CLIMATE AND ESG: TIME FOR ACTION

November 2021

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INVESTOR SERVICES

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FOREWORD

PAT SHARMAN, COUNTRY MANAGING DIRECTOR, UK

Climate change is the key issue of our time. Climate change risks know no boundaries and will impact pension schemes of all shapes and sizes. Asset managers and pension schemes alike are in a unique position to drive change through their capital allocation, and sustainable governance practices. They are closely linked. Asset managers have an important role to play in engaging with and influencing the companies or issuers in which they invest. Pension schemes have a key fiduciary duty to monitor their non-financial risks, such as climate change, and engage in active dialogue with their asset managers to drive change.

As an independent sustainable governance partner to asset managers and pension schemes, we place importance in understanding the current state of play in how our clients, and the market view Environmental, Social and Governance (ESG) and climate risks.

Last year, we conducted a wide-reaching survey, asking representatives of pension schemes of all shapes and sizes about their attitudes towards ESG issues, and to understand contemporary thinking on how pension schemes could embed ESG and climate change considerations within their governance functions.

We repeated the survey this year in partnership with Pensions Age.

Our findings paint an encouraging picture of pension schemes and trustees stepping up to the climate change challenge. The question remains whether this recognition is occurring at a rate fast enough to create meaningful change. There is still work to do, particularly on education around quantifying the significance of climate risks – both physical and transition – as well as how to measure and manage those risks effectively.

The recent Intergovernmental Panel on Climate Change (IPCC) report on climate change highlighted that we have a narrowing range of responses and time to reducing greenhouse gas emissions, which means certainty around climate change being a systemic risk is growing.

COP 26 will also place a renewed focus on the importance of tackling climate change. In mid-October this year, the UK Government published their 'Roadmap to sustainable investing' which outlines future sustainability disclosure requirements for companies, asset owners, asset managers and investment products. This followed the introduction in October 2021 of new requirements for larger schemes over £5bn, and master trusts, to report on their climate risks in line with the Task Force on Climate Related Financial Disclosures (TCFD) – in October next year, these same requirements apply to schemes over £1bn.

The time for trustees and the pension industry to take action is now. With the mounting regulatory and financial risks, of climate change to pension scheme assets, schemes and trustees should start by getting their hands on data to start understanding these risks and ultimately take action tackling climate change and ESG risks.

SURVEY METHODOLOGY

WHAT TYPE OF SCHEME DO YOU REPRESENT?

55%

Corporate Defined Benefit

8%

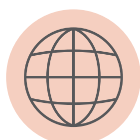
Hybrid or Consultant

16%

Defined Contribution Trust Based

7%

LGPS



14%

Master Trust

The survey was conducted in partnership with Pensions Age. A total of 130 participants responded to the survey.

PENSION SCHEME SIZE

The survey represented schemes across the size spectrum:

RESPONDING TO THE CLIMATE CHALLENGE

Climate change has become a global emergency. In August, the IPCC released its Sixth Assessment Report on the science of global warming. The report made for disturbing reading, and the United Nation's (UN) Secretary-General, António Guterres, called it a "code red for humanity". The biggest single takeaway is the significant climate change that's occurring in our lifetime, and urgent steps need to be taken to limit the effects.

NO TIME TO WASTE

It's easy to read the findings in the IPCC's report and take the view that time is running out, and that the world lacks the collective will to transition away from fossil fuels in time to avert the worst-case scenario. But the report itself presents a clear case for seizing the initiative and collectively taking the steps necessary to prevent climate disaster. Up until now, climate change, and the human involvement in rising global temperatures was muddied by debate. But that debate is now over. With COP26 fast approaching, the time has come to take definite steps to decarbonise the world.

To highlight the scale of the challenge, almost 60% of companies in the S&P 500 and more than 40% of companies in the S&P Global 1200 hold assets at high risk of physical climate change impacts.[1] Furthermore, globally, around $18trn of equities, $8trn of bonds and an estimated $30trn of unlisted debt are linked to high-emitting sectors of the economy.[2]

For the investment industry, and for pension schemes in particular, the challenge is immense. The physical risks posed by climate change, such as extreme weather events, is leading to a global policy response. This in turn is creating transition risks, as companies look to reduce their carbon emissions. The effects of this transition away from carbon-intensive sectors, and overall decarbonisation, will impact a large majority of a pension schemes' funds and constituent holding companies or issuers. The challenge for pension schemes, and ultimately for pension trustees, is to work out how to react to policy changes from regulators and government (particularly in the wake of COP26) and to effectively mandate climate-related risk reporting across their portfolios, strengthening governance functions.

1. https://www.spglobal.com/en/research-insights/featured/understanding-climate-risk-at-the-asset-level-the-interplay-of-transition-and-physical-risks
2. https://www.economist.com/finance-and-economics/2021/09/04/could-climate-change-trigger-a-financial-crisis

THE EVOLVING REGULATORY LANDSCAPE

The integration of ESG across UK pension schemes – and the regulatory requirement to make comprehensive disclosures on ESG-related investment policies continues to gather pace. Last year, trustees were instructed to include further detail in their Statements of Investment Principles (SIPs) on their stewardship policy and arrangements with asset managers, including Implementation Statements on how asset managers are incentivised to align investment strategy and decisions with the trustee's investment policies, including ESG.

59%

of survey respondents highlighted that regulatory requirements were one of their top two drivers for looking at climate risks

The integration of ESG across UK pension portfolios gained momentum last year, thanks in part to rules introduced in October 2019 requiring schemes to disclose their policy on ESG and climate change relating to investments in their SIPs, and well as publishing their implementation statement. From October 2020, trustees must include further detail on their stewardship policy and arrangements with asset managers, including how asset managers are incentivised to align investment strategy and decisions with the trustee's investment policies, including ESG.

The Pension Schemes Bill 2019-21 introduced new requirements for pension schemes to report on climate change and stewardship criteria, requiring trustees and scheme managers to monitor risks and opportunities related to climate change. Revisions to the UK Stewardship Code also came into effect, laying down a clear set of expectations – and guidance – directed at asset owners, asset managers and service providers on how to manage investments (including pensions) in ways that lead to sustainable benefits for the economy, environment, and broader society.

There is also a growing focus on sustainable governance. The second most important factor highlighted by pension schemes in our survey is a focus on good ethics and governance.

The regulatory landscape is not just impacting pension schemes. In our survey of fund professionals in May 2021, 51% of respondents believe that ESG standards will become a mandatory component of investment fund governance and 79% expect tighter regulation on ESG and climate change over the next three years.

Regulatory pressure designed to encourage meaningful action, and measurable insights, shows no sign of letting up. From October 2021, pension schemes valued at more than £5 billion, as well as all authorised master trusts, must report on their climate risks in line with the Task Force on Climate Related Financial Disclosures (TCFD) guidelines. These guidelines will also apply to all pension schemes valued at over £1 billion from October 2022. However, this has arguably created a misalignment between the reporting requirements of pension schemes and those of asset managers and the companies and issuers they invest in.

DID YOU KNOW?

The TCFD lays out guidelines on climate-related financial disclosure to assess the resilience of company business models to climate risk and opportunity. This framework has rapidly established itself as the global industry standard in climate-related reporting.

TCFD reporting requires firms to disclose the metrics and targets used to assess and manage relevant climate risks and opportunities. Pension schemes must report on Scope 1 and Scope 2 greenhouse gas emissions, and if available, Scope 3 (this looks at greenhouse gas emissions across a company's supply chain, or in the case of financial services companies, emissions from the companies that banks lend money to, or total emissions from all the companies and issuers that an asset manager invests in).

Despite growing global support for TCFD, the group said difficulties remain –

"there is significant work still to do to mainstream the consideration of climate-related issues within financial decision-making" and "at the same time, companies continue to struggle to quantify the impacts of climate change, and to source the data they need to fully assess the threats of a changing climate"

DETERMINING ESG AND CLIMATE RISKS

A key factor of ESG integration is the ability to assess non-financial risks of companies. These risks can be a key headwind to a company over the longer term, which may have the potential to destroy shareholder value. This includes ESG risks that breach the principles of UN Global Compact, such as human rights abuses, labour rights, environmental damage and corporate governance scandals. Then we have climate risks, which the TCFD defines as the physical and transition risks of climate change as follows:

- Physical risks emanating from climate change can be event-driven (acute), such as increased severity and frequency of extreme events (e.g., cyclones, droughts, floods and fires). They can also relate to longer term (chronic) risks in precipitation and temperature, and increased variability in weather patterns (e.g. sea-level rise, which can impact global supply chains).
- Climate risks can also be associated with the transition to a lower carbon global economy, the most common of which relates to policy and legal actions, technology changes, market responses (such as carbon tax/pricing) and reputational considerations.

Managing both ESG risks, and physical and transition risks of climate change will be a critical factor for UK pension schemes, especially to protect member pensions pots.

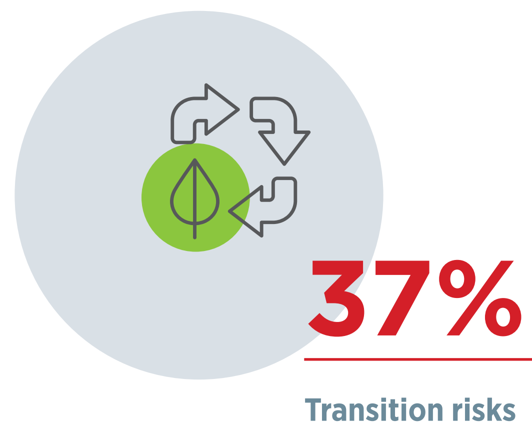
Staying on this theme, 37% of survey respondents highlighted that transition risks are a main area of concern when considering climate challenges and the impact to their scheme.

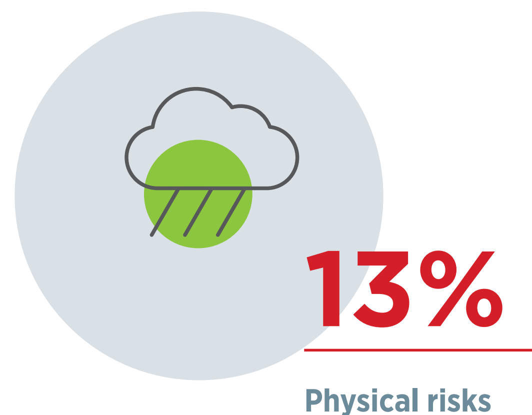
In contrast, only 13% of respondents are concerned about physical risks, which in fact, are just as challenging to pension schemes. The physical risks of climate change pose real long-term risks to companies, industries and countries in which they operate. For example, extreme weather events can create supply chain disruption, or force companies to relocate key manufacturing facilities if they are in areas more prone to flooding. Changing climate patterns and the increased risk of wildfires present another problem. In 2020, Australia battled its largest bushfire on record.[3] More recently, the Word Weather Attribution consortium published their first assessment outlining the role of climate change in Australia's bushfires, citing that global warming boosted the risk of the hot, dry weather likely to increase bushfire risk by 30%. If global temperatures rise by 2C, such devastating conditions would occur at least four times more often.[4] With costs approaching $100 billion, the fires are Australia's costliest natural disaster.[5]

It's important to recognise that climate change it multi-faceted, and some risks may be less obvious, which is why a focus on both physical and transition risks is required.

A GAP STILL EXISTS:

Where is the focus:





3. https://www.carbonbrief.org/explainer-how-climate-change-is-affecting-wildfires-around-the-world
4. https://www.bbc.com/news/science-environment-51742646
5. https://theconversation.com/with-costs-approaching-100-billion-the-fires-are-australias-costliest-natural-disaster-129433

CLIMATE RISK IS OVERTAKING OTHER ESG CONSIDERATIONS

It is no surprise that managing investment risks, and responding to regulatory changes, continue to drive the need of pension schemes to look at ESG and climate risks. When asked about their top two factors, 64% of survey respondents told us that managing investment risk was a driver behind looking at ESG and climate risks. Regulatory requirements (59%) were also a consideration, along with competitive pressures (53%) and better-than-expected performance (42%).

THE FOCUS ON CLIMATE:

64%

of survey respondents are looking at ESG and climate to manage investment risk

65%

cited managing climate risks as a priority

Market expectations are growing on the need for asset owners to take positive action through their ownership of equities and their allocations to renewable energy and similar assets. Groups such as ShareAction have continued to be proactive in encouraging pension savers to ask questions of their providers about how their money is invested.

Moreover, when considering sustainability as a broader theme, our survey makes it clear that managing climate risks is front of mind for pension schemes, with 65% of respondents highlighting this as the more critical factor, compared to 42% of respondents choosing environmental responsibility and 34% citing a focus on good ethics and performance as key.

This is not surprising, given the impact of the IPCC's findings this year. Over the long term, we are likely to experience changes in global and regional climates and we are already experiencing a higher velocity and frequency of extreme weather events today. Over the summer period, we saw widespread flooding in China, Germany and Belgium, a heatwave across the US and Canada, and fires sparked by record temperatures in Turkey, Greece and Italy.

In August 2021, Spain recorded its hottest ever temperature, with the Andalusia region reaching 47.2C (116.96 Fahrenheit), while Sicily in Italy reported temperatures reaching 48.8C (119.84F). These weather events will continue to increase in frequency as warming continues.

Adaptation to a changing climate, therefore, is a key challenge for asset owners.

In 2019, a potential 300 billion working hours were lost due to rising temperatures

Climate change risk assessment 2021

3.9 billion will be exposed to major heatwaves by 2040

Climate change risk assessment 2021

Estimated insurance losses from natural catastrophes reached $40 billion in H1 2021

InsuranceJournal.com

Global warming to cause productivity loss equal to 80 million jobs by 2030

United Nations, 2019

HOW ALIGNED ARE PENSION SCHEMES TO THE REALITY OF CLIMATE CHANGE?

Despite the fact that pension schemes are focused on targeting climate risk, the perception of the impact is misaligned.

As with last year, our survey highlights the challenges pension schemes face around ESG integration and addressing climate change within pension funds and portfolios. This year, 79% of pension schemes told us climate risk ranks "high" or "somewhat high" on their agenda – understandable given the extent to which climate risk has grabbed headlines this year. Even so, despite the increase in visibility on climate risks, our survey suggests attitudes have not really changed much in respect of the impact climate risks can potentially have on a scheme's investments.

The UK pension industry recognises the importance of taking action, to a point. Our survey found that 23% of respondents believed climate change would have a "high impact" on their scheme's investments (an increase of 3% from last year), while 50% considered climate change would have a "medium" impact (49% last year). However 20% of respondents believed their scheme would face a "low impact" from climate change – down from 22% in 2020. While the direction of travel is encouraging, there appears to be a mismatch between the climate risks presented by the IPCC's report, and most pension schemes believing the impact will be either medium or low.

COMPARE AND CONTRAST 2020 WITH 2021

What impact do you think climate change will have on your scheme's investments?

	2020	2021	
High impact	17%	23%	▲
Medium impact	49%	50%	▲
Low impact	22%	20%	▼

More work is still required to understand the impacts of climate change on pension scheme investments

While the results indicate a marginal improvement from last year -– there is clearly some education still needed to quantify the importance of climate risks – both physical and transition, and the negative impacts these can potentially have on companies held with portfolios, depending on sector, and also where their operations are based. Having clear metrics, and understanding these risks will be a big part of a scheme's governance framework. Given the likely action expected from governments following the COP26 summit, we expect to see current awareness and attitudes evolve, and for more participants to recognise the impacts on climate change on pension schemes and take them more seriously.

To compound this fact, the survey results also highlighted that schemes and trustees still lack the tools and information required to enhance the decision-making and governance process. Of our survey respondents, just 32% told us they had sufficient information to understand how climate risks impact their investments, 44% said they did not have enough information, despite 79% of respondents saying that climate risk was very high or high on their agenda.

THE DEMAND FOR GOOD-QUALITY DATA

The survey also shows that many schemes lack the data to turn concern into action and this may be part of the challenge in determining the actual risk of climate change on a scheme's investments.

Despite the introduction of a number of initiatives - there is still insufficient clarity in the industry around how to interpret and disseminate the meaningful data needed to effectively manage climate risk. Without access to this data, making bold action on tackling climate risks is increasingly difficult. When asked about their top two challenges in getting access to data, 57% told us the greatest challenge was not being able make meaningful comparisons. 41% of respondents said a lack of data made it a challenge to understand what's needed to manage climate change, and 42% said their biggest challenge came from knowing how to access the right data.

Creating more self-sufficiency in reporting on climate risks could become a core focus for pension schemes. This is because many schemes are struggling to obtain the data from their own asset managers. 70% require more comprehensive information from their asset managers on how they are addressing climate risks, which has not moved from a year ago when we conducted our previous survey.

INFORMATION GAP

32%

Only 32% of schemes have sufficient information to understand climate risks

44%

don't have enough information

2020 AND 2021: NO CHANGE -

70%

of respondents require more comprehensive information from their asset managers on how they are addressing climate risks

72%

want to see better reporting of ESG and carbon data

What data are pension schemes looking for? The positive news is that pension schemes know the type of data they need. 69% of respondents told us they need access to data that measures climate risks from their scheme's investments, 70% require more comprehensive information from their asset manager on how they are addressing climate risks, 72% want to see better reporting of ESG and carbon data, and 60% want more information about the different types of climate risks (physical and transition). Only when schemes can measure their portfolios' carbon footprint, carbon intensity, and understand other environmental factors, they can then address their exposure to the risks of climate change.

GROWING DATA EXPECTATIONS

We want more information about the different types of client risks (physical and transition)

55% 2020

60% 2021

A LONG WAY TO INDEPENDENCE

11%

Only 11% of respondents independently verify their scheme's exposure to ESG and climate risks

INDEPENDENCE AND LOOK THROUGH WILL BECOME KEY REQUIREMENTS

For UK pension schemes to strengthen governance around the risks of climate change – and to protect the pension pots of their members – schemes need to develop an independent viewpoint of their respective climate risks, one that is separate from the views of their asset managers.

This creates the conditions for stronger stewardship and engagement between a scheme and its asset managers on the topic of managing climate risks.

Surprisingly, only 11% of respondents surveyed independently verify their scheme's exposure to ESG and climate risks. And this is weighted more towards larger schemes of £1bn in size or more.

Our survey also revealed that very few pension schemes have dedicated resources in house. Just 10% of pension schemes have a specific person or team overseeing ESG or climate risk – and this is the domain of the larger schemes.

As a result, 80% of respondents place a clear reliance on consultants or asset managers in managing the impact of ESG and climate risks.

CONSISTENT REPORTING A CHALLENGE

57%

of survey respondents found it challenging to access data in order to make comparisons

And despite custodians arguably being best placed to monitor ESG and climate risks criteria, as they are responsible for processing and storing all data related to a scheme's investment portfolio, only 2% of respondents used this avenue. There is also little engagement between pension schemes and their custodian, with no dialogue taking place with 52% of respondents.

Sustainable governance is a central theme for custodians like CACEIS, as they supply independent rigour, consistency, and oversight to the safekeeping of assets. Monitoring and reporting on ESG / climate risks is simply an extension of a custodian's existing governance focus and provides pension schemes with an independent viewpoint of these risks.

Custodians can help pension schemes measure ESG or climate risks in a consistent manner across all their asset managers. This can be broken down to see what's happening at a portfolio, sector and individual security (ISIN) level across pooled funds and segregated mandates – so achieving full 'look-through'. Attributing carbon intensity and absolute emissions to specific issuers and sectors, can help trustees with clear targets for engagement as they start their TCFD journey.

DID YOU KNOW?

In recent years, asset managers have embraced the case for ESG investing and incorporated sustainability factors into their investment processes, but wide variations exist. And measuring and reporting on climate risks is relatively less formed. It's little surprise, therefore, that 57% of schemes found it challenging to access data in order to make comparisons.

This consistency is hard to achieve when pension schemes are relying on their range of asset managers to provide data around their ESG and climate risks, with little standardisation and sometimes vastly different interpretations of how they integrate these risks into their investment decision making.

Aggregating these disparate sources of data into a single point of view will be challenging. That's where custodians can help, so pension schemes and trustees can measure their asset managers exposure to ESG and climate risks to the same, consistent standard. This will improve governance and decision-making.

77%

of survey respondents rely on their asset manager or consultant for help with ESG and climate risks screening

Independent look through will be key for pension schemes so they can access the right level of detail on how their pooled funds and segregated mandates are exposed to ESG and climate risks.

Going forward, trustees will need to find solutions so they can form an independent viewpoint of ESG and Climate Risk factors and robustly document their policies on these material financial considerations. It also helps create a level playing field between schemes and their asset managers on these key risks and facilitates stronger dialogue with Implementation Statements in mind.

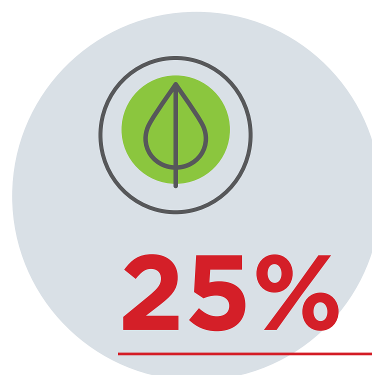
Finally, pension schemes must also be mindful of variations between different asset classes. Consultancy group Redington's 2021 Sustainable Investment Survey suggested that private equity, equities and credit strategies were more consistently incorporating ESG into their recommendations relative to other asset classes. Conversely, the survey suggested multi-asset and liability-driven investment (LDI) strategies showed comparatively fewer instances in which ESG considerations impacted an analyst's recommendation. Redington believes this is likely a result of increasingly diversified portfolios and shorter holding periods (in the case of multi-asset strategies), as well as a lack of reliable ESG data available for analysts to make well-informed decisions.[6]

Furthermore, asset owners will increasingly hold private market strategies to higher standards to close the data gap on ESG and climate risks, which can be inconsistent and lack the granularity that is required for good governance and decision making. However, the direction is changing. In a recent survey conducted by PWC in 2021, it was concluded that "private equity firms are entering a new age of ESG maturity", where 47% of survey respondents have not undertaken any work on climate risk exposures to portfolios but intend to do so in the next year. This should open up the availability of more climate data relating to private market strategies in the future.[7]

ARE PENSION SCHEMES LOOKING FAR ENOUGH AHEAD?

Better access to information from asset managers would certainly be helpful in giving pension schemes the steer they need to encourage the adoption of more climate-focused initiatives. For example, moving towards net zero is a key approach to defining a climate strategy, but when we asked survey participants whether they had plans to adopt net zero targets, 25% told us they would be adopting net zero targets, 30% said they were "thinking about it", 37% had "no plans yet".

THE ROUTE TO NET ZERO



of schemes surveyed said they would be adopting net-zero targets

"The purpose of pension schemes setting net zero targets is not solely that the schemes themselves should be net zero aligned, but that they should make an impact in reducing the real economy's contribution to climate change. Good stewardship is a method for achieving that change"

House of Commons Work and Pensions Committee, Pension Stewardship and COP26

6. https://redington.co.uk/publication/sustainable-investment-survey-2021/
7. https://www.pwc.com/gx/en/services/sustainability/publications/private-equity-and-the-responsible-investment-survey.html

Similarly, when we asked participants to tell us whether they were planning to align their pension schemes in line with the TCFD reporting recommendations, 33% said they would, whereas 34% said they were "thinking about it", 30% had "no plans yet".

Ultimately, by October 2022, all pension schemes over £1bn in size have to undertake mandatory reporting in line with TCFD recommendation. This still leaves a long tail of smaller schemes that are not covered by these requirements. In reality, however, we believe that TCFD reporting will eventually become best practice in 2024, especially when smaller schemes find it easier to access new ESG and carbon reporting tools coming into the market.

Finally, member sentiment is playing a role in why schemes are taking more action on ESG and climate risks –21% of respondents ranked demand from member expectations as their first and second choice. However, against this backdrop, a key area of opportunity is more member communication around ESG and climate change. Our survey revealed that engagement levels with members is still low, where over half of survey respondents revealed that they have no dialogue with their members on the issue of climate risks. This is not surprising given all the data challenges we've described previously, but member communication is an important consideration given the related risks to member pension pots of climate change.

CONCLUSION

PAT SHARMAN, COUNTRY MANAGING DIRECTOR, UK

We know from the IPCC's report that climate change risks know no boundaries, and will clearly impact pension schemes of all shapes and sizes. Managing the risks of climate change will be a critical factor for UK pension schemes, especially to protect member pensions pots. The risks of climate change are becoming increasingly evident – through rising heatwaves, droughts and flooding in different parts of the world, creating real impacts for companies and their supply chains, not to mention the challenges and investment that companies face when transitioning from fossil fuels to renewables. There will be winners and losers, and pension schemes will need to adapt and evolve accordingly.

Our 2021 survey suggests that process has already begun. Trustees are starting to recognise the opportunities of responsible investing and measuring ESG and climate risks - with many more now believing their investment decisions can truly make a difference to members and wider society. However, while progress is being made, more work must be done to provide schemes with better support on climate risk and ESG-related issues, whether through training, access to data, or industry collaboration.

For pension schemes, the priority must therefore be to create a level of informed independence in how portfolio exposure to ESG and climate risks are assessed and monitored, and how their investments are impacted by the physical and transition risks of climate change.

The IPCC's findings were a shock to the system, presenting the climate challenges ahead as insurmountable without significant and immediate action. Fortunately, UK pension schemes are in a unique position to drive change, managing the risks of climate change to their investments to deliver the best outcomes for their members. The UK pensions market is the third largest in the world, overseeing over £2.5tn of assets. This is a tremendous responsibility and collectively gives pension schemes the power to make a real difference in driving the climate agenda alongside their asset managers.

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