Quattro Pensions
CONSULTING ACTUARIES

news bulletin

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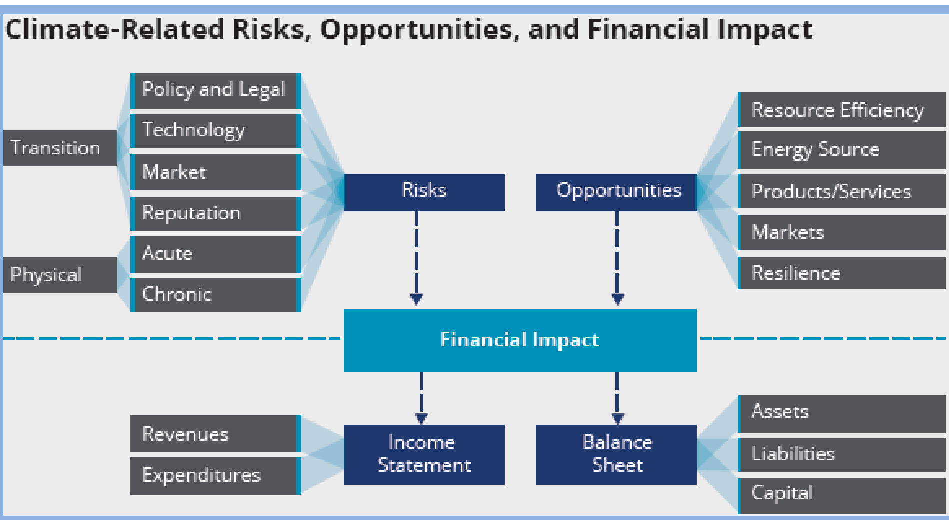

Source: Recommendations of the Task Force on Climate-related Financial Disclosures

In our bulletin of November 2014 we wrote about the risk of "Stranded Assets". This term refers to sudden rapid loss of value due to, for example, technological disruption or legislation change. The way in which the global climate is changing brings with it the real threat of "stranding" and significant economic disturbance as we collectively move away from the fossil fuels that have for so long been dominant in our economy.

Climate change and investment risk

Counsel's Opinion

In December 2016 an organisation called ClientEarth published Counsel's opinion relating to the responsibilities of pension fund trustees in regard to climate risks. The opinion is in unequivocal terms. Put simply, if trustees are advised that climate change risks are financially material, then they must be taken into account when setting and updating investment strategy.

The Opinion is framed against two hypothetical counter-arguments that are often encountered in real-life situations:

(a) trustees are not legally permitted to take climate change into account as it has moral and ethical implications and

(b) trustees have delegated their day-to-day investment decisions to fund managers so are neither permitted nor required to concern themselves with these issues

The Opinion then considers case law (Cowan v Scargill etc), the statutory background (Pensions Act 1995 etc) as well as the recent Law Commission report on "Fiduciary Duties of Investment Intermediaries" and the Pension Regulator's stance.

The conclusion was that "Any factor that is financially material **can and must** be taken into account, whether or not it would ordinarily be described as an ESG[1] factor". (Emphasis added.) Further, the trustees may well have delegated the day to day management, but not the responsibility for strategic decisions.

So, this then begs the question, is climate change a material risk to our investments? Again, we get some help from the Opinion, which makes it clear that "material financial risk in this context does not mean that it would necessarily have an **immediate** impact on investment return. It may include longer term financial consequences."

Ultimately, every set of trustees will need to consider for themselves whether they believe climate risk <u>could</u> be material to their equity, property, debt or other investments.

Note that this is not about whether trustees personally believe in climate change or not, because even if you don't believe in climate change, the actions of others (markets and legislators) still poses a risk to your investments. If Governments collectively move the World away from using fossil fuels the share price of oil companies is likely to take a hit, regardless of what you personally believe on the subject!

With this in mind, it is worth considering the direction of travel of the G20's Financial Stability Board…

[1] *ESG: Environmental, Social, and Governance*

The Bloomberg Recommendations – "What gets measured better gets managed better"

The FSB asked Michael Bloomberg to chair a taskforce. With one eye firmly on the crisis of 2008, the FSB was worried that a lack of information about (climate) risks can lead to a mispricing of assets / misallocation of capital and can potentially give rise to concerns about global financial stability "since markets can be vulnerable to abrupt corrections".

While existing laws throughout the G20 require corporate disclosure of material risks, when it comes to climate risk, at best this tends to be relegated to a sustainability report and confined to information about levels of Green-House Gas (GHG) emissions. Generally, such reporting never touches the all-important financial pages of the report and accounts.

Bloomberg's taskforce was asked to design "disclosures that will help financial market participants understand their climate-related risks… " that "… could promote more informed investment, credit [or lending], and insurance underwriting decisions" and, in turn, "would enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks".

The resulting report is very detailed, but boils down to four recommendations for forward-looking disclosures about climate risk that should appear within an organisation's financial filings. The recommendations are for voluntary adoption. And, lest you think this is just some boilerplate that your investment managers will deal with when analysing the investment outlook, the recommendations extend to asset owners as well including public- and private-sector pension plans.

The recommendations themselves are summarised at the back of this bulletin in an extract taken directly from the report. There is a huge body of supporting documentation to help with the implementation of the recommendations.

Bloomberg goes on to acknowledge that in terms of reporting, some asset owners often have no public reporting requirement, while others provide for extensive public reporting. For purposes of adopting the Task Force's recommendations, asset owners should "use their existing channels of financial reporting to their beneficiaries and others where relevant and feasible".

Asset managers should also up their game, providing more detailed reporting, including "items such as the aggregate carbon intensity of the portfolio compared with a benchmark, the portfolio's exposure to green revenue (and how this changes over time), or insight into portfolio positioning under different climate scenarios".

Final comment

It will take some time to digest both these documents. The FSB taskforce in particular is a very weighty tome indeed. However, their approach has been from the start an industry-led one, from across G20 with different sectors represented, each with competing interest, different politics and legislative tensions. Yet it has come together very quickly and reached accommodation to deliver a coherent set of detailed proposals.

Key to this is the shift to financial disclosure. GHG emissions disclosure is all very well, but really the big question is what does it mean for P&L and the Balance Sheet? Thus the disclosures should now sit within the financial statements. Does this have implications for corporate risk / audit committees and indeed for auditors etc? Further, these disclosures will need to be forward looking, not just backward reporting. For pension funds in the UK, this is likely to mean improved discussion in the annual reports for members based on a thought-out strategy and dialogue with the scheme's investment managers.

The scope of the recommendations will cover all listed companies, PLUS asset owners / managers throughout the G20 and this reaches some 80% of all global economic activity. So, despite the murmurings of a certain newly-minted reality-show politician on the other side of the Atlantic, it is very clear that some of the most powerful institutions are becoming ever more serious about the potential impacts of climate change.

Sources:

ClientEarth Opinion: Link

FSB Recommendations: Link

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