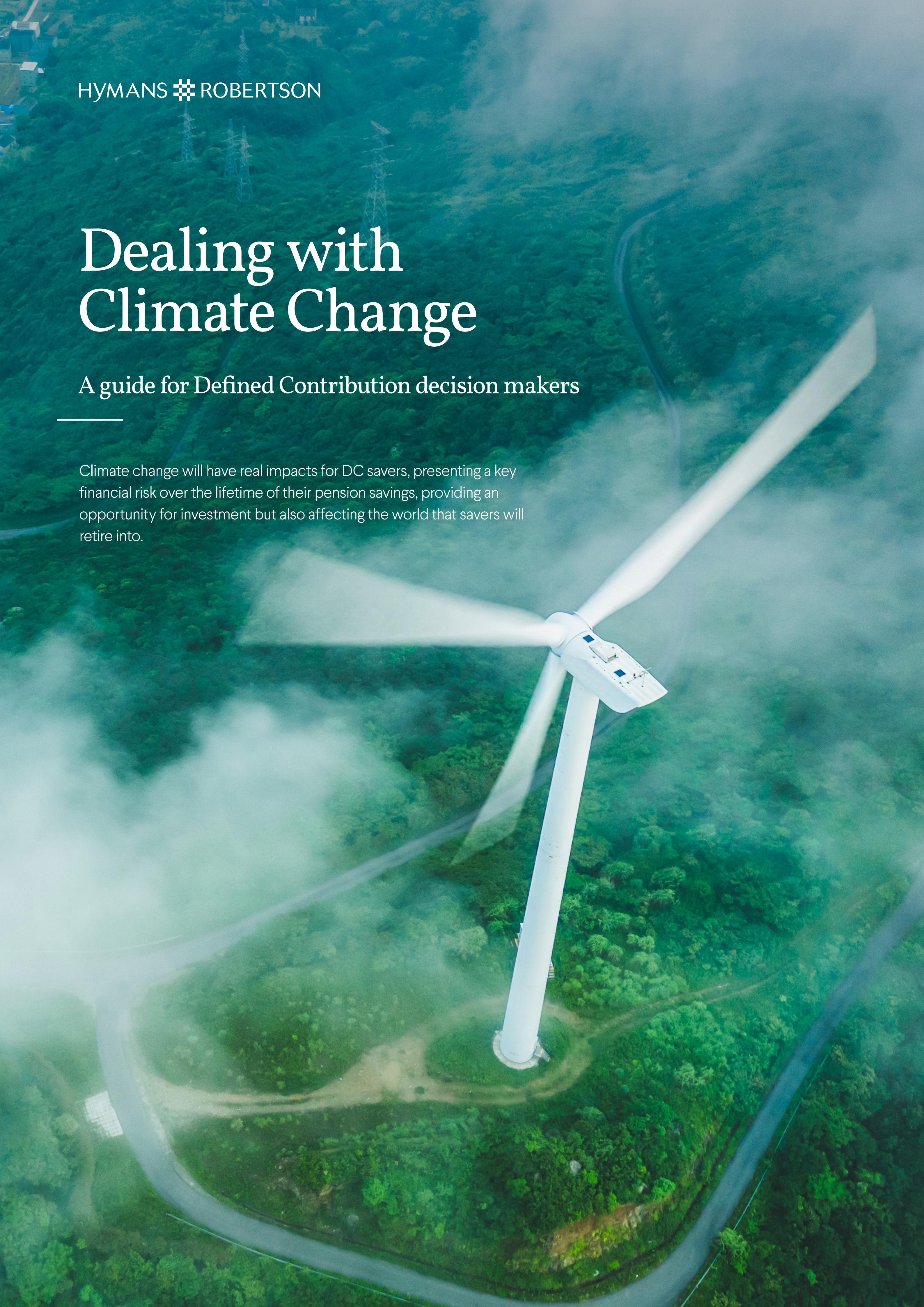


HYMANS ROBERTSON

Dealing with Climate Change

A guide for Defined Contribution decision makers

Climate change will have real impacts for DC savers, presenting a key financial risk over the lifetime of their pension savings, providing an opportunity for investment but also affecting the world that savers will retire into.

A checklist to address climate change in your scheme

Climate change and its impacts will be with us for decades. Given the potential for material impacts on member outcomes, it's vital for DC trustees to have a clear plan to address climate risk (and opportunities) within their scheme. Trustees may also consider this a great opportunity to start engaging with their members on what they are doing to adapt their scheme to this constantly changing environment. Below, we outline eight steps that trustees can take now to address this material risk. Many trustees have already started to make progress relative to some of these:

1. **Get educated:** Ensure there is a clear understanding of climate risk, developing trends and regulatory changes on the trustee board. 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.

3. **Review manager and provider policies:** Check whether managers and providers' climate change policies are aligned with the trustees' beliefs. Meet with your 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.

4. **Assess exposures to risk:** Assess the potential impact of climate risk on member outcomes. The impact of different approaches to climate change should be considered by taking into account differing potential scenarios for future climate change outcomes. Consider exposures to different sources of risk.

5. **Review your investment arrangements:** Trustees should consider the types of funds included in both the default and the self-select range. Trustees should consider aspects such as whether passive or actively managed funds should be used and, if passively managed, what benchmarks should be adopted. Consider the benefits of change relative to the status quo.

6. **Monitor your managers:** Ensure that you meet regularly with your managers or otherwise assess their performance. Ensure that climate metrics are regularly calculated and discussed by trustees. Get the detail on how managers have voted and challenge their approach where appropriate.

7. **Communicate with members:** Consider how you communicate your actions, and progress towards long-term goals to members. Use stories to explain to members the benefits of their investment and the impact their investments are having. Use language and examples that members can relate to. Issue surveys to understand if your members believe enough is being done within the scheme to combat climate change. Communicate on the action being taken to address climate-related risks and opportunities.

8. **Document your processes:** Ensure that responsibilities are clearly assigned and that the process employed by the trustees, investment managers, platform providers and advisers are all understood.

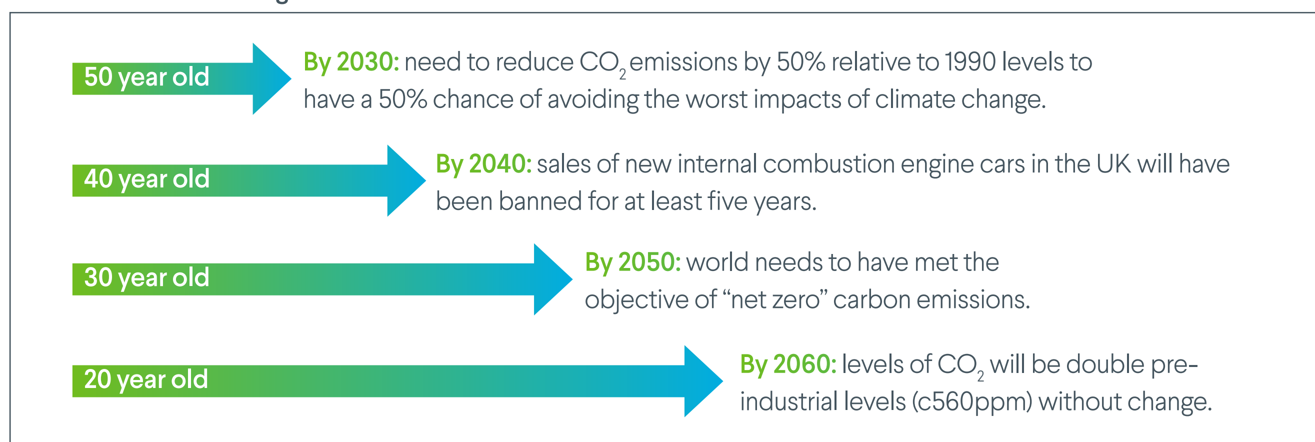
Why is climate change important?

Climate change will impact all members of DC schemes over the coming years and decades. It's important for decision makers, be they trustees or governance committees, of pension schemes to take this topic seriously and consider how they can use their influence, both directly and through their investment managers, to create positive change and ensure that our DC members have a future to retire into.

The purpose of saving for retirement is to enable individuals to achieve the standard of living they desire when they reach retirement. Because of this, pension savings are invested with a long-term approach. It therefore follows from this, and a regulatory requirement to consider time-horizon, that trustees should also consider this longer-term picture when devising and reviewing the investment strategies for their DC schemes.

The scale of policy change needed to address climate change considerations, and reflect global commitments, makes the issue relevant to all members, regardless of age.

Considering a member in 2020 who wants to retire at age 60:



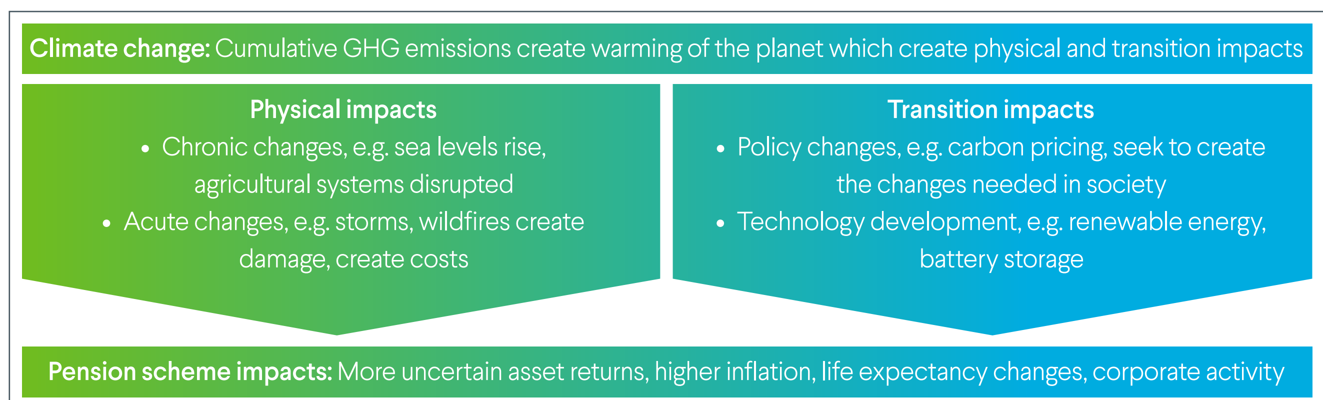
There is growing evidence that pension scheme members are starting to take a greater interest in where their pension savings are invested. Popular initiatives such as Make My Money Matter, which is seeking to encourage pension scheme members to challenge fiduciaries on where their pension money is invested, are gaining traction. Technology firms such as Tumelo are providing a platform for members to engage on voting issues of interest and make their voices heard. Finally, regulatory change, which we address below, continues to push climate change up the agenda for pension schemes.

In research carried out for the Defined Contribution Investment Forum in 2020, 65% (up from 56% in 2018) of those DC members surveyed said they would have more trust in their pension and 50% (up from 40% in 2018) said they would contribute more to their pension if they knew it was invested in a responsible way. Many DC members are still 30 or 40 years from their retirement date – and the impact of climate change is very real for them. We have a great opportunity now to use topics such as climate change in a positive way to engage those members.

What impact will climate change have on financial markets?

There are two key channels by which climate change will have an impact on financial markets, being the physical impacts that arise directly from a changing climate, and the transition impacts that arise from the response of policy makers.

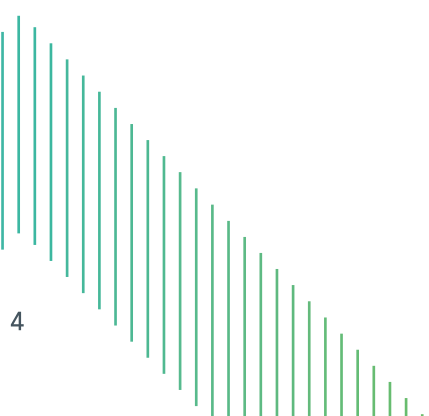
This will feed through to uncertain economic impacts, such as on GDP, inflation and asset returns. The actions of policy makers, companies and broader society will ultimately determine the nature and extent of the risks faced.



An increasing awareness and understanding of climate change, together with growing regulatory change, is forcing companies to adapt and address the impact they have on the environment. For example, greater adoption of renewable energy and push to move away from fossil fuels creates “stranded assets” as companies are unable to economically exploit reserves of oil and coal. The result is that companies write off the value of these assets which has an impact for shareholders. If sufficient progress relative to global commitments is not being made, then companies overly reliant on fossils 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.

In supporting the 2015 Paris Agreement, the UK Government has created a legislative requirement to bring greenhouse gas (GHG) emissions to “net zero” by 2050. This means that such changes are likely to continue. This can be achieved both by reducing emissions and implementing offsetting measures. This will test the resilience and adaptability of companies whilst creating opportunities within investment for pension schemes.

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. It means that change does not need to be uniform.



The role of pension schemes in addressing climate change

Pension funds make up approximately 36% of asset owners worldwide. This puts pension scheme fiduciaries in a position of great responsibility from which they can make a sizeable difference. There are two ways that pension schemes can have an impact:

- **By moving capital: In DC schemes, this can be achieved by improving the sustainability of the default strategy, and**
- **By influencing the behaviour of others: In DC schemes, this can be most effectively achieved through stewardship, typically via a platform provider**

In the UK, most DC assets are invested in passively managed funds. This does not mean that decision makers cannot have an impact on the way in which members' money is invested. The choice of passive fund, the index it seeks to track, and the investment manager's stewardship activities can all be chosen 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.

Looking beyond the default strategy, there are both active and passive funds available within the DC marketplace which address climate change and trustees should make sure that the funds which they offer to members fit as closely as possible with the trustees' own beliefs and members' views on climate change and investment more generally.

Case study: Climate stewardship in action

Climate Action 100+ is a collaboration of investors which is engaging with the largest global emitters of CO_2 to take necessary action on climate change. One notable success of this collaboration has been to gain a commitment from Shell to align executive remuneration and the energy transition, although engagement with the company continues. Ensuring that managers are aligned to such collaborations and challenging them on the actions taken can ensure that members money is being adequately represented.

Regulatory requirements for DC schemes

Government has continued to prioritise the consideration of climate change by pension schemes and has progressively introduced legislation that requires trustees to develop, implement and report on their approach to managing ESG risks, including climate change. These requirements have also been broadened to encompass other pension providers.

- **From 1 October 2019**, trustees had to set out their policies, including how they address climate change, within their Statement of Investment Principles. Trustees also had to publish their SIP.
- **From 1 October 2020**, trustees had to produce and publish an Implementation Statement for their scheme, setting out how they have implemented their policy.
- **From 1 October 2021**, trustees of larger pension schemes (including Master Trusts) will need to meet minimum climate governance expectations. These requirements will be extended to other schemes over time.
- **By 31 December 2022**, trustees of larger pension schemes (including Master Trusts) 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.

The pace of change is rapid and from both a regulatory and a financial perspective, trustees cannot ignore the need to address climate change.

It [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

Understanding and applying the TCFD framework

The TCFD was established by Mark Carney in 2015 and has 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 allowing more informed investment, credit and insurance underwriting decisions.

There are four elements to the TCFD framework as illustrated and, although this was not explicitly developed for pension schemes, it has been adapted for their use. Guidance produced by the Pensions Climate Risk Industry Group provides a number of actions that trustees can take to embed climate risk into their processes. The key actions that trustees could and should be taking within this framework are summarised below.

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

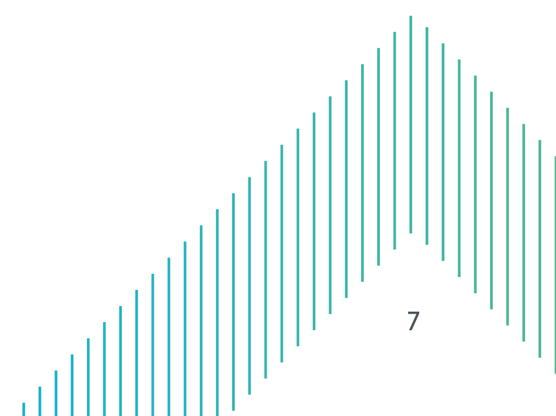
- Develop and maintain processes for identifying, assessing and managing climate-related risks.
- Ensure the integration of climate-related risks into overall risk management.

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 against which 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 relate risk with respect to the chosen metrics and measure performance against this target.



Managing the risks and opportunities 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 easy to consider whereas others will be more complex. It is also important to understand that climate risks will change through 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 industry sectors that give rise to risk. A likely short-term source of risk will be the imposition of a "carbon tax", the goal of which is to place an increasing price on 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	Potential climate related opportunities
Fossil fuel reserves: whilst 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.	**Resource efficiency:** improving efficiency across production and distribution processes (e.g. energy efficiency) can result in direct cost savings to organisations' operations.
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.	**Alternative energy sources:** increasing investments in renewable energy sources such as wind, solar, wave and tidal and the associated grid infrastructure.
Other carbon intensive companies: various industries (e.g. cement manufacturers) which have high carbon emissions may face higher costs as they are forced to evolve their processes or face carbon taxes.	**New products and services:** organisations that innovate and develop new low-emission products and services may improve their competitive position.
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 scrutiny.	**Developing resilience to climate change:** relevant for organisations that may require longer-term financing and investment.

Case study: Embedding a climate tilted strategy in the default arrangement

The trustees of the XYZ pension scheme were reviewing its default investment arrangements. The trustees had a clearly defined belief that climate change presented a long-term financial risk to members and wished to adopt an approach that sought to mitigate these risks. The trustees were also keen to ensure that the investment manager chosen had a strong approach to stewardship and was prepared to take voting action against climate laggards.

After reviewing the options available, the trustees developed a strategy comprising equal allocations two multi-factor, climate/ESG tilted funds. Both strategies included tilts away from more carbon intense companies to lower carbon companies, one strategy explicitly excluded companies in certain sectors, including tar sands and thermal coal. Both managers were also rated "Strong" by our Responsible Investment team based on the strength of their stewardship credentials. The trustees were satisfied that there would be no financial detriment to members from the new strategy and that the risks that may emerge would be sufficiently managed.

The trustees have asked their investment adviser to monitor the carbon risk exposures of the revised default strategy on an ongoing basis and report on manager voting and engagement activity. The trustees will also review market developments over coming years.

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