Spotlight on Pensions
PRESENTS
Le Grand View

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Pension schemes vs climate change: leading the way?

Managing climate change is firmly on the agenda. The effects of rising global temperatures are now becoming noticeable to all, without the need for sophisticated measuring instruments.

Following the goal set in the 2015 Paris Agreement to hold the increase in the global average temperature to well below 2 degrees centigrade above pre-industrial levels, signatory countries are putting in place action plans to reduce their carbon output.

Both as a response to those and in many cases also because it is good business, private organisations are also starting to implement practical measures of their own. These measures are becoming more visible, acting as a reminder, if one were needed, that remedial actions will impact our lives in many ways from now on. One only has to go to a motorway service area or hotel car park to see the growing number of charging points for electric vehicles, for example.

Many believe that the Paris Agreement's core objective is too optimistic and is not attainable. Indeed, there is growing scientific evidence that we may have already gone past the point where the maximum 2 degree increase can be met.

Given the extent to which carbon emissions are fundamental to our current way of life, achieving the level of reduction implied by the Paris Agreement will be challenging, to say the least. The recent lockdown due to Covid-19 has graphically demonstrated the economic impact of making drastic changes to our daily lives. Furthermore, the distortions that can arise from limited interventions, such as the gradual easing of restrictions including the instruction to use private cars in preference to public transport, illustrate the impacts that altering one aspect of behaviour can have upon the overall emissions reduction effort.

Yet it is clear that major changes must be made. It is also clear that, as with the fight against Covid-19, everyone is potentially impacted and has a role to play. It is relatively easy to understand the impact of using vehicles powered by burning fossil fuels and to accept a state-mandated move towards more environmentally friendly alternatives. Perhaps more difficult to grasp is the impact of, and upon, the investments we make, both directly and indirectly through collective arrangements such as pension schemes.

Pension schemes' contribution

Our government is gradually developing policies to address areas of our lives where climate change control measures must be taken. In this vein the Department for Work and Pensions (DWP) has consulted on proposals for new requirements for pension schemes. The focus is on climate risk governance and mandatory compliance with the 11 recommendations of the international Task Force on Climate-related Financial Disclosures (TCFD). It is intended that the current Pension Schemes Bill will contain powers to make appropriate regulations.

The consultation document identifies practical implications for the financial system, through two main channels:

- **Physical risks** - the physical impacts that climate change is already bringing and will continue to bring in the event of global average temperature rise (global warming). Risks include the rise in sea levels, with impacts such as flooded industrial sites and mass migration, as well as phenomena such as increased rate of extreme weather events which threaten physical assets and disrupt supply chains; and
- **Transition risks** - the risks associated with action to tackle climate change. In order to realign our economic system towards low carbon, climate-resilient solutions, what regulations, behavioural changes, structural readjustment will take place and how will that affect current and future investments? Such risks include the future change in the energy mix on which the world depends or new, climate conscious consumer trends.

Worryingly, recent research by the International Monetary Fund has specifically identified that stock prices do not reflect future climate risk, observing "a sudden shift in investors' perception of this future risk could lead to a drop in asset values, generating a ripple effect on investor portfolios and financial institutions' balance sheets". Such a shift could occur at any time, and without warning.

The risk to pension schemes and members - and to the wider community - is clear. It adds a more immediate and practical justification for new mandatory rules requiring action, building upon recent new requirements around schemes' statements of investment principles.

New disclosure

The proposed new rules will require climate-related financial disclosures in four categories:

- **Governance** - the organisation's governance around climate-related risks and opportunities
- **Strategy** – the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning
- **Risk management** – the processes used by the organisation to identify, assess and manage climate-related risks
- **Metrics and targets** – the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

These disclosures will be required from all organisations in which pensions schemes are likely to invest, as well as from schemes themselves, in respect of their own positions. Clearly, in order to make the required disclosures, background work upon which the reporting will be based will need to be undertaken. This implies a significant increase in schemes' workloads.

Implementation timetable

Recognising the additional burden, DWP's proposal is to stagger the implementation of the new requirements according to scheme asset size. There are detailed and complicated proposals in the consultation document, but broadly reports under the new regime would be required from schemes with £5bn or more of assets by the end of 2022 at the very latest, and from schemes with £1bn or more one year later.

It is then proposed to review in 2024 the effectiveness of TCFD-aligned reporting and governance measures. That review will also consider extending the requirements to smaller schemes.

More to come

It is also important to note that these new regulations are only the latest step in a continuing process, which will impact schemes' workloads over the coming years. One interesting idea picked up by the consultation document is of being able to identify the "implied temperature rise" from a particular activity, or from an investment portfolio. Although challenging to quantify, this is seen as a useful contributor to understanding the impact on the climate of particular actions and to helping everyone in their efforts to control temperature rises. The consultation document includes an intention to devise a way of measuring this and then to require schemes to implement it. Such an assessment basis, more widely adopted, could also clearly be used to underpin the development of wider taxation policies with a climate-impact focus.

Given the size and importance of pension schemes and their role as investors, it is inevitable that they will be subjected to regulation over their climate impact.

Dawning implications

Most people are now aware of the climate change issue and the connection with rising average global temperatures. They are also beginning to appreciate some of the actions that will need to be taken if this is to be prevented from destroying the planet. But the full picture of the likely regulatory-driven changes needed in our everyday lives is far from complete. This consultation gives a taste of the kind of complications involved, in one area. In case anyone was in any doubt, the impact will be widespread and significant.

Pension scheme impacts

Given the size and importance of pension schemes and their role as investors, it is inevitable that they will be subjected to regulation over their climate impact. The resultant increased workloads will undoubtedly increase the size below which viability as an independent scheme is called into question, hastening the consolidation movement already underway. For example, the pensions minister has made clear his enthusiasm for the new superfunds, an enthusiasm which he says is shared by the DWP, The Pensions Regulator and the Pension Protection Fund. Smaller schemes will find it increasingly difficult to swim against the consolidation tide, if that is their choice.

From a slow start, anecdotal evidence suggests that schemes are now embracing climate control issues in their investment considerations, in growing numbers. As a new area of focus, it will take time to devise an effective response and develop appropriate procedures, including reporting to enable scrutiny. Aside from its specific proposals, this consultation gives some useful pointers on how requirements upon schemes are likely to develop going forward, with implications for the wider community.

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