

INVESTOR REPORT | September 2016

The hot debate on climate risk and pension investments: Does practice stack up against the law?

ShareAction»



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Introduction

ClientEarth and ShareAction established a project in 2015 which set out to clarify the legal obligations of UK pension fund trustees and their asset managers to assess and manage climate and carbon-related financial risks (“climate risk”). Through this process, we engaged with the legal and investment communities to promote discussion and gain feedback on how climate risk features in the investment decision-making process of pension funds. This report sets out the responses from these interactions, and our legal analysis where considered relevant.

Climate change poses potentially significant financial risks to pension funds and their members. According to the Economist Intelligence Unit, a scenario of 6°C warming could lead to a present value loss of US\$13.8 trillion of manageable financial assets, roughly 10% of the global total (i.e. total stock of assets held by non-bank financial institutions).¹ At the same time, if the investment system does not take steps to move towards a low-carbon economy, then it could be left with as much as US\$100 trillion in “stranded” fossil fuel assets by 2050, according to Citigroup.² A recent report by the University of Cambridge Institute for Sustainability Leadership, “Unhedgeable risk: How climate change sentiment impacts investment”, argues that the systemic nature of climate risk means that a portion of the risk is unhedgeable for individual funds and that avoiding such risk will require system-wide approaches, such as strong regulation.³

Trustees’ legal duties require them to address material financial risks to the fund. They need to show that they have taken appropriate advice,⁴ equipped themselves with appropriate knowledge⁵ and considered relevant issues during the investment decision-making process.⁶ Pension fund trustees can delegate investment powers to asset managers, but trustees retain supervisory and overall strategic decision-making powers. That is to say, trustees will retain ultimate responsibility for the acts or defaults of their asset managers if they have not taken all reasonable steps to satisfy themselves that their asset managers: have the appropriate knowledge and experience to manage scheme investments;⁷ are carrying out their work competently;⁸ and are exercising their powers of investment in accordance with the law.⁹

The prudence test should also be understood as requiring that trustees and their asset managers are aware of good practice within the pensions and investment sectors. This may mean learning from those who are showing leadership in these sectors, for example, by incorporating publicly available information on climate risk assessment into their financial risk assessment practices, or are at the very least considering whether they should take similar action. Indeed, the actions of industry leaders,ⁱ particularly post-Paris, should have sent a strong signal to trustees that the financial risks associated with climate change should be factored into risk assessment practices.

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Growing numbers of mainstream investors are recognising that climate risk is likely to be financially material to investment portfolios. The direction of travel for climate change policy and the projected implications of climate change itself clearly indicate that climate risk needs to be managed now in order to prevent serious future financial consequences and/or detriment to portfolio value. Trustees, on the other hand, often interpret their legal and fiduciary duties narrowly, prioritising short-term financial return over the serious financial risks that climate change poses to assets, investments, pension pots, and the wider economy.

i | A range of pension funds are already incorporating climate change risk assessment in their investment decision-making practice, including the Environment Agency Pension Fund, BT Pension Fund, Nordea, Calpers and France’s public sector ERAPF fund.

Trustees often cite legal advice as the reason for not considering climate risk when making investment decisions; that doing so is somehow incompatible with their legal and fiduciary duties. This, of course, is a flawed interpretation of the legal and investment responsibilities of pension fund trustees.

What is “climate risk”?

Before we look at the responses, it is important to consider the concept of “climate risk” or, more specifically, the financial risks associated with climate change. We are concerned here with three sources:

Financial risk from the physical impacts of climate change

The physical impacts of climate change, particularly those caused by extreme weather events, could detrimentally impact on the economic value of a wide set of asset classes (e.g. property, timberland, agriculture, and infrastructure assets such as telecommunications, power plants, coastal oil refineries, ports, airports, roads and railway). While this places current business models and assets at risk, it also provides opportunities for adaptation solutions and resilient infrastructure.¹⁰

“ The value at risk associated with an altered climate may already be material, and investors who bet heavily in the wrong direction could do systemic damage to the financial system.

Financial risk from the transition to a low-carbon economy

Changes in policy and market variables from transitioning to a low-carbon economy may influence the relative economics of goods and services (e.g. carbon tax, fuel economy mandates, a drop in costs of renewable energy, changes in commodity prices etc.). The frequently discussed risk under this category is that of “stranded assets” from unburnable carbon. This refers to assets that lose their value or turn into liabilities before the end of their economic life cycle. As well as potentially

jeopardising the economic stability of carbon-heavy industries, transition risk is also projected to have a potentially detrimental impact on the institutions that invest in these industries, including pension funds (i.e. those institutions that continue to engage in business-as-usual behaviour).

Systemic financial risk

Physical and transition risks have the potential to scale into systemic risk to the global economy. According to Howard Covington, the value at risk associated with an altered climate may already be material, and investors “who bet heavily in the wrong direction could do systemic damage to the financial system”.¹¹

Methodology

To explore the extent to which climate risk is being measured and managed by pension trustees and their asset managers, we have used a combination of analytical approaches. Over the course of eight months, ShareAction and ClientEarth have organised a series of meetings and events with lawyers, actuaries, investment consultants, asset managers, trustees and civil society groups. This included an event held in July 2016 (“July event”) to mark the second anniversary of the Law Commission’s 2014 report, *Fiduciary Duties of Investment Intermediaries* (“Law Commission report”).¹² The then Minister of State for Pensions and pensions expert, Baroness Ros Altmann, and the ex-Law Commissioner who led the review, David Hertzell, both spoke at the event, together with five key industry figures. We also worked with Professional Pensions to develop a survey of pension industry subscribers (“Professional Pensions survey”), which was conducted on 22 August 2016 and attracted 101 respondents.¹³

Through this series of meetings, events and surveys, we raised and discussed a number of questions, including:

- Do pension trustees and their advisers see climate risk as financially material to their portfolios?
- What barriers prevent climate risk being taken into account in pension investment decisions?
- What needs to happen to allow climate risk to be considered more fully in pension investment decisions?

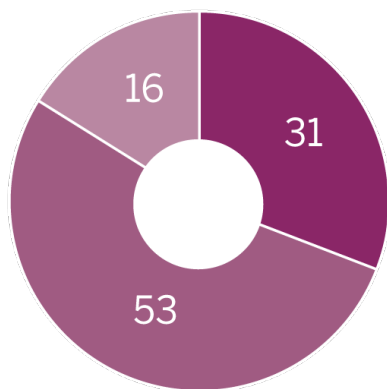
We set out our findings in the body of this report.

Research questions

Do pension trustees and their advisers see climate risk as financially material to their portfolios?

53% of respondents to the Professional Pensions survey said that they do not see climate change as posing financially material risk to their own or their clients' portfolios. Some dismissed the notion of climate change, while others said it has to be taken into consideration alongside other factors. One commentator said, "Climate change is an overblown nonsense whose so-called catastrophic consequences are perpetuated by the climate change doom-mongers who need to keep the discredited idea going to justify their jobs." However, 31% disagreed. One respondent

Do you see climate risk as a financially material risk to your portfolio or those of your clients?



-
- **31% Yes**
 - **53% No**
 - **16% Don't know**
-

commented, "Ultimately the long-term impact of unchecked climate change will have profound impacts on the world and inevitably impact investments". Another said, "You would have to be a fool not to take into account the risks of climate change". Yet, the same person also warned, "there is also the 'risk' that climate change will not prove to be as extreme as some (but not all) scientists think, thus leaving schemes with inappropriate portfolios".

One in eight said they did not know whether they saw climate change as a financially material risk.

In discussions, the key reasons given for taking account of climate risk in pension investments were: (a) the likelihood of climate change being a significant financial factor for pension funds given their long-term investment horizons; and (b) a belief in the wider societal importance of addressing climate change.

David Hertzell emphasised in his presentation at the July event that pension funds need to pay attention to long-term priorities such as climate change due to the long-term nature of their investment horizons. He commented that the first discussions around short-termism were around the collapse of the UK manufacturing industry. While this concern is now less apparent, the focus has shifted to: (a) funding longevity; and (b) whether the investment decisions we are making are contributing to long-term problems, ultimately damaging the returns we are seeking to protect.

What barriers prevent climate risk being taken into account in pension investment decisions?

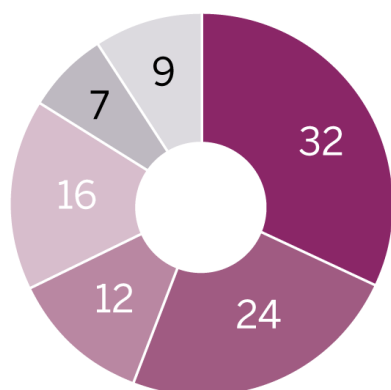
One-third of survey respondents said that trustee boards' perception of climate risk is the main barrier to its consideration in pension investment decisions. One respondent said that it was lower down on the list of priorities for many clients. Another commented that there was a lack of trustee understanding as to what climate risk actually meant.

One respondent argued that while climate change is a major problem, environmental, social and governance ("ESG") risks are being driven by politics rather than by economic logic. The same person added, "If you really are concerned about climate change you should be making major changes to your lifestyle, not ticking a box by avoiding investing in firms whose products you still use."

Another respondent said, "Given the state of the deficits, and the investment outlook, it's all about return." One person challenged the premise of the question and said, "Your question takes it as given that all trustee boards should be considering climate risk - I don't agree."

Failure of advisers to discuss risks with clients

What barriers prevent climate risk being taken into account in pension investment decisions?



- **32%** Trustee boards do not see climate risk as a sufficiently high risk factor
 - **24%** Advisers not talking to trustee boards about climate risk
 - **12%** Additional expense of investment
 - **16%** Lack of legal clarity as to whether climate risk can be taken into account
 - **7%** Incentives creating short-term thinking
 - **9%** Other
-

24% of survey respondents said that the main barrier to climate risk being taken into account in pension investments was the failure of advisers to discuss it with their clients. One person said, “Advisers need to highlight it more for it to be considered more fully in pension investment decisions”. Another commented, “It’s not on the ‘sell LDI’ⁱⁱ crib sheet for consultants”.

Mike Clark, previously of Russell Investments and now Founder Director of Ario Advisory, stated in his presentation at the July event that he had once heard an asset owner say investment consultants were not proactive enough on these issues, and an investment consultant responded, “well, you never ask”. He said that this exchange highlighted the dichotomy in the system. One lawyer commented that asset managers are passing the buck if they say that they cannot take ESG factors into account where it is not in the mandate, as it is fundamentally their responsibility to assess and manage risk.

Expense

We heard from one lawyer that the additional expense of taking into account ESG factors such as climate risk in investments for defined benefit schemes could not be justified from a legal perspective unless there were financial benefits for the employer. For example, if the employer’s unique selling point was that they were an environmentally and socially responsible business, then their pension investments would need to reflect that to avoid reputational damage. Her view was that this was the only means of justifying investment decisions that incorporated factors such as climate risk. A sustainability consultant expressed concern about the potential increased costs for schemes should prescriptive regulations be put into place.

Lack of legal clarity

16% of survey respondents identified a lack of legal clarity as to whether climate risk can be taken into account by trustees as the main barrier to its incorporation in investment decisions. The Law Commission report recommended that the Occupational Pension Schemes (Investment) Regulations 2005 (“Investment Regulations”)¹⁴ should be reviewed to provide clarity for trustees on the extent to which they may consider ESG factors in investment.

The UK Government launched a consultation on how to implement the Law Commission’s recommendations in 2015 but said there was insufficient consensus among consultation respondents for amending the Investment Regulations. Currently, the Regulations state that trustees are obliged to prepare a written statement of investment principles (“SIP”) which must cover

the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. The conflation of financial and non-financial factors in the Investment Regulations was cited by many respondents to the consultation as a cause for confusion.

“ 16% of survey respondents identified a lack of legal clarity as to whether climate risk can be taken into account by trustees as the main barrier to its incorporation in investment decisions.”

The Investment Regulations require that the investment of scheme assets should be in the best interests of members and beneficiaries.¹⁵ However, trustees and their advisers have tended to interpret this duty as an obligation to maximise portfolio returns, potentially at the expense of considering longer-term risks. This may jeopardise other trustee duties, such as investing assets in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.¹⁶ The Law Commission report clarified that “trustees are not required to ‘maximise returns’”. Trustees must weigh returns against risks, including long-term risks.”¹⁷ The report also clarified that trustees should take into account factors such as climate risk in making investment decisions where they are financially material.¹⁸ However, as the survey data in this report strongly indicates, many schemes are still failing to take financially material risks like climate risk into account, believing that they have to focus solely on short-term returns.

David Hertzell said that the decision not to amend the Investment Regulations has left us with outdated terminology and that he was not convinced that

most trustees would be able to sort their way through that confusion. He felt that the result would be caution and a lack of significant change to the status quo.

George Latham of WHEB Asset Management also commented at the July event that we need further clarification of fiduciary duty, saying that asset owners still use fiduciary duty as a reason for not engaging on longer-term issues. We spoke with several lawyers who emphasised that there was still a misconception around ESG issues for trustees, seeing them as solely “ethical” and non-financial. These lawyers said that there was a need to promote understanding of the distinction between financial and non-financial factors for trustees, and that trustees tend to think they know what they will be advised without consulting lawyers. One lawyer noted that the charging structures in law firms combined with trustees’ focus on minimising costs often meant that trustees fail to ask for legal advice when they should.

An additional source of confusion was a misconception of the legal position where trustees delegate to their asset managers. One lawyer commented that many trustees do not have the skills to adequately track the extent to which their asset managers monitor and manage long-term risks such as climate risk. In answer to a question about how far ESG factors such as climate risk are taken into account in investments, one survey respondent said, “It is a factor in manager selection but beyond that we depend on managers for individual decisions” and another commented, “We use fund managers and get comfortable they have strong governance”.

However, pension fund trustees’ legal duties to act in the best interests of members, to exercise “prudent” investment behaviour and to balance risks against returns cannot be wholly delegated to fund managers. Trustees must still comply with these duties when undertaking the functions that have not been delegated. The day-to-day investment decisions, such as the types of investments to hold, may be delegated to asset managers but trustees retain supervisory and overall strategic decision-making power. This normally includes determining the overall investment objectives and making strategic investment decisions, such as the risk/return profile appropriate to the membership.

Trustees also retain legal responsibility for

monitoring asset managers. They will not be held responsible for the acts or defaults of asset managers as long as they have taken all reasonable steps to satisfy themselves that their asset managers: have the appropriate knowledge and experience to manage scheme investments;¹⁹ are carrying out their work competently;²⁰ and are complying with the Investment Regulations.²¹ It is concerning that some trustees do not appear to have the skills or resources necessary to undertake these crucial aspects of their duties.

“Difficulty in quantifying relevant risks does not mean that trustees are relieved of their obligation to manage them. Indeed, trustees are legally obliged to assess and manage material financial risk and climate risk should be no different.”

Lack of clear analysis

Several survey respondents highlighted the lack of clarity around climate change as an investment risk. One respondent said in response to the question about whether climate risk is financially material, “Climate risk is undoubtedly a risk, but we have no idea what we should do to reduce that risk. Until this becomes clearer, we believe the only logical thing to do is to ignore it.” A lack of clear analysis of investment risk, lack of knowledge on what to do to alleviate climate risk in investment terms, and the absence of climate-related reporting by companies were flagged as particular problems.

As Sarah Barker observes in her recent paper, the above may be due to pervasive uncertainty

regarding the speed, magnitude and distribution of climate change impacts, resulting in paralysis in the development of an appropriate strategic response (or “uncertainty paralysis”). However, as she rightly points out, difficulty in quantifying relevant risks does not mean that trustees are relieved of their obligation to manage them.²² Indeed, trustees are legally obliged to assess and manage material financial risk and climate risk should be no different.

Difficulty of trustees’ role and “group think”

All of the lawyers we spoke with said that trustees are in a very difficult position and face numerous challenges, and this often means that climate risk is not a priority. One lawyer in particular commented that trustees are cautious about being seen to be ahead of the curve or acting in ways which would be considered unusual by their peers. In her article, Sarah Barker identifies this as “standards-based conduct”, that is, defaulting to compliance with industry standards/norms. As she concludes, however, inaction on this basis is unlikely to conform to trustees’ duties of exercising due care, skill and diligence on behalf of beneficiaries.²³

Perceived lack of relevance

One investment consultant stated that belief in the pensions and investment world that climate change exists is high but belief that it is relevant to their investments is low. One survey respondent said that they were doubtful of its relevance, and another respondent said that they had more pressing priorities than climate risk.

Several lawyers linked a lack of trustee interest in climate risk to a lack of diversity on trustee boards and a need for education on the financial implications of climate issues. One lawyer commented that trustees are often not financially qualified, older, conservative (with a small ‘c’) and sceptical of the importance of climate risk. One survey respondent said that the age of the average trustee makes them averse to change.

One lawyer said that part of the problem was that trustees are unable to take their own beliefs into account and therefore need to be more convinced than a person managing their own money. She also commented that a paradigm shift would be required for pension funds to start taking climate

risk seriously. For example, corporate social responsibility is now taken very seriously, whereas it was once quite radical. She said that this shift could potentially be promoted by something like a hugely successful environmental-focused fund, but should be assisted by prods from government.

A pension actuary commented that he had not taken climate risk into account when advising his clients as they were small funds with mature schemes invested in institutional funds. He said that, in these cases, climate risk was swamped by other risks. Another pension actuary said that he had not done so because the client was at the beginning of their journey on considering sustainability concerns, and that it had been necessary to take small steps.

Changes to trustee role

An investment consultant commented that trustees had been forced to adopt a market-efficient position as a result of regulatory changes in recent years. He said that changes to the regulatory environment had required them to use mathematical models rather than their own judgement, causing short-term risk management and loss of skills.

Short-termism and incentives

Baroness Altmann commented in her presentation at the July event that pension fund management is about more than asset management, since pension funds need to consider meeting specific long-term liabilities, rather than just maximising returns.

George Latham commented that current incentives encourage asset managers to think short-term, and there is a need to change reporting requirements to shift this focus away from short-term performance.

One lawyer identified barriers associated with short-termism, including the usual brevity of trustees' term of office, asset managers being assessed on a short-term basis and human beings in general not being long-term thinkers. Another lawyer said that requirements for pension funds to report on a quarterly basis made it harder to hold onto an asset manager or asset if they or it were underperforming. A sustainability consultant commented that savers' ability to look at the performance of their pension online could lead to a focus on short-term performance on the part of pension funds. A survey respondent said, "I do not believe that any trustee board believes that they are not allowed to consider climate change risk. If ESG issues are not considered enough according to some people's

opinions, it will be because there is always another short-term crisis that boards have to address." One survey respondent commented, "short-termism rules the day".

Scale of pension schemes

An investment consultant commented that most pension schemes do not operate at a size to do strategic asset allocation in the way the law imagines they can. A lawyer agreed that smaller schemes have far less influence on issues such as climate risk. One survey respondent said that while they considered climate risk to be financially material, they administer two small schemes and do not have the resources to monitor investments for ESG compliance adding, "It is the investment managers who should offer ESG wrappers".

“ Apart from the Red Line initiative and good work on governance by the likes of [LGIM] and Newton, pooled fund investors tend to feel powerless.

Anonymous comment,
Professional Pensions survey

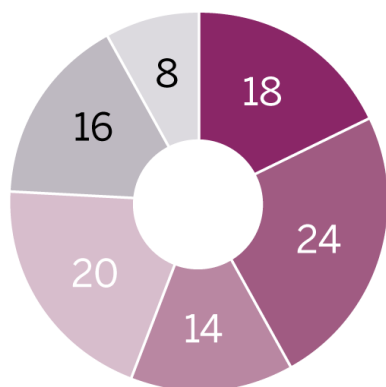
Baroness Altmann suggested that pooled funds can help pension funds wishing to access a diversified range of climate friendly long-term investments and manager expertise in a more cost-effective manner than would be possible for each pension fund individually. Janice Turner of the Association of Member Nominated Trustees ("AMNT") said at the July event that many investors had discovered in the shareholder spring of 2012 that they were unable to set a responsible investment policy, having been told by their investment consultants that they were too small to become involved in responsible investment. She pointed out that this was a huge

issue, as half of the £5.5 trillion of assets under management in the UK are in pooled funds. A survey respondent made the same point, saying, “Apart from the Red Line initiative and good work on governance by the likes of [Legal and General Investment Management] and Newton, pooled fund investors tend to feel powerless”.

What needs to happen to allow climate risk to be considered more fully in pension investment decisions?

According to 24% of survey respondents, advisers prioritising climate risk as a serious problem would put the theme at the front of pension investment decisions.

What needs to happen to allow climate risk to be considered more in pension investment decisions?



- **18%** Better trustee education
- **24%** Advisers need to highlight it more
- **14%** More product development
- **20%** Higher media profile of the financial impact of climate change
- **16%** Clarification of the law on pension investments
- **8%** Other

Other changes suggested included better analysis of investment risk and more effective government policy.

One commentator said, “Advisers need to highlight it more for it to be considered more fully in pension investment decisions but that is not saying this is necessary - trustees must take that decision.”

“ Trustees need to think long-term rather than to the post-meeting sandwiches.

Anonymous comment,
Professional Pensions survey

Another respondent said that climate change requires major changes to what and how people consume, which means more than just avoiding poor investments. A second said that major coordinated government action was required. One respondent observed, “Trustees need to think long-term rather than to the post-meeting sandwiches.”

Asset owners

Mike Clark of Ario Advisory said at the July event that it was necessary for asset owners to do things differently and that this could be achieved by demanding change from managers and consultants. Another pension adviser commented that asset owners need to demonstrate the demand for climate risk to be taken into account. He said that asset owners need to be willing to pay advisers for extra advice, or sack them if they do not integrate climate risk into their standard offering. Catherine Howarth, Chief Executive of ShareAction, said at the July event that trustees need to have policies on how they address financial and non-financial factors relevant to long-term outcomes, and should not have high-level boilerplate statements in their SIPs.

Frances Lawson, barrister at 6 Pump Court, quoted Mark Campanale of the Carbon Tracker Initiative

in her presentation at the July event, saying, “If investors throw the hard-earned cash of pension fund members at the fossil fuel industry right now - knowing it is in steady but clear decline - then no one should be surprised that they face the possibility of being sued.” She emphasised that much of the sector is currently behind the curve and that, from the perspective of a practising barrister, this is a very dangerous place to be. She said that, as a minimum, trustees need to do the following to cover their liabilities:

- Obtain specialist advice on climate risk.
- Assess the exposure of their portfolio to climate risk.
- Incorporate a climate risk management approach within their SIPs.
- Have a strategy in place for hedging and mitigating any climate risk identified.

“ Asset owners need to be willing to pay advisers for extra advice, or sack them if they do not integrate climate risk into their standard offering.

Anonymous comment,
July event survey

George Latham stressed the need for education and training of pension trustees through the Pensions Regulator’s toolkit. He said the toolkit should incorporate a knowledge briefing on the nature of fiduciary duty. A lawyer we spoke with emphasised the need for education and greater diversity on trustee boards. This was in the context of discussing trustees’ delegation of their investment powers to asset managers. Where a pension fund trustee has delegated investment powers to asset managers, trustees retain supervisory and overall strategic decision-making powers. This lawyer commented that most trustees do not currently have

the knowledge base to adequately oversee asset managers’ analysis of climate risk. An actuary we spoke with agreed that further education of asset owners was needed on the issue of climate risk.

One NGO representative called for a network of charities who want to make deep changes to their investments so that they are socially and environmentally positive, instead of being the opposite.

Polycymakers

At the July event, David Hertzell said it was disappointing that the Government had not updated the Investment Regulations following its 2015 consultation, commenting that this was a missed opportunity. He said that updating the Investment Regulations would have had an impact, as it would have highlighted the importance of considering long-term factors. Catherine Howarth agreed that the Government could and should have reached a different conclusion on amending the Investment Regulations. However, she emphasised that this was not “game over” and that the Government could still review that decision.

An investment consultant said that defined contribution (“DC”) pensions was the one place where pension investment could be truly green, due to younger beneficiaries and longer time horizons. However, he commented that the current regulatory system makes this challenging, as auto-enrolment requires a strong focus on value for money. One lawyer said that the situation was similar to that of fishing quotas, saying that it is impossible to persuade fishermen to change their behaviour without government intervention, even if it is in their long-term interests.

Asset managers

David Hertzell said that trustees will continue to rely on asset managers for management of risks such as those associated with climate change, and that he would be surprised if many trustees of smaller schemes were aware of the Law Commission’s recommendations. One investment consultant commented that some asset managers now consider climate risk as a “hygiene factor”, screening out certain investment risks without explicitly informing trustees that they are taking these risks into account. Janice Turner said that asset managers need to find a way of managing

voting on pooled funds and that it is vital for the Financial Reporting Council to push them to do so.

Investment consultants

Most of the lawyers we spoke with agreed that the position in the Law Commission report is clear for them as legal professionals, but that they are not as involved in discussions about investment strategy as they would like. They said that trustees rely heavily on investment consultants for direction on investment strategy. One lawyer commented that trustees tend not to pick funds or asset managers based on their own research but on the advice of investment consultants. Janice Turner called for investment consultants to raise questions with pension clients as to whether they believe that ESG factors are financially material and, if so, to assist them with developing suitable policies. George Latham said that he had noted that some investment consultants (including Mercer) advise pension fund clients to put climate change on their risk register. He commented that this is very helpful as it means that pension trustees can engage with the issue through a familiar means.

finally looking at the portfolio. He emphasised that there is no single solution to advancing the agenda on climate risk, and that a series of interventions and nudges is needed. A survey respondent agreed, saying that all of the factors cited are inter-dependent.

Pension scheme members

David Hertzell commented that members represent the strongest force for change on this issue. Catherine Howarth highlighted the new DC Code and guides issued by the Pensions Regulator as a positive step forward, as the guidance reflects the Law Commission's clarifications on fiduciary duty, which state that trustees should take into account ESG risks where they are financially material. It also provides details on how trustees can engage with pension scheme members and assess their views. A lawyer we spoke with commented that climate risk will only get onto the trustee agenda through a combination of members expressing their views and investment consultants taking the issue more seriously.

System-wide

George Latham commented that when considering climate risk, most investors start by looking at the exposure of the portfolio. However, it is important to get these factors in the right order. He recommended that they should start by developing investment beliefs, looking at how that is incorporated into investment strategies, before

Conclusion and recommendations

The results set out in this report highlight three standout issues that need to be addressed to ensure the relevant actors take climate risk into account in their investment decisions:

1. A need for more education for investment decision-makers on why climate risk is financially material and how the risk can be monitored and addressed;
2. A need to ensure the relevant investment decision-makers fully understand the legal position on incorporating climate risk into pension investment decisions; and
3. The importance of the role of investment consultants in raising and advising on the issue.

Education on climate risk

As mentioned earlier in this report, one investment consultant commented that while belief in the pensions and investment world that climate change exists is high, belief that it is relevant to investments is low. The industry survey conducted by Professional Pensions found that 53% of respondents did not think climate change poses financially material risks to their portfolios or those of their clients. Nearly one-third of respondents felt that the main barrier preventing climate risk being taken into account was a lack of perception on trustee boards that climate risk is a sufficiently high risk factor. 18% of respondents to the Professional Pensions survey thought trustee education would help climate risk to be taken more seriously in pension investment decisions. We recommend that the Pensions Regulator (and other relevant regulators) take steps to educate investment decision-makers on climate risk, why it should be considered as a financially material risk and what steps can be taken to assess and manage the risk. This could include issuing guidance and adding additional sections to the Trustee toolkit on the Pensions Regulator's website.

The Pensions Regulator's 21st century trusteeship and governance discussion paper (July 2016)²⁴ explores how trustees can better meet the demands of scheme governance. This paper states that the Regulator was concerned by some of the gaps identified in its research on trustee knowledge and understanding ("TKU"). Half of all schemes with one or more non-professional trustees did not believe that all of these trustees had a level of TKU that met the standard in the Regulator's TKU code of

practice. We were pleased to note in this report that the Pensions Regulator intends to increase its focus on educating and supporting trustees and we would recommend that this programme include a focus on long-term investment factors such as climate risk. It is also vital for trustees to take action to ensure that they have adequate levels of TKU, or else risk breaching their legal duties.

“ We recommend that the Pensions Regulator (and other relevant regulators) take steps to educate investment decision-makers on climate risk, why it should be considered as a financially material risk and what steps can be taken to assess and manage the risk.

Legal clarity

16% of respondents thought that lack of legal clarity was the main barrier preventing climate risk from being taken into account in pension investment decisions. Many of the lawyers we spoke with also emphasised a lack of understanding on the part of investment decision-makers as to what the law requires of them.

Trustees and their advisers have tended to interpret their duty to act in the best interests of the members as an obligation to maximise portfolio returns, potentially at the expense of considering longer-term risks. The Law Commission report clarified that trustees are not required to maximise returns but

that they must weigh returns against risks, including long-term risks.²⁵ The report also clarified that trustees should take into account factors such as climate risk in making investment decisions where they are financially material.²⁶ However, as the survey data in this report strongly indicates, many schemes are still failing to take financially material issues like climate risk into account, believing that they have to focus solely on short-term returns.

We believe that, following the Law Commission report, the legal position on this issue is in fact clear and that it is the understanding of many investment decision-makers as to what the law requires that is inadequate. As David Hertzell commented, trustees continue to rely on asset managers for management of risks (including climate risk). He said he would be surprised if many trustees of smaller schemes were aware of the Law Commission's recommendations.

We hope that in due course, the Investment Regulations will be amended to ensure the relevant investment decision-makers fully understand the legal position. In the meantime, alternative methods of highlighting this issue must be considered. We recommend that the Pensions Regulator (and other relevant regulators) take steps to educate investment decision-makers on legal duties in relation to the financial risks associated with climate change.

The role of advisers

24% of respondents to the Professional Pensions survey thought that advisers should play a key role in ensuring that climate risk is assessed and managed in pension investment decisions. We heard repeated calls in our discussions for investment consultants to outline the financial implications of these risks to their trustee clients and assist them with developing suitable policies. Asset manager incentives and reporting structures were also cited in discussions as key reasons for industry failures to consider climate risk in pension investments. It seems clear that work on short-termism in capital markets, initiated by the Secretary of State for Business, Innovation and Skills in June 2011 in commissioning the *Kay Review of UK Equity Markets and Long-Term Decision Making*,²⁷ should continue. It is particularly important for trustees to ensure that asset managers' investment horizons are adequately aligned with those of the fund, and that this is incorporated into the investment mandate. It is also important that trustees ask their

investment consultants to advise them on climate risk, and that investment consultants raise climate risk with their clients on their own initiative.

“ It is vital that trustees and asset managers are not only assessing and reacting to these risks, as their legal duties require, but also considering the myriad opportunities presented by climate change.

Final remarks

It is crucial that understanding around this issue continues to accelerate. The case for asset owners, in particular, to take action on these issues rather than simply continuing with business as usual, is becoming ever more pressing. As Sarah Barker observes, decisions based on methodologies and/or assumptions that are no longer fit for purpose in the contemporary investment environment are not likely to be considered duly diligent.²⁸

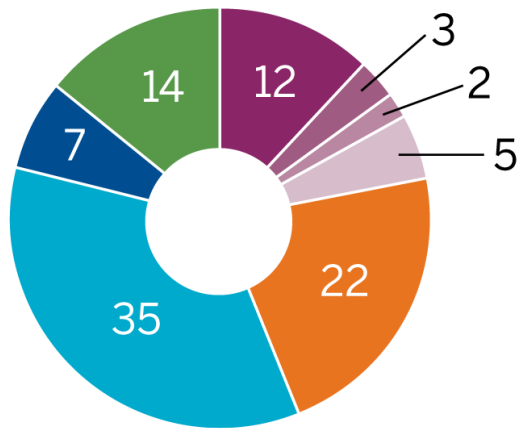
The investment landscape is evolving, and rapidly. As at 3 September 2016, 180 states have become signatories to the Paris Agreement and of these, 26 have signed and ratified the Agreement (including the US and China, two of the world's largest emitters of greenhouse gases). This will have implications for institutional investors given the transition risk discussed earlier in this report. Recent revisions to the Institutions for Occupational Retirement Provision (“IORP”) Directive are also indicative of significant change to come for investors. The Directive requires, among other things, institutional investors to document their own risk assessment on new or emerging risks including climate change and stranded assets (Article 29).ⁱⁱⁱ The future livelihoods of millions of UK pensioners

depend on the trustees who look after their savings and these actors have a critical role to play in meeting the financial risks posed by climate change. It is vital that trustees and asset managers are not only assessing and reacting to these risks, as their legal duties require, but also considering the myriad opportunities presented by climate change.

iii | While it remains to be seen how Brexit will impact transposition of this Directive into domestic law, it is nevertheless clear that the financial risks posed by climate change are becoming increasingly recognised

Appendix A

Respondents to Professional Pensions survey (22 August 2016)



-
- **12%** Consultant/actuary or similar
 - **3%** Financial director
 - **2%** Investment consultant
 - **5%** Pension scheme administrator
 - **22%** Pension scheme manager
 - **35%** Trustee
 - **7%** Solicitor
 - **14%** Other
-

All graphs are from the 22 August 2016 Pensions Buzz survey results report by Professional Pensions, published by Incisive Business Media Ltd.

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ShareAction (Fairshare Educational Foundation) is a registered charity that promotes Responsible Investment practices by pension providers and fund managers. ShareAction believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

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About ClientEarth

ClientEarth is a non-profit environmental law organisation, working to create pragmatic solutions to key environmental challenges such as climate change. The Company and Financial Project seeks to use the law and legal strategies to drive greater integration of climate-related financial risk into the management decisions of influential actors in the corporate and financial sectors to support a rapid shift of capital toward green investments.

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