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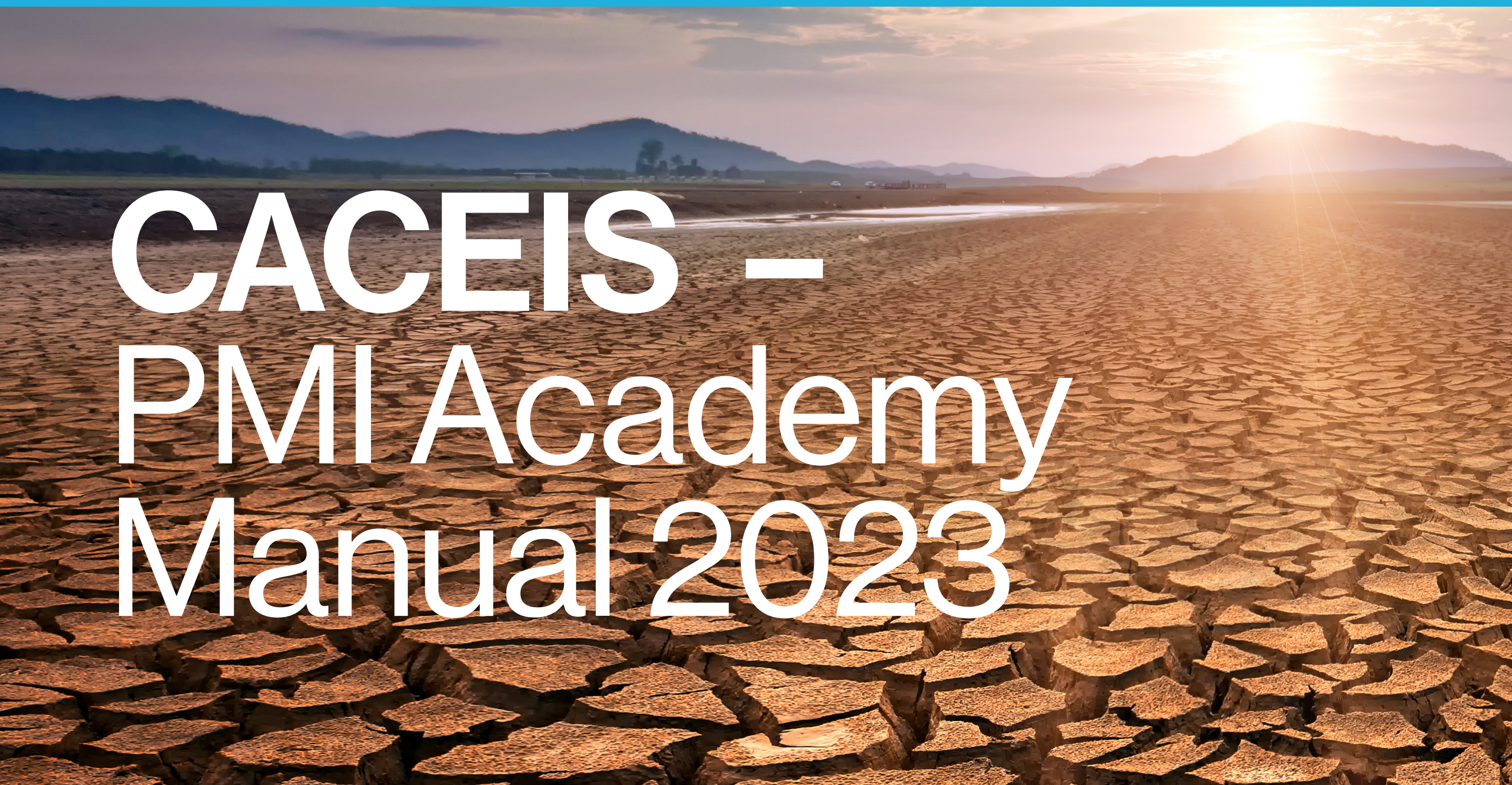

CACEIS – PMI Academy Manual 2023

This learning guide is for pension scheme trustees to help them develop a framework for their pension scheme to manage climate and nature-related risks

Pensions Management Institute
Moving pensions forward

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Climate, nature-related risks and biodiversity

Pension schemes and trustees are starting to become more familiar with climate risks, and some pension schemes even starting to put net-zero targets in place. This has been accelerated by the requirement for all pension schemes over £1bn in size (excluding insurance policies) to report on their climate risks in line with the Task Force on Climate-related Financial Disclosures (TCFD) framework.

Building a framework to manage climate risks

The first step for trustees is setting out a policy on net zero for their scheme, and determining data gaps, especially in measuring emissions performance from the segregated mandates or funds that make up their scheme's portfolio. This requires access to data on Scope 1, Scope 2 and Scope 3 (where available) emissions – each segregated mandate, total fund level and at a security level. The latter will provide insight into the highest emitters, which could put the ability to meet net zero targets at risk.

Leveraging data solution providers, including custodian banks, for this data gives trustees the ability to make independent assessments of a scheme's exposure to emissions and apply a more consistent approach to capturing this information across all asset managers. It will make the process more efficient and will strengthen governance around net zero.

Pension schemes can only plan their net zero journey when they know their baselines, and set appropriate benchmarks. To this end, data will also help pension schemes set a baseline, so they can be more informed about how emissions across their portfolio change year by year.

Another important step is to assess the ambition of asset managers and their commitment to net zero. Some of the areas that might be useful to know are

- What are their targets?
- Is emissions data reported and how frequently are they evaluating these targets?
- For individual securities that have higher emissions, and no polices to align with net zero, how do these compare relative to their peers?

Targets signify some level of commitment. However, commitments need to be credible, which requires some demonstration of how this ambition is being achieved, ideally on an annual basis. An independent review can help assess if there is alignment between the net zero goals of asset managers and the pension scheme. This step requires plenty of engagement, and we would recommend organising a series of questions to apply a consistent approach to this information gathering, which we have organised in the table below.

1	**Do you have a net zero goal in place?**
2	**How are your net zero goals integrated into each of your funds or mandates? Do you track emissions across the funds/mandates you manage for us?**
3	**Does your net zero plan integrate the regular disclosure of emissions targets?**
4	**What's your policy on companies that are not aligned to net zero?**
5	**How are you engaging with companies on net zero?**

With a framework, pension schemes trustees can begin to make a comparison across the different asset managers to see if they are 'achieving net zero', are 'aligned', 'aligning', 'committed to aligning' and 'not aligned'.

This can also form the basis of regular reviews and ongoing due diligence.

Context is also key. When pension schemes de-risk and move from equities to bonds, this can skew a scheme's metrics on net-zero. This means developing a narrative for stakeholders and members becomes very important.

Building a framework to manage nature risks and opportunities

Our impact and reliance on nature

We often take nature for granted, without realising the full extent of how dependent we all are on ecosystems. And the challenges are much closer to home than we think. To begin with, more than half (55%) of the word's gross domestic product (GDP) is moderately or highly dependent on nature[1]. This number has risen from 44% in 2020. At the same time, biodiversity is declining – in total, the world has lost 69% of its wildlife populations in the past half a century[2]. That's a staggering number.

In the UK, our river systems are crucial in providing us with freshwater for drinking and farming and in supporting biodiversity. Yet, only 14% of England's rivers are classified as being of 'good' ecological status[3].

If we are dependent on nature and we are depleting it, this creates risks for us as individuals and communities, but also for companies that rely on stocks of natural assets (sometimes referred to as natural capital). For pension scheme trustees, understanding the nature-related risks that sit in their scheme portfolios through the companies they invest into will be an important part of good governance.

[1] PWC

[2] World Wildlife Fund Living Planet Report

[3] National Geographic – based on UK Government report in 2022, a year that resulted in 375,000 recorded sewage spills into rivers and waterways in England and Wales.

A recap on the impacts to companies of nature-related risks

Physical risks
There is the potential for declining asset values for equities and corporate bonds as a result of ecological risks affecting the way that companies operate. This might impact profits or cause a market-based re-evaluation of that company because of operational risks associated with dependency on natural resources, especially if those resources become scarce or fall in quality. This could lead to an increase in raw material costs, a deterioration in supply chains, or disrupted business operations.

Regulatory and legal risks
This includes the reputation risk faced by companies that continue to have a negative impact on nature. New regulations could impose limitations on companies or impose limitations in activities that impact biodiversity. Finally, risks increase that companies will be subject to damages because of 'greenwashing' – where a company makes deceptive or misleading statements about their environmental activity or footprint.

A key factor that has to be recognised is the complexity around nature-related risks, but that should not stop pension scheme trustees from making a start. For companies, managing climate risk usually results in a focus on reducing greenhouse gas emissions. Nature is different because it is very localised. For companies, this means understanding what to do positively on biodiversity and nature-related risks is more complex.

However, frameworks such as the Task Force for Nature-Related Financial Disclosures will go a long way to helping navigate nature-related risks and opportunities.

What can pension scheme trustees do?

We've outlined a step by step approach that trustees can follow to build a governance framework for their pension scheme to manage nature-related risks.

Those trustees already familiar with the Task Force on Climate-Related Financial Disclosures,

Step 1:
A key starting point is building knowledge on nature-related risks and the impact that these can have on companies. Trustees don't need to be experts – they require enough understanding to ask the right questions of their asset managers, and assess the responses, to help them understand where all their materials risks are on nature within the pension scheme they are responsible for. Some service providers also provide education in this area.

Step 2:
Trustees can map the list of the industry sectors that have the highest impact to nature-related risks against the sector allocation of their pension scheme. They can then begin to determine where their exposures to nature-related risks lie. We've outlined some of these sectors below.

There are also tools available for trustees to use. ENCORE, which was developed by the Natural Capita Finance Alliance, is an online tool that helps map high priority sectors.

Trustees can then use this information to analyse and assess where the largest nature-related risks might be embedded within their pension scheme's portfolio. They can then use this knowledge to have a more robust dialogue with their asset managers on nature-related risks.

Sectors	Challenges
Construction, energy, paper, tobacco across the supply chain, personal care	Companies reliant on wood as a natural resource or changing land use from forests to agriculture
Food businesses across the food supply chain	Global food production is the largest contributory factor to loss of biodiversity. Companies in this sector are also more vulnerable to threats such as loss of pollinators, deforestation, erosion and declining soil fertility
Fashion or other heavy water usage industries such as computer chip manufacturers	Companies in these industries have a high impact on the environment through their usage of water. Managing and limiting water usage will be a crucial part of how they limit their impact on nature.
Minerals and extractive industries	Industries that have an impact on nature and the local environment, particularly in areas deemed to be ecologically sensitive.

Step 3:
With this information, trustees can then establish a high level framework on nature. To begin with, it can cover the themes and beliefs that are important to trustees, the pensions scheme and where relevant, the sponsoring company. It could also include some high level goals – for example, to understand the scheme's exposure to nature-related risks. This can then help establish a meaningful dialogue with asset managers on alignment of beliefs and highlight the scheme's expectations from their asset managers on areas like reporting and transparency on nature-related risks

Step 4:
Engage with your asset managers on their biodiversity-related risk assessment and stewardship activities being conducted with the companies they invest in. Are they 'ground truthing' – conducting on-the-ground due diligence on the supply chains of the companies they are investing in? Most nature-related risks are actually found in the supply chains of companies.

Trustees can also engage with their scheme's asset managers on how they are allocating capital to companies or sectors that are avoiding or reducing nature-related risks.

Approaching each asset manager consistently can make the engagement process, and analysis from it, more efficient. We've provided a list of questions that trustees can ask when engaging their asset managers on nature-related risks.

Step 5:
Become familiar with the Task Force for Nature-Related Financial Disclosures (TNFD). Many trustees have now become familiar with the Task Force for Climate-related Financial Disclosures framework (TCFD), and when reviewing TNFD, they'll notice some strong similarities, which we believe will accelerate the adoption of TNFD. Furthermore, being informed about the framework and the metrics required will help in any dialogue with asset managers about how they are assessing and managing nature-related risks and opportunities from the companies they are investing into within their pooled funds or across segregated mandates.

Nature and fiduciary duty

Biodiversity loss and the degradation of nature is another risk that needs to be managed and will form an important part of the fiduciary duty of pension scheme trustees. The threat of biodiversity loss is now becoming more widely recognised and in the World Economic Forum's Global Risk Report 2023, biodiversity and ecosystem collapse was cited as the fourth-largest global risk over the next decade.

We should also expect focus on these issues to intensify, which will place more scrutiny on pension schemes. The United Nation's Biodiversity Conference (COP 15) late last year was an important global stage to elevate the challenges we face with biodiversity loss, and more recently, the launch of the TNFD framework will amplify the understanding of nature-related risks and their impact to investments.

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