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# Tackling climate change

A guide for Defined Benefit decision-makers

## Climate change is increasingly having a real impact on both Trustees and sponsors of DB schemes. This presents a key financial risk over the lifetime of schemes, but also provides opportunities for investment and to positively impact the world that savers will retire into.

*"Climate change is an issue that can't be ignored when it comes to pensions. In reality, it matters more than interest rates, company and sector performance and inflation."*

- Guy Opperman, Pensions Minister

Climate change and its impacts will be with us for decades. It is vital for DB scheme Trustees and sponsors to have a clear plan to address climate risks (and opportunities) for their scheme given the likely material impacts on investments, funding positions and sponsor covenants.

Trustees may also consider this an opportunity to start engaging with their members on what they are doing to adapt their scheme in this constantly changing environment. Larger schemes will be required to make climate-related disclosures in the coming years and may seek to get ahead of the regulatory curve by demonstrating to members that climate risk has been factored into the scheme's investment decision-making processes.

# A checklist to address climate change in your scheme

We outline nine steps that Trustees can take now to address this material financial risk. Many Trustees have already started to make encouraging progress on many of these:

1. **Get educated:**
Ensure there is a clear Trustee board understanding of climate risk, developing trends and regulatory changes. Of particular importance at this stage is to gain an understanding of the Taskforce for Climate-related Financial Disclosures (TCFD) framework. The UK Government has published proposals that will require larger schemes to report against this framework on an annual basis. Schedule training sessions to dive deeper into key areas of opportunity or concern.

2. **Develop beliefs and objectives:**
Discuss differing views and beliefs within the Trustee board to develop a policy on climate change which can be used to aid development of your policy. Translate beliefs into clear climate-related objectives and metrics for the strategy (a key TCFD requirement).

3. **Review manager and provider policies:**
Check whether your investment managers, and providers' climate change policies are aligned with the Trustees' beliefs. Meet with your investment managers and consider how they monitor and engage with companies. Consider their policies on voting on climate change issues and ask them to explain their thought processes. Establish how well-placed they will be to support you with future TCFD reporting requirements.

4. **Assess exposures to risk:**
Assess the potential impact of climate risk on your funding and investment strategy. The impact of different approaches to climate change should be considered by modelling a variety of potential scenarios for future climate change outcomes. Consider the different sources of risk that may arise such as policy change, carbon pricing, extreme weather events and how they could affect your scheme.

5. **Understand the strength of your sponsor's covenant:**
Consider to what extent the scheme's sponsor is exposed to climate risk. Climate risks may directly impact the ability of the sponsor to fulfil their promises to the scheme or weaken the covenant over time. Ask the sponsor for their views on climate risks and opportunities, and their plans to mitigate and capitalise on these.

6. **Review your investment arrangements:**
Consider the types of funds the scheme invests in, including whether passively or actively managed funds should be used; and, if passively managed, what benchmark is appropriate. Consider the benefits of change (for example to a fund with a lower carbon intensity) relative to the status quo.

7. **Monitor your managers:**
Meet regularly with your investment managers and assess their performance. Ensure that climate metrics are regularly calculated and discussed by Trustees. Request details on how investment managers have voted and challenge their approach where appropriate.

8. **Communicate with members:**
Consider how you communicate your actions and progress towards long-term goals for members. Articulate clearly the impact their investments are having. Use language and examples that members can relate to. Survey your members to find out if they believe enough is being done within the scheme to combat climate change.

9. **Document your processes:**
Ensure that responsibilities are clearly assigned, and the processes employed by the Trustees, investment managers and advisers are all understood.

## Why is climate change so important?

Climate change is a non-diversifiable, material financial risk that will impact us all for decades to come, with important roles to be played by DB Trustees and scheme sponsors. It's crucial for these decision-makers to prioritise climate risk and consider how they can use their influence, both directly and through their investment managers, to safeguard members' benefits and the long-term viability of the scheme.

As asset owners, socially conscientious Trustees may also feel a responsibility to drive positive change and ensure that DB members have a future that is worth retiring into. The sheer scale of pension scheme assets under management makes meaningful, positive change entirely possible.

The scale of policy change needed to address climate change challenges, and reflect global commitments, makes this relevant to all scheme Trustees, sponsors and members.

## What impact does climate change have on financial markets?

There are two key areas in which climate change impacts financial markets; the physical impacts that arise directly from a changing climate, and the transitory impacts that arise from the response of policy makers. This can lead to uncertain economic outcomes, such as on GDP growth, inflation and, crucially, asset returns.

The diagram below summarises the key impacts and consequences of climate change faced by the financial system, including pension schemes:

**Transition to a low carbon economy**

- **Policy changes** - carbon pricing, seek to create the changes needed in society
- **Development of technology** - renewable energy and its adoption enables the policy changes to be adopted

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**Physical impacts**

- **Chronic changes** e.g. sea levels rise, agricultural systems disrupted
- **Acute changes** - storms, wildfires create damage and give rise to costs of adaptation and reconstruction

**Consequences for pension schemes**

**Asset returns**

- Lower asset values/ returns
- Increased credit spreads
- Higher insurance costs

**Economic factors**

- Reduced GDP
- Reduced productivity
- Higher/lower inflation
- Gilt yields

**Covenant**

- Lower profitability
- Supply chains
- Different impact by sector
- Need for strategic plans

**Demographics**

Higher uncertainty when setting longevity and morbidity assumptions

Alongside the economic impact of climate change lie the demographic impacts of water scarcity and quality, increases in vector-borne diseases, crop failures and many others. Further research into the impact of these factors on mortality is required, however Trustees should consider a potential range of outcomes for their scheme (such as mortality improvements occurring at a different rate from that assumed in long-term funding plans).

The actions of policy makers, companies and broader society will also influence the nature and extent of the risks faced. In supporting the 2015 Paris Agreement, the UK Government has created a legislative requirement to bring greenhouse gas emissions to "net zero" by 2050. Such changes are likely to continue and accelerate. Net zero can be achieved both by reducing emissions and implementing offsetting measures. This will test the resilience and versatility of companies, while creating opportunities for investment by pension schemes.

### How are businesses reacting?

An increasing awareness and understanding of climate change, together with ever-increasing regulatory change, is forcing companies to adapt and address the impact they have on the environment. Greater adoption of renewable energy, and a strive to rely less on fossil fuels, is giving rise to "stranded assets" as energy companies find themselves unable to economically exploit reserves of oil and coal. This results in companies writing off the value of these assets, with negative impacts on shareholders. Shell and BP wrote off up to $22bn and $17.5bn respectively in mid-2020 from weakened long-term demand for oil and an acceleration towards a lower-carbon economy. If progress relative to global commitments is not made, companies overly reliant on fossil fuels are significantly at risk from the prospect of a carbon tax. Some countries, such as Sweden, have successfully implemented a carbon tax, and we can expect this trend to expand globally.

Net Zero refers to a position of balance between $CO_2$ emissions and the level of $CO_2$ removed from the atmosphere by natural or man-made processes.

Paris Agreement refers to a 2015 international agreement that seeks to limit the rise in global average temperatures to well under 2 degrees Celsius above pre-industrial levels by the end of this century, and to pursue efforts to limit temperature increases to 1.5 degrees Celsius.

# The role of DB scheme Trustees in driving climate change action

Pension funds make up approximately 36% of assets worldwide. Pension scheme fiduciaries have great responsibility and therefore can make a meaningful difference. There are two key mechanisms through which pension schemes can drive positive change:

- **By moving capital:** Shifting core investments towards those which are less carbon intense and allocating to alternative assets that specifically target positive environmental outcomes.
- **By influencing the behaviour of others:** In DB schemes this can be achieved most effectively through robust stewardship, holding managers and other providers to account for their actions and, ultimately, changing corporate behaviour.

In the UK, a significant amount of DB assets is invested in passively managed funds. While investment managers have limited discretion in stock selection, there is still plenty of opportunity for DB schemes to exert influence even in these passive investments. Implementation Statement requirements mean that all schemes (regardless of whether funds are actively or passively managed) must describe their voting and engagement activities. The choice of passive fund, the index it seeks to track, and the investment manager's stewardship activities, can all be influenced and scrutinised by Trustees. Products are continuing to be developed and we have seen some great examples of passive managers working to influence the management of companies to adopt policies more aligned with a net zero target.

There is a wide range of funds available which seeks to address climate change, and Trustees should make sure that the funds their scheme invests in correspond with their own beliefs and objectives on climate change. If you are most concerned about de-carbonising your portfolio, you may seek a fund that excludes companies involved in fossil fuel exploration, extraction or processing. If you prefer to take advantage of the opportunities created by the transition to a low-carbon economy, a fund that focusses on clean energy technology will support this objective. Such solutions exist across passively and actively managed funds.

### Case study: Climate stewardship in action

Climate Action 100+ (a collaboration of investors) is engaging with the largest global emitters of $CO_2$ to take robust action on climate change. One notable success of this collaboration (with a particularly active participation from the Universities Superannuation Scheme) has been to gain a commitment from Shell to align executive remuneration with the energy transition. Despite successfully achieving this objective, engagement with the company continues.

Ensuring that the investment managers' approaches to collaborations are aligned with the Scheme's own beliefs is crucial.

# Regulatory requirements for DB schemes

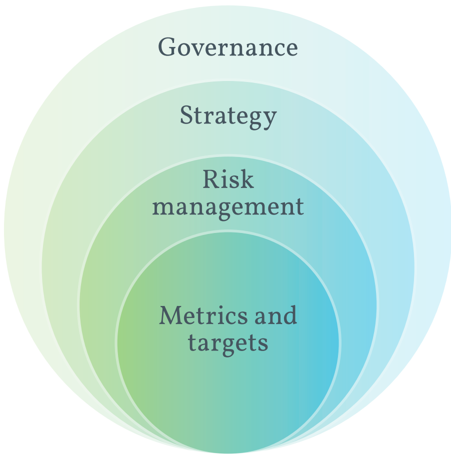
The Government has continued to prioritise climate change considerations of pension schemes and has progressively introduced legislation that requires Trustees to develop, implement and report on their approach to managing ESG risks. These requirements have also been broadened to include other pension providers.

- Since 1 October 2019 Trustees must set out their policies, including how they address climate change, within their Statement of Investment Principles. This is to be included in the scheme's investment report section of the annual report.
- Since 1 October 2020 Trustees must produce and publish (free of charge and online) an Implementation Statement for their scheme setting out how they have implemented their policies.
- From 1 October 2021 Trustees must produce and publish (free of charge and online) an annual report on voting and engagement. By 31 December 2022, Trustees of larger pension schemes will need to report on the implementation of their approach to climate risk in-line with the framework developed by the Taskforce for Climate-Related Financial Disclosures (TCFD). This requirement will be extended to other schemes over time.

## Understanding and applying the TCFD framework

The TCFD was established in 2015 by former Bank of England Governor, Mark Carney, and it developed a framework for the disclosure of climate-related financial risks. The goal of the framework is for disclosures to inform stakeholders as to how companies are managing risks and to allow more informed investment, credit and insurance underwriting decisions. There are four elements to the TCFD framework (as illustrated overleaf) and, although this was not explicitly developed for pension schemes, it has been adapted for their use. Moreover, as noted, TCFD-aligned reporting will become a regulatory requirement for DB pension schemes.

Guidance produced by the Pensions Climate Risk Industry Group provides a number of actions that Trustees can take to embed climate risk considerations into their processes. The key actions that Trustees should be taking are summarised on the next page.



## The TCFD Framework

### Governance

- Establish and maintain oversight of climate-related risks and opportunities.
- Establish and maintain processes to ensure those managing the scheme on behalf of the Trustees are assessing and managing climate-related risks and opportunities.

### Risk Management

- Develop and maintain processes for identifying, assessing and managing climate-related risks.
- Ensure the integration of climate-related risks into overall risk management.

### Strategy

- Identify climate-related risks and opportunities that will impact the investment strategy of the scheme over different time horizons.
- Assess the impact of identified risks and opportunities on the scheme's investment strategy.
- Assess the resilience of the scheme's assets and investment strategy to climate-related risks in different scenarios. The scenarios should consider different policy pathways.

### Metrics and Targets

- Select GHG emissions and non-emissions metrics to assess scheme assets against climate-related risks and opportunities.
- Obtain the Scope 1/2/3 emissions and other data to calculate the selected metrics.
- Set a target to manage climate-related risk with the chosen metrics and measure performance against this target.

We view the TCFD framework as a powerful tool to help Trustees understand and manage climate-related risks, capitalise on opportunities and support a comprehensive industry response to climate change. While the framework provides a set of actions that Trustees can undertake to help understand and manage climate risk, it is as much about disclosure and accountability to stakeholders. Climate risk reporting will become mandatory for some schemes, but regardless of whether a scheme falls into scope or not, we view the TCFD framework as a useful climate risk management system worthy of consideration by all schemes.

### Carbon exposure: what metrics should I consider?

The availability of appropriate climate metrics is an essential part of understanding a portfolio's exposure to climate risk, as well as forming a central pillar of the TCFD requirements. While a number of metrics could be selected to support this, Weighted Average Carbon Intensity (WACI) is likely to be adopted as the industry-standard emissions-based metric.

WACI measures exposure to carbon-intense companies, expressed in tons of $CO_2$ per million dollars of revenue. This matters as companies with higher carbon intensity are more likely to face greater exposure to transition risks and regulatory change.

Climate risk cannot be distilled to a single number.  Other metrics such as exposure to fossil fuel reserves or alignment with the Paris Agreement can also be used in decision-making.  Schemes that have access to robust, credible data can use this to calculate their chosen metric(s), allowing both risks and opportunities to be better identified, understood and acted upon.

# Managing the opportunities and risks arising from climate change

One key element of the decision-making framework is being able to identify, measure and then manage the risks and opportunities that will arise from climate change. Some risks are relatively straightforward to consider, while others are fraught with complexity. It is also important to understand that climate risks will evolve over time as policy makers act, and physical impacts are felt.

Risks and opportunities are likely to arise at different levels: in some cases consideration may need to be given to individual companies, whereas in others it may be groups of companies or entire industry sectors that give rise to risk. A likely short-term source of risk will be the introduction of a "carbon tax" which increases the price of carbon emissions, thereby encouraging companies to change their activities. Such a policy change could also create opportunities for companies to innovate and develop new technologies.

**Sources of climate-related risk**

**Fossil fuel reserves:** while there will be a long period of transition, companies that derive profits from the production of fossil fuels will be subject to societal and regulatory pressures.

**Fossil fuel supply/use chains:** companies that provide support to fossil fuel companies or which make direct use of their products (e.g. power generation) will be exposed to transition risk.

**Other carbon intensive companies:** various industries (e.g. cement manufacturers) which have high carbon emissions may realise higher costs as they are forced to evolve their processes or face carbon taxes.

**Indirect contributors to climate change:** companies that contribute to deforestation (e.g. unsustainable palm oil production) or other forms of land-use change may also be subject to increased scrutiny and regulatory action.

**Potential climate-related opportunities**

**Resource efficiency:** improving efficiency across production and distribution processes (e.g. energy efficiency) can result in direct cost savings to organisation's operations.

**Alternative energy sources:** increasing investments in renewable energy sources - such as wind, solar, wave and tidal - and the associated grid infrastructure.

**New products and services:** organisations that innovate and develop new low-emission products and services may improve their competitive position.

**Developing resilience to climate change:** relevant for organisations that may require longer-term financing and investment.

Pension schemes' decision-makers will need to understand these sources of risk, consider the potential financial impacts on the funds their schemes are invested in, and take appropriate action. A likely first step would be to understand your portfolio's carbon exposure.

This could highlight a need to engage with an investee company via your investment manager, asking them to challenge management on the steps being taken to manage climate risks. Perhaps you will even want to make more substantial changes to your strategic asset allocation to capitalise on attractive investment opportunities that also reduce your scheme's exposure to climate risks.

# The role of investment managers in tackling climate change

Investment managers have been developing products that will help to reduce the potential financial impacts of climate change on pension schemes. These funds seek to tilt exposure away from, or remove entirely, companies with high levels of fossil fuel reserves or carbon emissions. Recognising the opportunities that exist and the potential to invest to create change, funds may also tilt exposure towards companies that demonstrate more sustainable practices, or that contribute to solving key global challenges. Increasing numbers of funds aim to align their investments to some or all the United Nations Sustainable Development Goals.

As demand increases and the availability and comparability of data improves, products are likely to evolve and become increasingly sophisticated. It is important for Trustees to understand the potential benefits of different products and any changes that emerge, to ensure they can identify strategies most appropriate for their scheme.

## Case study: Embedding a climate-tilted strategy in the scheme's strategic asset allocation

The Trustees of a large charitable organisation sought support to develop and implement a detailed set of responsible investment beliefs. This led the organisation to introduce changes to their strategic asset allocation to reflect their view that climate change is a risk that ought to be considered as part of their investment strategy.

### What action did they take?

As a first step, the Trustees allocated 10% of their portfolio to a lower carbon-tilted, global passive equity fund (instead of a more traditional market-cap global equity tracker fund). The approach taken by the fund is to reduce exposure to companies with worse-than-average carbon emissions and fossil fuel assets within their sector, while increasing exposure to those which are successfully generating revenue from the transition to a lower carbon economy.

This had 3 beneficial impacts:

- Reduced overall exposure to coal, oil and gas companies – by approximately 75% less than the market-cap equivalent.
- Increased exposure to companies with lower emissions and decreased exposure to companies with higher emissions within each sector, maintaining diversification across sectors and avoiding full sector exclusions.
- Increased exposure to companies generating revenue from renewable sources, energy efficiency and environmental solutions.

The Trustees went on to double their exposure to this fund and are actively considering further steps, including exploring funds that specifically target alignment with the Paris Agreement. They continue to seek evidence of strong stewardship and engagement with companies from their existing investment managers, through receipt of regular, detailed voting and engagement reports and challenging and encouraging further engagement and action.

# Conclusion

Getting to grips with the risks a scheme faces is familiar territory for most Trustees and sponsors. We view climate risk as one of the most material financial risks that all schemes should consider throughout their decision-making processes. Daunting as this may seem, there is an abundance of resources to help Trustees and sponsors navigate the challenges, and – equally importantly – to capitalise on the many opportunities that also arise.

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