ACTING ON ESG AND CLIMATE RISKS

IN THIS CASE STUDY, WE WALK THROUGH HOW TRUSTEES CAN MAKE A START IN ASSESSING THEIR PENSION SCHEME'S EXPOSURE TO ESG AND CLIMATE RISKS

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We all recognise the importance of saving into a pension scheme from an early age. We also need to apply the same thinking on risks to pension scheme investments from climate change. This is because the companies and bond issuers that pension schemes invest in, either through pooled funds or segregated mandates, must start allocating capital to address climate and transition risks at the earliest available opportunity. The later they leave it, the more challenging it will become, creating a significant risk to members' pension pots.

WHAT DOES THIS MEAN FOR TRUSTEES?

Defined Benefit and Defined Contribution schemes can be impacted by climate risks in different ways. Gaining access to good data and setting a strong governance framework lies at the heart of managing these risks.

A recap

Trustees of DB and DC schemes have to disclose financially material considerations towards ESG and Climate Change in their SIP. Furthermore, schemes with 100 or more members are required to produce an implementation statement that covers how asset managers are encouraged to align with trustee policies on sustainability and voting requirements.

We are going to outline a three point plan on how trustees can start working with their asset managers.

Trustees should start by working with their asset managers and other service providers to tap into their knowledge about climate change and the risks it poses. The next step is getting access to aggregated good quality data that's independent from those asset managers, to assess how companies and bond issuers that make up a pension scheme's investment portfolio are impacted by climate change risks. The third key step is to set a governance framework for the scheme to monitor and manage environment, social and governance (ESG) and climate change risks – while continuing to hold asset managers to account through regular dialogue and engagement.

DB

Ask the sponsoring employer for its view of the climate-related risks and opportunities it faces and how it is responding to them.

- Access data on measuring your scheme's ESG risks and carbon footprint based on TCFD recommendations
- Have a robust dialogue with your asset managers about their approach to ESG risks and climate risk
- Document your approach to ESG and climate risks in your SIP

DC

How are ESG factors and climate risks reflected in your default strategy and self-select funds.

Sustainable Governance to Drive Change

Protecting pension scheme members' pension pots from ESG and climate risks

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THE CHALLENGE: UNDERSTANDING THE LAY OF THE LAND

Acknowledging the scale of climate impacts, and the risks they pose to pension scheme investments, is a vital part of the process.

17%

In our recent pension scheme survey, just 17% of respondents said climate risk would have a high impact on their investments.[1] The reality is very different.

What's in store for younger generations?

738 economists estimate that failing to tackle climate change will cost the world US$1.7 trillion a year by 2050, escalating to about US$30 trillion a year by 2075.[2]

The physical risks of climate change are accelerating. In 2021, Canada recorded its hottest day in history at 49.6°C and in Sicily, temperatures reached 48.8°C. In November of last year, the European Environmental Agency reported Europe had experienced its warmest decade on record. Weather disasters in the US have also cost US$750bn over the past five years.[3]

Rising temperatures lead to extreme weather patterns, which are growing in frequency. Closer to home, for example, in February 2022 Storm Eunice led to the highest wind speeds ever recorded in the UK.

To put the scale of exposure to physical risks in context, almost 40% of companies in the S&P Global 1200 index hold assets at high risk of physical climate change impacts. Wildfires, water stress, heatwaves, and hurricanes (or typhoons) linked to increasing global average temperatures represent the greatest drivers of physical risk.[4]

Did you know?

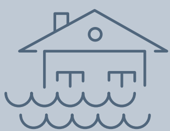
Pension schemes invest globally – so when looking at climate risk we must think globally. Climate risks for companies in developed markets are underestimated. More frequent extreme weather events means an increasing probability of supply chain disruption. Company supply chains are often complex, and tied to developing markets, meaning climate impacts pose a risk for many companies regardless of where they're headquartered.

The scale of the challenge is immense. Energy used across all global economic sectors accounts for around 72% of global CO_2 emissions.[5] In the UK, for example, households and the energy, manufacturing and transport sectors also accounted for 72% of all CO_2 emissions in 2019.[6] This gives rise to physical and transition risks, which will have an impact on pension scheme investments.

Trustees also need to consider the socio-political changes put in place to address these physical risks. More than 70 countries that account for more than 80% of global CO_2 emissions and about 90% of global GDP – including the UK – have put net-zero commitments (mostly for 2050) in place. These commitments – mostly related to energy use – are driving the regulatory agenda and speeding up the transition from fossil fuels to renewables.

37%

37% of pension schemes highlighted that transition risks (stranded assets) are a main area of concern when considering climate challenges and the impact to their scheme's investments.



13%

In contrast, only 13% of respondents were concerned about physical risks, which in fact, are just as challenging to pension scheme investments.[7]

[1] CACEIS survey, October 2021 in partnership with Pensions Age. 130 total respondents.
[2] https://www.weforum.org/agenda/2021/04/economists-global-action-climate-change-natural-disasters
[3] https://edition.cnn.com/2022/01/10/weather/2021-us-billion-dollar-disasters-climate-noaa/index.html
[4] https://www.spglobal.com/en/research-insights/featured/understanding-climate-risk-at-the-asset-level-the-interplay-of-transition-and-physical-risks
[5] https://www.c2es.org/content/international-emissions/
[6] https://www.ons.gov.uk/economy/environmentalaccounts/bulletins/ukenvironmentalaccounts/2021
[7] CACEIS survey, October 2021 in partnership with Pensions Age. 130 total respondents.

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	Physical Risks	Transition Risks
What's the risk?	• Physical climate change risks include extreme weather events or the changing climate conditions	• As governments support and subsidise low-carbon industries, they are, in turn, increasingly regulating, restricting and taxing high-carbon ones
What you need to consider	• These risks can have a direct impact on areas such as company operations, disruption in supply chains or loss of real estate (floods)	• High carbon companies' operating costs may be much higher • Their business models may no longer be viable
Action	• Schemes need to consider how companies in their portfolio are mitigating future climate change risks to their operating models?	• Schemes need to consider the impact to companies of transitioning to a low-carbon economy across their entire portfolio
	• Measuring carbon footprint of scheme investments • Look at the rate of change in a company's footprint • Engagement by your asset manager	• Engagement by your asset manager

THE SOLUTION: HOW CAN TRUSTEES TAKE DECISIVE ACTION?

We have a strong belief that 'you cannot effectively manage that which you cannot accurately measure'. Although standards and definitions around ESG and climate data are not yet a perfect science, they are key to effective stewardship and governance. This means that when setting their governance framework around ESG and climate risks, trustees need to think big but start small.

Forming a viewpoint of those risks that's independent from the scheme's asset managers is a crucial first step. An independent perspective is important, especially when assessing whether a scheme's asset managers are working in line with the trustees' stated ESG and climate change policies.

For trustees, this means acquiring data that enables them to at least start understanding the ESG and climate risks within their scheme's investments.

A good starting point for trustees is to engage with service providers, such as custodians or consultants, to see whether 'out of the box' reporting solutions are available that integrate information on ESG and carbon emissions data from leading providers such as Sustainalytics or MSCI.

Measuring ESG breaches

Reports that highlight ESG risks and breaches, for example, will allow trustees to begin identifying, managing, and monitoring those risks. Trustees can set an engagement framework with their asset managers for companies or bond issuers that have the highest breaches across environmental, social or governance factors.

Trustees should consider ESG reporting solutions that measure risks against established sustainability initiatives, such as United Nations (UN) Global Compact or UN Sustainable Development Goals, which adds another layer of credibility to reporting and governance.

> Good governance means finding data solutions that show ESG breaches at an individual security level, a pooled fund or segregated mandate level, and at an overall portfolio level.

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Measuring carbon emissions

Turning to climate risks, trustees need to acquire data that measures the carbon emissions generated by the companies and bond issuers held by their pension scheme through pooled funds or segregated mandates. The table below outlines the carbon emissions metrics that can be collected to measure climate risk exposure.

Carbon Footprint Measure	Why?
Total carbon emissions	• This reports on a scheme's total CO_2 emissions attributable to their portfolio of investments • You can track the total greenhouse gas emissions and measure over time
Weighted average carbon intensity	• This measures a scheme's exposure to carbon intensive assets • You can begin to assess high carbon assets from low carbon assets

Scope	Type	What's covered?
Scope 1	Direct	• Emissions from a company or under their control, such as facilities, manufacturing processes or vehicles
Scope 2	Indirect	• Emissions incurred from electricity purchased and used by a company
Scope 3 (emissions within a company's supply chain)		• Purchased goods and services • Transport and distribution • Business travel • Employee commuting • Waste operations • Investments

With all forms of data collection, the devil is in the detail. What's important when collecting this information is the ability to 'drill down' and look at carbon emissions by security, industry, and geography across a pension scheme's portfolio. Trustees can then form an engagement plan with their asset managers based around areas of their scheme's portfolio that have the highest exposure to carbon emissions – in other words, climate risks. This information can also help inform voting policy, which plays a key role in stewardship.

Carbon emission information also helps trustees build a baseline of their scheme's carbon emissions footprint, so they can begin setting effective targets that work towards net zero. It can also identify whether certain companies or bond issuers are making headway in reducing their own carbon emissions, enriching insight for further dialogue with asset managers in how they are engaging with these entities on their carbon emissions trajectories.

Measuring climate risk exposure

Since October 2021, pension schemes over £5 billion and all master trusts must report on climate risks in line with Task Force on Climate Related Financial Disclosures (TCFD) recommendations. These rules will apply to pension schemes over £1bn in size from October 2022. However, the regulations should not be viewed as a box-ticking exercise. Climate risks have no boundaries and impact pension schemes of all sizes. Climate change is a financial risk that all schemes should be actively managing.

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CALL TO ACTION: PATHWAYS TO GOOD GOVERNANCE

The pathway to good governance? Engagement, engagement, engagement. Collecting independent data to assess ESG and climate risks can help create a stronger framework for stewardship and engagement. Trustees benefit from having greater insight, resulting in a stronger dialogue with their asset managers on how they are managing these risks. The data will also let trustees prioritise engagement with those companies or sectors with troubling ESG or carbon emissions scores. It also means they can hold their asset managers to account on how they are engaging with companies or bond issuers around these risks.

This information can also help with the key question of our time: should pension schemes disinvest or divest from higher carbon emitting companies, such as those in the oil and gas or airline sectors, or should they actively engage through their asset manager? Access to data will give trustees the confidence to independently review whether the carbon footprint trajectories of these companies is in line with published commitments, bringing more data-led insight into decision making.

Developing a consistent and consolidated viewpoint of how different asset managers are integrating ESG and Climate Risks into their investment decision making will help trustees with their governance framework. We've outlined a checklist of questions trustees can ask their asset managers to strengthen knowledge and understanding.

Question	Why it is important
How are you holding companies and bond issuers accountable for their climate commitments?	This helps determine how frequently an asset manager is engaging on the topic of climate risk with the companies or bond issuers they invest in.
How closely aligned are your voting practices with your approach to sustainability and managing climate risks?	Voting is an important tool for asset managers to hold companies accountable for their commitments to climate change.
Are you using climate scenario analysis to capture how the funds your scheme invests in will be impacted should certain climate risks materialise?	Climate scenario and 'pathway' analysis should be an important part of risk management, and investment decision making.
What data sources are you using to assess sustainability and climate risks – and what's your decision-making process when data sources conflict with your own research?	It's important to understand how sustainability and climate considerations are embedded into an investment process and how decisions are made.
Can you provide reporting within the scope of the TCFD?	With more pension schemes now reporting on climate risks in line with the TCFD framework, this will highlight whether you need to address reporting gaps for your pension scheme.

NEXT STEPS

We've outlined five goals to help trustees in setting a framework for their ESG and climate risk governance to help protect members' pension pots:

- **Start collecting your own ESG and carbon footprint data**
- **Set expectations with your asset managers in how they are engaging with companies and bond issuers on ESG and climate risks**
- **Monitor and analyse decisions on ESG and climate risks**
- **Engage with your asset manager on compliance with TCFD reporting**
- **Keep your members up to date on how you are addressing ESG and climate risks within their scheme**

Partnering with trusted sources, and creating open lines of contact with specialists, service providers and data sources, can help pension schemes and trustees unlock high quality insights and make effective data-driven decisions on ESG and climate risks.