CACEIS AND LOCAL GOVERNMENT PENSION SCHEMES

Part 3

Why climate change matters

In this section of our guide, we will be examining why LGPS board and committee members need to be both aware of and concerned about climate change. The way schemes approach the issue is likely to have a long-term impact on the benefits paid to members. By understanding why climate change is – and will continue to be – such a dominant force in managing pension assets, those overseeing portfolios must strengthen their fiduciary duty and improve member outcomes.

WHAT'S THE RISK?

Climate change poses real risks to companies, industries and the countries in which they operate, meaning the pension funds investing on behalf of hundreds of thousands of members need to be resilient to these challenges.

For the moment, at least, there is no one set approach or policy for pension funds to follow, nor a single agreed framework or methodology to help make decisions. There is no specific investment structure through which to align portfolios and implement climate change policies. But, for the LGPS, this current absence of a solid, adoptable framework does not mean the issue can be ignored. As we learned in previous sections of this guide, the pressure to act is only growing, so it is important to be flexible and innovative in climate awareness and activity – and the best way to do that is to learn what might be at stake.

WIDER ENVIRONMENTAL ISSUES

Alongside climate change, there are a huge range of factors within the "E" part of ESG upon which boards and committees need to be able to quiz their fund managers.

Plastics, biodiversity, deforestation – any business or company that is even peripherally involved in sectors that might be affected by changes in policy and public demands may be impacted, which means their value in an investment portfolio could be hit too.

EXPLORING CLIMATE CHANGE RISK

The first step in understanding your risk is to recognise it is multi-faceted. Rather than applying a simple equation, as might be the case with interest rates or inflation, there are multiple risks related to climate. These need monitoring and managing separately. According to the company, region or sector you're looking at, assets will be more exposed to one type of risk than others. Recognising this variability should help boards and committees understand how significant these risks could be to their portfolio.

PHYSICAL & FUTURE LIABILITY

Physical climate change risks include extreme weather events or the changing climate making areas of the world uninhabitable, which can affect company operations and the cost of insurance. It is important to know how asset managers and other third parties take these risks into account when assessing their portfolio holdings, to ensure they have fully considered long-term implications. The physical risks posed by climate change need to be recognised as a corporate liability, too, as they may cause higher operating costs for companies or even a fundamental change in business model. For example, global insurer Allianz has warned that disruption to supply chains as a result of climate change has already led to an increase in business interruption insurance claims.

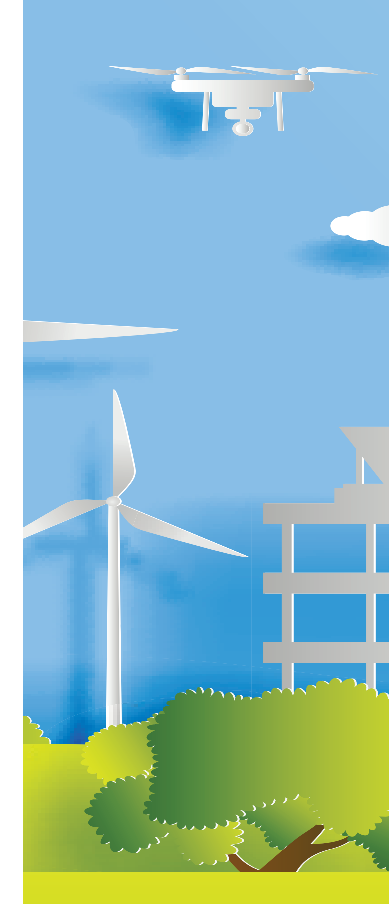
For long-term investors, this is something important to consider. Asset managers should be demanding strategy updates from companies on how they are mitigating and managing future risks to their operating models and those of their supply chains. According to KPMG, recent estimates suggest that there have been close to 1,000 climate change related class action lawsuits filed in 25 countries. Specialist law firms such as ClientEarth are using existing rules to push for change, including lobbying the government for regulatory change. Ignorance is no longer a defence.

INDIRECT

While there are plenty of direct financial and physical risks from climate change that will impact companies, boards and committees need to be aware of the indirect ones too. The largest of these may arise from the transition to clean or renewable energy. As governments support and subsidise low-carbon industries, they are, in turn, increasingly regulating, restricting and taxing high-carbon ones. This means not only will some of these companies' operating costs be much higher, but their business models may no longer be viable. Furthermore, public policy may shift, creating a series of unknowns and elevating transition risk.

While this at first might seem to apply only to energy companies, it is important for schemes to consider the impact of transitioning to a low-carbon economy across their entire portfolio. Haulage, tourism, manufacturing, retail and even real estate need to consider how changing regulations and societal expectations will impact what they do and how they do it.

REGULATION IN FOCUS



Climate change has been creeping onto the regulatory stage for a number of years, with global events such as the United Nations' Climate Change Conference (also known as COP) demanding international governments and regulators address the growing concerns of the global populous.

In 2015, under what has been become known as the Paris Agreement, more than 160 countries committed to limit increases in global average temperatures to less than 2°C above pre-industrial levels. There are further objectives to keep increases within 1.5°C of pre-industrial levels, but with less common support.

One of the main ways to achieve this is to reduce greenhouse gas emissions, which will require considerable focus from both the public and private sectors. Around the world, each region, country and jurisdiction has taken a different approach to try and achieve this.

For UK pension fund trustees, the Paris Agreement is going to become an important element of their fiduciary duty. The government's new Pensions Bill as it stands will compel trustees to regularly assess and report the climate change risk in their portfolio and if it contributes to the phenomenon using the terms agreed in Paris.

"All three components – environmental, social and governance – are integral parts of sustainable economic development and finance," according to the EU.

EUROPEAN UNION & CLIMATE CHANGE

The European Union is taking a leading role on climate change, bringing the economic power of its 27 member states to achieve it, and ***despite the UK's exit from the EU, the bloc's wider approach will influence asset managers operating across borders***.

To meet its Paris Agreement obligations, the EU aims to reduce greenhouse gas emissions by at least 40%, compared to 1990 levels, by 2030. To do this, the European Commission has estimated it needs an additional investment of €180bn per year. All key legislation for implementing the target was adopted by member states by the end of 2018. But it is taking an even greater step. On 11 December 2019, it presented the European Green Deal, a growth strategy to make Europe the first climate neutral continent – by 2050. The deal aims to mobilise at least €1 trillion of sustainable investments over the next decade, according to the commission. "It will enable a framework to facilitate public and private investments needed for the transition to a climate-neutral, green, competitive and inclusive economy," it said.

Under this deal and directive, the EU wants to see investors, companies, governments and regulators put environmental and social risk factors alongside pure financial ones, and is creating a framework to make it happen. The so-called sustainability taxonomy, which is under development, should help investors and their providers to understand, measure and monitor the sustainability risks within their portfolio, and make changes where necessary.

THE US AND THE PARIS AGREEMENT

In November 2019, President Trump notified the United Nations, which is behind the Paris Agreement, that the US would be removing its support for the project, claiming it would cost the US economy $3trn in economic output and 6.5m jobs. The decision did not remove the US immediately but set in motion a year-long process, which will complete the day after the 2020 US presidential elections. This means if a new leader is elected, they can – eventually – bring the US back in.

A STEP BEYOND: THE UN SUSTAINABLE DEVELOPMENT GOALS

These goals, introduced by the United Nations in 2015, are designed to be a blueprint for transforming the world in which we live by ending poverty and levelling the playing field for all. Halting, or slowing, climate change plays a huge part in achieving the goals, meaning if boards and committees develop an investment strategy around these goals, they can address climate and other ESG risks.

The goals, which aim to mobilise $10trn in public and private capital, have a target completion date of 2030. They have been adopted by 193 governments globally.

TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD)

Over the coming months and years, boards and committees will hear more about the Task Force on Climate-related Financial Disclosures (TCFD).

The TCFD, spearheaded by former Bank of England governor Mark Carney and former New York mayor Michael Bloomberg, is an initiative launched to help companies and investors discover and report the financial risks posed to them by climate change. The group's initiative aims to develop a "consistent, climate-related financial risk disclosure" that can be used by companies of any size and in any sector or geography – and, in turn, their investors.

Still under development, it aims to create a framework through which to provide information to asset owners and other stakeholders around the physical, liability and transition risks associated with climate change.

The framework is unaffiliated to any country, region or regulator and is being developed to be voluntary. However, there are already moves to adopt it by some governments who want to use a standardised framework that has been independently developed. For example, UK pensions minister Guy Opperman has voiced support for the framework and outlined how pension funds will be compelled to complete the disclosure, under terms within the latest Pensions Bill.

HOW TO: MEASURE CARBON INTENSITY

'Carbon footprinting' has become a buzzword in recent years, with high-profile investors dedicating to carrying it out across their whole portfolios. Several LGPS funds have already begun to do this for some or all of their investment holdings.

But, for some, what it means is unclear.

Essentially, it is the process that shows asset owners the amount of carbon the companies within their portfolios produce and therefore contribute to greenhouse gas emissions, which heat up the atmosphere.

The lower the carbon footprint, the lower the emission – and, potentially, the lower the risk to a long-term investment portfolio.

However, to measure and monitor this risk, you first have to be able to identify it. The most common way of doing so is to evaluate the 'carbon intensity' of a company.

There are three levels – commonly referred to as scopes – of carbon intensity that can be applied to companies, with each level having a broad range.

- **Scope 1:** Direct impact of an organisation, or emissions that are created by assets that the organisation owns.
- **Scope 2:** Measures carbon that a company does not create but consumes, which includes electricity usage and natural resources.
- **Scope 3:** Measures the impact of a company's value chain, including the carbon impact of its products after they are sold.

Some asset management companies integrate these metrics into their decision-making process, as it helps assess risks and opportunities. Boards and committees should note that it is these scopes that can be applied when assessing their own portfolio companies.

RISK AND OPPORTUNITY

It is becoming increasingly important for investors to tackle this topic with their asset managers to ensure they are adequately assessing the carbon intensity of their portfolios as new regulatory demands are applied.

These demands will not just impact a pension fund portfolio, but (as highlighted above) a trustee's fiduciary duty and long-term investment performance.

By identifying the companies that boast the highest carbon impacts, boards and committees can encourage asset managers to either engage with them to reduce their emissions – or divest entirely.

But there is another angle to this, too. Looking at the rate of positive change, where companies are showing reduced carbon emissions over time or where progress is sufficiently strong in reducing carbon intensity, may signal an investment opportunity.

YOUR GOVERNANCE PARTNER

At CACEIS, we are proud of our strong expertise in UK pensions governance and our innovative solutions to support this market to improve overall governance. We support and offer LGPS cost transparency, ESG, other governance reporting solutions and custody, and aim to help the LGPS to navigate an increasingly challenging environment.

As part of our education partnership with the PLSA, which focuses on data governance, we host workshops and speak at conferences and seminars to share our insight, especially on areas around cost transparency and ESG.

To learn more about our ESG and Climate Change reporting solutions, please call James Paris, at CACEIS UK, on 0207 153 3665 or email james.parish@caceis.com

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