CONSIDERING CLIMATE RISK

As a consultation on new trustee guidance on climate risk is launched at the PLSA Investment Conference, ***Stuart O'Brien***, the Chair of the Pensions Climate Risk Industry Group, explains why all trustees need to think about climate change.

THERE'S A COMMON MISUNDERSTANDING OF TRUSTEE DUTIES WHEN TALKING ABOUT PENSION FUNDS AND CLIMATE CHANGE. DEPENDING ON WHO YOU SPEAK TO, THE VIEW IS EITHER THAT TRUSTEES HAVE A FIDUCIARY DUTY TO FIX THE CLIMATE CRISIS OR THAT THEY DON'T.

Although they're diametrically opposed, it's possible to have some sympathy for both views. The first – that trustees have a duty to help prevent global temperature rises – sounds appealing when we consider the huge change in capital flows required to rapidly and drastically reduce the world's carbon emissions if we're to even get close to limiting global temperature rise to well below 2°C above pre-industrial averages – and this is essential if we're to avert dire consequences for the planet and society. The second view – that this has nothing to do with trustees – bases itself on an understanding of trustee fiduciary duties as focusing on the provision of pensions, not saving the world.

Both views, however, somewhat miss the point that climate change presents a financial risk to pension funds. If the world gets hotter and the frequency of extreme weather events increases, it won't just be humanity that suffers. Businesses will too, and some will be particularly hard hit. Similarly, if the world's governments bring in regulation to drastically reduce carbon emissions, the business models of many companies will be stretched and in many cases become unviable. By contrast, companies with the edge on green technology (particularly clean energy production) will thrive. These are the 'physical' and 'transition' risks of climate change: the physical risk that businesses will be directly affected by changes in the climate; and the transition risk (and opportunities) that business models will be impacted by the move to a zero-carbon economy. That change might happen more rapidly and more deeply than trustees are expecting (or markets have priced in) should also be considered. Some projections forecast an effective 100% loss in value for certain sectors by around 2040 under scenarios in which global warming is limited to 2°C. So what are trustees to do about this?

INTEGRATION OF CLIMATE RISK IN TRUSTEE DECISION-MAKING

Every journey starts with a first step. Many trustees will have updated their scheme's statement of investment principles before October last year. Led by their investment consultants, many will have included some wording about the trustees recognising ESG and climate change as financial risks. How many will have gone further than this and actually thought about how these risks might manifest themselves and what the impact might be is probably more questionable. A common refrain is that it's difficult and trustees will therefore leave it to their investment managers. Many trustee policy statements in statements of investment principles will say as much.

It is unquestionably a complex and multi-faceted subject. However, trustees cannot abdicate their responsibility any more than they can for other financial risks. Imagine the trustee who says: "we know interest rates are a financial risk to our assets and liabilities but it's complicated so we just leave

that to our investment managers." What exactly is being left to the manager tracking a market cap weighted equity index? Trustees retain the legal responsibility for setting their scheme's investment strategy, appointing their managers and agreeing the investment mandates set for those managers (whether pooled or segregated, active or passive). Trustees cannot escape the need to consider how all of these might be impacted by climate-related risks. To the earlier misunderstandings, this is not about trustees changing the world (whether you take the view that they have a duty to do so or not), it is about trustees understanding financial risk.

Unfortunately, because the issues are complicated trustees might be forgiven for not knowing where to start.

THE PENSIONS CLIMATE RISK INDUSTRY GROUP

In 2019 a cross-industry group, the Pensions Climate Risk Industry Group (PCRIG), was established by the Department for Work and Pensions, the Pensions Regulator and other government departments including the Department for Business, Energy and Industrial Strategy. The group was tasked with producing guidance on how pension trustees might sensibly address climate-related financial risks as part of their governance processes.

On 12 March the group will launch a public consultation on climate risk guidance for pension trustees. The draft guidance builds on the disclosures recommended by the Task Force on Climate-Related Financial Disclosures (TCFD) to provide a framework through which exposure to climate-related financial risks and opportunities can be identified, assessed, managed and disclosed by pension trustees.

WHAT CAN BE EXPECTED FROM THE PCRIG GUIDANCE?

The group's draft guidance provides suggestions on how to integrate the consideration of climate-related risks within trustee governance and risk management processes, as well as making recommendations as to how pension trustees might approach scenario analysis (ie what financial impacts different climate scenarios might have on pension scheme assets). The consultation also looks at what metrics trustees might usefully measure and monitor as part of a strategy to integrate climate risk considerations into their investment decision-making.

One of the key principles applied by the group is that any guidance produced should help trustees comply with their existing legal duties, not create new ones. As such, although the guide uses the TCFD recommended disclosures as a framework, it approaches governance, strategy and risk (the core elements of the TCFD recommendations) in a way that should be familiar to pension trustees.

THIS IS NOT ABOUT TRUSTEES CHANGING THE WORLD, IT IS ABOUT TRUSTEES UNDERSTANDING FINANCIAL RISK

The guidance also puts the emphasis on trustee processes and procedures rather than what trustees might provide by way of public disclosures. This shouldn't be surprising, given that trustees (as asset owners) will not be providing public disclosures in the same way that corporates will do for their investors. However, disclosures do have value and with the forthcoming requirement on trustees to provide annual 'implementation statements' to their members from October 2020, trustees may need to revisit how they approach communication with their members. The guidance takes a voluntary approach to disclosures. However, trustees should be cognisant of evolving government policy in this area.

CLIMATE RISK REPORTING AND GOVERNMENT POLICY

The government set out its expectation for all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022 as part of its Green Finance Strategy in July 2019. At the time of writing amendments to the Pensions Bill have been tabled by the government, creating a regulation making power that can be used to mandate such reporting by pension schemes. The DWP has said that it will consult extensively on both the content and timing of regulations before laying secondary legislation. However, recent comments by the Pensions Minister would suggest that a regulatory 'stick' may be used if trustees aren't adequately responding on climate risk on a voluntary basis.

WHAT NEXT?

Consultation on the PCRIG guidances launches on 12 March. Details of where to find it and how to feed into the PLSA's response to the consultation will be provided in PolicyWatch.