

# Pension Fund Trustees and Climate Change





# Pension Fund Trustees and Climate Change

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## **ACKNOWLEDGMENTS**

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First I would like to thank the ESRC for funding this project and to acknowledge the support of ACCA, UKSIF, the PMI and the NAPF. In compiling this report, I am grateful to Hannah Clarke for her assistance with the interviews for this project and, of course, to the interviewees who gave their time, without whose participation the research would have been impossible. I would also like to thank Caroline Oades (ACCA) for her energetic coordination of the project and for her invaluable guidance throughout the research process. Thanks also to Peter Butler (Governance for Owners) and Penny Shepherd (UKSIF) for their suggestions and comments on the interview questions. I am also grateful to Mike Jones (Cardiff University) for his comments on drafts of the report and to delegates attending a presentation of this research at the annual Accounting and Finance Colloquium for the University of Wales, Gregynog, Wales, especially Richard Macve and Doris Merckyl.

I am also grateful to delegates at the 'Climate Change, Consumers, and Business' conference, Cardiff University, 11 June 2008, who provided helpful ideas and suggestions on the development of the report. I would also like to thank delegates at the 12th Financial Reporting and Business Communications conference who commented on the paper, especially Richard Taffler and Margaret Woods. Thanks to Jared Davies, Gareth Dyer, Richard Laughlin, and David Marginson for their help with the methodological aspects of this research. Lastly, thanks to my colleagues at Cardiff Business School, who have helped in the development of this report, namely Howard Mellett, who has discussed every stage of the project with me and offered invaluable advice, and Gerald Harbour, who read and commented on earlier drafts of the report. I would also like to acknowledge the useful comments made by my many undergraduate and MBA students who have read early drafts of the report and discussed it in lectures and tutorials. Thanks also to the two anonymous reviewers for their constructive comments and suggestions on the report.

ISBN: 978-1-85908-449-6

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## Glossary

AVC	Additional voluntary contribution
CDP	Carbon Disclosure Project
CDSB	Climate Disclosure Standards Board
CSR	Corporate social responsibility
DB	Defined benefit
DC	Defined contribution
ESG	Environmental, social and governance factors
IIGCC	Institutional Investors Group on Climate Change
IPCC	Intergovernmental Panel on Climate Change
NAPF	National Association of Pension Funds
PMI	Pensions Management Institute
SEE	Social, ethical and environmental
SER	Social and environmental reporting
SIP	Statement of investment principles
SRI	Socially responsible investment
UKSIF	UK Social Investment Forum
UNEP	United Nations Environment Programme

## Foreword by the chief executive of UKSIF

I hope that this timely report will act as a wake-up call to trustees to put climate change, resource efficiency and social sustainability at the heart of their investment practices.

Pension funds need an economic recovery that lasts. To achieve this, they must take greater responsibility as asset owners for creating a low carbon, resource efficient and socially sustainable world.

Specifically, trustees need to integrate sustainability issues fully into their pension fund governance role. This is about investment beliefs and improved contractual relationships, not about usurping the roles of investment consultants or fund managers. Quality of responsible investment must become a significant factor in the awarding and retaining of mandates. Specialist support is now available from the major investment consultancies. Asset managers have increasing capacity to deliver responsible investment practices; but the most experienced recognise that current contractual obligations can prevent the longer-term approach required by the fiduciary requirements of their clients.

Climate change is probably the most significant of the range of social and environmental issues that will cause cataclysmic change to wealth generation opportunities over coming decades. Even more significantly for pension fund trustees, public policy responses to reduce carbon emissions should move that impact forward into the next few years.

The size and extent of the recent financial and economic crisis was almost unimaginable to most people before it rapidly took hold and yet, in retrospect, the dangers of the culture and practices that prevailed seem clear. It can similarly be difficult to accept, in spite of the mounting evidence, that rapid or discontinuous change will happen as a result of climate change. But there can be no real excuses if pension fund trustees do not learn from their new experience.

The conclusions of this research demonstrate what has long been known anecdotally – that, with certain notable exceptions, pension fund trustees are not driving the change needed to ensure that the finance sector protects future wealth generation and quality of life.

As the report highlights and government ministers and regulators are increasingly emphasising, this is part of a wider problem of lack of accountability by pension fund trustees for behaviours in the investment supply chain between them as beneficial owners of capital on the one hand and the users of that capital on the other. As Donald MacDonald, chair of the board of the United Nations-backed Principles for Responsible Investment Initiative (PRI), has said about the financial crisis: 'As clients and part owners of the financial institutions at the core of this crisis, institutional investors should accept some shared responsibility for the behaviours that led to the crisis'.

Earlier this year, the government chief scientific adviser, Professor John Beddington predicted a 'perfect storm' of food shortages, water scarcity and insufficient energy as early as 2030 – a date that should be well within the planning horizon for most fiduciaries. He anticipated that these would lead to social upheaval and be exacerbated by unpredictable impacts from climate change.

I therefore commend this important research report to you. Its conclusions demand urgent action.

It is increasingly clear that the ability to meet pension fund liabilities will be under ever more threat unless pension fund trustees adopt more sustainable investment practices. Most importantly, so will the prosperity and well-being of both pension fund beneficiaries and wider society.

Penny Shepherd MBE  
**Chief Executive**  
**UKSIF – the sustainable investment and finance association**

## Foreword by the chief executive of ESRC

We are beginning to realise the potential magnitude of impact from climate change – not only on the natural environment, but also on human society as a whole. It seems clear that the question is no longer whether climate change will affect society, but rather how much. In order to answer this question, the Economic and Social Research Council (ESRC) is funding a number of research initiatives on environmental change and society. This report, funded by ESRC and ACCA, looks into climate change impact on pension fund performance – and how this goes largely unrecognised.

Climate change has already been identified as an important issue for financial investment strategy, with industry experts expecting it to have a material impact on investment performance over the next five years. One example is knock-on effects from extreme weather events on increased risks and costs for the insurance industry, as highlighted by the Stern Review.

From a purely financial point of view, it therefore makes sense to identify how climate change will affect business, not least for pension funds looking to maximise return on investment over a number of years. The case is even stronger from an ethical viewpoint, in terms of ensuring that investment is socially responsible. As this report points out, pension fund trustees are in a unique position to affect corporate behaviour. Pension funds are major shareholders in UK companies, empowering trustees to wield significant influence in strategic decisions.

It is a potential which so far has been largely untapped. The survey shows that pension fund trustees generally are little aware of how climate change can affect the performance of pension funds, or how much fund managers' strategic decisions reflect responsible investment regarding climate change. It has uncovered a lack of accountability and governance between trustees, fund managers and fund members.

The study provides an invaluable insight into pension fund trustees' attitudes and investment priorities. It illustrates how pension funds can realise their strategic shareholder potential – not only in terms of climate change impacts, but also for the broader issue of best practice in governance and accountability.

Ian Diamond  
**Chief Executive**  
**Economic and Social Research Council**

## Executive summary

Pensions are among the most significant consumer products and investments purchased by society. Protecting pensions against material financial risk is crucial to the maximisation of social welfare. There is a substantial and growing practitioner and policy-driven literature on the relevance of climate change to institutional investment, calling for pension fund trustees to incorporate it into their investment strategy decisions. Trustees are in a unique position, with significant power to affect corporate behaviour through the strategy they implement in their pension funds, as pension funds own the largest proportion of shares in UK listed companies. We therefore investigated trustees' attitudes towards their role and responsibilities in relation to climate change, to discover whether they are harnessing their power to effect change. This report summarises the views of 20 interviewees, in order to explore some of the emerging themes. The findings suggest a substantial gap between theory (in terms of recommendations from the literature) and trustee practice regarding climate change.

This study is the first to address trustees' attitudes towards climate change and its potential impact on pension fund investment. Further, it represents a first attempt to gather interview evidence on trustees' views. The findings of the full study provide rich, in-depth evidence about trustees' attitudes towards their role and responsibilities regarding climate change.

Interviewees indicated that climate change did not generally feature on the agenda of their trustee meetings and that they considered it to be a relatively unimportant environmental, social and governance (ESG) factor. Trustees interviewed were generally unaware of their fund managers' activities concerning climate change and displayed a low level of accountability to their members in relation to this subject, rarely engaging with members on their responsible investment policy. Although most of our interviewees said that climate change could be a material issue for their funds, their understanding of how it could affect shareholder value and financial return was partial.

One salient outcome of the research process was that trustees recognised an urgent need to improve their knowledge and understanding of climate change issues and the way in which they can affect pension fund performance. They acknowledged their (unrealised) potential in affecting corporate behaviour through their actions relating to climate change. The interviewees suggested that the interview process itself would incite them to consider climate change in a more active manner. They also made a series of suggestions as to how they intended to change their behaviour accordingly.

We also found evidence of a significant size factor in our interviews, as trustees from the larger funds were more aware of the connection between climate change and financial return, and were generally more knowledgeable about the relevance of ESG issues to pension fund investment.

This study also carries broader implications for pension fund governance and accountability. One of the most significant outcomes of the research was evidence of weakness in accountability chains between trustees and fund managers, trustees and members, and trustees and the sponsor companies. Although we focused specifically on climate change issues, the interviews indicated that the lack of accountability and governance was not limited to the issue of climate change but applied to all areas of socially responsible investment (SRI). Despite the increasingly close focus of the institutional investment community on ESG factors, trustees were not engaging with their fund managers or their pension fund members on their SRI policy. Even the leaders among our sample acknowledged a lack of communication in these areas. There is an evident lack of accountability and governance between the various intermediaries involved in pension fund investment, which contrasts starkly with the highly developed accountability chains between companies and their shareholders/stakeholders through social and environmental reporting (SER).

As a result of these findings we make recommendations on two levels. First, on a theoretical and academic level, we suggest that there is an urgent need for further research into the accountability and governance links between the intermediaries involved in pension fund investment, specifically between trustees and their pension fund members, fund managers and their sponsor companies.

Second, on a practitioner level, there is an urgent need for a code of practice, or at least a set of principles representing best practice in accountability and governance for the pension fund community, in relation to climate change specifically but also emphasising other extra-financial issues. The Myners principles, although representing an important improvement to pension fund governance, did not focus on ESG accountability within the trustee community. Myners illuminated trustees' lack of expertise across all areas of trusteeship. The broader, 'soft', qualitative issues covered by ESG investment require attention by trustees and other members of the pension fund community. In the broader context, if trustees lack expertise in mainstream financial investment, their lack of specific knowledge about climate change risks and opportunities is not surprising. A code of best practice on governance and accountability aimed at trustees would help to resolve this situation. A code of best practice on climate change, produced with government backing as a mainstream policy document for trustees, is suggested as a means of forcing trustees to address the material issues of climate change seriously and urgently.



# 1. Introduction

*The most recent science says climate change will go further and faster. We are closer to the thresholds than we thought...what we do now could determine the fate of billions of people. These could be the most important years in history.* (Forum for the Future 2008: 70)

The need for the financial services industry to discharge accountability to society and to behave ethically has been highlighted in recent years. Scandals such as Barings, and the more recent focus on unethical activity within the banking sector, have forced ethics and accountability within financial services into the limelight. It is becoming increasingly evident that the current global financial crisis clearly has its roots in weak governance practices and low levels of ethical behaviour and accountability. In the pension fund industry, the role of the pension fund trustee has been scrutinised intensely since the turn of the century as trustees have been identified as passive and lacking in the necessary skills to carry out their role (Myners 2001; Myners 2004; NAPF 2007). As a result, trustees' responsibilities have been established more explicitly and their role formalised. Climate change is one of the many issues growing in relevance for pension funds and their trustees. The extent to which trustees are embracing this aspect of their role has been little researched and this report contributes to the existing literature by providing evidence about their attitudes towards their role and responsibilities regarding climate change.

Climate change has been catapulted into the centre of the global stage by a series of significant reports from the United Nations Working Party and the UK government (Intergovernmental Panel on Climate Change (IPCC) 2007; Stern 2006). There is now consensus among the scientific community that human intervention, especially business activity, has caused global warming, with carbon emissions from the burning of fossil fuels since the industrial revolution heating the atmosphere. The IPCC, established in 1988, estimated that by the end of the 21st century, global temperatures will have risen by between 1.5 and 5.8 degrees centigrade. As a result, they predicted changes such as the thawing of permafrost, declines in biodiversity, rising sea levels and extreme weather patterns. These events will lead to flooding, droughts and storms, which will have direct, unpredictable and possibly devastating consequences on human civilisation. The most recent scientific research suggests that climate change is occurring far more quickly than previously anticipated, shifting the risks associated with climate change from the longer-term to the short-to-medium-term future.

Climate change will affect (and is already affecting) the financial services industry and is an important factor in socially responsible investment (SRI). The consideration of environmental, social and governance (ESG) issues in institutional investment, which include climate change, is moving quickly into the mainstream (Friedman and Miles 2001; Solomon and Solomon 2006; Solomon 2007; Sparkes 2002). Indeed, a survey of fund managers around the world found that 70% believed the integration of social, ethical and environmental (SEE) factors into investment

analysis would become mainstream in investment management in the following three to ten years. The survey also found that 60% of fund managers consider that screening for social, ethical and environmental factors would be mainstream in the following three to ten years (Ambachtsheer 2005). Further, SRI is continuing to expand at a global level, spurred on by an anticipated increased client demand for the integration of ESG analysis in mainstream institutional investment (Mercer Investment Consulting 2006).

Climate change has been identified as a central issue for institutional investment strategy (Mercer Investment Consulting 2006). Mercer's survey shows that a high proportion of fund managers expected climate change would have a material impact on investment performance. *The Stern Review* (Stern 2006) makes reference to the need for the financial services industry to respond to the potential negative impacts of climate change. 'The insurance sector will face both higher risks and broader opportunities, but will require much greater access to long-term capital funding to be able to underwrite the increased risks and costs of extreme weather events' (Stern 2006: 304; see also Ceres 2006).

Climate change has also been identified as an important issue for pension fund trustees (Carbon Trust 2005, 2006). We discuss the links between pension fund financial performance and climate change in more detail in the following section.

This research aims to investigate the attitudes of trustees towards their role and responsibilities in relation to climate change. Our findings should contribute significantly to current knowledge in a number of ways. First, this is the first research project addressing trustees' attitudes towards climate change, as a specific ESG issue. Second, the research uses interview methodology, in order to provide rich in-depth data on trustees' attitudes, whereas previous studies have implemented questionnaires. Third, the trustees targeted are from companies listed on the London Stock Exchange, and are therefore not biased towards high performers in corporate social responsibility, or the public sector. This means that the results should represent trustee practice and attitudes across the corporate pension fund community. Chapter 2 summarises the extant literature and policy documents relating to the role of pension fund trustees in climate change and to SRI more generally. Chapter 3 outlines the interview research methodology applied in this study. Chapter 4 presents the findings of a thematic analysis of the interview data. The report concludes with a discussion in Chapter 5.



## 2. Climate change and trustees

Trustees have been under pressure to expand the remit of their responsibilities and to improve the manner in which they deal with these responsibilities. The Myners Report (Myners 2001) examines the responsibilities of trustees and recommends that they adopt a voluntary set of principles to improve pension fund governance and investment decision making.<sup>1</sup> A review was undertaken in 2003–4 to assess the extent to which the Myners principles had resulted in behavioural change within the trustee (and broader institutional investment) community – The Myners Review (Myners 2004). This review revealed substantial improvements, with over half of the trustees surveyed formalising previously ad hoc behaviour, with trustees appearing better informed and addressing issues they would perhaps have bypassed before Myners (2001). Nonetheless, the review also highlighted some continuing problems. Specifically, trustees' skills and expertise had not improved significantly; there was a continuing lack of clarity regarding the trustee's role; insufficient resources were being devoted to asset allocation decisions; there was a continuing mismatch in perception between trustees and fund managers over investment time horizons; there was insufficient promotion of shareholder engagement; and inadequate commentary on progress in implementing the Myners principles (2001). A report by the NAPF (2007) also reassesses the success of trustees in dealing with their many responsibilities. Although the report acknowledges significant progress in trustees' adoption of the principles, especially in the area of trustee knowledge and understanding, it still indicates areas of concern, especially in relation to trustees' assessment of their own performance. Although Myners (2001), Myners (2004) and the NAPF report (2007) do not mention climate change issues in relation to the trustees' role, other reports have identified them as a rapidly evolving area for trustee concern, as we see below.

Climate change has been forced to the top of the agenda among ESG considerations, in light of recent developments. *The Stern Review* (Stern 2006) and the final conclusions of detailed research by the United Nations (IPCC 2007) have abruptly moved climate change issues to the forefront of international public policy and onto global political agendas. Below, the findings of extant research and professional reports are summarised, with respect to the role of trustees in SRI, and more specifically, consideration of climate change in pension fund investment.

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1. Specifically, the Myners principles recommend that, in relation to pension fund trustees: trustee boards should ensure they have access to appropriate skills and resources; decisions should be taken only by those trustees with adequate skills and expertise; trustees should engage with investee companies where it is in the interests of their fund members to do so; and the SIP should report annually to stakeholders on the fund's investment strategy and returns.

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### **SOCIALLY RESPONSIBLE INVESTMENT: FROM MARGIN TO MAINSTREAM**

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Since the start of the 21st century, SRI has metamorphosed from a marginal issue into a consideration in mainstream institutional investment (Mansley 2000; Solomon and Solomon 2006; Solomon 2007). One of the principal reasons for this shift from margin to mainstream has been the change in approach to SRI from a strategy of screening to a strategy of engagement and dialogue with companies on SEE issues. Another reason for the more integrated approach towards SRI has been its linkage to corporate governance, as evidenced by a change in terminology from 'SRI' to 'consideration of ESG factors' in institutional investment. This represents not simply a change in terminology but a deep-seated shift in attitude, with the recognition of the importance of equating SEE issues with issues such as board performance and remuneration (Solomon 2007). Drivers for SRI have come from external lobby groups as well as from pension fund members and society as a whole (Solomon et al. 2002).

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### **PENSION FUNDS, TRUSTEES, SOCIALLY RESPONSIBLE INVESTMENT AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS**

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The need for institutional investors to embrace a socially responsible role has been acknowledged (Monks 2001). There has been a growing demand from pension fund members for their funds to adopt an SRI policy, provided that it does not compromise financial returns (EIRIS 1999; Targett 2000). A change to pension fund law in 2001, forcing all pension funds to disclose in their Statement of Investment Principles (SIP) the extent to which, if at all, they adopt an SRI policy, shone a spotlight on the social accountability of pension funds. A report published around the same time comments that the new disclosure requirement would be likely to cause a number of major pension funds to require their fund managers to place greater emphasis on these issues (ACCA 2000). These predictions were correct in that the majority of trustees incorporated reference to SEE issues in their annual statements in 2001 (Cowe 2001: 8). Indeed, Mathieu (2000) shows that over half of all pension funds had incorporated SRI factors into their investment decisions as a result of the amendment to pension fund law. Similarly, following the amendment to UK pension fund law, a number of countries followed suit (Freshfields Bruckhaus Deringer 2005).

There have been extensive efforts at an international level to promote SRI with the launch of the Principles for Responsible Investment by the United Nations. Approximately 360 institutions have signed up to these principles, representing in excess of US\$14 trillion in assets (UNEP 2008). Climate change disclosure and performance, sustainability disclosure and biodiversity have been among the ESG areas where signatories to the principles have focused their engagement with investee

companies. Similarly, the London Accord<sup>2</sup> has been instrumental in raising the profile of ESG issues, and the activities of the institutional investment community regarding climate change and other ESG matters, within the wider business communities.

Despite these significant changes, the fiduciary responsibility of trustees to maximise return to their members has been used as an excuse for not adopting SRI. Under the rubric of 'fiduciary duty' much is justified. The unexceptionable fiduciary requirement that trustees may consider 'solely' the interests of beneficiaries is adduced to justify non-involvement in 'social' or 'political' investments. Activism is dismissed as being unrelated to adding long-term value to the trust portfolio (Monks 2001: 125).

Institutional investors have also avoided SRI, believing ESG factors to be unquantifiable and incapable of being incorporated into investment analysis. This view is now acknowledged as outdated, however, as:

*it is increasingly difficult for investment decision-makers to claim that ESG [environmental, social and governance] considerations are too difficult to quantify when they readily quantify business goodwill and other equivalently nebulous intangibles* (Freshfields Bruckhaus Deringer 2005: 11).

The 'Freshfields Report' (Freshfields Bruckhaus Deringer 2005) provided groundbreaking evidence that trustees should not only be taking account of ESG issues in their investment strategy decisions, but that they are in breach of their fiduciary duty if they do not. The study aimed to dispel the all-too-common misunderstanding that fiduciary responsibility is restricted by law, in a narrow sense, such that SRI cannot be pursued. The report explained two cases where ESG considerations must be included as part of a pension fund's fiduciary responsibilities: when there is a consensus among the fund beneficiaries that ESG factors should be taken into account, and where ESG considerations are reasonably expected to have a material impact on the financial performance of the investment. Failure in either of these cases to incorporate such factors into the investment strategy would represent a breach in fiduciary duty. This approach alters the whole view of SRI.

One of the few studies of trustees' views towards SRI, conducted immediately following the introduction of the SIP disclosure requirement, found evidence of confusion among the trustee community (Solomon and Solomon 2003).<sup>3</sup> The research involved a questionnaire survey

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2. The London Accord is a cooperative project which seeks to disseminate the thinking of the institutional investment community to a broader audience by producing reports on issues such as climate change and financial services.

3. The study involved an extensive questionnaire survey distributed to trustees from the entire population of pension funds that were members of the National Association of Pension Funds (NAPF), ie 891 organisations. There was a total response rate of 18%. Over three-quarters of the respondents were from private-sector pension funds.

distributed to an extensive sample of trustees. They were generally uncertain about their role in SRI and were concerned that pursuing an SRI strategy might conflict with their fiduciary duties. The report contrasts the trustees' attitudes with the views of pension fund directors, and other leading members of the institutional investment community, who were surprised at trustees' lack of interest in SRI and their unwillingness to debate SRI policy. The research reflects the general uncertainty within the financial community regarding trustees' fiduciary duty and SRI.

## **TRUSTEES AND CLIMATE CHANGE, AND THEIR POTENTIAL TO INFLUENCE CORPORATE BEHAVIOUR**

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In 2005, three organisations collaborated to produce a report to guide pension fund trustees in understanding and addressing risks associated with climate change.<sup>4</sup> The report's aim was to raise awareness among trustees about climate change and their fiduciary duty. It was also intended to show trustees how to address climate change in their investment strategy decisions (Carbon Trust 2005). Pension funds are the largest and most influential group of institutional investors in the UK. Furthermore, exposure of UK pension funds to investment in corporations has been estimated at 72.5%.<sup>5</sup> If companies are affected by climate change then so are pension funds. Conservative estimates suggest that up to 5.1% of market capitalisation could be at risk from the consequences of climate change, with less conservative estimates suggesting figures up to ten times higher (Carbon Trust 2005).

The potential for trustees to engage with companies and influence their behaviour is acknowledged (Cadbury 1992; Hampel 1998). Therefore, if climate change is raised as an issue for pension funds, there is a need for it to be integrated into investment strategy. Trustees advise the pension fund managers they appoint who then engage with companies, and corporate behaviour in relation to climate change will alter: 'Considering that both the physical and mitigation-related policy impacts of climate change will influence the ability for companies to create and maintain wealth for shareholders...pension trustees will want to ensure that these risks...are being

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4. A group of organisations collaborated in 2005 to produce this report into trustees' duties and climate change, namely the Carbon Trust, Mercer Investment Consulting and the Institutional Investors Group on Climate Change (IIGCC). The Carbon Trust is an independent not-for-profit company established by the UK government to lead low-carbon technology and innovation within the public and private sectors in the UK. Mercer Investment Consulting is a leading global provider of investment consulting services. It is dedicated to developing intellectual capital related to socially responsible investment and the integration of ESG factors into investment processes. The IIGCC is a forum for collaboration between pension funds and other institutional investors on issues relating to climate change.

5. This arises from direct investment in listed company shares but also through investment in corporate bonds (see Carbon Trust 2005).

addressed in relation to the funds in their care' (IPCC 2007).

The risks arising from climate change fall into five general categories: regulatory risk, physical risk, litigation risk, competitiveness risk and reputational risk.<sup>6</sup> As a result, the Carbon Trust report (2005) advises trustees to:

- assess their understanding of climate change risk and determine whether or not it could have a material impact on their pension fund's assets
- explore the current approach of their pension fund to check whether it reflects their policy on climate change risk
- behave as active owners by encouraging their pension fund managers to engage with companies on climate change risks and by participating in the public policy debate.

Importantly, the report recommends that trustees should: 'investigate the linkages between climate change and their fiduciary duties with respect to providing pension funds over the long term. Within these fiduciary duties, corporate pension funds should be encouraged to align their approach to climate change risks with sponsoring company policies' (Carbon Trust 2005: 15). This suggests that trustees from company pension schemes should consider climate change under their fiduciary duty and should not adopt a passive stance to the potential impact of climate change risk on their fund.

It has also been acknowledged that climate change can provide opportunities as well as risks, through, for example, investment in companies that focus on renewable energies (Carbon Trust 2005). Again, trustees should assess whether their fund is adequately considering such opportunities in its investment strategy.

The Carbon Trust (2006) developed a model for estimating the amount of shareholder value at risk from climate change. It found certain industries (bulk commodity chemicals and building materials) to be significantly at risk. The Trust's report makes a series of recommendations for senior management and investors. One of these recommendations is for institutional investors to ensure that climate change risk features on their agenda for engagement and dialogue with their investee companies.<sup>7</sup>

A questionnaire survey was conducted by the UK Social Investment Forum (UKSIF) to discover the attitudes and practices of UK pension funds in relation to responsible investment (UKSIF 2007). The questionnaire asked

pension fund representatives about trustees' views<sup>8</sup> and revealed information about the role of trustees in responsible investment and climate change. For example, the survey indicated that one-fifth of trustees from the pension funds surveyed were thought to be aware of three climate change initiatives: *The Stern Review* (Stern 2006), the United Nations Principles of Responsible Investment, and the United Nations Environment Programme Finance Initiative. Further, the study found that one-third considered their trustees were aware of at least two of them.

On ESG considerations more generally, the survey found that representatives from two out of three corporate pension funds surveyed thought they had trustees who believed that ESG issues could have a material impact on their funds' investments in the long term. These findings indicate a broad knowledge base among the trustee community and a strong interest in climate change and ESG issues generally. Nevertheless it is notable that the sponsor companies were CSR leaders.

Overall, earlier studies examining the level of proactiveness on climate change within the financial services industry have produced disappointing results, with a number of barriers to engagement being identified. For example, one study found that earlier engagement with climate change within the financial sector was being prevented by (*inter alia*):<sup>9</sup>

- the view that climate change is marginal to corporate financial performance
- a sense of shared responsibility that deters one group from taking the initiative
- the lack of understanding of the connection between climate change and financial risk, with a corresponding lack of monetary value being perceived in action on climate change
- the provision of insufficient analysis and information by key financial and insurance sector advisers
- poor data availability, which renders analysis of potential company risks difficult.

As the data for this study were gathered over five years ago, it may be hoped that some of these barriers have since been overcome among the trustee community.

Another report considers whether the debate on climate change has affected institutional investors' behaviour. This report, commissioned by the HeadLand Consultancy

6. These risks have been identified by the US State Pension Fund-led Investor Network on Climate Risk (see Carbon Trust 2005).

7. See Solomon (2007) for a more detailed summary of the findings from the Carbon Trust reports (2005, 2006).

8. The survey resulted in 33 usable responses from pension fund contacts for companies listed in the FTSE4Good UK Index and in the Carbon Disclosure Project's Climate Leadership Index.

9. This study was the UNEP Finance Initiative's *CEO Briefing on Climate Change* (2003) quoted in Carbon Trust (2005).

(2007), discusses a qualitative survey of 19 mainstream UK fund management houses representing over £3 trillion assets. The research did not focus solely on SRI specialists, which implied a relatively unbiased view. Overall, the survey indicated that climate change as a specific ESG issue was not attracting the attention it has deserved since Stern (2006). The report shows that the potential economic influence of climate change has been recognised by the fund management industry but that this recognition has yet to change mainstream investment behaviour. The authors comment that: 'While corporate governance and SRI policy makers have expressed a fundamental interest for some time, their fund management counterparts see climate change as an influence in the future but not yet core to investment decision-making' (HeadLand Consultancy 2007: 3).

The report acknowledges that, as the impact of climate change is considered to be slow and cumulative, it is outside a typical fund manager's remit as 'they are not looking at 2012 let alone 2050'. Many thought social and environmental reporting (SER) to be of little value, usually being simply an attempt to get the 'green fraternity off their backs' and that: 'If the statement of investment principles does not include an obligation to consider climate change, [fund] managers have no responsibility to take it into consideration' (HeadLand Consultancy 2007: 7).

Respondents suggested that even those companies that have themselves identified and are managing climate change issues in their own businesses may fail to ensure that their pension fund trustees do the same: 'Some also believe the onus rests on trustees to instruct both corporate management and fund managers to drive changes in corporate behaviour that would, in turn, generate movement towards a more sustainable and low carbon economy' (HeadLand Consultancy 2007: 7). The report therefore highlights the potentially potent role of trustees in driving change in corporate behaviour. Discovering whether this power to influence corporate behaviour is being harnessed by trustees and whether they are aware of their potential, are important aspects of the current research.

## **A RISING DEMAND FOR CLIMATE CHANGE DISCLOSURES FROM THE INSTITUTIONAL INVESTMENT COMMUNITY**

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One study (ACCA 2007) focuses on reporting climate change information but also emphasises user needs. In other words, the report acknowledges that the institutional investment community is demanding information on climate change for making decisions. Spence and Gray (2007) provide interview evidence from listed companies that there is a market-driven motivation for SER, arising from a desire to be included in SRI indices or achieving differentiation among investors through other means. Spence and Gray discuss 42 high-impact companies that received 2006 ACCA UK awards for sustainability reporting. The report makes frequent reference to a significant and growing investor (and other user) demand for detailed disclosures on climate change: 'There is also

increasing interest from the investment community, with the Carbon Disclosure Project, the Institutional Investors Group on Climate Change (IIGCC), Investor Statement on Climate Change and the...FTSE4Good Climate Change criterion' (Spence and Gray 2007: 7).

Institutional investors require detailed company-specific benchmark targets in order to engage effectively with companies on climate change issues, eg emissions. At the moment, there are industry-level targets but these need to be disaggregated, and presented with interpretation and explanation: 'Although a large proportion of companies are reporting data, the format is still inconsistent and comparisons are extremely difficult. Much needs to be done in this area to ensure that the data reported are useful to the report users, including investors' (Spence and Gray 2007: 10).

The report claims that 79% of companies in the sample provided descriptions of climate change impacts, and two-thirds reported performance trends with explanation: 'This helps readers and stakeholders to understand the performance data and put them into context' (Spence and Gray 2007: 11).

Centrica have reported carbon dioxide emissions and emissions in relation to EU Emissions Trading Scheme which is 'useful for investors wishing to calculate the financial impact of Centrica's carbon emissions and trading' (Spence and Gray 2007: 12) Disclosure of targets is important, 'so that stakeholders can assess the relevance and suitability of targets, thereby understanding the company's approach' (Spence and Gray 2007: 15).

*It is envisaged that future climate change reporting requirements of stakeholders will change as the issue becomes more urgent and prominent...it is becoming increasingly apparent from recent scientific papers that climate change is occurring much more quickly than predicted* (Spence and Gray 2007: 16).

*The main reason for companies to report on climate change performance is that stakeholders demand it. Investors...have started to take a definite interest in organisations' carbon management and reporting, putting increasing pressure on those who do not report to start doing so* (Spence and Gray 2007: 19).

## **COLLABORATIVE ACTION ON CLIMATE CHANGE BY THE GLOBAL INSTITUTIONAL INVESTMENT COMMUNITY**

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Institutional investors are not working in isolation on climate change but are collaborating and, importantly, singling out climate change as an especially relevant ESG factor. The Carbon Disclosure Project (CDP) is the world's largest collaboration of institutional investors, including 50 signed-up members who together own assets of \$40 trillion. They have collectively signed a single global request for corporate disclosures of information on greenhouse gas emissions. The Climate Disclosure Standards Board (CDSB) is addressing the lack of consistency in climate change reporting. It seems that the

investment community is increasingly using carbon data to assess material financial risks arising from climate change. This type of collaborative action is quite unprecedented within the pension fund industry. Indeed, corporate pension funds have traditionally almost never been activist: 'There is an implicit understanding that each company's pension fund will refrain from an activist stance in return for a reciprocal stance from all others' (Monks and Sykes 2006: 232).

Clearly, the potential impact of climate change has changed pension fund behaviour dramatically.

### **INSTITUTIONAL INVESTOR ACTIVISM AND ENGAGEMENT ON CLIMATE CHANGE**

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Academic studies have found that the process of private SEE disclosure, through one-to-one meetings between institutional investors and their investee companies, has been evolving quickly over the last decade (Friedman and Miles 2001; Solomon and Solomon 2006). Engagement and dialogue in the specific area of climate change has resulted in the exertion of demand-led pressure on companies to disclose carbon emissions and other climate change data.

*Investor pressure is increasingly being used to encourage businesses to tackle their emissions. One large institutional investor recently engaged with a group of companies that had persistently not disclosed their carbon footprint as part of the annual Carbon Disclosure Project questionnaire: over half subsequently provided a full answer and others provided some information. Other investors are working with companies to encourage appropriate action and enhance the market value of their business (CBI 2007: 31).*

Such active involvement in climate change issues by the institutional investment community indicates that the markets are responding to climate change risk.

### **PUBLIC VERSUS PRIVATE SECTOR PENSION FUNDS AND ESG CONSIDERATIONS**

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Solomon and Solomon (2003) reveal significant differences in attitude towards SRI between trustees from the private and public sectors. This is consistent with the views of Monks (2001), who considers that public sector pension funds are more interested in corporate accountability to a broad group of stakeholders than are private sector pension funds, which are forced to be primarily concerned with maximising shareholder value and driving corporate profitability.<sup>10</sup> For example, Solomon and Solomon (2003) claim that trustees from public sector

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10. Monks (2001: 129) stated: 'By creating a system in which "ownership" is nobody's concern, the private companies have effectively neutered the vote of their system. This is in contrast with the public pension plans, some of which are conspicuously activist, and the labour plans that are beginning to think in global terms'.

pension funds agreed significantly more than private sector trustees with the suggestion that the (then) new SIP disclosure requirement would be an inducement to companies to act in a socially responsible manner. This difference in view between the public and private sectors is not surprising. In the private sector, the fund managers of defined benefit schemes are subject to a conflict of interest, or even to tacit collusion between corporate sponsors,<sup>11</sup> in that they are employed by the corporate sponsor to manage the fund. Excessive shareholder activism could result in the fund manager effectively losing his/her job, as companies are hostile to activist techniques being equally directed towards themselves. It has therefore been suggested that private sector pension funds have a tendency to pursue 'self-protective passivity' in their investment strategies, whereas public sector pension funds are not subject to such constraints (Coffee 1991).

### **SCEPTICS IN THE CLIMATE CHANGE 'DEBATE'**

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Despite the overwhelming scientific evidence demonstrating progressive global warming, linked to human activity, there is a continuing 'debate' on climate change. There are those who do not accept the gravity of the scientific findings and who challenge climate change theorists (for example, Carter 2007; Morris 1997). Some consider global warming to be no more than scaremongering, inflated by media misrepresentation: 'The empirical evidence used to support the global warming hypothesis has often been misleading, with "scare stories" promoted in the media that are distortions of scientific reality' (Lewis 2007: 2).

There are sceptics who do not accept that the threat from climate change is as urgent or as pronounced as we may be led to believe from scientific reports. There are those who suggest that the climate change issue represents no more than an example of doom-mongering. There are those who believe that the current warming is simply a cyclical movement rather than a trend: 'Global warming and cooling scares pre-date the current concern over global warming that began in the 1980s...The prophets of carbon energy alarmism have been proven wrong time and again along the way' (Bradley 2003: 19).

*The government claim that global warming is more threatening than terrorism is alarmist and unwarranted... It is strikingly similar to the direct predictions of 40 years ago of an imminent ice age and to other past doom forecasts due to alleged overpopulation, depletion of food supplies, and chemical pollution (Lewis 2007: 2).*

As well as a wave of scepticism about the causes and effects of climate change, there is also an element of denial, in the form of apathy. This is considered to be a common reaction by society to high-consequence risks such as climate change, where people cannot see how they

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11. I am grateful to one of the anonymous reviewers for this comment.

as individuals can influence the state of the world and therefore choose to ignore it. These are core concepts underlying the notion of a risk society (Beck 1992, 1997, 1999; Giddens 1990, 1991).

The climate change sceptics have put forward detailed deconstructions of reports by the IPCC and Stern, providing reasons why the scientists' findings may be flawed (for example, Carter et al. 2006; Lewis 2007). These arguments tend to be based on speculation about measurement methods and modelling that could be applied to any outcomes of scientific research and, if taken seriously, would render all scientific findings invalid.

There are those who believe that a government-led, international collaborative approach to climate change is unnecessary as the 'market' will find a solution. As suggested in a recent lecture: 'once the apocalyptic forecast is seen in context and the likely failures of government action are recognised, the case for urgent, centralised action against climate change seems much less convincing' (Robinson 2008: 23).

*[I]f damaging man-made climate change is in prospect, the only real hope of avoiding the damage is probably through market responses...a big advantage of relying on markets is their flexibility and adaptability. Views about global warming will change. It may appear a more serious issue now, in which case markets will enhance the profitability of 'greenery', so reacting in the 'right' direction. Or it may seem less serious, so that 'greenery' starts to go out of fashion and the market again reacts in the right direction (Robinson 2008: 24–25).*

Interestingly, studies of the pace at which SRI<sup>12</sup> has accelerated in recent years indicates that the financial markets are taking the initiative in dealing with climate change and other ESG issues effectively. As we saw above, 'markets' are demanding climate change reporting from companies. Certainly, the force of the free markets is at work, promoting companies that are 'greener' and shifting funds away from businesses that do not adopt a socially responsible approach. Nonetheless, according to Stern and the IPCC, the scale of the problem would suggest that leaving markets to solve it is not sufficient and that a combination of natural forces and government collaboration on climate change is necessary: 'Market forces will drive big changes, but they will not by themselves be enough to do the job. The full range of public policies must be deployed to create the right incentives' (CBI 2007: 3)

Sceptics have dismissed the findings of the IPCC by suggesting that they overstated the effect of anthropogenic (human induced) greenhouse gases on the climate (Lewis 2007).

Another notable point is that the importance of climate-change-related risks and opportunities to the investment community is not dependent on the doubtfulness or otherwise of the 'science'. If government policy is tackling climate change then this can affect investment irrespective of actual climate change. For example, if the government regulates, taxes or encourages pro-climate change behaviours, this can affect companies' financial performance.<sup>13</sup>

On the basis of the above, we seek in this study to solicit the views of pension fund trustees in order to ascertain their attitudes towards their role in relation to climate change. Especially, this study builds on previous research (for example, UKSIF 2007) by using interview methodology to further our understanding of trustees' views.

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12. SRI may be interpreted as a natural, free market 'solution' to ESG problems by the institutional investment community.

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13. I am grateful to one of the anonymous reviewers for making this observation.

### 3. Methodology

This preliminary report summarises the views of 20 interviewees from the trustee boards of pension funds, whose sponsor companies were initially selected from the FTSE100 list. We encountered some difficulty in persuading trustees to participate, therefore we also interviewed volunteers from other pension funds. The interviews were conducted between October 2007 and May 2008. Details of the size and type of pension fund from which the trustees were drawn are presented in Table 3.1 (see page 18). Table 3.1 also includes details relating to the period for which the trustees have been on their current trustee board, how they were appointed (where possible), their professional qualifications and any personal interests they may have that could relate to social and environmental issues. Where possible, we interviewed member-nominated trustees and at least ten of our interviewees were member-nominated. Given the difficulties in attracting interviewees to participate in the research, however, this was not possible in every case. We believed that it was likely that member-nominated trustees might have more awareness of, or interest in, wider issues such as climate change.<sup>14</sup>

It is also noteworthy that almost three-quarters of the interviewees had either a specific qualification relating to trusteeship or pension fund investment, or had relevant experience. This suggests that the people who participated in our research were generally experienced and highly knowledgeable in the area of pensions. Similarly, half of our interviewees had acted as trustees for more than five years, indicating their long-term experience of trusteeship. Another interesting observation from the data in Table 3.1 is that 13 of the interviewees stated they were members of societies that were in some way related to nature, the environment (wildlife) and/or charity. This would imply that they are likely to have a pre-existing interest in social and environmental issues such as climate change.

Breaking into the trustee community was the most challenging stage, as once interviews began, other trustees seemed willing to participate, encouraged by the prospect of receiving the final report. They seemed keen to discover their peers' views in this area. Also, the support of ACCA, PMI, NAPF and UKSIF helped in attracting participation, as the project was advertised widely. The interviews were conducted over the telephone, because of the time constraint on conducting the survey, and because trustees are spread geographically around Britain. The interviews were semi-structured, with general research questions allowing the interviewer to follow up interesting points made by interviewees and develop issues as they arose. All interviews were recorded and transcribed for analysis.

The research questions evolved throughout the project, with any new issues revealed in interviews being incorporated into the questions.

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14. We thank one of our anonymous reviewers for making this point. We had assumed this might be the case but had not made our assumption explicit in earlier drafts of the report.

#### THE RESEARCH APPROACH

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From a methodological perspective this study differs from previous interview research into the SRI (Friedman and Miles 2001; Solomon and Darby 2005; Solomon and Solomon 2006). These previous studies applied a grounded theory approach, assuming that the researcher did not attempt to influence the views of the research participants. Previous work has sought to theorise the evolution of SRI by questioning members of the institutional investment community about their views on SRI. In these earlier studies, researchers aimed to leave the research participants 'as they found them'. In this sense, the resulting theoretical model was 'grounded' in the data and the research process was not influenced by the personal views of the researchers.

In contrast, the motivation for the present study derives from a normative view held by the researcher that the trustee community 'should' be engaging in the climate change debate and considering the risks arising from climate change for the pension fund industry in an active manner. Further, the research is being carried out in order to change the current situation 'for the better' (according to the researcher's 'world view'). This means that the methodological framework needs to allow for the research process to influence the interviewees so as to alter their 'world view'. This project represents the initial stage of a broader, cyclical study investigating (and consequently influencing) the attitudes of trustees regarding their role and responsibilities in relation to climate change. The research therefore draws on the body of literature relating to soft system methodology and action research<sup>15</sup> (for example, Argyris 1993; Greenwood and Levin 1998; Checkland and Poulter 2007). The complete research project aims to conduct an iterative process of interviewing trustees and other members of the institutional investment community, about the trustees' roles and responsibilities regarding climate change. Each stage results in a change in the world view of the groups being researched. This report, which represents stage one of this iterative process, involves instigating a learning process by which both the interviewer and the interviewee learn from the research. This learning process differs from that encapsulated in more positivist research methodologies.

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15. Soft system methodology and action research adopt an approach which is far more interactive than other interviewing methods and involve an iterative research method. Usually, there is a problematisation within an organisation, requiring research in situ to find joint solutions. In the case of this study, the problematisation is industry-wide, ie the need for pension fund trustees to tackle climate change issues. This study represents the first stage of interviews to assess the trustees' 'world view' relating to climate change in order to then pursue further interviews and interact with the interviewees to find ways of dealing with the problematised issues.

**Table 3.1: Trustee and pension fund details**

Trustee	Time on board	Nomination	Relevant professional qualifications	Membership of relevant organisations	Size (£s) of fund	Size (members)	Type fund
1	4 years	Member-nominated	Fellow, Chartered Insurance Institute and PMI Associate	n/a	2.6bn	16,000	DB
2	10 years	Company-nominated	PMI qualification	National Trust, Historic Transit Association, Wood Turning Club	1.7bn	16,000	DB
3	15 years	Company-nominated	Trustee certificate	None	60m	1,000	DB/DC
4	1 year	Member-nominated	None	Member of a charity	450m	16,000	DB
5	3 years	n/a	ACCA qualified accountant	None	34m	708	DB
6	5 years	Chairman of trustees	Banking & Finance degree	Friends of the Earth	230m	7,000	DB
7	10 years	Independent trustee	Chartered accountant	National Trust, English Heritage and Devon Wildlife	20m	400	DB
8	6 years	n/a	Chartered accountant, PMI trustee qualification	Fellow of RSA, National Trust	30m	400	DB
9	9 years	Member-nominated. Trustee director	None	Member of several charitable organisations	40bn	350,000	n/a
10	1 year	Member-nominated	Fellow of Faculty of Actuaries. Worked in pensions over 20 years	Active church member and charity worker	1.2bn	17,000	DB with DC section for AVCs
11	2 years	Member-nominated	None	RSPB and local Wildlife Trust	4.5m	447	Final salary
12	21 years	Professional trustee, independent	Chartered accountant	Co-operative Union, Ethical Investment Research	550m	40,000	DB
13	4 years	n/a	Certified accountant	National Trust, RSPB	3.9bn	95,000	Final salary
14	3 years	Company-nominated	None	National Trust, RHS	4.5m	100	DB
15	9 years	Member-nominated. Trustee director	Passed online trustee toolkit, PMI certificate in trustee knowledge and understanding	Labour Party	19bn	210,000	DB
16	n/a	Member-nominated	Economics background	Local environmental groups and Fairtrade campaign	n/a	n/a	DB
17	11 years	Member-nominated	Qualification in investments	None	400m	n/a	DB with AVC
18	5 years	Member-nominated	None	None	1.5bn	n/a	Final salary
19	24 years	Company-nominated	Personnel manager	National Trust	n/a	820	n/a
20	1 year	Member-nominated	None	None	220m	1,000	DB

More positivist approaches involve one-way learning,<sup>16</sup> where the researcher gathers data and reports upon the data objectively, without influencing the 'world view' of the participants. Fig. 3.1 summarises the methodological approach adopted in the current research.

In this study the findings are reported objectively and the analysis of the data is conducted objectively. Nonetheless, to some extent the interview process tended to influence the views of the research participants. This was partly because of the subjective stance of the researcher, but also because of the trustees' reactions to the interviews.

Some aspects of the 'soft systems' methodological approach seem especially relevant to this study.<sup>17</sup> For example, the method uses 'rich pictures' to describe the problem (Checkland and Poulter 2007).<sup>18</sup> These were developed by the researcher throughout the research process in order to problematise trustees' involvement (or lack of involvement) in the climate change debate in terms of their role and responsibilities as they are and as they 'should' be, from the normative perspective of the researcher. The development of rich pictures aided the researcher in identifying problems relevant to trustees and climate change in order to develop and refine the research questions.

A second characteristic of this methodological approach, relevant to this project, is that consensus was not considered realistically achievable. Instead, the researcher assumed that the population of research participants may come to an 'accommodation' (Checkland and Poulter 2007). This applies to the trustee community, because as we see in the following section, the research revealed a wide diversity of 'world views'. It is unlikely that trustees have a consensus view on how to deal with climate change, given the emergent and controversial nature of the climate change debate. Furthermore, all the trustees we interviewed came from different perspectives, with different world views and different backgrounds. The best that could be achieved was to improve the situation in terms of their knowledge base and to develop a new world view among the trustee community, not based on achieving a consensus but on arriving at a community-

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16. Termed single-loop learning, according to Argyris (1993) in action research. This type of 'learning' is considered by some academic as inferior to double-loop learning, as information only flows one way between parties. Double-loop learning involves both parties engaging with each other in a more dialogical manner.

17. There are similarities and differences between soft system methodology and the approach used in this study. For example, an evident difference is that making a case study of one organisation is the usual method used, whereas this study is based on interviews with people from different organisations. Nonetheless, we focus on the similarities in this section.

18. Rich pictures are generally hand-drawn diagrams, developed by the researcher, which attempt to express the problem to be dealt with in the research, by specifying the people and groups involved and the issues relating to them.

level accommodation with the climate change issue. Indeed, one similarity between the approach used in this study and action research methodology<sup>19</sup> is that, 'both the researchers and practitioners are able to gain knowledge through participation in the project...the methodology provides a powerful means of improving and enhancing practice' (Hoque 2006: 366).

Although action research and soft systems methodology have been criticised for a lack of objectivity, the advantage of a more interactive relationship between researcher and researched is the powerful potential for the research to result in change to the status quo, through changing the world view of the research participants.

One salient issue arising in the research was that of non-response. Because it was so difficult to solicit participation, we had to advertise the project, inviting participation. Therefore, many interviewees were volunteers, so our sample was likely to be biased towards trustees who were relatively interested in climate change issues. Many trustees we approached declined to participate. This may indicate they shared a sceptical view on climate change: 'I am appalled at this spend of public funds on what seems to be yet another "research" project which looks like it is only getting funding because it has the words "climate change" tagged on the end' (non-participating Director of FTSE100 pension fund in a sector with high environmental impact).

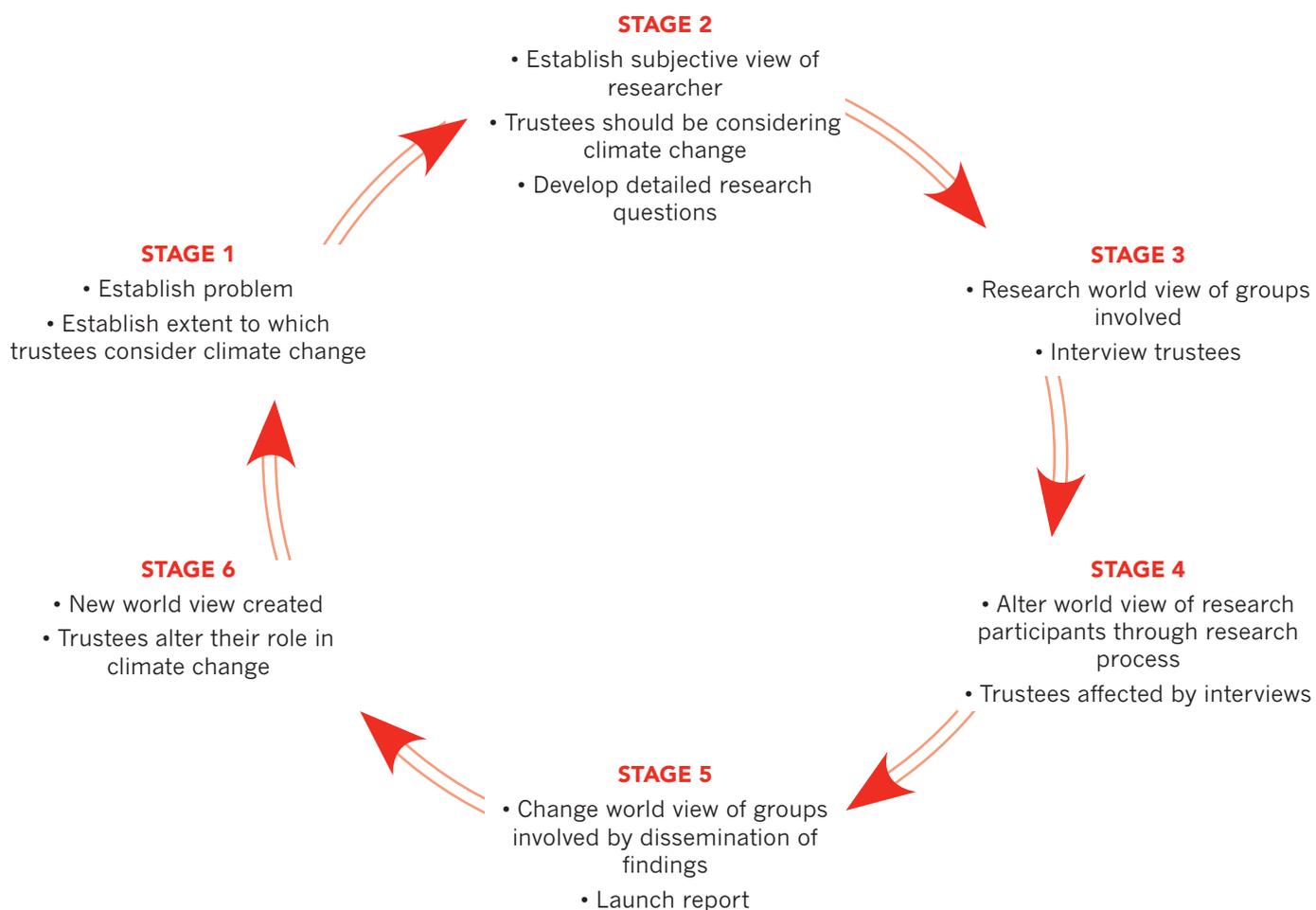
It was interesting to speculate on reasons why trustees would not participate. It is possible that their sponsor companies to some extent blocked participation. This could be because companies were embarrassed that despite strong public support for environmental policies within their corporate operations they did not pass on concerns about climate change and other ESG factors to their pension funds. This asymmetry would represent an acute embarrassment for them if it became public, especially given suggestions by practitioner research (eg HeadLand Consultancy 2007) that companies should adopt consistent approaches to ESG between themselves and their pension funds. These issues are discussed further in the concluding section.

From a methodological perspective, the high level of non-response could be seen as evidence of defensive strategies, whereby members of the trustee community were 'in denial' about the research question. In other words, their evasion may represent a refusal to consider that climate change represents an important issue (Argyris 1993). One focus of action research methodology is on ways in which individuals and groups develop defensive modes of behaviour in order to maintain the status quo and resist change that may arise through double-loop learning. As well as non-response, the attitudes portrayed

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19. Again, there are also significant differences, mainly that 'action research' usually focuses on changing one organisation through a long process of case studies and interviews.

**Figure 3.1: Research approach**



by the trustees interviewed were to some extent suggestive of defensive routines. According to the action research literature, such defensive routines and attitudes occur in response to perceived threats and inhibit genuine learning within organisations. In this case, the trustees may experience a threat to their attitudes and behaviour in relation to climate change. Learning is crucial if trustees are going to address a problem such as their role in climate change when they may feel threatened or uncomfortable about the issues because they realise they would have to change the status quo. From a subjective stance, changes to the status quo are necessary if pension funds are to move forward by embracing the risks and opportunities presented by climate change.

## LIMITATIONS

One limitation of the study was the low response rate. Scepticism may be a possible explanation for the low response to our call for participation in the research. We did find evidence of scepticism regarding climate change among the trustees we interviewed. This took the form of uncertainty about the genuine relationship between human activity and climate change as well as a non-acceptance that climate change would affect financial returns in the short term. These views may be dispelled by education and training. The concept of trustee bodies as 'learning organisations' allows intervention through research and dissemination of research findings to alter trustees' world views and their views of their role and responsibilities in relation to climate change.

## 4. Themes evident from the interviews

The data from the 20 interviews were analysed in order to detect themes. The themes that emerged from the data have been grouped under a series of collective headings.

- (i) Trustees' general approach to climate change
- (ii) Trustees' views on climate change and financial return
- (iii) Trustees' accountability to pension fund members on climate change issues
- (iv) Obstacles to trustees' consideration of climate change
- (v) Trustees' attitudes towards their future role in climate change
- (vi) Discriminant analysis: a size effect in trustees' attitudes.

### (I) TRUSTEES' GENERAL APPROACH TO CLIMATE CHANGE

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This section provides some evidence on how trustees are treating climate change within their remit, and the extent to which they consider it is an important factor for their pension fund. Specifically, we consider whether climate change features on the agenda of trustees' meetings and the importance attributed to climate change by trustees in relation to other ESG issues.

#### **Climate change rarely on the agenda of trustee meetings**

The overall impression from our interviewees was that climate change did not appear on the agenda for their meetings and was rarely, if ever, mentioned: 'No, we don't discuss it' [climate change] (T4) and 'A very, very small amount of our time (T18).

One trustee believed that climate change should perhaps be discussed 'once in a while', but concluded, after a discussion with the interviewer, that once a year, for about half an hour, would be enough. In answer to the question, 'Do you consider that climate change is an issue that you should consider at trustee meetings?', ten interviewees responded negatively whereas nine said that climate change should be mentioned occasionally, but certainly not regularly. A further trustee considered that it could be on the agenda, responding: 'Maybe, yeah, perhaps, yeah' (T8).

#### **Climate change in relation to ESG considerations generally**

The majority of our interviewees (14) considered that climate change was a relatively unimportant issue in isolation but that it represented a factor to be considered among the whole gamut of ESG considerations; for example: 'I think on its own [climate change] is not at all [important]. As a factor in the general environment it has an impact' (T4).

Furthermore, climate change was viewed as relatively less important than other ESG factors: 'I think a lot of trustees would find abuse of people, inappropriate labour mobility, investing in inappropriate organisations or governments as important, or probably more important, than climate change' (T3).

Another trustee commented that on a scale from 1 to 10, climate change has an importance of about 2. Another also attempted a quantification: 'I'd say for any responsible individual it must be important and I think if I'm taking five or six areas then it's either 20% or slightly more in our consideration, climate change' (T3).

Two of the interviewees stated that it was 'not at all' important (T5), and 'unimportant' (T8). Four interviewees said that although climate change was not a very important consideration at present, it would become increasingly important in the future.

### (II) TRUSTEES' VIEWS ON CLIMATE CHANGE AND FINANCIAL RETURN

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In this section we provide evidence about whether the trustees considered climate change to be part of their fiduciary duty, and whether they believed climate change to be material to pension fund investment.

#### **Confusion over whether climate change is part of a trustee's fiduciary duty**

There was a clear dichotomy in trustees' views about whether or not climate change represented part of their fiduciary duty. Eleven of the interviewees believed that it fell under the umbrella of their fiduciary duty, but generally in conjunction with other factors.

*Oh absolutely, I think yeah. (T3)*

*I would say so, yeah, I mean anything that could affect the provision of the pension's entitlements to members is of relevance to the trustees so this could be one such thing – the answer is yes. (T8)*

*Yes, I think it should be; there's kind of a personal view that everybody...should have it at the back of their mind, but if you think of the trustee board as a parallel to a real company board then company board members do have a duty to say 'can we change our business at all to reduce energy consumption, pollution, everything else that affects climate change', so yes I think we do. (T2)*

One interviewee, from a large fund explained: 'My personal view is that it would be a breach of our fiduciary duty if we did not take into account extra financial issues that could materially impact upon our portfolio' (T9). This view is consistent with that encapsulated in the 'Freshfields Report' (Freshfields Bruckhaus Deringer 2005). He later continued: 'I mean climate change is the "E" of ESG, a big chunk of the "E", and the interesting issue about the climate change side is that it has got the capacity to have absolutely profound and devastating negative effects on the wider environmental issues, the droughts, the floods...'

(T9). The depth of knowledge held by this trustee showed that he was an outlier, coming from the largest pension fund interviewed.

Seven of the trustees stated that climate change was not encapsulated in their fiduciary duty, with one stating that it was in conflict with it: 'It's [climate change] in conflict with the general principle of protecting the members' benefits' (T4).

*Well as things stand, I think the answer is no, isn't it. I think that's probably one where there is a right and wrong answer and I think the right answer is no, but it's unfortunate.* (T11)

*Well, no: other than that it's part of our overall responsibility to protect out members' funds...I mean in the same way that we wouldn't necessarily recommend people investing in, I don't know, junk bonds...it's part of the mix but it's not enough...it's something you have to take into consideration like everything else...it's not our responsibility on its own.* (T6)

Another trustee seemed to imply that climate change was not encapsulated in his fiduciary duty but he seemed uncomfortable about saying so: 'Er, yeah, er, sort of, er, I mean, I, I think it would be callous to say no, isn't it? ...I think it's, um, recommended rather than obligatory' (T18).

Despite the fact that almost all the trustees interviewed sought legal advice on their responsible investment policy, there was low consensus about whether or not climate change should be considered within their fiduciary duty, implying that the advice they were receiving may not have been consistent.

### **The 'missing link': making the connection between climate change and financial return**

Despite a general interest in climate change issues among the trustees, and a general understanding of what would result from climate change, they seemed to display little understanding of a direct link between climate change and financial return. Many commented that the 'connection' between climate change and financial return was unclear. When asked whether they thought climate change was an important factor affecting financial return and shareholder value, most of the interviewees claimed that it had very little, if any impact:

*It's not relevant. For us, it just has not entered into our discussions at all...I think, if you like, the official answer on that would be, we don't think it's an issue that would affect the viability of the pension fund in meeting its obligations. That would be the official answer. I think in reality, we just haven't given that any kind of thought.* (T8)

*I think the honest answer is to say that we've yet to make that connection...I think at the moment it's barely scratching the surface...it's a huge concept, it's a big topic, what may help is to translate what we mean by that back into language that currently appears in SRI.* (T10)

*I think we need to be very careful not to headlong dive towards a policy of investment which takes all the factors of climate change into account at the expense of return on investment.* (T18)

This comment shows there is a pervasive and continuing belief among members of the trustee community that SRI damages financial return, which is hard to dispel, despite the growing evidence to the contrary.

Another interviewee believed that climate change was not at all important as a factor affecting financial return and shareholder value. He also said that it should not be taken into account in the pension fund's investment strategy. This prevalent view among interviewees contrasts starkly with the Carbon Trust's recommendations (2005) that trustees should investigate the linkages between climate change risk and their fiduciary duties. Conversely, it confirms the UNEP findings (UNEP 2007, 2008) that the connection between climate change and financial risk is not understood and that this is preventing the financial sector from engaging with climate change issues.

Where interviewees did believe that climate change could affect shareholder value and financial return, their explanations were often vague, indicating a partial understanding of the connection:

*I believe climate change is a significant issue just in **general terms**; and it is bound to have **some impact in some way** on the way business is conducted and the returns that businesses get from whatever they do and indeed the opportunities for business. Some businesses will prosper and...new businesses [will] arise because of climate change; others will fall away for different reasons. So there will be an impact, and therefore there will be an impact for pension funds in terms of their investments **and so on** and the returns from those investments.* (T8, emphasis added)

*I mean, climate change affects the economy...and therefore the returns on investment are likely to be suppressed by the overall cost to the economy. **It's hard to think what else.** We haven't got a climate action plan of any kind for the pension scheme.* (T16, emphasis added)

When trustees were asked whether they considered climate change could have a material impact over the long term, there was a slightly more positive response. Eleven trustees responded 'yes', but four said 'no', with another admitting: 'To be honest, we don't know' (T1).

These findings reflected those of UKSIF (2007), which suggest that trustees believe that ESG factors are material. Nonetheless, despite a general belief that climate change would have a material impact in the long run, trustees' explanations of the nature of this material impact were, again, rather vague and unspecific: 'Well clearly in terms of fossil fuels, city centre life, transport policy, it all has an impact on climate change **doesn't it?**' (T3, emphasis added).

*I take it [climate change] to mean changes in temperature, rainfall and so on and if they change, either getting hotter or colder, then it will affect activities that can take place in any one particular part of the world. (T2)*

One trustee explained that potential benefits and opportunities relating to climate change were, in his view, over-valued, referring specifically to, 'anything to do with green energy at the moment within the UK' (T6).

There were rare cases where a trustee provided a detailed explanation of climate change effects globally but did not make a connection with pension fund investment.

*It's going to have major economic impact on some areas, like perhaps Sahara in Africa; depending on the impact also you may get areas such as Canada and the Northern United States, where you may get profound changes when effectively you get less freezing. So you may actually get quite profound climate change or impact on lifestyles and on how realistic it is to live in certain areas that are close to the Arctic or the reverse, close to the Sahara where you've got extremes of temperature; so I think there will be big impacts on some specific areas. (T7)*

Even the trustee from the largest fund interviewed commented: 'Well, the difficulty is that there's no academic evidence that actually substantiates that ESG integration improves returns. I mean if you look at the latest study from UNEP FI and Mercer's I think the best they can say is that...it's simply not the case that there is a negative return' (T9). This interviewee discussed at length the fact that although 'good' financial returns seemed to be associated with 'good' CSR, there was no determinable causal relationship. In other words, correlation had been found but not causality. He continued:

*everything's under threat at the moment. I mean, there have been riots in Mexico over the price of tortilla flour, the price of pasta is shooting up in Italy and again there's a world shortage of cereals...a lot of farming, agricultural production has been moved over to produce soya...for use as bio-fuels... it [climate change] affects everything, commodities, and a whole range of our physical investments in the corporate world...If you look at the IPCC Report and the Stern Report...if those reports are **only one quarter correct** then...the level of risk to our investments is still incredibly high. If both those reports are correct then we could be facing **a very bumpy ride ahead**...so our view is that value is being put at risk. (T9, emphasis added)*

This detailed, insightful explanation of the linkages between climate change and portfolio investment was an isolated example from the interview data. It is possible that, because climate change is generally viewed as a long-term material risk, trustees of short-term-oriented pension funds may dismiss it, given that they tend to focus on short-term investment return and risk (see, for example, the Hampel Report 1998). Indeed, the Myners Review (2004) states that: 'While trustees, consultants and fund

managers agreed in principle that pension funds could operate over long time horizons...there was still a mismatch between the perceptions of trustees...and fund managers [who]...still have unnecessary incentives for herding and short-termism in investment' (Myners Review 2004: 17).

Trustees should be focusing more closely on long-term risks affecting investment. Nonetheless, the risks relating to climate change are quickly moving into the short-term, with climate changes occurring far more quickly than previously anticipated.

The 'beliefs' of trustees are not to be regarded as an ephemeral, personal issue but as a driving force in setting investment strategy. Indeed, the Marathon Club, committed to promoting 'long-termism' in institutional investment, has emphasised that, 'the formulation and articulation of trustee investment beliefs is a fundamental building block in the setting of a coherent investment policy' (Marathon Club 2007: 10). Furthermore, as the Marathon Club outlines, trustees need to devote time and effort to determining and making explicit their core beliefs as an essential backdrop to making decisions in trustee meetings.

### **(III) TRUSTEES' ACCOUNTABILITY TO PENSION FUND MEMBERS ON CLIMATE CHANGE ISSUES**

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As the pension fund members are the ultimate owners of shares invested by the pension fund, trustees' accountability is to them. In this section we consider evidence from our interviews on the ways in which trustees are discharging this accountability to pension fund members, in relation to climate change, by engaging with their fund managers as well as with the scheme members themselves.

#### **Lack of awareness of pension fund managers' activism generally**

Although the majority of trustees (14) were aware that their fund managers engaged with investee companies, they had little detailed knowledge of the engagement process. This is despite recommendations such as the Myners Review (2004), which emphasises that trustees have a responsibility for ensuring that appropriate shareholder engagement is undertaken by their designated fund managers. Half the interviewees said they received summaries of activism from their fund managers, but half said they did not. Many interviewees indicated that they did not read their fund managers' activism reports on their responsible investment policies: 'They've certainly told us they monitor...but I don't know the precise details' (T16).

It is surprising that even now, after the efforts of Myners (2001, 2004) and other bodies, trustees are still not engaging with their fund managers in order to ensure they are acting as active shareholders.

### **Trustees delegate climate change responsibility to fund managers**

Although trustees are formally responsible for deciding the investment strategy of their pension fund, it seems their decision to delegate investment decisions to their fund managers has led to an impression that this frees them from a need to consider potentially material risk factors such as climate change.

*I would say that the view is probably agnostic [on materiality of climate change] – I mean we're expecting our managers to have that skill...Now **it's not our place** as trustees to dictate to a manager...if these companies are at risk of not being sustainable as businesses that's for them to factor into their fundamental analysis. (T12, emphasis added)*

*We get activism reports...I think only annually, but they may be half-annually, which say how the fund managers have voted shares in certain companies...so **that is the limit of our activism**. Really we're just monitoring what they do; **we don't instruct the fund managers** how to use their shares. (T2, emphasis added)*

There was also evidence that trustees play a passive role within the institutional investment community, with comments that:

*We just **outsource and shut our eyes**: shut our eyes in terms of the detail of where the underlying investments sit. (T7, emphasis added)*

*Responsibility for exercising [voting] rights is delegated to those managing the investments, so basically **we've washed our hands**. (T11, emphasis added)*

This contrasts sharply with the Carbon Trust's recommendations (2005) that trustees should be behaving as active owners by encouraging their fund managers to engage with investee companies on climate change risks. The readily available literature on trustees' role and responsibilities also indicates that investment consultants can provide advice on responsible investment strategies. We did ask the trustees if they sought advice from this source and 15 stated that they did. This would suggest that they should be receiving advice and information on strategy relating to issues such as climate change that would help them in advising their fund managers.

### **Scant awareness of pension fund managers' activism on climate change**

As well as not instructing their fund managers on climate change, the trustees seemed largely unaware of what actions their fund managers were taking. The trustees we interviewed were generally unaware of whether climate change was being addressed by the fund managers in carrying out their mandate. When asked if they knew the extent to which the one-to-one meetings between their fund managers and the investee companies incorporated climate change in their discussions, there was a significant negative response, with 16 trustees saying they did not:

*From memory not a single fund manager has mentioned climate change or ethical responsibilities. (T6)*

*Nothing immediately is springing to mind. (T10)*

*I don't even know which companies these fund managers are investing in. (T17)*

*I haven't actually seen anything including climate change. (T18)*

In relation to communications from fund managers to trustees, one interviewee commented, 'it's a very bare summary...so whether there's any climate change content in those discussions, it doesn't say anything about that, not that I remember' (T11).

We asked the trustees if they were aware of any climate change-related issues that had arisen in the process of engagement and dialogue. Only two trustees responded that they were aware of any at all. One commented:

*[Climate change has] been **raised occasionally** by a trustee or the chairman brings it up at the general meeting when an individual has raised it and whether it's anything to do with [investee company] – it tends to be general rather than specific concerns. (T3, emphasis added)*

Nonetheless, one trustee admitted that his lack of knowledge might be due to a lack of interest on his part: 'I've never noticed it [climate change] but I wouldn't say I read every word of them [activism reports]; I go through them quickly but most of them seem to be round things like remuneration packages for board directors and those kind of things' (T2). Another commented: 'I know that they do engage... but whether they actually engage on issues such as climate change then I am not so sure (T15).

We also asked the trustees if climate change issues had arisen on the agenda for voting in their fund's investee companies. The majority (16) of the interviewees said that they had not or that they did not know whether they had. One commented, 'I wouldn't have actually seen the, er, the agendas' (T18).

Again, this finding suggests a gap between recommendations (Carbon Trust Report 2005) that advise trustees to behave as active owners by encouraging their fund managers to engage with investee companies on climate change risks, and trustee practice. Instead, the trustees we interviewed were generally unaware of their fund managers' activities in relation to climate change, and did not seem to be actively attempting to change their knowledge base. One trustee said they only received information where fund managers had voted against company management, 'as trustees we've only been told about the cases where they go against management' (T12).

In only one case did a trustee instruct the fund managers specifically on climate change, 'we basically, in discussions with investment managers, asked them to ensure that they

have taken account of the long-term effect of climate change in their investment' (T13).

This isolated case represented what trustees 'should' be doing.

### Little engagement between trustees and pension fund members

We asked the trustees whether they engaged with their pension fund members on climate change issues and on the potential impact of climate change on the pension fund. All the interviewees except two said they did not. This lack of engagement with members was not restricted to climate change issues but reflected a general lack of engagement across the whole area of SRI. Although trustees generally communicated their SRI policy to their members, little detail was provided:

*I can't actually remember seeing it in any of our newsletters...I think if there's been any reference to social responsibility at all it's been a one-liner. (T18)*

*Communication is one of the areas where the old school adage of 'could do better' applies to our board of trustees. (T10)*

*I think until recently communication with members has probably been distinguished by lack of communication. (T11)*

*I don't think we do that very well at all...I think the answer would have to be no. (T19)*

*Well, we produce an annual report [for] all members and when we put a statement in about SRI we did publish what the SRI was; we don't routinely put that statement in every year but I mean over the years, we have kind of told them what our policy is and that's all. (T2)*

This lack of communication does not indicate a high level of accountability flowing from pension funds to their members. From the largest fund's trustee there was, however, evidence of accountability to members:

*without having a kind of **fetish about communication**...I still think we should improve it and we are gradually making improvements but like all of these things **there's a learning curve**...but I think we probably give more information than most pension schemes do. I think we genuinely do try to be as open as possible. I'm not at all sure we actually achieve that...as a general principle we go for transparency not only from the companies in which we invest but we want our own actions to be transparent as well. (T9, emphasis added)*

Nonetheless, even though this trustee seemed to be an outlier, representing best practice, his fund still has a long way to go in the area of communication. This quote also suggests that pension funds need to become learning organisations regarding climate change (Argyris 1993).

There was a general indication from our interviewees that the reason there was so little communication with members was lack of demand from them:

*I mean I can only remember in the last ten years maybe three or four people who've asked us what our SRI policy is but I don't remember any of them making any comment once they received it, other than it wasn't a particularly dynamic one. (T2)*

*To my knowledge, we've never received requests from members. We would respond by disclosing more generally; the fact that there has been silence from the members indicates that there is no particular desire on their part to have more detailed information in that area. (T7)*

*I would think there's probably nobody who ever asks to see it...a long queue of people banging at the door asking to see this policy? No. (T8)*

*To be quite frank, we have not had any pressure whatsoever from members on...climate change issues. (T9)*

When asked whether they received feedback from members on the implementation and effectiveness of their responsible investment policy, only one trustee said that they did: 'Yes we do...if the fund managers aren't doing very well we get told – people complain' (T6). The rest of the interviewees said they did not, or that they were not aware of any feedback, with one commenting: 'There's a degree of cynicism in the world...the only questions we're asked are about the fund's ability to pay pensions' (T18). In addition, we asked the trustees if they ever consulted the pension fund members in setting their responsible investment policy: only one of them did.

Although it should be reasonable to expect that institutional investors be accountable to their members, a number of reasons have been proffered in the literature for why this does not necessarily happen in practice:

- most individuals are simply unaware that it is their money that institutional investors are investing
- many individuals have not been too concerned about how their investments are managed
- 'institutional investors have traditionally been very resistant to any interference in their investment decisions' (Hildyard and Mansley 2001).

Our findings seem to support such suggestions that there are inherent obstacles to the accountability of the financial services to members. Overall, the interviews indicated that there was a low level of accountability in the relationship between fund managers and trustees, as well as directly between trustees and the pension fund members. This would suggest that the chains of accountability between pension funds and their members are not strong. This supports previous suggestions that there is a governance vacuum in pension fund investment (NAPF 2005).

#### (IV) OBSTACLES TO TRUSTEES' CONSIDERATION OF CLIMATE CHANGE

In this section we consider the obstacles that our interviewees perceived to their consideration of climate change in their role as trustees. These obstacles included:

- a lack of knowledge and understanding of the financial impact of climate change
- a lack of reliable data and evidence on the potential impact of climate change on the pension fund industry
- the difficulties in obtaining a consensus from members on climate change issues
- the problems associated with trustees being overloaded in their duties, and
- lack of guidance from sponsor companies and trustees' advisers.

These themes, derived from analysis of the interview data, are summarised in Fig. 4.1.

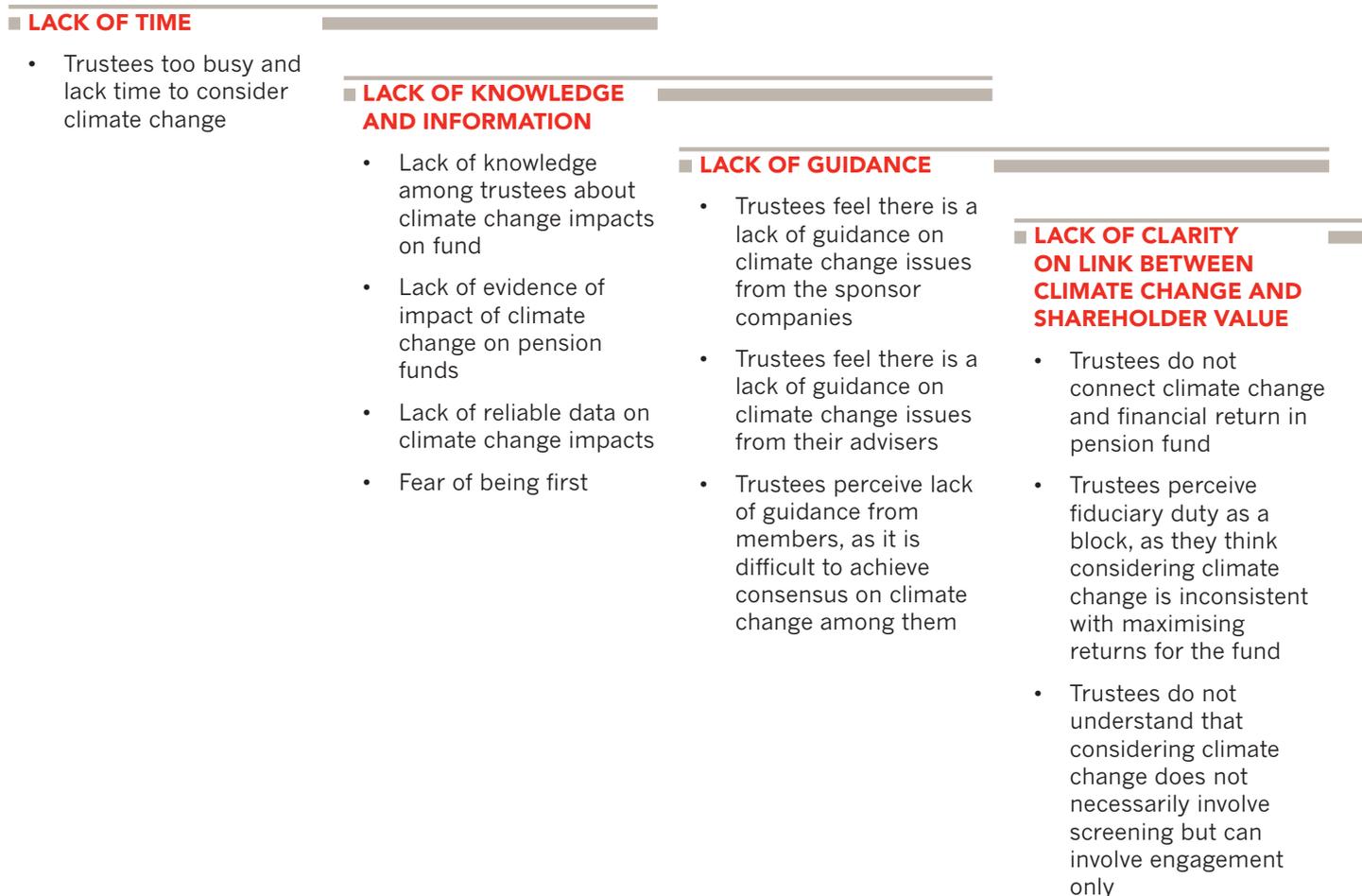
#### Lack of knowledge concerning the financial impact of climate change

The trustees we interviewed claimed that they had inadequate knowledge of the links between climate change and pension fund performance, and indicated that their understanding of climate change impacts was inadequate. In response to a question asking: 'What obstacles do you believe may be limiting your ability to take climate change impact into consideration in the pension fund?', trustees gave the following answers.

*I think basically it's probably just a **lack of awareness and a lack of knowledge of the issue**. I mean maybe if we asked our investment adviser to talk about it with us, assuming that they're on the case on the climate change issue, we'd understand better what the possible implications could be and could consider whether any action would be appropriate. (T8, emphasis added)*

***Lack of knowledge and information** probably is one major factor in the wider view on climate change...I feel I haven't got the information to tackle these things and maybe some of it is actually out there and just kind of passing me by. (T2, emphasis added)*

Figure 4.1: Obstacles to trustees' ability to consider climate change



**Lack of information, lack of interest** and it's an area that just hasn't ever been flagged. (T5, emphasis added)

...knowledge of what activity is impacting on climate change so there's obviously that element and **a lack of knowledge**. (T3, emphasis added)

It was clear throughout the interviews that one of the main reasons why trustees were not taking climate change into account in a systematic way was their lack of understanding of its potential financial impact.

For the pension fund...well I think the honest answer is to say that we've **yet to make that connection**. (T10, emphasis added)

Well, even **starting to make those connections** and understanding...it's a big...concept. (T10, emphasis added)

The penny hasn't really dropped. (T10)

One trustee explained that this lack of knowledge and understanding was not, however, restricted to the trustee community.

I think climate change, unless all the scientists in the world are wrong and we're all just being sort of brainwashed by the media...is a real issue but nobody really knows what effect it's really going to have in the future and particularly the long-term future and nobody is certain how governments are going to react and deal with climate change; **all these things are very unpredictable and scientists don't understand it well enough yet so to predict how climate change could affect companies' performance and equity returns...whether it's going to be really at all material on economic grounds and equities and so on. It may be pretty immaterial but it may be very material** and it's hard to say. (T8, emphasis added)

Trustees' views of their own ignorance were supported by their evident lack of knowledge regarding existing evidence. We asked the trustees if they were aware of several relevant publications. Their responses are displayed in Table 4.1 below and suggest a general lack of awareness of the reports. This contrasts with the findings of the UKSIF (2007) report, which suggest that the majority of trustees were believed to be aware of major climate change initiatives, especially *The Stern Review* (2006).

**Table 4.1: Are trustees aware of existing reports and studies on climate change and pension fund investment?**

	Yes	No
<i>Responsible Investment in Focus: How Leading Public Pension Funds are Meeting the Challenge</i> (UNEPFI and UKSIF 2007)	3	17
<i>The Association of British Insurers Guidelines on Responsible Investment</i> (ABI 2007)	6	14
<i>The Stern Review: The Economics of Climate Change</i> (Stern 2006)	11	9
<i>Principles for Responsible Investment</i> (UN PRI Initiative 2006).	2	18
<i>Responsible Investment Trustee Toolkit</i> (Higgs and Wildsmith 2005).	2	18
<i>Eurosif European SRI Study</i> (Eurosif 2006)	2	18
<i>Climate Change and Shareholder Value</i> (Carbon Trust 2006)	2	18
<i>A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment</i> (Freshfields Bruckhaus Deringer 2005)	3	17
<i>A Climate for Change: A Trustee's Guide to Understanding and Addressing Climate Risk</i> (Carbon Trust 2005)	1	19
<i>Potentially Material Social, Ethical and Environmental Risks by Industry Sector for Pension Fund Trustees</i> (Just Pensions 2005).	2	18

There were various comments on *The Stern Review*, which has been discussed widely in the global media.

*Definitely heard of it [Stern] and in fact I picked it up in a bookshop and flicked through it and it's a very, very comprehensive document but I've never read it, and I don't even have a copy, but it's the sort of thing I'd actually like to read because I'm actually genuinely interested in the subject. (T8)*

*I'm aware of it in terms of following it in the news...and the reaction...becoming a little bit of a political football... but again I've never actually read the document itself. (T10)*

*Now, I've heard of The Stern Review, um, but actually not in connection with...um...oh, it might have been in connection with pensions, I might be telling a lie there, but I've heard it referred to but I've never really looked at it. (T18)*

Even where trustees had heard of reports, they did not make the connection with pensions, indicating a significant 'missing link'. The broad lack of knowledge displayed in Table 4.1 is particularly surprising given that some of these reports were aimed specifically at the trustee community. Another interviewee commented in relation to *A Climate for Change: A Trustees' Guide to Understanding and Addressing Climate Risk*: 'No, but that's the sort of heading document that seems to be reasonably user friendly and we should be reading' (T3).

#### **Lack of evidence, lack of reliable data, difficult to quantify**

Many interviewees blamed a dearth of evidence for their lack of involvement in actively incorporating climate change into their portfolios:

*It's very difficult to try and evaluate that [climate change] in any numeric form. (T13)*

*One [obstacle] is the lack of reliable data; what benefit does climate change investing have on the future performance of the fund – and certainly reliable data is an issue. (T13)*

*The other thing is we don't believe it's yet proven that responsible investing...does actually bring a beneficial financial reward to the scheme. (T13)*

#### **Difficulties in obtaining a consensus from members on climate change**

The trustees we interviewed claimed that obtaining a consensus view on climate change was difficult, if not impossible:

*How do you decide what the overall view of 15,000 people is? You know you've got a complete spectrum of people who are out-and-out 'green nuts' to out-and-out people who deny climate change is even happening, so it makes it quite hard to go either way really. (T2)*

*We had an exciting event every year called the members AGM and from 10,000 members we used to get about 50 people turning up...and they would stand up and say 'you mustn't invest in tobacco companies' or 'you must invest in...' something else. And of course you have as many different points of view in the room as you have people... and in the end you can't do anything about any of it. (T14)*

*We shouldn't spend more than half an hour [on climate change] at a trustee meeting...it's very inadvisable to have an open debate because...people...will talk about egg production where half the chicks are liquidised...that kind of debate can easily occupy a day, if you let it. (T18)*

Although Freshfields Brickhaus Deringer (2005) states that a consensus demand from pension fund members would force SEE issues to be a fiduciary duty for trustees, such a demand does not seem to be forthcoming.

#### **Lack of guidance from trustees' advisers**

Some trustees commented that there was a lack of guidance on climate change from their plan sponsor companies and from their advisers 'and I think [there is] the lack of any particular message coming from any of the trustees' advisers' (T14).

This finding highlights a weak governance link in terms of trustees' ability to obtain knowledge and advice necessary to fulfil their role. Some of the trustees mentioned that they would consult their investment advisers. Such consultation, however, demonstrates their reliance on third-party advice, which represents one of the constraints in the financial market. According to the Myners Review (2004), 80% of schemes at that time employed an investment consultant, with 53% of all schemes relying on a pool of just eight organisations. One implication is that the appointment of more competent trustees would help to overcome this weakness.<sup>20</sup>

#### **Lack of involvement with sponsor company**

We asked trustees whether they engaged with the plan sponsor in implementing their responsible investment policy, and 13 said they did not. Our interviewees indicated that there might be a gap between what companies are doing on climate change and what their pension fund trustees are doing. The HeadLand Report (2007) stated that companies should be instructing their pension fund trustees to adopt a similar green approach to their own, but our evidence suggested this was not happening in practice. One trustee bemoaned: 'the lack of any particular direction from the company...that is not a criticism of the company, it's just a statement of fact' (T14).

Evidence of a gap was suggested: 'whatever we think is acceptable...our company has a sustainability policy and a very strong ethics policy. That doesn't necessarily apply to

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20. Thanks to one of the anonymous reviewers for raising this point.

the pensions scheme because we've got other peoples' money and unless we have a remit from them which I can't imagine how it would be agreed [sic]' (T16).

One trustee provided a possible explanation for why the sponsor companies were not engaging on SRI issues with their pension fund: 'Nowadays, I have to say, in common with most pension schemes, the representation of the plan sponsor in terms of numbers is the same but the actual seniority of the individual is less than was the case before...' (T11)

Of the seven trustees who said they did engage with their plan's sponsors, one commented: 'Yes...the company has a social and environmental policy about child labour and pollution and so on and we align ourselves with that and possibly even a step further'. (T18)

Even where trustees talked of engagement with the plan sponsor, there was no evidence of aligning the company's sustainability policies with the fund's responsible investment strategy:

*the plan sponsor is there in the trustee body and from time to time the chairman of the trustee body, who is also the non-executive part-time chairman of the company, does have to, so to speak, remove his trustee's hat and say 'let me for the moment speak on behalf of the company'. So there is, if you like, a continuous dialogue which I think works quite well...but again I have to say, in my experience, **the company has not input into that dialogue any particular point of view that has a link with its own policies on matters like this...**they certainly haven't tried to, in any sense, lean on the trustees either to do things or not to do things. (T14, emphasis added)*

#### **Trustees view climate change as a subjective, not objective, issue**

Our interviewees seemed to perceive climate change as a personal, moral issue rather than as an issue which should be applied objectively to their pension fund. One trustee identified confusion over a personal or an organisational response to climate change:

*my view is that the primary responsibility of a trustee is to the members and **irrespective of my personal feelings regarding climate change**, in the capacity as a trustee, the priority is to protect the assets of the members and to protect their future benefits and I'm not convinced that I should impose **my own judgements** as to what I believe to be ethically correct to the extent that might prejudice the role of custodian and guardian that goes with being a trustee. (T7, emphasis added)*

Another trustee identified a conflict between personal and organisational views:

*we don't believe it's our role as fiduciaries to introduce our own behavioural biases as to what they may or may not invest in...you're going straight into **the individual views and opinions and subjective views of individual***

***trustees...it's not our place to dictate to managers what they should do. (T12, emphasis added)***

Confusing personal ethics with a need to address climate change on a financial basis seems to impede trustees in embracing a role in climate change:

*this is where the individual trustees might say, 'I saw something in the news last night about such and such', or, 'I think wind farms are a great thing for the future – you know we could have something in our portfolio with wind farms in it'...**we wouldn't do that.** (T12, emphasis added)*

#### **Abnormal returns**

Some trustees commented that it was not possible to make abnormal returns by taking account of climate change issues because the data were too visible:

*the way our managers are expected to execute our beliefs...trying to buy into things that the rest of the market have missed...or...have over-exaggerated, so to the extent that climate change, as politicians and others are latching onto it...it's intended to be more transparent...I'm not sure how that works because [if] it means that Trucost reports are available to everybody, then it probably means...the performance potential is limited. (T12)*

This argument does not, however, consider that for long-term investment in companies you need to ensure that they are managing their climate change risk strategically.

#### **Some trustees are sceptical about climate change**

There was evidence of a degree of scepticism among members of the trustee community about the validity of global warming and climate change arguments:

*the effect of climate change and ascribing it to an event is kind of tricky anyway...are there more hurricanes disrupting transport and oil production as a result of climate change or **was it going to happen anyway?** (T18, emphasis added)*

*I find the emotional aspects of it are usually well presented and documented but it remains very subjective and I guess **I'm a hard-nosed accountant who wants to see the numbers.** (T11, emphasis added)*

*I think that you will find that there will probably be some colleagues on the trustee board that don't buy into the issue of global warming, **that they think it's a bit of a con** and they've got their own personal opinions about that. (T15, emphasis added)*

***I would be very sceptical at this stage** and I know people are putting a lot of work into this, which is all to the good because clearly work should be done in this area; but I think it's incredibly difficult to really predict what it's going to mean. (T8, emphasis added)*

*I think I might be one of the sceptics for the time being. I'm not saying that pollution is good, obviously not, but I'm not sure I can agree with what is being made of climate change.* (T17, emphasis added)

Some of these comments mirror the sceptical views encapsulated in a small body of academic literature discussed earlier (for example, Carter et al. 2006; Carter 2007; Robinson 2008).

### **Trustees too busy with other responsibilities**

Another obstacle identified by trustees was a sense that their role encompassed an increasing array of responsibilities, rendering climate change a less significant consideration than others under their remit.

*I think it's something [climate change] that with all the other changes, and this sounds pathetic, but with all the other things that have been going on in the pensions world over the last few years, it's just got pushed down the pile.* (T2, emphasis added)

*You are trying to do what you need to do to protect your assets and when you start onto things like this [climate change], they are nice to have and nice to be involved with, and until somebody really comes along and says, 'right you really need to start thinking about this', you don't, because there's just so much regulation to get involved with and to keep up with, that anything else beyond that is wishful thinking right now.* (T5, emphasis added)

Myners (2001) focuses on the role of the trustees, highlighting the need for them to become more engaged in pension fund investment generally. Indeed, the Myners Review (2004) highlights the small amount of time devoted to trusteeship, with the average being 10.6 hours per year in board meetings. Myners' criticisms (2001) have had some positive impact on the trustee community, although as the Myners Review (2004) shows, there is still room for improvement. Further, Myners (2001) does not address social and environmental responsibilities. It seems that this is an area that has been ignored by trustees in their quest to improve their performance and effectiveness, given time constraints.

### **SRI perceived as screening, not engagement**

Another obstacle to trustees' consideration of climate change within their remit may be attributed to their insufficient understanding of SRI strategy. The interviewees generally interpreted SRI strategy as screening, not engagement, suggesting an outdated understanding, because a 'best in sector' approach superseded negative (and positive) screening several years ago (Solomon 2007). Some interviewees clearly had no conception of any positive relationship between SRI and financial return,

*The idea that small contributions will win the day is just rubbish and therefore it's no good our members retiring on a smaller pension because our scheme didn't invest to maximise its profits when another scheme does, [it] doesn't benefit them, so we can't take climate change into account'. (T4)*

Clearly, taking account of climate change in institutional investment does not require a negative screening approach and active fund management can affect corporate behaviour in relation to climate change. This seems to be an area where awareness of current strategies and approaches would benefit the trustee community.

### **Fear of being first**

Another impediment identified by the leaders among the interviewees was a fear of being first: 'I think within the sector there's a natural reluctance to be the first person... because there's a lack of confidence that everybody else is going to do it' (T9). This type of attitude is indicative of a defensive strategy, a barrier created by trustees to avoid changing the status quo (Argyris 1993). It also reflects the finding of the UNEP, discussed earlier, that a sense of shared responsibility may deter the group from taking the initiative. Fear of being first has traditionally been a problem in financial markets, which are frequently characterised by 'herding' behaviour. For example, Guyatt (2005) explains that prevailing dominant conventions (short-termism, gravitation towards defensible decisions and reluctance to incorporate corporate responsibility factors into the core investment process), reinforced by institutional herding tendencies, represent behavioural obstacles to responsible investing. Our evidence suggests that the same sort of herding behaviour is blocking trustee activism in the area of climate change.

## **(V) TRUSTEES' ATTITUDES TOWARDS THEIR FUTURE ROLE IN CLIMATE CHANGE**

In this section we consider a series of aspects raised by trustees regarding their perceptions of their role and responsibilities in relation to climate change in the future. Specifically, we consider:

- whether trustees believed that climate change would grow in importance
- whether they believed they could improve their conduct in the area of climate change
- how they claimed they should be responding to the 'challenge' posed by climate change
- the extent to which trustees considered they have a potential to influence corporate behaviour, and
- some reflections on how this research project could affect their attitudes towards their role regarding climate change.

Interestingly, this section provides suggestions from trustees on the way forward for them in relation to climate change.

### Climate change will grow in importance for pension funds

Although there was little evidence to suggest that climate change issues were viewed as an important consideration by trustees at present, there was a general belief among our interviewees that this situation would change in the future. As we saw earlier, some interviewees believed climate change could have a material impact over the long term. Nonetheless, this view tended to be qualified by the perception that climate change factors would not become material for many years (even decades) and that in the short-to-medium term they were not material, but that this may change over time:

*there will be **long-term economic changes** and that will have a degree of impact on the [pension fund] industry itself. (T7, emphasis added)*

*Those are extremes that we're not feeling in the UK yet and I don't suppose we will, **certainly not in our lifetime...**I find it hard to see within the **next 20 to 30 years** really. (T2, emphasis added)*

*Well, given I said that we take no regard to it because it's in conflict with the members' interest, I think **over time** we will have to have, and be seen to have, policies that members will...ask for, but that's not currently the case. (T4, emphasis added)*

*Right now I don't [think that climate change is an important factor affecting financial return and shareholder value]...but I think in the future, **probably the next three to five years, maybe even two to five years**, then I think it will become an issue. (T5, emphasis added)*

*I think members will increasingly be more aware of climate change and may ask the pension trustees what their policies are doing with climate change. (T6)*

*I think it's really hard to say at the moment...so I would say at the moment not a lot, but that view could easily change **in the next six months or couple of years...**I would think that, where we are today, it is very difficult to really appreciate the scale of this and it will become clearer. I think it will become clearer over the years going forward rather than right now, because I just don't...certainly in a fund my size, I don't see what the impact is on the funds but I'm going to check up because you've raised it with me [laughs]...but **I'm not seeing it as a kind of flashing light at this stage** and maybe I'm wrong; I'm quite prepared to accept that I could be wrong but I think it will become an issue over time, I think it's bound to, but how big it's going to be, I don't know. (T8, emphasis added)*

*Well pensions are one of the biggest investors in the stock market, aren't they, and climate change is going to impact enormously on businesses around the world, so it's going to affect a lot of companies individually: it's going to affect their dividends and stock value, which is the life blood of pension funds isn't it?...next time we're appointing our fund managers...it [climate change] will be a much bigger consideration than it was last time. (T11)*

### Trustees acknowledge room for improvement

We asked our interviewees whether they thought that the consideration of climate change in their pension fund's investment strategy could be improved, in order to gain an insight into possible future policy recommendations from the trustee community themselves. Thirteen of the trustees we interviewed believed that the consideration of climate change in their pension fund's investment strategy could be improved, with the rest saying they were unsure, '...we need to monitor and record some of those conversations more clearly now' (T3).

*Things can always be improved, yes. **We could be more active:** whether it would produce any impact on the companies in which we invest, I'm not sure. (T2, emphasis added)*

*I think **more briefing notes from organisations such as the PMI** and other outfits as well as our investment managers advising us, so I think education and knowledge are important. Discussing it [climate change] on a regular basis at trustees' meetings needs to have a disciplined, timetabled element to it. (T3, emphasis added)*

*I think from the conversation we've had, we really need to start, probably, considering the whole social responsibility thing from the start. So I think it's fairly basic we just even begin to give it some thought and to start making sure that when we start seeing these funds come up, we ensure that we're in there. (T5)*

*I think what we could do on our fund is to **at least have it on our agenda** and to ask our investment advisers to **give us some advice or give a presentation** or have a discussion point at a future meeting of the trustees. (T8, emphasis added)*

*I'm going to talk to our investment advisers. (T8)*

Two trustees answered with a definite 'no': 'I don't think it needs improving...I think it's appropriate to the current situation' (T18).

### How trustees say they should be responding to the climate change challenge

We asked the trustees specifically how they thought they should be responding to the climate change challenge. The responses were quite mixed. Summarising their general views, six were quite negative about the need for them to play a role in encouraging the consideration of climate change within their pension funds. Five were positive, indicating that they saw it as an important element of their socially responsible investment strategy. Three trustees said that it was too early to tell and the rest were generally unsure. Most said that they should be responding in some way, for example:

***We should be trying to monitor any issues...**and we probably should have on our horizon that we should be thinking more about investing in responsible companies, responsible in relation to climate change. (T2, emphasis added)*

*I think as part of four or five socially responsible policies, we should be discussing it with our advisers, asking questions of the fund managers, and once a year having a discussion on it as trustees and recording those statements. (T3)*

*It's probably something that's worth discussing with fellow trustees to see whether we believe we need to look at our investments or whether we should have a mandate with our fund managers to say, 'here is a list of companies we don't wish to invest in, if they are abusers of the environment'. (T5)*

### **Trustees' potential to affect corporate behaviour on climate change**

We asked the trustees whether they considered that in their role as trustees the approach they adopted towards climate change could potentially affect corporate behaviour. Nine trustees said that it could, six said that it could not. The others did not express a definite view. Trustees who said that they could influence corporate behaviour provided reasons why: 'Oh yeah...I think if corporates believe their stock is being shunned then I think they'd take action' (T6).

*We could influence core tactics...if we had an ethics policy where climate change came more to the fore... then that might reflect on the pension fund. (T4)*

*I mean in principle trustees as a body, you know all trustees or all pension funds clearly have a **massive ability to impact**. Whether they will do is another question because trustees are often a fairly passive group of people that really don't sort of punch their weight but in theory they could have a big impact, yeah. (T8, emphasis added)*

*Umm, it could do, I suppose, in the likes of the third world and what have you. If you can stop people emitting a huge amount of carbon out of factories, and what have you, yeah, I suppose you could. (T1)*

*Where there's money the answer would probably be that it could...I don't think we're taking any kind of action which would influence corporate behaviour, but I think if enough people said we're not investing...then obviously it **could** have that effect. (T18, emphasis original)*

*We don't see that the corporates are just there to do as they wish without reference...to the shareholders...what we want to do is have that dialogue with those companies over strategic direction. (T9)*

*There's a lot of investment powers...and a concerted move could pressurise management boards of companies. (T17)*

One trustee explained in detail how the impact could arise:

*[There are a] couple of levels, one is the mandate that we have through investing in a number of very large companies [and] then there's the pension opportunity for*

*us to be kind of held up as a role model for how big pension scheme governance looks...so I think on both those levels we've got significant opportunity to influence other trustee bodies as well as companies. (T10)*

Another trustee, from a large pension fund, also explained that they could probably affect corporate behaviour on climate change, although this trustee seemed unclear about the mechanism by which this would happen: 'by using our influence we can probably influence companies to perhaps change their policies on their carbon footprint, so I think that is something we could probably do. Now I might be naive here but it is certainly worth a try, in my opinion' (T15). From the interviewee who represented a leader in the field, there was evidence of accountability to members in this area, 'what we're doing is looking at how we can influence the behaviour of...the top six UK carbon emitters...' (T9).

Overall, the majority gave the impression that there was a latent potential for change, which could be mobilised. Those who were unsure about their potential impact seemed to think there was a time factor involved, with climate change becoming more significant in the future, thereby making their potential impact more significant in this area: 'I'd like to think that we could have some impact on companies' investment policies and investments but I think at this point in time our impact is minimal' (T13).

### **Government or free market solution?**

There were some suggestions from interviewees about how climate change may be tackled in a broader context. There was a suggestion from interviewees that the government, not just national but international, should play a more dominant role in the area of climate change.

*My key point...is that it's in the 'it's not the law yet therefore we don't have to do it' category...I think it's changing and I recognise that there will be more and more pressure put on trustees...it's immensely complex and I think it needs...the world government treatment...I used to buy the Eagle [comic] when I was a child and there were dreams of a world government. (T18)*

This suggests a utopian vision for the future and for dealing with climate change, in direct contrast to suggestions that the market will deal with it, probably adequately, without government intervention (Robinson 2008). Alternatively, another interviewee indicated that legislation would not be an appropriate route even though he thought that government intervention was necessary, as the market had failed, but that a voluntary framework set up by government was preferable to regulation of any sort:

*People like governments and regulators...and politicians...**what they do in terms of climate change is going to be absolutely critical**...they're the people who are going to have to set the framework...it would be very useful for governments to play an encouraging role...I would like...to try and **minimise the enforcement or the compulsory regulatory approach by government**...a supportive framework is much more important...*

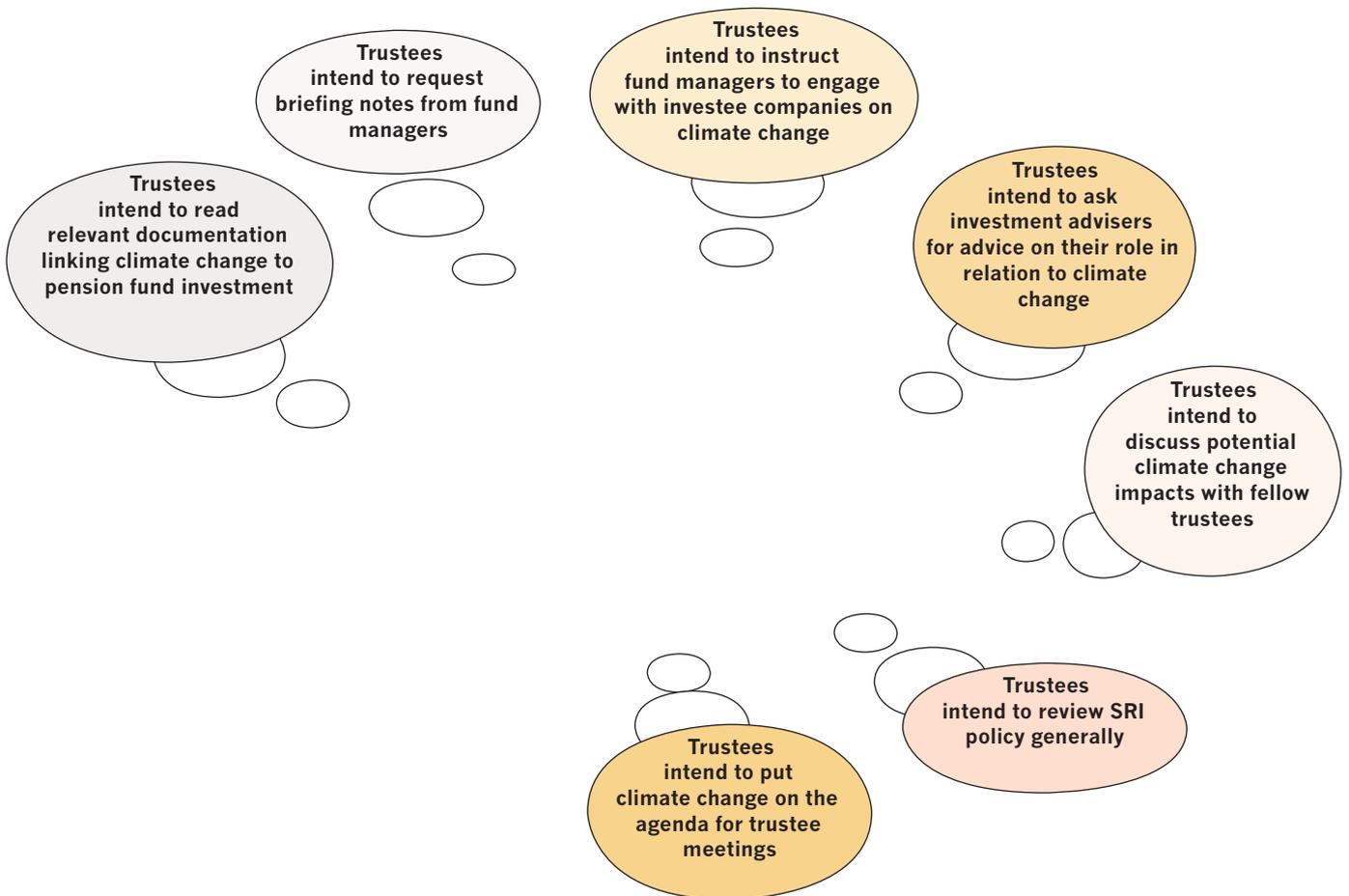
*voluntary codes I'm all for, I don't mind the government setting the framework, but I think it's much more important for the government to try and put its own house in order first. (T9, emphasis added)*

**Research alters trustees' world views**

There was no evidence to suggest that the trustees we interviewed treated climate change with insincerity or in a light-hearted way. Although it was clear they were not conversant with the issues, on the whole, and did not generally understand their role in climate change, they displayed a serious attitude towards the issues. They clearly believed that they needed to know more and to understand how they should be responding. They made suggestions as to how they could improve in the area and what they should be doing in the future. Their intentions to alter their role in climate change by changing their behaviour are summarised in Fig. 4.2.

The trustees were generally quite humble about their lack of knowledge and expressed concern. From a methodological viewpoint, these findings are significant as they show how the research process influenced trustees' world views in relation to climate change. Their views about their role in relation to climate change were distinctly different by the end of the interview. Whether these changes in attitude will lead to changes in behaviour and approach that are genuine and lasting remains to be seen. This can be tested by further research, as depicted in Fig. 3.1 (see page 20). Nonetheless, at this stage of the research, the trustees interviewed treated climate change with gravitas and, in some cases, by the end of the interviews they were unsettled about their lack of knowledge, where this had become obvious throughout the interview.

**Figure 4.2: Impact of the research – trustees alter their role in climate change**



*Well, I don't think we are ignorant or dismissive of climate change...but I'm not sure we're anywhere near the forefront and I think it would be highlighted more if we were [more] knowledgeable...of the individual businesses that our money is being invested in, and I think if we incorporated those sort of questions when we're reviewing with our fund managers more, then I think we would be up there with the better trustee boards in terms of climate change and other social issues. (T3, emphasis added)*

Trustees seemed perturbed by the questions in the interviews. When asked at the end of the interview if they believed that there were any issues that should be mentioned, and asked for their observations and comments, most of them indicated a sense of unease about their lack of engagement with the issue of climate change in relation to their duties as trustees. They also expressed concerns as to whether they were outliers or whether other trustees would give similar views.

*I mean I suppose it leaves me feeling a bit as if I've got my head in the sand about these things. I mean I've said no to an awful lot of things. Now whether that will turn out to be true for everybody or not is really what I'm most interested in seeing in the report. You've gone through a whole heap of things there and I'm thinking 'Oh, not doing that', 'Never heard of that', and whether we should or not is then a follow-on. (T2, emphasis added)*

*Well, I think from this conversation we've had, I mean, I will be going back to our chairman and saying, 'look, there are probably six areas that we have to be' – well, I would use the words 'socially responsible as trustees', and I think we would obviously share that with members and I'm sure members would support us, the majority anyway. (T3, emphasis added)*

*It's actually quite good because you think, well, you take part in a survey, but I'm sat thinking, mm, [laughs] OK, we need to do something. (T5)*

*It's been quite an eye-opener, I must admit, so it will be quite interesting to read the report...I hope it [my response] is of use, even if it is proof that we are totally heathens. (T5, emphasis added)*

*In fact I'll make a note...I will discuss this with our investment advisers, whether this [climate change] is something we might usefully do and whether other pension funds are having this kind of debate. (T8)*

*In terms of the actual SRI policy...we've yet to have a conversation around that but the fact that I'm taking part in this interview...this is a very helpful trigger for me to [raise it] at one of our next meetings. (T10, emphasis added)*

*...participating in this research...it's an opportunity again for me to step back and think, 'am I missing something here, am I blind to something here, am I prejudiced here?'. (T11, emphasis added)*

*It's been a bit of an eye-opener. (T17, emphasis added)*

*Some uncomfortable thoughts, which isn't a bad thing, that maybe how perhaps hiding behind a tracker and not actually grasping the nettle is more comfortable for us...Again following this conversation I'll try and make it higher [priority] than it has been. (T19, emphasis added)*

*I guess...this will stimulate discussion and thinking and an appreciation among trustee boards of the importance of climate change. (T10, emphasis added)*

There was also an emotional response about their lack of involvement in climate change within their role:

*I feel guilty that I ought to be doing a lot more. (T16, emphasis added)*

## **(VI) DISCRIMINANT ANALYSIS: A SIZE EFFECT IN TRUSTEES' ATTITUDES**

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The interview data were analysed according to pension fund size (measured by both number of members and asset value) in order to detect any significant differences in trustees' views towards their role and responsibilities in relation to climate change. Some evidence of a size effect emerged from the analysis and from the interviewees' comments: 'we probably are more conscious of climate change than most other funds...because we are a **very large fund**' (T9, emphasis added). Trustees from larger funds were generally more knowledgeable, with the significant outlier (trustee 9) being from the largest fund in the sample: '**the big schemes** have got more resource, more money, more manpower to be able to do some of the thinking and some of the work that's necessary' (T9, emphasis added).

This finding is consistent with Solomon and Solomon (2006), who present evidence of a significant size factor in private dialogue and engagement by institutional investors with their investee companies on SEE issues. In addition, trustees from larger funds seemed to have more engagement with their plan sponsor on climate change issues than the smaller funds. Indeed, trustees from smaller funds commented that they did not have the ability, because of their size, to instruct their fund managers: 'A small pension scheme **simply has no scope** to do that...we expect [the fund manager] to behave responsibly in a whole variety of ways, in relation to its holdings, **but we can't tell them how to do it**, so to speak (T14, emphasis added).

The difference here between larger and smaller funds is not surprising, given the greater resources available to trustees from larger funds as well as the greater sense of responsibility they may have, as well as the larger number of members relying on them.

## 5. Concluding discussion

Given that there is readily available literature on the relevance of climate change to institutional investment, especially pension funds and insurance companies, our interviews suggested a substantial gap between ‘theory and practice’. In theory, according to the recommendations of various published documents (for example, Freshfields Bruckhaus Deringer 2005; Carbon Trust 2005) trustees should be including climate change issues in their role and responsibilities, ensuring that the fund managers are considering these issues in the portfolio investment. In spite of existing recommendations, we found that trustees were generally unaware of their fund managers’ activities and policies in relation to climate change. Indeed, trustees’ lack of knowledge about their pension fund managers’ activism was not restricted to climate change issues: they had little idea of the process or outcome of engagement, dialogue and voting by their fund managers in any area. This contrasts with the recommendations of the Carbon Trust (2005) and Myners (2001). Our evidence does, however, support the findings of the Myners Review (2004), which criticises trustees for not engaging adequately with their fund managers on issues of shareholder activism. Given the strong credentials in terms of expertise and relevant qualifications that characterise our trustee sample, we cannot dismiss their overall lack of active involvement with their fund managers on the basis of their being under-qualified for their role. Given the trustees’ role as custodians of their members’ assets, such a dearth of knowledge and indeed, interest, in active management of the funds under their care is worrying. It implies a low level of accountability to pension fund members in an area of growing risk and concern for the financial services industry.

These findings could have much broader and more serious implications for financial accountability. Given that the Myners Review (2004) found continuing weaknesses in many areas of trusteeship, our findings on climate change may simply represent a small piece of a much larger jigsaw, depicting an image of low trustee accountability to members through lack of interest and action.

Nonetheless, our findings suggest that trustees’ lack of engagement on climate change may reflect a lack of interest from pension fund members. We have summarised the many obstacles to trustees’ taking action on climate change in Fig. 4.1. These obstacles, grounded in the data, suggest that little progress has been made, in this area of the financial services industry, since the UNEP identified obstacles to the financial sector engaging with climate change in 2003 (Carbon Trust 2005).

### TRUSTEES’ ACCOUNTABILITY TO MEMBERS IN RELATION TO CLIMATE CHANGE RISK

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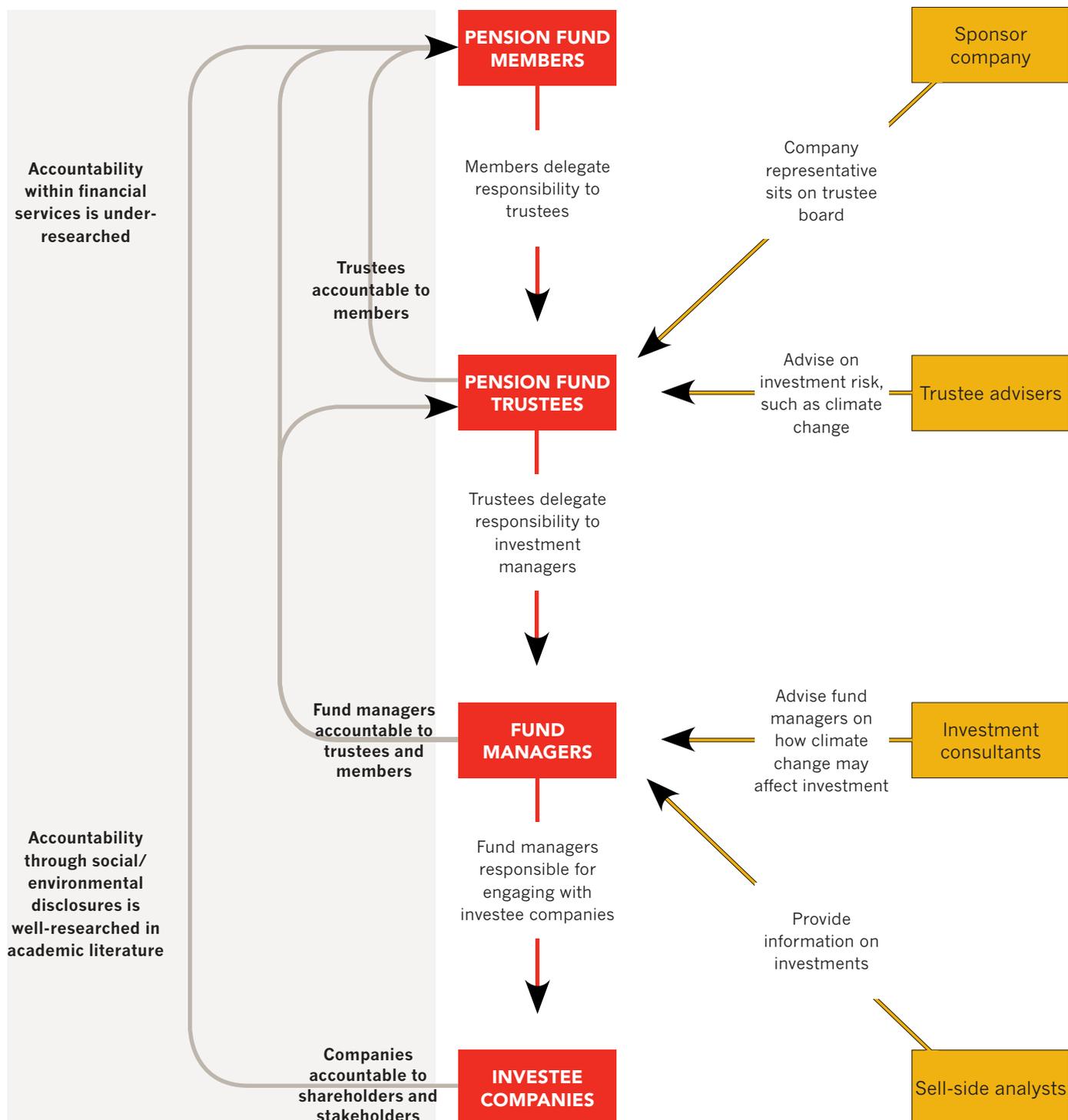
We now present a diagrammatic model summarising the way in which responsibility and accountability flow between the various groups involved in pension fund investment, in relation to climate change risk. Fig. 5.1 (page 36) shows that the accountability links flowing from companies to shareholders (in this case the pension fund members) through social and environmental reporting are relatively well-developed. The diagram indicates that this area of accountability has been well researched in the academic accounting literature. Nonetheless, the chains of accountability flowing between fund managers and the trustees who appoint them, and between fund managers and pension fund members have not been well researched. Little is known about the levels of accountability in these intermediary relationships.

The chains of accountability between trustees and their appointed pension fund managers and between trustees and their pension fund members are clearly weak, according to our interview evidence. Indeed, from the perspective of corporate governance and accountability in the financial service sector, these findings paint an uncomfortable image.

As mentioned above, a crucial question for financial services accountability is the extent to which these findings, specific to climate change factors, may be generalised to pension fund investment more broadly. To what extent are these evident gaps in accountability and governance between the various intermediaries in pension fund investment in relation to climate change reflected in relation to other qualitative, non-financial issues? To what extent may our findings be generalised to suggest that there are seriously low levels of accountability between trustees, fund managers, members and sponsor companies in relation to the whole gamut of ESG factors? Or even more worryingly, to what extent is this true across the whole gamut of material financial and non-financial issues? Although focusing their answers on climate change, the interviewees frequently referred to climate change as one aspect of ESG, and discussed their actions in relation to their SIPs generally. Further research is required to gauge the extent to which these gaps in accountability are evident in relation to other, more general factors.

There is also the issue of plan sponsor involvement (or lack of involvement) in the pension scheme and the gap between what the sponsor company is doing regarding climate change and what their pension fund is doing. The HeadLand report (2007) says they should be linked but we found little evidence for this. This is especially interesting given that some (at least four) of our interviewees were company-nominated. Perhaps the sponsor did not want trustees to take part, in order to hide this asymmetry – that could be a reason for the low response. Is it possible that companies do not want it to become public knowledge that their ‘green’ policies and strategies are not being transferred to their pension schemes? Is it possible that companies are blocking trustees’ participation in research?

**Figure 5.1: Chains of responsibility and accountability in pension fund investment**



The contrast we found between what companies are doing in relation to climate change and their pension funds' activities can be interpreted at best as a lack of consistency in approach, but at worst as an illustration of hypocrisy.

Another issue raised in discussing these findings with colleagues was that if pension fund managers are dealing with climate change (and they are, according to evidence: Solomon and Solomon 2006) then does it matter that trustees are not conversant with climate change impacts and materiality? From an accountability perspective, it does matter. Trustees have a responsibility to be accountable to the pension fund members by keeping abreast of issues that could affect their pension fund. As outlined in the reports by the Carbon Trust (2005; 2006), trustees have a duty to understand potential climate change impacts on their fund and should instruct their fund managers to take climate change risk into account. They should not be 'washing their hands' of any responsibility in this area by simply delegating responsibility and decision making to fund managers. Yet, this is a theme arising from the interviews. The Myners Review (2004) emphasises the importance of trustees' engagement with their fund managers across all areas of investment strategy. Climate change is just one of many areas where trustees should be dynamic and proactive in their accountability relationships. Further, trustees have a responsibility and duty to engage with the pension fund members to discuss the ways in which, *inter alia*, they are dealing with climate change risk.

## **POLICY RECOMMENDATIONS**

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These findings suggest there may be a need, recognised by some of our interviewees, for raising awareness of the ways in which climate change may affect pension fund investment. The findings indicate that trustees may require clearer understanding of the way in which climate change risk can reduce financial returns and the ways in which assets may be protected from negative impacts. Given that trustees and fund managers within the pension fund industry have a tendency towards 'short-termist' strategies, it is important to raise awareness on two levels. First, trustees need to be encouraged to adopt a more long-term approach towards investment strategy, which they then relate to their fund managers. Secondly, the rapid manner in which climate change is moving from a long-term issue into the short-term concern, as scientific research indicates acceleration in the changes, needs to be conveyed quickly and forcibly to the investment community.

Training for trustees in the area of climate change risks and opportunities represents another potential policy recommendation. The notion of trustees as non-specialist amateurs has been dispelled to some extent since Myners (2001) but has perhaps not been considered in the area of non-financial risks, such as climate change. Nonetheless,

at the most basic level, trustees need to introduce climate change onto their agenda. Our findings suggest there is little or no discussion of climate change issues among trustees in meetings. A range of other suggestions made by the trustees, for action in relation to climate change, were summarised in Fig. 4.2 (see page 33). There is an urgent need for trustees to take a more proactive interest in the activities of their delegated fund managers, not just in relation to climate change but also across the whole gamut of material risks and opportunities that affect their pension funds.

Unless trustees confront the risks associated with climate change and gain a more detailed understanding of potential material impact on their pension funds, they could be ignoring a time bomb which, according to the latest evidence, may not explode in the short term but could affect the financial community in the medium to long term. In the 21st century, climate change is now a significant 'non-financial' risk factor requiring action from the financial services industry if accountability to shareholders and other stakeholders is to be discharged effectively. Trustees should be responding to the climate change challenge.

As a result of these findings, we make recommendations on two levels. First, on a theoretical and academic level, we suggest that there is an urgent need for further academic, but practitioner-led, research into the accountability and governance links between the intermediaries involved in pension fund investment, specifically between trustees and their pension fund members, their fund managers and their sponsor companies. This research, as well as examining these links across all areas of pension fund investment, should also focus on the accountability chains relating specifically to ESG issues. As well as acknowledging the material importance of ESG issues, further research may reveal whether the quality of ESG management in institutional investment represents a weather vane, or proxy, for the quality of management and accountability across all investment issues.

On a practical level, there is an urgent need for a code of practice, or at least a set of principles representing best practice, in accountability and governance for pension funds, and especially for the trustee community, with an emphasis on consideration of extra-financials. The Myners principles, although representing an important improvement to pension fund governance, did not focus on ESG accountability within the trustee community. These broader, 'soft', qualitative issues require attention by trustees and other members of the pension fund community. A code of best practice on governance and accountability aimed at trustees would help to resolve this situation. Further, and more radically, a code of best practice which emphasises material non-financial (extra-financial) factors such as climate change, as well as financial factors, is overdue and is required urgently in order to drag these critical material issues into the

mainstream of institutional investment. Greater integration of climate change (and other material extra-financials) should, for trustees, involve the following developments:

- integration of climate change issues into trustee agendas for meetings
- information being actively sought by trustees on the potential material impacts of climate change factors on their fund, from investment consultants, advisers and other specialists
- integration of climate change issues into strategy for the fund
- integration of climate change issues into the asset allocation decision made by trustees
- integration of climate change issues into the SIP and responsible investment policy
- integration of climate change issues into discussions between trustees and their delegated pension fund managers (by implication, where such engagement is not occurring, trustees should be seeking to engage with fund managers on their investment style and activism on all relevant issues, not just in relation to climate change).

These recommendations echo, to a large extent, those made by the Carbon Trust (2005). The difference is that we recommend a formal code of practice to be developed and implemented for pension fund trustees, which encapsulates the above best-practice guidelines.

With all due respect to the Carbon Trust and other organisations that lobby on climate change issues, the indication from this report is that a code of practice should emanate from a more central, mainstream body: either the government or a collaboration of mainstream investment institutions. As with the codes of best practice for corporate governance, a code of practice for trustees on climate change needs to be given the highest stamp of authority. If this is not the case, there may be a temptation for trustees to view the code as a marginal, voluntary and unnecessary document. We are not proposing a mandatory code, but within a voluntary environment, a code of best practice on climate change needs to be authenticated and pushed by the mainstream institutions. Climate change is such a critical issue for the financial services industry, for the economy and for society as a whole, that there should be no problem obtaining support for a code of practice from the UK government and from major mainstream financial institutions.

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**RR/106/001**

ISBN: 978-1-85908-449-6

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