Principles for Responsible Investment

PROGRESS AND PRIORITIES

REVIEWING SUSTAINABILITY IN KEY PENSION SYSTEMS

APRIL 2024

UN environment programme | finance initiative

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work 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.

PRI DISCLAIMER

This document is provided for information only. It should not be construed as advice, nor relied upon. PRI Association is not responsible for any decision or action taken based on this document or for any loss or damage arising from such decision or action. All information is provided "as-is" with no guarantee of completeness, accuracy or timeliness and without warranty of any kind, expressed or implied. PRI Association is not responsible for and does not endorse third-party content, websites or resources included or referenced herein. The inclusion of examples or case studies does not constitute an endorsement by PRI Association or PRI signatories. Except where stated otherwise, the opinions, recommendations and findings expressed are those of PRI Association alone and do not necessarily represent the views of the contributors or PRI signatories (individually or as a whole). It should not be inferred that any third party referenced endorses or agrees with the contents hereof. PRI Association is committed to compliance with all applicable laws and does not seek, require or endorse individual or collective decision-making or action that is not in compliance with those laws. Copyright © PRI Association (2024). All rights reserved. This content may not be reproduced, or used for any other purpose, without the prior written consent of PRI Association.

CONTENTS

ACKNOWLEDGEMENTS 4

EXECUTIVE SUMMARY 5

ABOUT THIS REPORT 8

ANALYSIS AND COUNTRY PROGRESS 9

NEXT STEPS 25

ANNEX 1 26

ANNEX 2 27

ACKNOWLEDGEMENTS

We would like to thank the following for their contribution to this report:

- Travis Antoniono, CalPERS
- Sally Bridgeland
- Blake Briggs, Financial Services Council (FSC)
- Peter Dorward, IC Select Ltd
- David Farrar
- Anastasia Guha, Redington
- David John, AARP Public Policy Institute
- Claire Jones, Lane Clark & Peacock (LCP)
- Fraser Lundie, Federated Hermes
- Will Martindale, Canbury Insights Ltd
- Zak May, IFM Investors
- Gregg McClymont, IFM Investors
- The Honourable Nick Sherry
- Don Russell, AustralianSuper

While we gratefully acknowledge these contributions, any views and opinions expressed in this report are those of the report authors.

EXECUTIVE SUMMARY

Pension funds are long-term investors and their ability to generate long-term returns relies on the performance of the markets and economies in which they invest. Because sustainability factors such as climate change and biodiversity loss threaten the performance of the markets and economies on which they rely for financial returns, pension funds have a responsibility to consider whether sustainability-related risks will inhibit their ability to protect long-term value and provide an adequate pension to their members or beneficiaries. Accordingly, pension funds are increasingly seeking to mitigate these risks through their investment decisions and stewardship activities.

Research carried out by the PRI in 2020 and 2021 on the Australian, United Kingdom, United States and Japanese pension systems found that there are policy, structural and market barriers to sustainability in these jurisdictions, which impact the ability of pension funds to incorporate ESG factors within their investment decisions and stewardship activities and to take action to pursue sustainability outcomes in keeping with their fiduciary duties. The research also identified intervention areas for policy makers and industry bodies, including the PRI.

Following this research, the PRI, the UNEP Finance Initiative (FI) and the Generation Foundation commissioned A Legal Framework for Impact, a report authored by Freshfields Bruckhaus Deringer and published in 2021. With a ground-breaking analysis of 11 jurisdictions around the world, the report considered whether the law permits or even requires investors to tackle sustainability challenges by setting and pursuing sustainability objectives. The report found that, under existing laws, pension funds are likely to have a legal obligation to consider investing for sustainability impact where this can help in pursuing their investment purpose and objectives. However, pension funds may face impediments to setting and pursuing positive sustainability objectives. With this in mind, this Legal Framework for Impact (LFI) briefing suggests a number of recommendations for policy makers to address these barriers.

In 2023, the PRI carried out further industry research and practitioner interviews in Australia, the UK and the US to gather updated perspectives on the barriers to embedding sustainability in pension systems. Drawing on the conclusions of the PRI's earlier pension reports and the LFI study, this report summarises the findings from this research in 10 priorities that are necessary for a pension system to take sustainability considerations into account.

These priorities could enable and incentivise pension funds, their investment managers and consultants to build sustainable investment portfolios and help pension fund members become more informed about the sustainability objectives of their schemes. However, the PRI acknowledges that they are not exhaustive and further nuance and context is necessary when introducing them to different markets and pension schemes. The priorities are summarised in a policy, market structure and investment practice framework (see Box 1).

This report also analyses the extent to which the Australian, UK and US pension systems have made progress on each priority. We use the analysis to highlight good practice and key gaps within each jurisdiction. We find that, while there has been some progress since the PRI's earlier reports – especially in relation to policy and regulation, with significant developments across all three jurisdictions – there are many elements across their policy, market structure and investment practice frameworks that still need to be addressed. Our aim with this research is to offer policy makers, investors and other interested stakeholders a view on the current state of the policy, market structure and investment practice environment for pension funds in these jurisdictions and to spur discussion on the priority areas for change.

Alongside this research, the PRI has been collaborating with its signatories to design Progression Pathways, which seek to better distinguish different approaches investors take to addressing sustainability-related risks, and set out what best practice looks like with respect to each approach. This may improve alignment on responsible investment objectives between actors along the investment chain. Policy and regulation may also seek to clarify how such approaches align with pension fund duties, and whether particular approaches are required.

For further queries about this report, or to discuss its findings, please email: SFS@unpri.org.

BOX 1: SUMMARY OF THE 10 PRIORITIES

POLICY

1. **The policy framework is comprehensive and consistent**

   Policy makers develop a comprehensive, consistent and supportive policy framework that provides clarity for pension funds as they seek to address sustainability risks and opportunities, including system-level risks, when they pose a threat to achieving their financial objectives. Policy and regulatory frameworks ensure that:

   a. There is clarity regarding the duties and obligations of pension funds to incorporate ESG factors into investment decisions and stewardship activity, and to consider taking action to pursue sustainability outcomes that are instrumental to fulfilling financial objectives in line with members' and beneficiaries' preferences.

   b. The long-term investment horizon and fiduciary duties of pension funds are recognised, incentivised and protected through appropriate parameters in investment decision-making, product choice and the tenure of pension fund trustees and senior executives, leading to decision-making that prioritises long-term goals.

2. **Policy and regulation distinguish between addressing exposure to sustainability-related risks, tackling underlying drivers of such risks and pursuing sustainability outcomes in parallel with financial objectives**

   Pension funds are enabled to move beyond ESG integration at a risk-return level and pursue sustainability outcomes. Standards and guidance should clarify when pension funds may be required to consider addressing system-level risks relevant to financial objectives, as well as when and how they might pursue sustainability objectives in the best interest of members and beneficiaries.

3. **Pension funds, investment managers and intermediaries produce standardised reporting on sustainability objectives**

   Standardised reporting provides information about the extent to which pension funds have met stated sustainability objectives and taken action to achieve those objectives. Similarly, investment managers and relevant intermediaries in the investment value chain align their reporting to support pension funds. Reporting by pension funds is in a format that is accessible to members and beneficiaries.

4. **There is appropriate guidance on the sustainability claims of pension funds**

   Regulators provide guidance to pension funds on how to demonstrate the sustainability claims of their offerings and ensure that their disclosures indicate the types of strategies that facilitate these claims. This is a key factor in ensuring that members and beneficiaries have confidence in the sustainability characteristics of their products. Such guidance should not create unnecessary restrictions on the types of strategy that can be considered sustainable, providing adequate incentives to innovate.

MARKET STRUCTURE

5. **Pension funds have scale or can otherwise access the benefits of scale**

   Policy makers and regulators encourage fund consolidation where there are benefits to the market within which the funds are operating. However, the impacts of consolidation on sustainability objectives and strategies should be properly considered. In the absence of consolidation, policy makers and regulators encourage pooling of investments or resources, including encouraging sharing of resources on stewardship activities.

6. **Suitable, sustainable investment products are available and accessible**

   Pension funds can access investment products with their desired sustainability characteristics, at appropriate cost and scale, to achieve their sustainable investment objectives.

BOX 1 CONTINUED

INVESTMENT PRACTICES

7. **Members and beneficiaries are educated about and engaged with regarding their sustainability objectives**

   Pension fund members and beneficiaries are appropriately educated about and regularly and systematically engaged with regarding their sustainability objectives. Where appropriate, the views of members and beneficiaries are reflected in pension fund sustainability strategies.

8. **Trustees and fiduciaries are capable and skilled, with sustainability knowledge**

   Trustees and fiduciaries are equipped to meet high professional standards and receive sustainability-related training.

9. **Trustees and fiduciaries are willing to move beyond traditional pension fund investment strategies and identify, implement and support the development of appropriate benchmarks to take action to pursue sustainability outcomes in keeping with their fiduciary duties**

   This includes provision of adequate incentives and market settings for moving, where appropriate, from traditional benchmarks focused on short-term, portfolio-level risks, towards benchmarks that allow the measurement of a scheme's impact on system-level risks and the impacts of system-level risks on funds over longer timeframes.

10. **Service providers are adequately incentivised to support the pursuit of pension funds' sustainability objectives**

    Service providers (notably investment managers and consultants) are adequately incentivised, able and willing to provide products and services that support pension funds' sustainability objectives. This includes protecting against the adverse impacts of market concentration, such as the potential for conflicts of interest or impacts on the principal-agent relationship due to the size of intermediaries relative to the pension fund clients they serve.

ABOUT THIS REPORT

In 2020, the PRI published reports on the private pension systems in Australia, the UK and US, following research which found that there are policy, structural and market barriers to sustainability in these jurisdictions, which impact the ability of pension funds to incorporate ESG factors within their investment decisions and stewardship activities and to take action to pursue sustainability outcomes in keeping with their fiduciary duties. It published a similar report on Japan in 2021.

In 2023, the PRI reflected on the findings of the Australia, UK and US reports in light of market developments, practitioner experiences and the PRI's own work in this area. To this end, industry research and practitioner interviews were carried out within the PRI's sustainable financial system programme to gather updated perspectives on the barriers to sustainable pension systems. The findings focus on occupational pensions as the area in which most developments (especially policy) have occurred; however, they may also be relevant to personal pensions.

Using the policy, market structure and investment practice framework from our 2020 reports, the findings from our research have been summarised in 10 priorities that are necessary for a pension system to take sustainability considerations into account. Drawing on the previous PRI reports, and the findings of the LFI for pension funds (see Box 2), these priorities could encourage pension funds, their investment managers and consultants to build sustainable investment portfolios and help inform pension fund members about the sustainability objectives of their schemes. These priorities are set out in Box 1. However, the PRI acknowledges that these priorities are not exhaustive and further nuance and context is necessary when applying them to different markets and pension schemes.

In this report, we analyse the extent to which Australia, the UK and US have made progress on each priority, based on desk research and interviews with nearly 20 practitioners from these markets. The analysis reflects our findings from this research and is supported by the detailed structural information in our 2020 reports. Through this research, we offer policy makers, investors and other interested stakeholders a view of the current state of the policy, market structure and investment practice environment for pension funds in these jurisdictions, with the aim of encouraging discussion of priority areas for change.

BOX 2: INTEGRATING THE FINDINGS OF THE LEGAL FRAMEWORK FOR IMPACT (LFI)

LFI findings on pension funds and sustainability risks

A Legal Framework for Impact, authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, UNEP FI and the Generation Foundation, is a ground-breaking study of whether the law in 11 jurisdictions around the world permits or even requires investors to tackle some of the world's most urgent sustainability challenges by setting and pursuing sustainability objectives.

Pursuing such objectives goes beyond managing ESG risks and opportunities. Instead, the investor intentionally seeks to address the root causes of sustainability risks like climate change, biodiversity loss, and social inequality, either as a means to achieving financial investment objectives and fulfilling legal duties, or in parallel to them.

Pension funds, legal duties and sustainability impact

The purpose of pension funds is to invest pools of assets to produce a financial return that provides an income in retirement to their members or beneficiaries. In all jurisdictions covered by the LFI, pension fund administrators are required to act with loyalty, skill and care, and must take appropriate account of all relevant circumstances when deciding how to discharge their legal duties. As a minimum, those legal duties usually require them to pursue some sort of financial return.

The LFI analysis found that, under existing laws, pension funds are likely to have a legal obligation to consider investing for sustainability impact where it can help in fulfilling their financial objectives. Because sustainability factors such as climate change and biodiversity loss threaten the performance of the markets and economies on which investors rely for financial return, they are likely to be relevant circumstances for many pension funds tasked with protecting long-term value and providing an adequate pension to their beneficiaries.

Where a pension fund concludes that these factors do have a bearing on its ability to achieve its financial objectives, it also needs to consider what, if anything, it may be able to do, including the possibility of pursuing positive sustainability outcomes to contribute to wider efforts to reduce relevant sustainability risks. It should then act accordingly.

Why do we need policy reforms?

Mitigating system-level risks and delivering on sustainability goals committed to by governments, such as those of the Paris Agreement on climate change or the UN Sustainable Development Goals, relies on improving the sustainability outcomes of investments. While pension funds are permitted and may be required to pursue positive sustainability outcomes to reduce sustainability risks and achieve desired financial outcomes, they face impediments to setting and pursuing positive sustainability goals. This LFI briefing sets out a number of policy recommendations to address these barriers.

ANALYSIS AND COUNTRY PROGRESS

This chapter describes the 10 priorities for embedding sustainability considerations in pension systems, and considers the extent to which the Australian, UK and US pension systems incorporate them.

POLICY

PRIORITY 1

The policy framework is comprehensive and consistent

Policy makers develop a comprehensive, consistent and supportive policy framework that provides clarity for pension funds as they seek to address sustainability risks and opportunities, including system-level risks, when they pose a threat to achieving their financial objectives. Policy and regulatory frameworks ensure that:

1. There is clarity regarding the duties and obligations of pension funds to incorporate ESG factors into investment decisions and stewardship, and to consider taking action to pursue sustainability outcomes that are instrumental to fulfilling financial objectives in line with members' and beneficiaries' preferences.
2. The long-term investment horizon and fiduciary duties of pension funds are recognised, incentivised and protected through appropriate parameters in investment decision-making, product choice and the tenure of pension fund trustees and senior executives, leading to decision-making that prioritises long-term goals.

DESCRIPTION OF THE PRIORITY

The LFI establishes that some jurisdictions provide a theoretical basis for pension funds to pursue some form of investing for sustainability impact in line with the long-term horizons of their fiduciary duty. However, the parameters are not always clear. Policy frameworks often provide incomplete signals, or they can limit the incentives for pursuing sustainability objectives, preventing them from being widely established in investment practice. For this reason, a key recommendation of the LFI is to clarify that, "in discharging existing duties to seek to achieve a financial return, pursuing sustainability impact goals is an option that investors should consider".[1]

Typically, the core focus of pension policy has been to safeguard members' funds by regulating for high standards of governance, cost control and investment performance over relatively short time horizons (when compared to the actual retirement horizon of members). Therefore, incentives continue to be largely aligned with short-term horizons rather than the long-term horizons conducive to members' and beneficiaries' interests.

COUNTRY UPDATES: REVIEWING PENSION FUND POLICY FRAMEWORKS

Australia

Australian superannuation funds (super funds) are permitted broadly to integrate ESG factors and take action on sustainability outcomes but, as highlighted in the 2022 LFI Australia report, the regulatory framework is incomplete.

Regulated super funds are required to pursue at least one core purpose: paying benefits to members either upon retirement, death or when they've met the prescribed age (the 'sole purpose test').[2] In fulfilling this purpose, trustees of regulated super funds (along with broader super funds) have an obligation under the Superannuation Industry (Supervision) Act 1993 (SIS Act) to act in members' best financial interests. The SIS Act also specifies a range of financial considerations that super fund trustees are required to address in their investment strategy.[3] These provisions do not explicitly clarify that trustees could consider sustainability-related system level risks as part of their investment strategy. This lack of clarity could cause trustees to narrowly interpret these provisions and fall short of considering these risks which could be relevant to achieving their financial objectives.

1 PRI, the Generation Foundation and UNEP FI (2021), A Legal Framework for Impact (p. 17)
2 Australian Government (1993), Superannuation Industry (Supervision) Act 1993 Sect 62
3 Australian Government (1993), Superannuation Industry (Supervision) Act 1993 Sect 52(6)

Nevertheless, the Australian Prudential Regulation Authority (APRA), which is responsible for regulating super funds, has acknowledged the responsibility of funds to consider ESG-related risks. In November 2021, it released guidance for regulated banks, insurers and super funds to manage climate change financial risks at the corporate level. In relation to the investment level, APRA released its updated investment governance guidance in July 2023, which validated existing market practice and confirmed that super funds should consider ESG risks (including system-level or market-wide risks) in their investment analysis, decision making and oversight. The regulator further acknowledged that super funds could set environmental or social impact objectives, where they are consistent with outcomes sought for members.

It is too soon to conclusively determine the effects of APRA's guidance on super funds' intentions to take action on sustainability outcomes. Nonetheless, the permissive environment for considering ESG risks that has existed for well over a decade has contributed to ESG integration becoming the industry norm. Over 70% of the funds under management supervised by APRA are managed by a super fund that is a signatory to an ESG protocol, that offers ESG investment options, or follows standard ESG practices.[4]

In more recent developments, it is notable that in November 2023 the Australian government introduced legislation to the House of Representatives that seeks to create a new purpose for superannuation. The Superannuation (Objective) Bill 2023 proposes a new standalone act which states that "The objective of superannuation is to preserve savings to deliver income in retirement, alongside government support, in an equitable and sustainable way."[5] The bill enshrines the objective of superannuation in legislation, requiring policy makers to assess future changes to superannuation legislation for compatibility with this objective.

In November 2023, the Australian Treasury published its draft Sustainable Finance Strategy for consultation. The consultation proposed a range of sustainability measures, including: establishing a framework for sustainability-related financial disclosures; developing sustainability product labelling; support for credible net zero transition planning; and developing a sustainable finance taxonomy. It also sought feedback on questions such as the role of the government or regulators in supporting effective investor stewardship.

In the meantime, however, Australia's regulatory framework provides limited clarity regarding expectations for investors to exercise stewardship. Where stewardship is referenced in Australia's regulatory framework, it is incidental and provides limited direction or support to engage in stewardship. APRA's investment governance guidance explicitly allows super funds to exercise stewardship activities and sets expectations that they evidence how they use their influence to generate investment value. However, neither the SIS Act nor APRA "recognise effective stewardship as a fundamental component of exercising trustee duties".[6]

In addition, no regulator-supported stewardship code exists in Australia. Instead, industry associations such as the Financial Services Council (FSC) and the Australian Council of Superannuation Investors (ACSI) have developed voluntary guidance on asset stewardship and a signatory-based stewardship code, respectively.[7] Neither explicitly set expectations or provide guidance on how super funds should consider or pursue sustainability outcomes in keeping with their fiduciary duties through stewardship practices. Furthermore, the existence of both guidance and a code covering different types of investors within the Australian market has contributed to variations in approaches to stewardship.[8]

As of early 2024, the outcome of the Treasury's consultation on the Sustainable Finance Strategy is not yet clear. However, the consultation indicates a willingness among policy makers to expand the Australian policy and regulatory framework for sustainable finance.

United Kingdom

Extensive activity by policy makers and regulators since our 2020 report means that there are relatively few gaps in the UK policy framework in terms of addressing climate-related risks. However, the framework remains incomplete in terms of consideration of wider sustainability risks, such as nature-related risks, and sustainability outcomes.

Pension fund trustees have been required since 2019 to explain in their Statement of Investment Principles (SIP)[9] how ESG factors, where financially material, are taken into account in investment decisions.

4 Rainmaker Information (2022), Superannuation ESG Study 2022

5 Sustainable' is defined on page 9 of the Exposure draft explanatory materials to the Superannuation (Objective) Bill 2023

6 PRI (2023), Strengthening Effective Stewardship in Australia (pp. 15-16)

7 PRI (2023), Strengthening Effective Stewardship in Australia (p. 8); Financial Services Council (2017), FSC Standards: Standard No. 23: Principles of Internal Governance and Asset Stewardship; Australian Council for Superannuation Investors (2018), Australian Asset Owner Stewardship Code

8 Responsible Investment Association Australasia (2022), Engage, Advocate, Collaborate: Unpacking Stewardship in Australasia in 2022 (pp. 8-9)

9 TPR (2023), DC investment governance and (2019) DB investment

In October 2020, an additional requirement came into force, to publish an Implementation Statement that backs up the scheme's policy claims within the SIP for defined contribution (DC) schemes, and on their policy on exercising their investment rights and engagement activities for both defined benefit (DB) and DC schemes.[10] Supporting guidance was published in 2022, which includes more detail on stewardship activities.

In 2021, the UK became the first jurisdiction to mandate (larger) pension schemes to report in line with the requirements of the Task Force on Climate-related Financial Disclosures (TCFD), through the Climate Change Governance and Reporting Regulations and to require schemes to select and report on metrics that indicate their progress towards alignment with the Paris Agreement. In addition, the UK has a voluntary but widely used Stewardship Code which calls for signatories to the Code to "systematically integrate stewardship and investment, including material ESG issues, and climate change, to fulfil their responsibilities".[11]

More recently, the Department for Work and Pensions (DWP) has looked at ESG factors beyond climate-related risks, for example by setting up an industry-led Taskforce on Social Factors (TSF), which has published a guide on Considering Social Factors in Pension Scheme Investments to support "pension trustees in embedding social factors within scheme's investment decisions and stewardship policies".[12]

In the Mobilising Green Investment, Green Finance Strategy 2023, the UK government acknowledged that "decisions around investing and systemic risks are complicated and that trustees would like further information and clarity on their fiduciary duty in the context of the transition to net zero".[13] To address this issue, the government proposed a number of steps including a review of the implementation of the DWP's Stewardship Guidance, and a series of roundtables to engage on how to continue clarifying fiduciary duty.[14] In February 2024, the Financial Markets and Law Committee published a paper on Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change. The paper gives an explanation of the legal position on sustainability which "is integral to decision-making by pension fund trustees where it may affect financial return or risk".[15]

These initiatives are important for supporting trustees. It is notable that in the DWP and Treasury's summary of responses to their call for evidence on Pension trustee skills, capability and culture, which sought information on whether guidance on fiduciary duty is sufficient to support trustees in their investment decision-making; the majority of respondents considered that fiduciary duties are "well-established", but there can be "some inconsistency in interpretation". Moreover, respondents noted a "lack of clarity on how fiduciary duty interacts with sustainability and climate change considerations".[16]

Notwithstanding these developments, some significant gaps remain in the UK policy framework. For instance, insurers (the ultimate buyers of pension assets in a DB pension buyout) do not fall under the same policy framework as DB pension schemes and are currently under less stringent rules to invest sustainably. Other areas of policy may also fail to consider sustainability objectives, or even potentially conflict with them. The Financial Conduct Authority (FCA) Consumer Duty, which came into effect in July 2023 and "requires [financial services] firms to put their customers' needs first", does not feature sustainability. In July 2023, the DWP, The Pensions Regulator (TPR) and the FCA issued their response to the feedback they received to the Value for Money: A framework on metrics, standards and disclosures consultation for DC schemes, which similarly does not include sustainability as one of its aims. This could unintentionally discourage non-traditional investment strategies or consideration of sustainability objectives.

However, the UK's Chancellor of the Exchequer, in his July 2023 Mansion House speech, did state that "investment decisions should be made on the basis of long-term returns and not simply cost". This was further supported by initiatives in the Chancellor's Autumn 2023 statement, which included pension reforms such as shifting incentives away from a focus on cost towards long-term value and investment performance and accelerating the consolidation of schemes.

The PRI's UK Pensions Policy briefing contains further information about the UK's pensions policy landscape.

10 DWP (2022), Reporting on Stewardship and Other Topics through the Statement of Investment Principles and the Implementation Statement: Statutory and Non-statutory guidance (p. 17)

11 FRC (2020), The UK Stewardship Code (Principle 7)

12 Taskforce on Social Factors (2024), Considering Social Factors in Pension Scheme Investments (p.3)

13 HM Government (2023), Mobilising Green Investment: 2023 Green Finance Strategy (p. 56)

14 Ibid.

15 FMLC (2024), Paper-Pension-Fund-Trustees-and-Fiduciary-Duties-Decision-making-in-the-context-of-Sustainability-and-the-subject-of-Climate-Change-6-February-2024.pdf (fmlc.org) (p.6)

16 DWP and Treasury (2023), Government response to 'Pension trustee skills, capability and culture: a call for evidence' (Question 18)

United States

A rule from the Department of Labor (DoL), Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, which came into effect in January 2023, restored the understanding that fiduciaries of retirement plans regulated under the Employee Retirement Income Security Act (ERISA) may consider ESG factors where these are relevant to a risk-return analysis. However, the DoL has not issued detailed guidance for pension funds on how they might respond to the rule in their investment decisions. A legal challenge to this rule brought by 26 states was dismissed by a District Court judge in September 2023. This decision has been appealed to the Fifth Circuit Court of Appeals.[17] As of early 2024, a second challenge remains to be heard by another District Court.[18] Two major pension policy revisions passed into law over the past few years. The SECURE Acts of 2019 and 2022 aim to increase access to workplace pensions and encourage saving for retirement, but do not feature sustainability objectives.

17 United States Court of Appeals for the Fifth Circuit, 18 January 2024, State of Utah et al. v Julie A.Su and the United States Department of Labor, Opening Brief for Appellants

18 PRI (2023), Policy report: 118th congress: summary and analysis of select proposed legislation in the financial services sector

BOX 3: OECD CORE PRINCIPLES OF PRIVATE PENSION REGULATION

As of early 2024, the OECD core principles of private pension regulation (2016) are under review. They "provide governments, regulators and supervisors worldwide with a relevant common benchmark and high-level guidance on the design and operation of private pension systems".[19] The outcomes of this review could have an impact on the sustainability design of pensions systems in the markets analysed above and more widely.

COUNTRY UPDATES: REVIEWING PENSION FUND INVESTMENT HORIZONS

Australia

Super funds are driven to invest for the long term in part due to the sole purpose test. Nevertheless, the Your Future, Your Super (YFYS) reforms, which came into effect on 1 July 2021, may reduce the incentives for and ability of super funds to pursue real-world sustainability outcomes in line with their fiduciary duties over the long term. The reforms include an annual performance test that compares a fund's eight-year rolling annualised return against APRA's strategic asset allocation benchmark. If a fund fails the test (underperforming the benchmark by 50 basis points or more) two years in a row, it is not allowed to accept new members until performance improves. The YFYS performance test uses passive benchmark indices, and trustees have to weigh carefully where they are prepared to take positions that run counter to the broader market.

In March 2024, the Australian Treasury asked for input to its consultation on the Annual Superannuation Performance Test - design options, with the aim of seeking feedback on reforming the test, should the government choose to do so.

United Kingdom

DB schemes in the UK undertake triennial valuations, which are often the occasion to reset their investment strategy. This does not in itself preclude the schemes from having a long-term approach. However, the jump in the overall funding level for DB schemes – the result of higher discount rates – means that the investment horizons of many pension funds have shortened as they prepare for buyout by an insurance company.[20] DC schemes in the UK have historically aimed to offer daily liquidity, limiting their ability to invest in illiquid assets, but, as master trusts grow in terms of assets and market share, they should become more willing to make less-liquid investments.

There are initiatives underway to promote pension funds' investments in unlisted assets and over a longer time horizon. The Mansion House Compact, for example, was launched in July 2023 and includes some of the largest UK DC pension schemes. Its members aim to increase their investments in unlisted equities to at least 5% of their default funds by 2030.[21] And, in a letter to the chief executives of the FCA and TPR in November 2023, the UK Chancellor of the Exchequer and Secretary of State for Work and Pensions set out their "vision for the pensions market in 2030", which includes "enabling pension schemes to invest in a diverse portfolio" and "prioritising a system that ensures long-term value of pension schemes over short-term cost".

United States

There are no specific regulatory incentives for long-term investment horizons. Market practitioners such as investment managers tend to have short horizons, with a continuing focus on quarterly performance in client reporting, which can have an impact on pension funds' longer-term objectives.

19 OECD (2016), Core Principles of Private Pension Regulation, (p.3)

20 Financial Times, 9 July 2023, The pension deal bonanza remaking the UK's retirement sector (ft.com)

21 Jeremy Hunt (2023), Chancellor Jeremy Hunt's Mansion House speech

PRIORITY 2

Policy and regulation distinguish between addressing exposure to sustainability-related risks, tackling underlying drivers of such risks and pursuing sustainability outcomes in parallel with financial objectives

Pension funds are enabled to move beyond ESG integration at a risk-return level and pursue sustainability outcomes. Standards and guidance should clarify when pension funds may be required to consider addressing system-level risks relevant to financial objectives, as well as when and how they might pursue sustainability objectives in the best interest of members and beneficiaries.

DESCRIPTION OF THE PRIORITY

As responsible investment practices by pension funds and other investors have become more sophisticated, differences in interpretation on how sustainability-related objectives can and should be pursued have become increasingly apparent.

ESG integration has to date been primarily concerned with avoiding idiosyncratic risks – that is, risks specific to a particular asset or a small group of assets. The LFI research suggests that even the most developed legal frameworks for sustainability still effectively fail to distinguish between addressing ESG risks and pursuing positive sustainability outcomes. This is the case on the legal duties side (why there is legal permission or obligation to pursue outcomes), and on the wider policy and practice side (how that is done in investment policy, strategy, etc.). This can lead to confusion among market participants and heightened risks of greenwashing.

The PRI is currently collaborating with its signatories to design Progression Pathways, which seek to better distinguish these different approaches to sustainability-related risks and set out what best practice looks like with respect to each approach. This may improve alignment on responsible investment objectives between actors along the investment chain. Policy and regulation may also seek to clarify how such approaches align with pension fund duties, and whether particular approaches are required.

COUNTRY UPDATES

Australia

Australian policy makers and the super fund industry are beginning to recognise the distinction between ESG integration and taking action on sustainability outcomes. As noted earlier in this report, APRA released updated investment governance guidance for super funds in July 2023. The latest guidance includes a section on ESG investing and risk factors, noting that, in addition to managing ESG risks, super funds may incorporate "environmental or social impact related objectives, where it can demonstrate that pursuing such additional objectives is consistent with the outcomes the Registered Superannuation Entity licensee seeks to provide beneficiaries".[22]

United Kingdom

As noted in the previous section, the UK became the first jurisdiction to require larger pension funds to report in line with the requirements of the TCFD and to require schemes to select and report on metrics that indicate their progress towards alignment with the Paris Agreement. The UK also has a well-regarded Stewardship Code. The UK's 2023 Green Finance Strategy (GFS) committed the UK Financial Reporting Council (FRC), the FCA, DWP and TPR to reviewing the stewardship framework, which includes the Stewardship Code and DWP's Stewardship Guidance.[23] The review of the Stewardship Code will include "the role of systemic stewardship in supporting the achievement of positive sustainability outcomes".[24] Depending on their outcomes, these measures could create incentives for pension funds to set themselves sustainability objectives to achieve the best outcomes for their members and beneficiaries and to use stewardship to support them.

United States

US policy makers have not established policy guidelines around sustainable investing by pension funds and there is no centralised stewardship code in the US.

22 APRA (2023), Prudential Practice Guide SPG 530 Investment Governance (p.18)

23 HM Government (2023), Mobilising Green Investment: 2023 Green Finance Strategy (pp. 55-56)

24 Ibid.

PRIORITY 3

Pension funds, investment managers and intermediaries produce standardised reporting on sustainability objectives

Standardised reporting provides information about the extent to which pensions funds have met stated sustainability objectives and taken action to achieve those objectives. Similarly, investment managers and relevant intermediaries in the investment value chain align their reporting activities to support pension funds. Reporting by pension funds is in a format that is accessible to members and beneficiaries.

DESCRIPTION OF THE PRIORITY

Consistent and comparable reporting by pension funds on sustainability objectives makes it possible to compare activity and results across the pension system and identify best practice. Where such reporting exists, funds that are making progress in terms of sustainability are better able to differentiate themselves from those that are not, so that members and beneficiaries can be better informed. Well-designed disclosure standards can also influence behaviour by investors and reduce the risk of greenwashing.

COUNTRY UPDATES

Australia

Super funds report on their sustainability ambitions and activities as part of their communications with members and beneficiaries and other stakeholders but, in the absence of standardised reporting, this tends to be based around case studies. Impact is therefore difficult to gauge or compare across funds. Nevertheless, as of early 2024, the Treasury has released a plan to implement mandatory climate disclosures for large Australian entities, including super funds. The requirements intend to cover super funds' financed emissions. However, at least initially, the proposal does not extend reporting requirements to broader sustainability risks, opportunities and impacts and dependencies.

United Kingdom

The SIP and Implementation Statement reporting requirements and TCFD disclosures mean that trustees are required to report on both intent and implementation regarding sustainability; there is evidence that this is starting to raise their awareness and expertise in this area. However, a number of practical challenges have arisen. TCFD reporting is resource intensive and has not so far been a catalyst for change in investment portfolios, and questions have been raised regarding the effectiveness of scenarios used in some of the analysis.[25] Additionally, data is not always accessible, especially on outcomes. The reporting may not always be as informative as was intended, as much of the new reporting is about the governance and risk management aspects of TCFD rather than the sustainability impact of investment portfolios. For example, an investor in a specialised biodiversity fund does not have scope within the current TCFD report to cover biodiversity outcomes (although this could be done alongside the required report). All of this means that trustees may have less incentive to change their investment policy and limited possibilities to prove that any changes they do make are successful. It is, by contrast, relatively easy for trustees to report progress on elements of ESG integration.

The DWP has committed to review the extent to which its guidance on Reporting on Stewardship and Other Topics through the SIP and Implementation Statement is being followed by trustees, and TPR has carried out a review of climate-related disclosures by occupational pension schemes. It has also stated that it is checking compliance with broader ESG and climate change reporting via schemes' SIPs and Implementation Statements.[26] Findings from these reviews will be valuable for understanding how to develop reporting standards that do not impose an excessive compliance burden and that lead to action in the portfolio. Overall, however, the reporting requirements appear to be helping trustees to evolve their thinking on sustainability.

The UK government has also announced its approach for developing the UK Sustainability Disclosure Standards. These standards will be based on the IFRS Sustainability Disclosure Standards, issued by the International Sustainability Standards Board, and will be published by July 2024. As of early 2024, it is not clear whether the standards will apply to pension funds.

United States

Pension plans in the US are required to report on their financial position; they give limited information on the investment portfolio, such as asset allocation. There is no regulation requiring pensions to report on their sustainability objectives. However, ERISA-regulated managers may feel limited in doing so by fiduciary obligations to defray "reasonable expenses".

25 Institute and Faculty of Actuaries, University of Exeter (2023), The Emperor's New Climate Scenarios

26 HM Government (2023), Mobilising Green Investment: 2023 Green Finance Strategy (p. 60)

PRIORITY 4

Appropriate guidance exists on the sustainability claims of pension funds

Regulators provide guidance to pension funds on how to demonstrate the sustainability claims of their offerings and ensure that disclosures indicate the types of strategies that facilitate these claims. This is a key factor in ensuring that members and beneficiaries have confidence in the sustainability characteristics of products. Such guidance should not create unnecessary restrictions on the types of strategy that can potentially be considered sustainable, ensuring adequate incentives to innovate.

DESCRIPTION OF THE PRIORITY

Clear guidance ensures that pension funds accurately and transparently demonstrate how the sustainability claims offered in a product are achieved through their chosen strategies. Simultaneously, regulatory guidance to pension funds should ensure they avoid inadvertently making misleading claims about the sustainability credentials of their investments. Doing so could cause members and beneficiaries to hold investments in lower-quality products or to disengage from their pension funds. However, given the increasing maturity, and therefore complexity, of sustainable investment practices, efforts to prevent greenwashing should be mindful of avoiding inadvertently penalising strategies that could be crucial for the low-carbon transition, discouraging innovation.

COUNTRY UPDATES

Australia

The Australian Securities and Investments Commission (ASIC) is providing guidance on how to communicate about and promote sustainability-related products and is undertaking investigatory and enforcement action in relation to those products.[27] ASIC has warned that it will investigate investors for misleading comments about their stewardship intentions and influence over fossil fuel companies, where their voting records show misaligned action. However, there is a concern that, without supporting direction and guidance by APRA on how to address system-level risks and respond to members and beneficiaries' sustainability objectives, super funds may be reluctant to set sustainability objectives across their portfolio, or develop new, sustainable products. For example, ASIC requires a lot of evidence to back up ESG claims, which may or may not be proportionate to the proof it requires of other claims, for example to distinguish between active and passive managers.

United Kingdom

TCFD reporting means that large UK pension schemes are required to gather and report information about how they identify, assess and manage climate risk.[28] However, these requirements are limited to climate risk so do not include wider sustainability disclosures. The FCA has introduced new rules under its Sustainability Disclosure Requirements, which include an anti-greenwashing rule and investment labels so that "financial products that are marketed as sustainable should do as they claim and have the evidence to back it up".[29] Although these rules will not initially apply to pension products, the FCA has confirmed that it will work with the DWP and TPR on developing proposals for rules that do so.[30]

United States

In the US, the Securities and Exchange Commission (SEC) has proposed two changes designed to address greenwashing. The first proposal, finalised in September 2023, amended the so-called Names Rule to expand naming criteria that require that 80% of holdings fit the terminology used in the fund's name. Fund managers have two years to comply with these changes. The second proposed rule, which has yet to be finalised as of early 2024, would allow funds to opt into one of three sustainability-related categories - 'ESG integration', 'ESG-focused' and 'impact' - and produce additional, tiered disclosures accordingly.

27 ASIC, 28 February 2023, 23-043MR ASIC launches first Court proceedings alleging greenwashing, 25 July 2023, ASIC commences greenwashing case against Vanguard Investments Australia and August 2023, 23-215MR ASIC commences greenwashing case against Active Super

28 DWP (2022), Governance and reporting of climate change risk: guidance for trustees of occupational schemes

29 FCA (2023), Sustainability Disclosure Requirements (SDR) and investment labels (p.3)

30 FCA (2023), Sustainability Disclosure Requirements (SDR) and investment labels (p.64)

STRUCTURE

PRIORITY 5

Pension funds have scale or can otherwise access the benefits of scale

Policy makers and regulators encourage fund consolidation where there are benefits for the market within which the funds are operating. However, the impacts of consolidation on sustainability objectives and strategies should be properly considered. In the absence of consolidation, regulators encourage pooling of investments or resources, including encouraging sharing of resources for stewardship activities.

DESCRIPTION OF THE PRIORITY

Market fragmentation is a significant structural barrier to successful policy implementation.[31] Larger funds are more likely than small funds to have the governance, resources, investment and stewardship expertise required to develop, monitor and report on sustainable portfolio strategies. Larger funds are also more likely to be able to encourage investment managers and consultants to provide sustainability-related services and to allocate additional resources to member and beneficiary engagement. Through market consolidation or the pooling of resources, and decreased barriers to collaboration on stewardship activities, pension funds can use the benefits of scale to work towards greater impact of their sustainability strategies. Importantly, stewardship activities, particularly in relation to companies, strongly rely on scale to produce meaningful market signals and outcomes. This is particularly relevant when considering how pension funds can collaborate to achieve their sustainability objectives; noting that they are each independent fiduciaries responsible for their own investment and voting decisions.

COUNTRY UPDATES

Australia

The Australian pension system is the most concentrated of the three systems under review in this report and the number of super funds continues to decline. Indeed, the former deputy chair of APRA stated that funds with less than A$30 billion of assets should consider merging with larger funds.[32] Even without regulatory intervention, super funds recognised the benefits of scale early on and established a collective investment vehicle, the Development Australia Fund (now IFM Investors) in 1990, when the superannuation system was considerably smaller than today. There is, however, a caveat to the Australian story: consolidation has been largely driven by performance league tables and other regulatory pressures, which are not in themselves necessarily conducive to long-term investing or sustainability. Ideally, such nuances ought to be considered in any further regulatory measures that encourage consolidation.

United Kingdom

The occupational pension landscape remains fragmented in the UK, with a small number of relatively large schemes and a large number of smaller schemes. According to TPR's Annual report on UK defined benefit and hybrid schemes 2022, while the number of DB schemes is declining, over 5,000 remain, of which approximately 80% have fewer than 1,000 members.[33] The number of DC schemes is also falling and, more significantly, almost three-quarters of the assets in trust-based DC schemes are now held in master trusts.[34] However, consolidation can be difficult to achieve because of the different legal and membership structures of schemes; although some of the UK's Local Government Pension Scheme pools have managed to successfully create investment scale without a full administrative merger of the underlying schemes. They have been among some of the most active advocates for sustainable investment.

The potential for consolidated occupational pension schemes to contribute more to the UK's economic growth is increasingly being discussed. In July 2023, the DWP published the outcome of a consultation on the Consolidation of defined benefit pension schemes, with a goal of developing super funds in the UK to "increase protection for members whilst also supporting wider economic initiatives".[35]

31 PRI (2020), In search of sustainability: Private retirement systems in Australia, the United Kingdom and the United States

32 APRA (2021), APRA Deputy Chair Helen Rowell - Speech to AIST Conference of Major Superannuation Funds

33 TPR (2022), Annual report on UK defined benefit and hybrid schemes 2022

34 TPR (2023), DC trust: scheme return data 2022 to 2023

35 DWP (2023), Government response: Consolidation of defined benefit pension schemes

The UK's Chancellor of the Exchequer also announced in July 2023 that the government will "facilitate a programme of DC consolidation, to ensure that funds are able to maintain a diverse portfolio of bonds, equity and unlisted assets and deliver the best possible returns for savers".[36] This was reiterated in the UK's Autumn Statement 2023, where the Chancellor of the Exchequer confirmed that the Mansion House reforms will be taken forward, starting with consolidation: "By 2030, the majority of workplace DC savers will have their pension pots managed in schemes of over £30 billion and by 2040 all local government pension funds will be invested in pools of £200 billion or more."[37] These are ambitious targets, but they demonstrate a clear push towards consolidation by the UK government.

United States

There has been no push towards consolidation in the US pension system, although the improved access to multiple employer plans created under the SECURE Act could encourage the growth of funds similar to the UK's master trusts.

36 Jeremy Hunt (2023), Chancellor Jeremy Hunt's Mansion House speech

37 Jeremy Hunt (2023), Autumn Statement 2023 speech

PRIORITY 6

Suitable, sustainable investment products are available and accessible

Pension funds can access investment products with their desired sustainability characteristics, at appropriate cost and scale, to achieve their sustainable investment objectives.

DESCRIPTION OF THE PRIORITY

A current challenge for sustainable investment strategies is to find appropriate products to match the scale and/or expertise of pension funds at a reasonable cost. Products may also be inconsistent (or be perceived to be inconsistent) with other objectives of the funds, such as liquidity or liability matching. The availability of appropriate products is fundamental to helping pension funds achieve their sustainable investment objectives.

COUNTRY UPDATES

Australia

Super funds are well placed to access sustainable investment products. Some have large in-house investment teams, in addition to the expertise provided by IFM and other external investment managers. As open-ended DC schemes, they have a long investment horizon, and high contribution rates mean that they do not face short-term liquidity constraints. However, their liabilities are denominated in Australian dollars and their investment portfolios need to reflect this. This means they will inevitably invest in the Australian economy and therefore have a certain degree of exposure to the sectors and industries prevalent in the Australian market, including a significant proportion of oil, gas and mining companies where ESG risks and, in particular, climate risks may be present.

United Kingdom

Many DB schemes are closed, and large parts of their portfolios are allocated to liability-matching products. These can be long-term investment strategies such as infrastructure, which could contribute to sustainability objectives, but are often liability-driven investment (LDI) products, investing in government and corporate credit and often without an explicit sustainability mandate. UK DC schemes are increasingly offering ESG options, including in default strategies. However, historically, UK DC schemes have sought underlying investments with daily liquidity, which restricts their ability to invest in asset classes such as private equity. They have also been reluctant to invest in strategies with higher costs, given the cap on fees imposed by the regulator.

However, regulators are helping to make a wider range of products more accessible to DC funds through measures such as the Productive Finance Working Group's 2021 Roadmap for Increasing Productive Finance Investment. This sets out recommendations for removing the barriers to DC pension schemes and other investors investing in less liquid longer-term assets. In 2023, the FCA published its rules and guidance on Broadening retail and pensions access to the Long-Term Asset Fund (LTAF), which aims to facilitate long-term investment in illiquid assets.

United States

As in other jurisdictions, larger pension plans can access suitable investment strategies to implement their objectives. The DoL's 2022 rulemaking allowed sustainable options to be utilised as default investment strategies. However, as discussed above, challenges to this change remain and there are fewer incentives within the US pension system to developing a sustainable default strategy for 401(k) plans.

INVESTMENT PRACTICE

PRIORITY 7

Members and beneficiaries are educated about and engaged with regarding their sustainability objectives

Pension fund members and beneficiaries are appropriately educated about and regularly and systematically engaged with regarding their sustainability objectives.[38] Where appropriate, member and beneficiary views are reflected in pension fund sustainability strategies.

DESCRIPTION OF THE PRIORITY

Member and beneficiary education and engagement is becoming more of a priority in all the markets reviewed for this report with the increase in DC provision, where the risk of a poor financial outcome in retirement is carried by the member rather than the scheme sponsor. The interests of beneficiaries and members typically extend many decades into the future, through many investment cycles. Member engagement enables trustees and plan boards to understand the preferences of their members across all aspects of their pension savings, including their sustainability objectives.

As noted in the previous priority, alignment between member and beneficiary preference and sustainability objectives is dependent on the availability and accessibility of suitable sustainable investment products.

COUNTRY UPDATES

Australia

The Australian pension system is built on a competitive model, and it is relatively easy for members to change providers. Super funds have therefore had to develop member engagement skills to understand what issues matter to their members and beneficiaries. Nevertheless, the LFI Australia report does suggest that policy makers could look at ways to help investors "take beneficiaries' sustainability preferences into account".[39] Super funds highlight responsible investing on their websites, and a number have faced related legal action from members. For example, the trustee of industry fund REST faced litigation in 2020 for allegedly failing to adequately disclose its approach to dealing with climate change. However, such cases are unusual.

United Kingdom

As stated in the PRI's report on Understanding and aligning with beneficiaries' sustainability preferences, the UK's Occupational Pension Schemes (Investment and Disclosure) regulations have since 2019 required "trustees of trust-based occupational pension schemes to specify the extent (if at all) to which they consider the views of members and beneficiaries on non-financial matters, including sustainability, when it comes to the selection, retention and realisation of investments".[40] Likewise, there is also a similar expectation for the independent governance committees of contract-based pension schemes. Furthermore, TPR expects trustees of DC plans to "consider any information provided when determining investment options to offer to members and strategies for the scheme".[41] This includes specific investment approaches, such as investing in sustainable funds. The UK Stewardship Code also encourages signatories to consider beneficiaries' views.

In practice, however, there are barriers to engagement between occupational DC pension funds and their members,[42] although some funds do carry out member research and surveys. Their relationship is indirect, with the employer acting as intermediary, and the average pot size in DC schemes is small, with some individuals having several pots due to changing jobs. An additional challenge is members' low understanding of pensions generally.[43] The LFI UK report includes as a policy for further consideration "options to enable consideration of certain sustainability impact goals and of individual investors' views on sustainability".[44]

United States

There is evidence that engaged members have higher savings rates than other participants in 401(k) plans,[45] but research does not extend to engagement on sustainability. As US funds navigate the debate about ESG integration and portfolio returns and raise their awareness of the risks of possible greenwashing, fund managers will need to communicate effectively with members and beneficiaries and possibly canvass their views on sustainability to guide their strategy.

38 See: PRI blogs Pension funds need to consider beneficiaries' sustainability preferences more – here's why the IORP II consultation matters (27 April 2023) and Bringing beneficiaries into the responsible investment conversation (4 May 2021); and the PRI's Understanding and aligning with beneficiaries' sustainability preferences report.

39 PRI, the Generation Foundation and UNEP FI (2022), A Legal Framework for Impact. Australia. Integrating sustainability goals across the investment industry (p.5)

40 PRI (2021), Understanding and aligning with beneficiary sustainability preferences (p.7)

41 TPR, Code of practice 13

42 DWP (2023), Understanding member engagement with workplace pensions

43 TPR and the FCA (2021), Call for Input: Pensions consumer journey

44 PRI, the Generation Foundation and UNEP FI (2022) A Legal Framework for Impact. UK. Integrating sustainability goals across the investment industry (p.5)

45 American Society of Pension Professionals & Actuaries (2022), How 401(k) Engagement Matters – a Lot

PRIORITY 8

Trustees and fiduciaries are capable and skilled, with sustainability knowledge

Trustees and fiduciaries are equipped to meet high professional standards and receive sustainability-related training.

DESCRIPTION OF THE PRIORITY

Trustees and fiduciaries are ultimately responsible for all decisions made by a pension fund, including investment decisions. They therefore play a central role in building sustainable investment portfolios and contributing to the development of a sustainable pension system more broadly.

Sustainability-related training should be provided to pension fund trustees and fiduciaries. This would ensure they have the right knowledge and understanding of ESG-related investment risks and opportunities, and of factors related to sustainability outcomes. This would make them "better equipped to take sustainability factors into account in their investment decision-making"[46] and to ask relevant questions of scheme advisers and fund managers. The PRI Academy offers a training course on responsible investment specifically designed for trustees.

COUNTRY UPDATES

Australia

Trustee boards in Australia are well trained and representative of different interests, and education and training are mandatory. Oversight of trustees' technical and ethical standards has tightened as the weight of the superannuation sector in the economy has grown. The Australian pension system illustrates the importance of trustees in facilitating change: the super fund sector, especially the profit-for-member funds, has been a key driver of the early adoption of responsible investing. Profit-for-member funds have traditionally been interested in social and governance issues, not least because they follow an equal representation trustee model, with both employees and employers represented at board level.

United Kingdom

Our 2020 report highlighted the lack of trustee education and diversity among UK trustees and governing bodies. The large number of schemes in the UK means that not all of them are overseen by professional trustees, and there is no standardised qualification for people with that designation, although training is offered by a number of providers, including TPR, which states that trustees must have the knowledge and skills to carry out their trustee duties within six months of becoming a trustee,[47] or at the time of appointment if they are a professional trustee. In its February 2023 discussion paper, Finance for positive sustainable change: governance, incentives and competence in regulated firms, the FCA noted the importance of training and improving competence on sustainability across the financial sector.

This paper was followed by a call for evidence in July 2023 from the DWP and Treasury on pension trustee skills, capability and culture. In the PRI's response, we recommended that sustainability-related training should be provided to pension fund trustees as well as to the service providers supporting them. This is to "ensure they are equipped to take sustainability factors into account in their decision-making [and in their interactions with fund advisers and managers] and allow them to consider pursuing positive sustainability impacts where relevant to achieving the purpose and objectives of the scheme".[48] Our response also recommended that the DWP and Treasury should look at how to encourage more diversity on trustee boards as a means of providing boards with access to a range of perspectives, helping to reduce knowledge gaps and avoid biased thinking when decision-making.[49]

In their response to the call for evidence, the DWP and Treasury said they'd work with TPR in developing a register of trustees to identify and help trustees and schemes where additional support is needed. They will also encourage professional trustees to become accredited and will consider whether future legislation is necessary to mandate accreditation. The response acknowledged that trustees would benefit from more support, guidance and training. However, it did not mention the need for sustainability-related training, representing a missed opportunity for improving trustees' ability to take sustainability factors into account in their investment decision-making.

46 PRI (2023), PRI response: DWP/HMT call for evidence – pension trustee skills, capability and culture (p.5)
47 TPR (2023), Becoming a new pension trustee | The Pensions Regulator
48 PRI, the Generation Foundation and UNEP FI (2022), A Legal Framework for Impact. UK. Integrating sustainability goals across the investment industry (p.14)
49 PRI (2023), PRI response. DWP/HMT call for evidence – pension trustee skills, capability and culture (p.6)

In early 2024, TPR published its General Code of Practice on scheme governance and administration, which "brings together and updates 10 existing codes of practice into a single set of clear, consistent expectations".[50] The Code aims to clarify its expectations for trustees and governing bodies and includes modules on climate change and stewardship; which reinforce some of the legislative requirements set out earlier in this report.

United States

Training is voluntary for trustees and fiduciaries in the US, although many states require trustees or fiduciaries of public plans to undergo certification. Our 2020 report highlighted research that suggests that some public plan boards may prioritise stakeholder representation over technical expertise, which could lead to lower confidence in adopting new approaches.[51] Our report also found that there is no consistent guidance for public plan boards on approaching responsible investment where internal resources or expertise may be lacking.[52]

50 TPR (2024), Final response to the consultation on a new code of practice

51 PRI (2020), In search of sustainability: Private retirement systems and sustainability: United States (p.10)

52 Ibid.

PRIORITY 9

Trustees and fiduciaries are willing to move beyond traditional pension fund investment strategies and identify, implement and support the development of appropriate benchmarks to take action to pursue sustainability outcomes in keeping with their fiduciary duties

This includes provision of adequate incentives and market settings for moving, where appropriate, from traditional benchmarks focused on short-term, portfolio-level risks, towards benchmarks that allow the measurement of a scheme's impact on system-level risks and the impacts of system-level risks on funds over longer timeframes.

DESCRIPTION OF THE PRIORITY

Fund performance is usually designed and measured against market benchmarks. Conventionally, mainstream market benchmarks tend to be backward-looking and contain the sustainability risks inherent in the broader market, without necessarily including the specific sustainability risks that are prioritised by the pension fund. Additionally, they may not cover asset classes or investment horizons that are more suited to investing for sustainability impact. Changes in the culture, practice and processes of markets, and in their regulation, could help trustees and fiduciaries move beyond traditional pension fund investment strategies, by exploring new assets for example, and encourage them to move towards benchmarks that allow the measurement of a scheme's impact on system-level risks and the impacts of system-level risks on funds over longer timeframes.

COUNTRY UPDATES

Australia

APRA and the super funds use traditional market benchmarks to measure and compare performance. There are concerns that the YFYS reforms could have unintended consequences, by constraining how trustees respond to longer-term, sustainability-related system-level risks. This is because the performance test focuses on performance against passive market benchmarks, and trustees have to weigh carefully where they are prepared to take positions that may diverge from the broader market. Additional costs related to stewardship resourcing, which could disincentivise certain activities, could also weigh on performance as measured under YFYS. At the same time, the Australian pension system is extremely competitive, including with regards to competing on investment innovation in furtherance of members' best interests.

United Kingdom

The introduction of TCFD reporting standards has helped to catalyse new thinking by UK trustees, but a range of pressures creates challenges for pension funds when considering sustainable investment practices. They may need to move from traditional market benchmarks and identify and implement benchmarks more suitable for their sustainability objectives, in addition to exploring new asset classes. This could increase the level of risk in the fund relative to conventional options.

United States

The recent regulatory back and forth at the DoL has had a chilling effect on the market. Plan managers are less willing to advance their sustainability considerations than those of similar schemes in other jurisdictions. Beyond regulators, there is increased activity from activist groups and plan participants to challenge pension managers taking steps to address sustainability risks. For example, New York City's pension funds face a legal challenge over efforts to divest from fossil fuel companies and achieve net-zero portfolios by 2050.

PRIORITY 10

Service providers are adequately incentivised to support the pursuit of pension funds' sustainability objectives

Service providers (notably investment managers and consultants) are adequately incentivised, able and willing to provide products and services that support pension funds' sustainability objectives. This includes protecting against the adverse impacts of market concentration, such as the potential for conflicts of interest or impacts on the principal-agent relationship due to the size of intermediaries relative to the pension fund clients they serve.

DESCRIPTION OF THE PRIORITY

Our earlier research found that investment managers and consultants are often better placed than their pension fund clients to undertake research and product development related to sustainability, because of the costs and expertise involved. Furthermore, larger investment managers often have more resources than their clients devoted to stewardship and advocacy. However, their business models or other pressures may make them reluctant to move ahead of their clients in terms of encouraging more rapid adoption of sustainable investing practices.

There is guidance available to support asset owners such as pension funds in their interactions with their investment managers; for instance, the PRI's Investment manager appointment guide includes sample ESG clauses that could be used in investment management agreements (IMAs) between asset owners and investment managers. There is also detailed information in the International Corporate Governance Network and Global Investors for Sustainable Development model mandate to help asset owners ensure their IMAs reflect their sustainability objectives. In relation to investment consultants, the Investment Consultants Sustainability Working Group has published a framework for trustees to use to assess the climate competency of their investment consultants.

COUNTRY UPDATES

Australia

Super funds use external consultants for investment expertise, including on sustainability-related activities. The LFI Australia report suggests that IMAs between asset owners (such as pension funds) and investment managers could be updated "to empower asset managers to shape sustainability outcomes and require them to consider sustainability-related system-level risks when making investment decisions"[53], where relevant to asset owners' fiduciary duties.

United Kingdom

Since our 2020 reports, both investment managers and consultants in the UK have increased their capabilities related to sustainability and appear to be more willing to use their influence with clients. However, our research for this report indicates that pension funds may still be reluctant to take on a leadership role. And, while investment managers and consultants may have the resources to undertake sustainability-related research and product development, their business models, or other pressures, may make them reluctant to move ahead of their clients, thus preventing the market from advancing. In addition, pension funds may not always be able to provide evidence that they've followed through on fund intentions on sustainability. For example, investment manager voting practices may not always reflect the policies of a client fund and the details of stewardship practices may be unclear.

In our response to the DWP and Treasury call for evidence on pension trustee skills, capability and culture, we recommended the development of an IMA template which should include standardised terms permitting investment managers to pursue desired sustainability outcomes and encourage stewardship.[54] Separately, in 2023, the PRI published its Stewardship for sustainability evaluation tool, which provides a framework to help investors evaluate and compare how their investment managers use stewardship to address sustainability issues.

United States

Mixed signals from the US political sphere have contributed to an uncertain environment for service providers, which may be more reluctant than they were in our earlier research in 2020 to highlight their sustainability-related products and services. However, ongoing conversations with PRI signatories demonstrate that there is still demand for such products and services to help them fulfil their fiduciary duties.

53 PRI, the Generation Foundation and UNEP FI (2022), A Legal Framework for Impact. Australia. Integrating sustainability goals across the investment industry (p.20)

54 PRI (2023), PRI response. DWP/HMT call for evidence – pension trustee skills, capability and culture (p.4)

NEXT STEPS

The 10 priorities presented in this report suggest areas where the PRI believes that the policy, market structure and investment practices of pension systems require the most attention for embedding sustainability considerations. In each market reviewed, the importance of a comprehensive and consistent policy framework was emphasised, with supporting guidance, regulations and incentives being essential to their implementation. In the absence of such structures, there will be limited capacity for change at scale.

While our findings need to be contextualised for different markets and pension funds, our aim for this research is to offer policy makers, investors and other interested stakeholders a view on the current state of the policy, market structure and investment practice environment for pension funds in Australia, the UK and US, and to spur discussion on the priority areas for change.

The PRI will use this research as the basis for ongoing advocacy work across key markets and to engage with relevant signatories. This will also inform the continued development of Progression Pathways, and how different investors can seek to address the sustainability-related risks that they face. We welcome stakeholder feedback in relation to developing regional contexts for the application of these priorities and on further insights on investor-led interventions.

For further queries about this report or to discuss its findings, please email: SFS@unpri.org.

ANNEX 1 – GLOSSARY

KEY TERMS

<table>
<tr><th>TERM</th><th>DESCRIPTION</th></tr>
<tr><td>Collaboration (stewardship)</td><td>Collaboration in the context of stewardship refers to investors or their service providers working together and/or with other stakeholders to pool resources and enhance their effectiveness in pursuing their sustainability objectives.

Collaboration can include informal means, such as sharing insights on how to approach an issue with peers, as well as formal mechanisms such as collaborative engagements or initiatives, or the use of an external service provider (e.g. engagement overlay service) that pools resources from multiple investors.</td></tr>
<tr><td>ESG incorporation</td><td>Assessing, reviewing and considering ESG factors in existing investment practices through a combination of three approaches: integration; screening; and thematic investing. ESG incorporation generally functions alongside, or in combination with, stewardship.</td></tr>
<tr><td>ESG integration</td><td>Ongoing consideration of ESG factors within an investment analysis and decision-making process with the aim to improve risk-adjusted returns.</td></tr>
<tr><td>ESG risk</td><td>An environmental, social or governance risk is a factor or issue that may expose a security, issuer, investment or asset class to unexpected changes in its current and future financial, economic, reputational and legal situation. Investors could reasonably expect an ESG risk to be disclosed at a corporate or issuer level, as its omission would result in an incomplete understanding of current or future financial prospects.</td></tr>
<tr><td>Stewardship</td><td>The use of influence by investors to protect and enhance overall long-term value, including the value of common economic, social and environmental assets, on which returns and client and beneficiary interests depend.</td></tr>
<tr><td>Sustainability impacts</td><td>The impacts of investors' actions on the environment and society, whether positive or negative.</td></tr>
<tr><td>Sustainability outcomes</td><td>The positive and negative effects of investment activities on people and/or the planet. They are understood in the context of global sustainability goals and thresholds.</td></tr>
<tr><td>System-level risks</td><td>System-level risks: a catch-all term for systematic risk and systemic risk, both of which have implications for investment performance.

▪ Systematic risk: risk, transmitted through financial markets and economies, that affects aggregate outcomes, such as broad market returns. The term is interchangeable with "market risk" or "market-wide risk". Because systematic risk occurs at a scale greater than a single company, sector or geography, it cannot be hedged or mitigated through diversification. One example of a sustainability-related systematic risk is the risk of reduced global economic growth due to sustained physical impacts of climate disruption; another is the opportunity cost associated with failing to meet the SDGs.
▪ Systemic risk: the risk that an event at a particular point in time or a chronic economic condition destabilises the financial system or leads to its collapse. An example of a systemic risk materialising would be a number of 'too-big-to fail' financial institutions defaulting on obligations to their creditors or investors. An example of a sustainability-related systemic risk would be a sudden repricing of assets across the fossil fuel sector, resulting in cascading defaults that destabilise financial markets – this is sometimes referred to as a potential 'climate Minsky moment'.</td></tr>
</table>

Source: various PRI publications

ANNEX 2 – KEY PUBLICATIONS

See below for a summary of the key PRI publications, guidance, legislation and policy referenced in this report.

PRI PUBLICATIONS

- PRI (2020), In search of sustainability: Private retirement systems in Australia, the United Kingdom and the United States
- PRI (2020), In search of sustainability: Private retirement systems and sustainability: Australia
- PRI (2020), In search of sustainability: Private retirement systems and sustainability: United Kingdom
- PRI (2020), In search of sustainability: Private retirement systems and sustainability: United States
- PRI (2020), Investment manager appointment guide
- PRI (2021), Pension systems and sustainability: Japan
- PRI, the Generation Foundation and UNEP FI (2021), A Legal Framework for Impact
- PRI, the Generation Foundation and UNEP FI (2022), A Legal Framework for Impact. Australia. Integrating sustainability goals across the investment industry
- PRI, the Generation Foundation and UNEP FI (2022), A Legal Framework for Impact. UK. Integrating sustainability goals across the investment industry
- PRI, the Generation Foundation and UNEP FI (2023), Legal framework for Impact: Briefing for policy makers
- PRI (2023), Evaluating managers' stewardship for sustainability
- PRI (2023), Policy report: 118th congress: summary and analysis of select proposed legislation in the financial services sector
- PRI (2023), Strengthening Effective Stewardship in Australia

AUSTRALIA

- Australian Council for Superannuation Investors (2018), Australian Asset Owner Stewardship Code
- Australian Government (1993), Superannuation Industry (Supervision) Act 1993
- Australian Prudential Regulation Authority (2021), Prudential Practice Guide CPG 229 Climate Change Financial Risks
- Australian Prudential Regulation Authority (2023), Prudential Practice Guide SPG 530 Investment Governance
- Department of the Treasury (2021), Treasury Laws Amendment (Your Future, Your Super) Act 2021
- Department of the Treasury (2023), Superannuation (Objective) Bill 2023
- Department of the Treasury (2023), Sustainable Finance Strategy
- Department of the Treasury (2024), Climate-related financial disclosure: exposure draft legislation
- Financial Services Council (2017), FSC Standards: Standard No. 23: Principles of Internal Governance and Asset Stewardship

UNITED KINGDOM

- Department for Work and Pensions (2022), Governance and reporting of climate change risk: guidance for trustees of occupational schemes
- Department for Work and Pensions (2022), Reporting on Stewardship and Other Topics through the Statement of Investment Principles and the Implementation Statement: Statutory and Non-Statutory Guidance
- Department for Work and Pensions, Financial Conduct Authority, and The Pensions Regulator (2023), Government-regulator response to 'Value for Money: A framework on metrics, standards and disclosures.'
- Financial Reporting Council (2020), The UK Stewardship Code
- Financial Conduct Authority (2019), PS19/30 Independent Governance Committees: extension of remit
- Financial Conduct Authority (2022), A new Consumer Duty
- Financial Conduct Authority (2023), Sustainability Disclosure Requirements (SDR) and investment labels
- HM Government (2019), The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019
- HM Government (2021), The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021
- HM Government (2023), Mobilising Green Investment: 2023 Green Finance Strategy
- The Pensions Regulator (2019), DB investment webpage
- The Pensions Regulator (2022), Governance and reporting of climate-related risks and opportunities web page
- The Pensions Regulator (2023), DC investment governance webpage
- The Pensions Regulator, Code of practice 13
- The Pensions Regulator (2024), General Code of Practice

UNITED STATES

- Department of Labor (2019), Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act)
- Department of Labor (2022), Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights
- Department of Labor (2022), SECURE 2.0 Act of 2022
- Securities and Exchange Commission (2022), Enhanced Disclosures by Certain Investment Advisers and Companies about Environmental, Social and Governance Investment Practices
- Securities and Exchange Commission (2023), Investment Company Names

CREDITS

AUTHOR:

- Josephine Notaras, PRI
- Emmy Labovitch, Independent consultant

CONTRIBUTORS:

- Nithya Iyer, PRI
- Nikki King, PRI
- Kelly Krauter, PRI
- René van Merrienboer, PRI
- Will Sullivan, PRI
- Kar Mei Tang, PRI

EDITOR:

- Mark Nicholls, MRG Comms

DESIGN:

- Will Stewart, PRI

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org