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ESG update – Taking action on climate change

In this briefing we discuss whether scheme trustees can justify taking action on climate change, and if so, how they might achieve this.

‘Code red for humanity’

This is the clear message from the UN Secretary General, following the release of the IPCC report on 9 August. This, combined with forest fires raging across Greece and California and the recent flooding seen in Central Europe, might convince many of us to take personal action on climate change, by eating less meat, for example, or buying an electric car.

Scheme trustees have the opportunity to do more. But can they justify taking action on what might be seen as non-financial issues? If so, what practical steps can they take?

Justification for tackling climate change

Recent legislative changes have opened the door for trustees to take action on climate change. When making investment decisions trustees are now:

- Allowed to take into account members’ views when making investment decisions
- Compelled to consider long-term financially material risks, including ESG risks.

Members’ views: If trustees of pension schemes feel that members want their pension invested in ways that help tackle climate change then they can justify taking action. Groups such as Make My Money Matter are calling for members of pension schemes to ask their pension provider to ‘go green’. Trustees could choose to survey their members on this if they had reason to believe that the membership would want to do more in relation to climate change.

IPCC report key points

- Global surface temperature was 1.09°C higher in the decade between 2011–2020 than between 1850–1900
- The past five years have been the hottest on record since 1850
- The recent rate of sea level rise has nearly tripled compared with 1901–1971
- Human influence is ‘very likely’ (90%) the main driver of the global retreat of glaciers since the 1990s and the decrease in Arctic sea ice
- It is ‘virtually certain’ that hot extremes including heatwaves have become more frequent and more intense since the 1950s, while cold events have become less frequent and less severe.

Source: BBC website

Financially material risks: There are clearly financially material risks associated with investing in some companies and sectors. The oil sector, for example, faces a number of economic risks:

- Potential for carbon taxes reducing their profitability
- The switch to electric powered cars and heating reducing their revenue
- Assets such as oil and gas fields becoming valueless
- High financing costs as banks are less willing to lend to these companies.

There is also the risk of a self-fulfilling prophecy. Divestment due to the perceived risk could lead to a sell-off of shares, resulting in a sharp drop in the share price and financial losses for remaining investors.

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These financially material risks can justify reducing exposure to companies associated with high levels of climate change risk. They can also justify investing in technologies likely to benefit from the transition to zero carbon. These investments can also hedge the risk of other investments doing badly.

As with any risk, it's possible to quantify the likelihood and financial impact, and the expectation is that institutions will need to carry out such analyses going forward.

What can trustees do?

Scheme trustees can take a number of practical steps on climate change:

Invest in technology designed to tackle climate change: Investing in wind and solar farms and technologies such as battery manufacturers is straightforward. A number of fund managers offer funds that do exactly that, and the range of options will likely expand, backed up by government policy, such as the recent call for UK pension funds to back the investment 'big bang'.

Doing so may well be in line with the views of members who want to see their money invested in these technologies. It's also reasonable to assume (as the Bank of England does – see right) that these investments will benefit if climate change is worse than expected, e.g. demand for batteries is likely to go up as the transition away from fossil fuels accelerates. Revenue from the sale of renewable energy may also get increasing support from governments.

Divest from companies contributing to climate change: Again, this is a practical option as there are a number of fund managers offering low-cost funds that exclude or underweight such sectors, while offering broadly-diversified access to stock markets.

Bank of England stress testing

- The Bank of England requires insurers to assess the potential impact of climate change on assets through stress testing
- This involves breaking down holdings into sectors likely to be most impacted, both negatively (e.g. fossil fuels extraction and energy-intensive industries), and positively (e.g. production of electric vehicles)
- The impact of both transitional risks (adjusting to a carbon-neutral economy) and physical risks (e.g. extreme weather such as floods) are considered
- The size of stresses on the sectors potentially the worst affected is highly material e.g. 30%–70% falls in value for those involved in fuel extraction and power generation under a disorderly transition (i.e. one where companies are required to immediately adjust)
- By contrast, under the same scenario a company involved in making electric vehicles might see its value rise by 10%

Stewardship: As shareholders, pension schemes can influence how these companies are run. Fund managers cast votes on shareholders' behalf, so it's important to ensure that your fund manager is casting votes and engaging with companies in line with member views. We provide information on how fund managers vote in our annual voting reports, and we can help select fund managers whose stewardship policies are most aligned with the views schemes wish to represent.

There are many recent examples of shareholder pressure resulting in changes to the ways companies are run in relation to climate change. One high-profile example is ExxonMobil, where activists took a seat on the board and forced through a change in management in order to push their agenda of 'accelerating rather than deferring the energy transition' to cleaner energy.

A balanced approach

Of course, trustees need to balance a number of conflicting risks and costs.

Replacing a diverse equity portfolio in its entirety with shares in Tesla, for example, would not be sensible, as the risk of over-dependence on one company is likely to far outweigh the reduction in climate-related risks.

Trustees should also recognise the risk of a bubble. It's quite feasible that the price of shares in some 'green' companies will become over-inflated as investors jump on a green bandwagon.

Equally, moving from a low-cost passive mandate to a high-cost active mandate could be counterproductive, as the higher fees might outweigh future losses caused by climate change.

Our case study, right, shows a practical approach some of our clients have taken to balancing these.

In conclusion, trustees can justify taking action on climate change and there is a range of practical and cost-effective steps to facilitate this.

Contact us

To learn more about how a more ESG-focused approach might fit within your scheme's investment portfolio, get in touch with your usual First Actuarial consultant or a member of the investment team.

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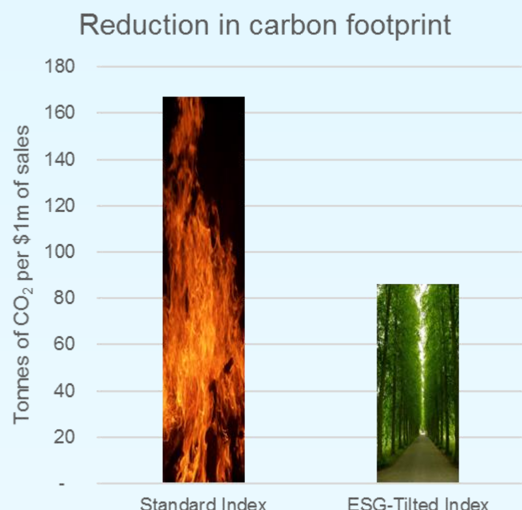
Case study

Many of our clients are keen to take account of ESG considerations such as climate change in their portfolios, but are less keen on high levels of active management risk and fees. We have identified a number of recently-launched funds which we believe meet their needs, such as 'ESG-tilted' equity funds.



These are very similar to 'standard' index-tracking funds, but their index weights constituents on ESG scores, and they will invest more in companies with high scores and less in companies with lower scores. The final make-up of such funds is still closely related to a typical market capitalisation weighted index, so by and large it can be seen as similar from a risk and expected return perspective, but allows some consideration to be taken of ESG in the event that those risks do materialise. These funds have demonstrably lower carbon footprints, as illustrated above.

Retaining at least some allocation to companies that score badly also gives the manager the opportunity to engage with those companies to try and drive improvements for investors, the environment and wider society. Some managers will exclude companies from the index if repeated attempts at engagement fail.

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