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PENSIONS WATCH – ISSUE 7: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

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In this edition we focus on why, how and to what extent climate change risk management has been dialled up by recent legislation, regulation and global collaborations and why this matters.

Moving the climate risk management agenda forward

> *"The global firepower of institutional investors must be harnessed and directed towards a net zero future… I greatly welcome those investors who are already… align[ing] their future returns with the future of our planet."*
>
> **HRH Prince of Wales,**
> **Foreword, IIGCC Net Zero Investment Framework Implementation Guide, March 2021.**[1]

The Pensions Scheme Act 2021, although a long time coming, was worth the wait – not least given the many measures it contains to further enhance the security of scheme members' benefits and retirement outcomes. Central to these objectives was mandating the recent DWP (Department of Work and Pensions) initiative to improve the assessment and reporting of climate risks for the UK's most impactful trust-based pension schemes.

Fully endorsed by The Pensions Regulator (TPR) in its recently published climate change strategy,[2] and with a phased roll out, starting on 1 October 2021, the measures will ultimately apply to defined benefit (DB) schemes with £1bn+ of assets, all master trusts and collective defined contribution (CDC) schemes.[3] Encapsulating the setting of strategic goals, scenario planning, risk assessment and performance measurement, Trustees of those schemes captured under the legislation will need to report on the total Greenhouse Gas (GHG) emissions ("absolute emissions") of their asset portfolios, the total CO_2 emissions per unit of currency invested ("emissions intensity"), and an additional climate metric, unconnected to the previous two[4] – assessing each at least annually and conducting a scenario analysis in year one and then at least triennially.

This reporting will be in a prescribed format, which complies with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), and published in a transparent manner on a publicly accessible website.[5] Crucially, rather than simply being a tick-box exercise, the TCFD disclosures should help Trustees better understand, assess and manage climate risks as they seek to both mitigate the physical and transition risks of moving to a climate-resilient economy and capture the opportunities arising from each.[6] Moreover, for DB schemes this risk assessment extends beyond just considering the assets, by helping to pinpoint the potential impact of climate change on sponsor covenant strength and the scheme's liabilities.

[1] See: https://www.parisalignedinvestment.org/media/2021/03/PAII-Net-Zero-Investment-Framework_Implementation-Guide.pdf
[2] TPR's climate change strategy was published on 7 April 2021. See: https://www.thepensionsregulator.gov.uk/en/document-library/strategy-and-policy/climate-change-strategy
[3] The DWP will determine in 2H23 whether the requirements should be extended to sub-£1bntrust-based schemes from 2024/25.
[4] Such as a portfolio alignment metric or a climate value at risk measure.
[5] The reporting should separate the Scope 1 and 2 emissions of scheme assets from Scope 3. As to what Scopes 1,2 and 3 comprise, see: There is no Planet B: Why climate change risk management is the world's hottest topic and how asset owners and asset managers should be responding. Chris Wagstaff. Columbia Threadneedle Investments. June 2020. p.18 and pp.29-30.
[6] More specifically, the TCFD disclosure framework requires action under four headings: Governance (identifying and managing risks and opportunities), Strategy (assessing the impact of these risks and opportunities on short and long term business strategy), Risk management (enhancing risk management to capture these risks) and Metrics and targets (understanding these in the assessment and management of climate risks).

Suffice to say, TPR continues to warn *all* Trustees of their fiduciary duty to address the risks posed by climate change and the need to integrate climate change within all decision-making.[7] However, to enhance Trustees' understanding of climate-related risk and opportunities and to support Trustees in achieving best practice, the regulator will shortly issue Trustee guidance on the TCFD disclosures and an update to its Trustee Toolkit.[8]

Wield a stick or dangle a carrot to enact change?

Of course, whether the legislation and TPR's climate change strategy go far enough to move the climate risk management dial sufficiently further forward by maximising the game changing potential of the UK's £2.5tn of pension scheme assets,[9] is another matter. While some schemes undoubtedly need a nudge from regulation and legislation to make the necessary changes to their risk management, there are many others with the foresight and sufficiently advanced investment governance, for whom being ahead of the curve with little, if any, prompting is the obvious path to take. NEST, the Brunel Pensions Partnership and the National Grid UK Pension Scheme are but a handful of prominent examples of the latter, making moves to align their portfolios to the goals of the Paris Agreement,[10] each recognising the systemic and financially material risk climate change potentially presents to the security of member benefits.

The IIGCC Net Zero Investment Framework 1.0

This move towards aligning portfolios with the Paris Agreement, so far enacted mainly by the UK's largest schemes, will undoubtedly be given a shot in the arm by the recently launched Institutional Investors Group on Climate Change (IIGCC) Net Zero Investment Framework 1.0.[11] Based on the expectation that governments and policymakers will deliver on commitments to achieve the +1.5°C temperature goal of the Paris Agreement, the Net Zero Investment Framework seeks to change the dynamics of the investment world by setting out the key actions and methodologies that can be used by asset managers and asset owners to implement a Paris Agreement-aligned investment strategy.

In essence, this comprises decarbonising investment portfolios in a way that is consistent with achieving global net zero GHG emissions by 2050, while increasing investment in the range of climate solutions needed to meet that goal. While the current framework focuses on four asset classes – sovereign bonds, corporate bonds, listed equity and real estate – version 2.0 of the framework, planned to be released in advance of COP26 this November,[12] will evolve best practice in relation to methodologies and approaches pertinent to these and two other asset classes: infrastructure and private equity.

Why does all of this matter?

Transitioning to a low carbon, and ultimately a net zero emissions, economy (like any disruptive force) will invariably result in winners and losers. While some companies and economic sectors will disappear, or experience higher costs of doing business. Others with the foresight and the ability to reinvent themselves – by transitioning to new low carbon technologies and/or offsetting their carbon emissions through carbon-capture technologies – stand to prosper, alongside those market entrants who emerge to tap into new areas of demand. Of particular concern are the potentially monumental declines in the physical asset values of those companies that fail to anticipate regulatory, reputational and, particularly, transition risks or those unable to reinvent themselves. In extremis, many assets will be rendered uneconomic and, in popular parlance, become stranded.[13]

In such a scenario, this would leave those pension schemes that fail to act, exposed to unacceptably high and largely unmanageable risks – risks that should be identified, evaluated and managed far in advance of their impact materialising. Indeed, there is a very real risk of financial assets with either prominent underlying climate risks or strong climate-friendly credentials being materially repriced far in advance of company balance sheets, physical assets and the real economy being impacted. Therefore, if these asset repricing risks, which might otherwise compromise the ability to generate long-run sustainable returns, are to be properly managed, there is a potential first mover advantage to pension funds of overcoming the myopia surrounding climate change risk management.

Ultimately, we need to create a UK pensions system that has resilience to both transition and physical climate risks. While legislation and regulation go some way to achieving this, collaborative asset manager- and asset owner-inspired measures are ultimately needed to square the climate risk management circle.

[7] For example, on or before 1 October 2021, all trust-based pension schemes with 100 or more members must set out, within their statement of investment principles (SIP), their policy on financially material climate risks pertaining to their scheme, publishing this with their implementation statement (which discloses the extent to which the Trustees have followed the objectives and policies set out in their SIP) on a publicly accessible website.
[8] See: https://www.thepensionsregulator.gov.uk/en/document-library/strategy-and-policy/climate-change-strategy
[9] Thinking Ahead Institute. Global Pension Assets Study 2020. WTW. December 2020. p.13. US$3.45tn converted at the USD:GBP exchange rate of 0.72.
[10] Coming into force in November 2016, following ratification by 146 countries, the Paris Agreement's central aim has been to strengthen the global response to the threat of climate change by keeping the global temperature rise this century *well below* 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5°C.
[11] The Net Zero Investment Framework started life in May 2019, with the backing of 110 institutional investors representing US$33tn in assets, as the Institutional Investors Group on Climate Change (IIGCC) Paris Aligned Investment Initiative (PAII). By March 2021, the initiative had grown into a global collaboration supported by four regional investor networks [Asia Investor Group on Climate Change (AIGCC) – Asia; Ceres – North America; Investor Group on Climate Change (IGCC) – Australasia; Institutional Investors Group on Climate Change (IIGCC) – Europe] all of whom engaged in the development of, what has now become, The Net Zero Investment Framework 1.0.
[12] See: https://ukcop26.org/
[13] For instance, if government policies were to align with limiting the post-industrial increase in global temperatures to 1.5°C, then a whopping 84% of remaining fossil fuels would need to be left in the ground, resulting in an estimated US$900bn of coal, oil and gas assets becoming stranded. See: There is no Planet B (June 2020). op.cit.p.14.

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