Insight Partner Article

Mitigating the risks of Climate Change through ESG action

Michael Bushnell
Managing Director, Cardano Advisory

In the world of pensions, do we really know where climate change stops and ESG begins (before we even add in the concepts of sustainability and responsible investment)?

Even for those working in the area of sustainability, the use of terms and the best way to present them to clients can be confusing. Clarifying the terms helps to illustrate why they are not interchangeable:

CLIMATE CHANGE: a phenomena of global temperature increases, affecting regional and global weather systems and climate

ESG: non-financial factors linked to the business or undertakings of an organisation or investment, typically grouped into Environmental, Social and Governance (ESG) areas

How do climate change and ESG factors interact?

Climate change is a specific phenomenon, one that will be primarily addressed by limiting temperature increases through reductions in greenhouse gas emissions, not directly through broader changes in companies' ESG approaches. However, climate change will impact the world's environment, society and regulation, requiring changes in our approach to ESG issues to mitigate those changes.

While 'ESG' has been part of investment considerations for many years, practical impacts have often been limited. Recognising the relationship between climate change and ESG issues gives us a chance to reinvigorate and reinforce our existing approaches.

Illustrating the potential impact of climate change on ESG considerations

Considerations	Low warming, rapid transition to a low-carbon economy	High warming, limited transition to a low-carbon economy
Environmental	- Reforestation to offset emissions increases - Increased regulation of land-use - Industrial or agricultural processes banned	Staff social activities
Social	- Migration prompted by new industry development likely - Demand for perceived 'climate-leading' products increases - Increased finance cost for perceived 'climate laggards'	- Water shortages impact industry and population distribution - Significant changes in agriculture and food availability - Biodiversity loss and increased risk of new pathogens
Governance	- ESG corporate oversight needed - Climate litigation risks increase - Transition plans and reporting pressures increase	- Need for flexibility in decision-making, supply chain and operational structures increases - Strong regional or industry trends in investment likely

Accepting that pension trustees are trying to avoid risk to ensure delivery of member benefits, what does a climate change lens tell us about our approach to ESG factors when setting investment policy or assessing employer covenant support?

Structural exposure is a real risk

Some companies will have exposure to risk simply as a result of the nature of their operations and locations, regardless of how well managed they are.

Location-specific risk (for example) might arise from an exposure to long-term climate or regulatory change, with some parts of the globe more exposed than others. If a business is reliant on a particular location, this increases the risk that volatility in weather might cause material and un-modelled disruption.

Identifying structural exposure in the covenant and investment strategy of a scheme allows reconsideration of investment preferences, e.g. to target opportunities that will do best when the covenant is most at risk. This is particularly relevant for those schemes considering running-off and looking to infrastructure or buy-and-maintain credit-heavy investment approaches.

Assessments of resilience must consider ESG factors

ESG factors are leading indicators of financial impacts which have yet to appear in financial information: social preferences may take years to impact an organisation that works to long-term contracts; migration may result in irrecoverable staffing shortfalls at factories which are only visible when orders eventually cannot be fulfilled; water shortages may shut down power plants at short notice, causing sudden increases in electricity supply costs and profit declines in manufacturers.

The scale of ESG risks and opportunities facing companies as they confront the coming decades of climate change is material. By ensuring that they properly incorporate ESG factor reviews into their approach to investment and covenant, trustees can ensure they place reliance only on those entities which have the best approach to ESG and therefore the best opportunity of avoiding these financial impacts.

Perceptions matter

The adoption of products and technologies (from food trends to cloud computing) is often led by reputation and perception as much as it is by quality or benefits to the user compared to alternatives.

Increasingly, this perception is being shaped by the ESG impact of companies. This trend is only likely to be accelerated by climate change and associated regulatory responses, which makes relative winners increasingly hard to determine. Much of the coming change in the economy is therefore likely to be led by a mixture of science, public support and regulatory support for capital. This process has historical precedent in previous periods of technological innovation (from railways in the 1800s to PC chips at the turn of the millennium).

As we move forward, ensuring that they are best positioned to understand and benefit from an increased focus on ESG factors should be increasingly high on trustees' agendas.

Next steps for trustees and advisors

Trustees have had to report their stance on ESG factors since at least the requirement to incorporate these into their Statement of Investment Principles in 2018. Since the roll-out of TCFD reporting to the largest pension schemes, trustees will also have started to report around climate change risks.

Now, we need to follow through on this positive start, recognising the importance of ESG factors to company performance and how this might be exacerbated by climate change, forming practical policies which aim to maximise future member outcomes, and supporting each other with ideas and strategies.

The pensions industry needs to rise to these challenges. There will be teething problems but change can be incredibly positive. After all, the move from 60:40 splits of investment portfolios was not easy and neither was the growth in covenant assessment, but members will be thankful for many years to come. Let's recognise the positive impact of ESG factors which can drive big change for the better.