17 April 2018

Mary Creagh MP
Chair of the Environmental Audit Committee
14 Tothill Street
London
SW1P 3JA

Dear Ms Creagh,

Green Finance Inquiry – Request for Information

Thank you for your letter which we received on 21 March 2018 requesting information as part of the green finance inquiry. I apologise for our delay in responding.

The duty of pension scheme trustees is to invest scheme assets prudently in such a way that ensures that all the benefits set out in the scheme rules may be paid as they fall due. This is what scheme members quite rightly expect. It would not be appropriate for trustees to use scheme assets which they do not beneficially own to further any wider social aims, however laudable those aims may seem to individual trustees. Trustees are responsible to their beneficiaries for providing the benefits set out in the Scheme rules; for the Government to seek to use trustees to meet its own climate change targets would be to divert these trustees from their fundamental common law duties.

It may also be worth emphasising the role of pension scheme trustees. They are responsible for all the assets of the scheme but their role is strategic. They are responsible for the Statement of Investment Principles which sets the investment strategy and they are advised on asset allocation. Day-to-day investment decisions are delegated to investment managers authorised by the FCA. The trustees monitor the performance of those investment managers against their strategy.

I offer the following comments in response to the specific questions raised in your letter:

1. The trustees agree that climate change is one of a number of factors that creates financial risk to which pension funds are exposed.

2. There are a great many different potential climate-related financial risks that affect investments in a range of ways. In a properly diversified portfolio creating a hierarchy of climate risks is not necessarily helpful. Every investment will carry a different patchwork of financial risks and climate-related financial risks, and many of these are overlapping, but legislative/regulatory change is central.

3. The Trustee Board is currently finalising its latest statement of investment principles which refers specifically to climate change risk for the first time.

4. As part of our investment process we have retained Hermes EOS to conduct intensive analysis and engagement with corporates with respect to climate change and the risk associated with any legislative and other changes. It is our belief that the move to a low-carbon economy could transform parts of the economy, introducing significant transition risks for poorly prepared companies in exposed sectors. Our focus is on the most exposed sectors, including oil and gas, mining, utilities and transportation.
For example, in the more energy-intensive sectors we look for greenhouse gas emissions reduction targets and the overall appraisal of asset portfolio risks from low-carbon scenarios. In the transportation sector, we are looking for clear and coherent strategies to reduce fleet emissions.

Within our private markets investment programme we directly invest in environmentally sustainable opportunities. In recent years we have made over £250m investment in solar power (ground-mounted and roof top), onshore wind, energy from waste, and waste water treatment, principally in the UK and North America. We are also an investor in battery energy storage assets in the UK to provide grid stability services (to regional distribution companies, electric vehicle charging stations and other ‘behind-the-meter’ applications with commercial and industrial users). We expect our total exposure to renewables and associated green technologies to rise by an additional £500m over the next 3-5 years, subject to the opportunity set.

5. We welcome greater disclosure by entities in which we invest of the financial risks (driven by climate change and other factors whether environmental or not) as this should assist the decision making of those to whom day-to-day investment decisions are delegated. The TCFD recommendations are intended to apply to a wide range of organisations that have very different reporting responsibilities. Even within the financial sector (as defined by the TCFD) the differences between an annual report for a bank and a private sector pension scheme are considerable; after all they serve different purposes. As a Trustee Board we are committed to communicating clearly with our members and we take great care and effort in doing so in an appropriate way. Engaging pension scheme members is a challenge faced by all pension schemes and we remain to be convinced that providing members with the information suggested by the TCFD report will improve member outcomes. Greater clarity is needed in explaining what members would do with this additional information. In defined benefit schemes, members need a holistic view of overall scheme performance. Focussing on an approach to one of a great many factors in financial risk may not give the balanced picture that is relevant for scheme members.

The TCFD itself highlighted the problem of different but overlapping guidance leading to confusion and any proposals in relation to pension schemes would need to take into account the various sources of guidance, and the scope for conflict between those sources, or the resultant lack of clarity.

6. A voluntary approach would have the benefit or making those reporting think more deeply about what how climate change risks are described and how to tailor them to their own circumstances. A legislative approach is likely to drive a box-ticking mentality where the objective is merely to meet the statutory requirements, rather than to provide useful information. There is also a concern that a statutory approach will lack the flexibility needed for the range of different organisations that will be caught.

7. Well thought through guidance is always welcomed, however any guidance for pension schemes must be tested against the question: will it improve member outcomes? The TCFD was unwilling itself to define, short, medium and long term which does rather create the expectation that any guidance following on from this report would be somewhat vague. The Government or regulators may consider publishing an example of how it thinks trustees should report on climate risk. Seeing an example may allow stakeholders to evaluate whether such a report would improve member outcomes.

8. The issues raised relating to pension schemes within the Risk Alert are already being considered as evidenced by the responses provided above to questions in this letter.
9. All investments carry financial risk and trustees must develop an investment strategy that balances those risks with the returns that may be available. It follows that financial risk is a key consideration in any investment strategy and there are many factors that feed into financial risk. However there is a risk of focussing on one factor to the exclusion of others. A business may seem to be particularly vulnerable to climate change but how it deals with that risk is fundamental to whether it poses a financial risk to investors. As a result the quality of management and governance of that business will determine how that climate change risk impacts on financial risk.

Climate change may affect a business in a number of ways. Its products may cease to be relevant, climate change regulation may make it less profitable, its impact on climate may make it reputationally unattractive to consumers; climate risk may increase the cost base; climate change concerns may stimulate new technology in that business or its rivals and so on. Each of these may affect businesses in different ways and very similar businesses may react to the challenges and opportunities in very different ways. As a result when considering the impact of climate change there are a lot of business specific details to consider whereas the role of pension scheme trustees is to set a strategic course for investments. Individual investment decisions are properly delegated to appropriately qualified investment managers.

In this context it is perhaps hard to see how pension funds reporting on such matters will assist member outcomes. At a strategic scheme wide level any such report would run the risk of being vague and nebulous, or, if greater detail is added to counter this, the report would be unlikely to be digestible for many members.

When looking at climate change risks, the TCFD named policy risks first with good reason. The scope for legislative and regulatory change to have a profound impact on companies is immense. As a result, clear long term policy from Government is welcome. However, we must be mindful of the difficulty of such long term policy approaches; for example, the regulatory treatment of petrol and diesel offers a salutary reminder. The motivations within the UK and EU for pushing diesel at the expense of petrol were laudable but the fact that such a policy had unintended harmful environmental (but not climate change) outcomes highlights the difficulty of confidently asserting that certain strategies are positive environmentally. From an investor perspective there was the additional harm caused by the falling share price of car manufacturers as a result of their damaging attempts to take advantage of the regulatory changes. Some thoughts arise immediately from this example:

- Good company management and governance is as important in this area as in all others;
- What companies do is more important than what they say and encouraging companies to ‘show off’ can create unhelpful incentives;
- Well-meaning policy is not infallible; and
- There is a danger in elevating one risk (important though it is) at the inevitable expense of all others. In this case one environmental risk was elevated at the cost of other environmental risks with unfortunate results.

I hope that this input is helpful to the deliberations of the Environmental Audit Committee. We would be pleased to provide any further information you may require.

Yours sincerely

Guy Griffiths
Chairman of Trustees