members by encouraging companies to act in ways our members can feel confident about.

2 Response

We welcome the opportunity to respond to this call for evidence. Climate change is one of our responsible investment priorities. We consider climate change to be a systemic risk that has the potential to have a significant impact on our portfolio as well as our members' quality of life in retirement. At the same time, we believe that climate change can offer investment opportunities. In 2020, we published our first scheme-wide climate change policy setting an ambition to reach net zero emissions in our portfolio by 2050 at the latest. We want to actively contribute to public discourse on climate change risks and opportunities as one of the UK's largest pension schemes by membership.

2.1 How should pension schemes contribute to setting COP26 targets and helping to achieve the targets once agreed?

Article 2.1(c) of the Paris Agreement states that Parties agree to make finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. The public and private sectors need to play a role in directing financial flows to meet this goal, and pension schemes play a key role in the financial system. In our view, schemes have several key areas of influence – portfolio decarbonisation, stewardship and advocacy:

- Portfolio decarbonisation: Schemes can work with the asset management industry to develop tools to assess the alignment of portfolios with the goals of the Paris Agreement and guide investment decisions. For example, Nest has moved its entire equity allocation into portfolios that use a climate change tilt and we are working with our fund managers on methodologies such as implied temperature rise to assess the temperature alignment of portfolios. We generally see divestment as a last resort option and believe that in public markets, divestment is often unlikely to have a significant impact on how the company conducts its business. However, we believe that where there is scientific consensus that an activity is misaligned with the goal of the Paris Agreement, investors should consider divestment due to the financial risk of stranded assets. There is also some academic evidence that fossil fuel divestment can impact financial flows if critical mass is reached.[1] Nest has started divesting from activities that we believe are not compatible with keeping global temperature rises to 1.5C, such as thermal coal and oil sands – we see no economic future for companies engaged mainly or purely in these activities.
- Stewardship: We believe that stewardship is a powerful tool that investors can use to influence companies to shift to low-carbon approaches. Particularly when working together, shareholders can push companies to improve their disclosure and management of climate change risks. Recent examples of successful stewardship outcomes include the replacement of two incumbent board directors at ExxonMobil by shareholders given a lack of progress on climate change. We believe that engagement is most successful when there is communication of expected outcomes and, if these outcomes are not met, a clear route of escalation. We do consider divesting from individual companies where progress is insufficient.
- Advocacy: Pension schemes also have the ability to actively contribute to public discourse on climate-related risks and opportunities and raise awareness of these issues. A key part of this is ensuring that members are kept informed, and where possible and practicable take part in the debate about how their contributions are invested. Pension schemes also have a huge potential to influence the asset management industry, which in turn will have ripple effects through the entire economy.

2.2 What role should international standards have in supporting pension schemes to assess climate change risks when considering scheme investments?

Most pension schemes have well-diversified portfolios investing in different countries and asset classes. International standardisation is therefore crucial. We are encouraged to see that the G7 is supportive of introducing climate change reporting requirements. We believe that a common international standard for climate change disclosure should be a key focus at COP26. There are a number of reporting frameworks, for example, Nest is a signatory to the Taskforce on Climate-related Financial Disclosures. We believe this framework is most useful for pension schemes as it focuses on the financial impacts of climate change. We use the framework to disclose on our own approach to climate change, and also ask all of our external fund managers and investee companies to report in line with the framework. However, we have faced challenges in particular with the metrics section of the report due to the lack of

[1] https://www.business-school.ed.ac.uk/about/news/research-shows-fossil-fuel-divestment-works

coverage and inconsistent methodologies for collecting data across different asset classes. Consistent disclosure requirements across the global economy would help to overcome these challenges.

2.3 Are there suitable financial products to enable pension funds to make climate-conscious investments? How should such investment be facilitated and supported?

Climate change is a systemic risk that has the ability to affect all asset classes. We therefore do not believe that climate-conscious investments should be offered as separate products to “mainstream” financial products and be priced at a premium. A significant part of our climate change policy is engaging with our fund managers on how climate-related risks and opportunities are considered in capital market assumptions and bottom-up analysis.

However, we have found that our ability to consider climate change more explicitly in pooled funds has at times been limited by other investors’ reluctance to deviate from the status quo and that in order to ensure that our views on climate change are considered, we have often had to go further through specific climate-aware funds. We are aware that these options may not be available to smaller schemes. Most fund managers now claim that they integrate ESG considerations, including climate change, into the investment process. Schemes may not have the resource to scrutinise these types of products. We therefore believe that a common taxonomy and labelling scheme could be beneficial to address the very real risk of greenwashing.

2.4 What regulatory changes or other government action has been most effective in delivering change in the UK; and what changes on the part of Governments elsewhere should the UK learn from?

We believe that the forthcoming regulations on climate change disclosure as part of the 2021 Pension Schemes Act will have a significant impact first and foremost on the understanding and disclosure of climate-related risks and opportunities by schemes.

We also believe that EU regulation, including on benchmarks and the taxonomy, has the potential to make a meaningful difference. We have used the EU Climate Transition Benchmark criteria for one of our fixed income portfolios. We therefore welcome the announcement to develop a UK taxonomy and would like to see alignment with the EU taxonomy. However, we also encourage the government to learn from the challenges of the process and ensure that the process is transparent and scientifically rigorous.

Government can also play a role in creating investment opportunities. We were pleased to see the announcement of a green gilt issuance later this year and also welcome the government making this available to retail investors via National Savings and Investments.

2.5 Do pension schemes have suitable information to assess climate risk, or do there need to be international reforms to financial reporting?

Nest has been using the TCFD framework to report on climate-related financial risks and opportunities voluntarily for a number of years. We find that while the quantity and quality of data continues to improve, there are still significant gaps. One instance is the lack of agreement on which metrics should be used to monitor risk and set targets. Another key issue is the lack of robust Scope 3 data.

While the TCFD recommendations have been adopted by many companies globally since they were published in 2017, the quality of voluntary disclosures is currently very mixed. Increased quality of reporting and greater standardisation is important to help us and other stakeholders assess how companies assess and respond to climate-change related financial risks.

We are aware that the TCFD is currently consulting on recommending more ambitious disclosures. Like many other pension schemes, we invest through external fund managers and ask them to provide the relevant metrics to meet our disclosure requirements. But we have found that some investment managers do not fully understand the disclosure requirements for pension schemes and are not able to provide the data we are requesting at the moment, let alone the new proposals. We believe that mandatory disclosures across the economy will be crucial to improve the situation and welcome the forthcoming consultation by the FCA on TCFD-aligned rules for asset managers.

There also needs to be clearer guidance on the content of these disclosures. We have raised this issue in the response to the consultation on climate-related disclosures by publicly listed and large private companies by the Department for Business, Energy, and Industrial Strategy.

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