CLIMATE CHANGE

Climate impact vs risk

Europe's pension schemes are all now aware of the financial risks of ignoring climate change but, morally, should schemes also be considering the climate impact of their investee companies too?

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Just a few years ago, this magazine was running articles about "growing interest" in environmental, social and governance (ESG) investment strategies. Today, in many European markets ESG is a primary factor in pension funds' long-term strategies. Research from PwC in 2020 suggested that ESG assets will account for between 41 and 57 per cent of all mutual fund assets in Europe by 2025.

In part this is because ESG funds have done well in recent years: PwC's analysis suggests that ESG-aligned funds outperformed non-ESG counterparts by a cumulative average of 9 per cent between 2010 and 2019.

The shift is also pragmatic: there are clear risks for funds, and many of the companies in which they are invested, in a world where policymakers and public opinion are pushing businesses towards a world of net-zero carbon emissions and encouraging investors to divest from carbon intensive businesses.

Pressure to minimise environmentally damaging activity is coming from legislation, regulation, campaigners and the court of public opinion, guided by the increased frequency and severity of extreme weather events, and urgent warnings from scientists about the pace of climate change.

Reducing exposure to risks related to climate change and the transition to a net-zero world makes sense. But should funds also be basing investment strategies on assessments of the environmental impacts of their investments? After all, what is good for the environment is ultimately good for the economy, investment returns, and society – and would also help to mitigate climate risks. Would such a strategy be compatible with a fund's fiduciary duties to pension fund members or savers?

The importance of impacts

Growing numbers of people now believe investors should assess climate impacts as well as risks. In August 2021, 34 economists and academics publicly urged the Norwegian government and parliament to commit the country's Government Pension Fund Global (GPFG) to a net-zero goal. They also criticised Norges Bank Investment Management (NBIM), which runs the GPFG, for focusing on climate risks, instead of climate impact.

NBIM spokesperson, Line Aaltvedt, says it expects companies in which it invests to "integrate relevant climate change risks and opportunities into their corporate strategy, risk management and reporting".

"We expect … a business plan for managing climate risk… targets to reduce greenhouse gas emissions, and… [*consideration of*] the sensitivity of their long-term business strategy and profitability to different future regulatory and physical climate scenarios."

Aaltvedt says that an expert group appointed by the Ministry of Finance to assess climate risk for the fund presented its report in August, and a political process of reviewing that report is now underway, so it cannot comment further at this stage. That report's recommendations include a suggestion that NBIM seeks "to influence companies' behaviour and strengthen the market's functioning through better climate risk reporting".

Growing numbers of investment professionals now see the case for investment strategies evolving beyond climate risk assessment. Willis Towers Watson's Thinking Ahead Institute co-head, Marisa Hall, thinks climate risk strategies tend to focus on too narrow a range of factors.

"TOO MANY INVESTORS HAVE APPROACHED ESG FROM A DEFENSIVE STRATEGY WHEN YOU ARE LOOKING AT RISK, RETURN AND IMPACT"

"Too many investors have approached ESG from a defensive strategy where you are looking at risk, return and impact."

Hall acknowledges that making these changes can be difficult. Larger funds may find it difficult to reduce climate risks or to focus on creating positive climate impacts because of their sheer size and the range of their investments.

However, Hall believes this will lead some to conclude that they need to do more than climate risk identification and mitigation. Instead, they must try to tackle systemic issues by analysing and seeking to reduce climate impacts. "They view it as within their fiduciary duty to work on climate impact," says Hall. "They believe that working on that will help their portfolio [*in risk and return terms*]."

She says some smaller investors delegate some of these tasks to investment managers. "When they're assessing managers they ask for disclosures around how they are dealing with climate impacts." Both approaches are the product of "enlightened self-interest" on the part of funds and their members, she suggests.

Europe leads the way

Regulators and policymakers will determine whether asset owners and investors are permitted or encouraged to use climate impact within their fiduciary duties. But the direction of travel seems clear. In the European Union, the European Commission published a new *Sustainable Finance Strategy* in July 2021, containing proposals for further development of reporting obligations under the Sustainable Finance Disclosure Regulation (SFDR), including introduction of reporting requirements on Principal Adverse Impact (PAI). It suggested that it could become mandatory for pension schemes and funds to consider the non-financial impact of investment decisions based on ESG factors. Financial regulators in non-EU European jurisdictions have tended to follow the EU's lead on ESG.

European pensions industry body PensionsEurope is currently consulting members and working groups to define a position on these proposals. But it has already stressed the need for proportionality in the way regulations are enforced; and a need for consistency and an integrated approach to changes in reporting regulations affecting corporates and institutional investors.

In particular, PensionsEurope secretary general, Matti Leppälä, asks for proportionality to be taken into account when revising the IORP II Directive – Europe's key legislation for pension funds. The proposals imply that pension funds would be required to report some information that some of the companies in which they are invested are not yet required to report. This would mean funds would have to obtain information from specialised data providers, at significant cost.

"Many big pension funds already do impact investing and are committed to net zero, so for them this is a natural development," says Leppälä. "The concern would be for smaller pension funds: how are they able to comply with these requirements? Our members are long-term investors, who have taken ESG issues very seriously for a long time, so this development is very welcome. But it's about the speed and practicality of how this is done."

Hall draws attention to a report published recently by the law firm Freshfields, commissioned by the Generation Foundation, the UN's Principles for Responsible Investment (PRI) and the UN Environment Programme Finance Initiative (UNEP FI).

The report considers how far laws require or permit investors to invest for sustainability impact. It concludes that where investing for climate impact can be effective in achieving financial goals, investors are likely to be required to consider using them.

"In effect," says Hall, "investors need to be able to set those impact goals and to measure progress towards them. We need to change the rules so that investors have more of a free hand to pursue sustainability goals that strengthen the overall economy, and therefore provide a more secure environment for their own investors."

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In 2019, the Varma Pension Insurance Company in Finland reviewed its climate policies, introducing a new strategy based on assessing transitional risks related to its portfolio. Its aim is to have a carbon-neutral investment portfolio by 2035.

Varma director of responsible investments, Hanna Kaskela, notes the difficulty involved in analysing data to identify climate risks and impacts. "There is a lot of opinion regarding climate change-related impacts, both negative and positive," she says. "You need to assess those thoroughly and have good data." She expects that in future investors are likely to be asked to report on other environmental impacts, such as the impact of business activities on biodiversity.

Hall is sure pension funds and other institutional investors will soon be asked to do more to improve the climate impacts of their investments. "The integration of ESG is almost yesterday's news," she says. "The difference now is what is being called for is pension funds to act as agents of change, to address systemic problems. For a fiduciary to be able to get to that position, they need to be able to say that working on those system challenges matters for my portfolio, because the world is so interconnected."

So pension funds across Europe will be investing to help save us all from the climate emergency – making it even more important that we all keep saving for retirement. ■