Climate risk is a reality – investors take note

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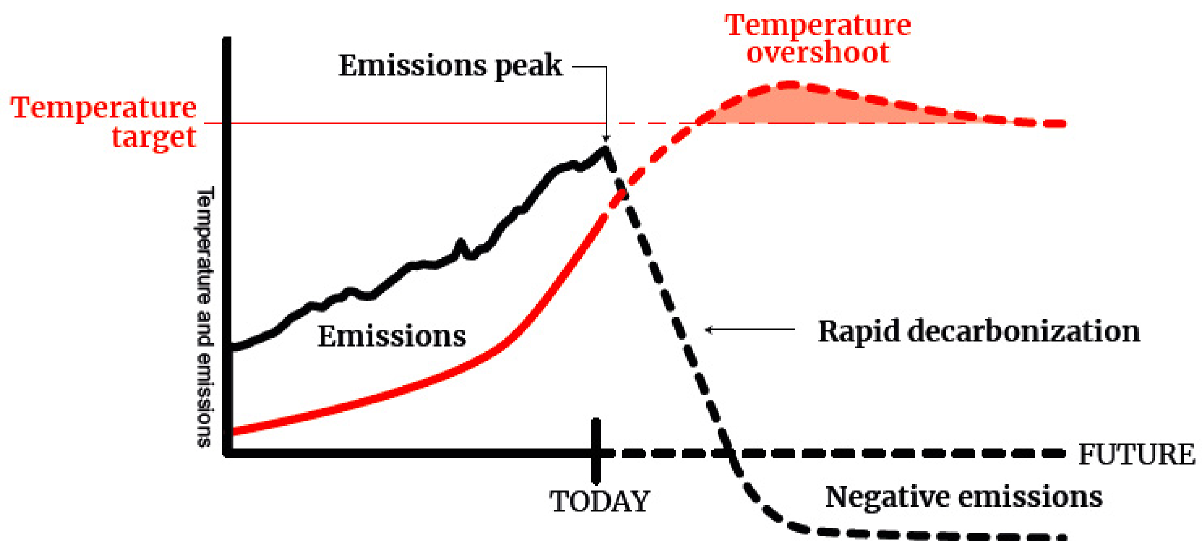
In recent months we have seen a proliferation of Environmental, Social and Governance (ESG) issues making the headlines, with an increased focus on climate change and climate-related risks. An upsurge of high-profile reports, organised campaigns and global events have put the issue of climate change firmly on the table.

At one such conference, Professor Colleen Vogel of Wits University noted: "We have made a move from being climate denier to climate delayer, thinking that it's someone else's problem. By delaying our role and response to climate change and the associated risks, we are only delaying the potential impact of environmental, societal and economic risk." It is clear that the investment sector has to respond accordingly. Some key inputs to this process are outlined below.

1. The IPCC Report on 1.5 degrees

The Intergovernmental Panel on Climate Change (IPCC) special report on the impact of global warming of 1.5°C (released in late 2018) set the benchmark for many of the current discussions. It examined the latest science-based climate research and scenarios, and concluded that the trend is worsening - and that we have to limit warming to 1.5 degrees. This will only be possible with "far-reaching and unprecedented changes in all aspects of society" from land use and infrastructure to energy and industrial systems. In order to achieve the 1.5°C target, CO2 emissions must decline by 45% (relative to 2010 levels) by 2030.

The larger the temperature overshoot and the longer it persists, the harder it will be to return to the original temperature target. Faster and stronger emission reductions may reduce the need for negative emission technologies (illustration courtesy WMO & UNEP).



Source: Bioenergy International, courtesy WMO & UNEP

In this regard, South Africa committed to the 2009 National Policy on Climate Change to meet global emission standards. This has been followed by several policy papers, but we are yet to see meaningful action.

In South Africa (and Africa in general), we are at significant risk with our high and low pressure systems, and warming statistics between 1.5°C and 2°C. These affect our rainfall patterns, which, in turn, result in flooding or drought. The KwaZulu-Natal province, for example, experienced extreme flooding (with a death toll of over 70 in April this year, and extreme drought (ongoing since 2015, with several dams drying up) in some regions, with severe social and financial implications.

The 2019 World Economic Forum Global Risk Report, which paints an ominous picture of environmental concerns from extreme weather to biodiversity loss, demonstrates how high the stakes are from a business perspective. A decade ago, the global financial crisis was on the agenda and these environmental risks were not. This indicates a move in the right direction, but is this too little, too late – and what can investors do, to make a difference?

The discussion emanating from the IPCC Report has highlighted the knock-on effect of climate change on society and the economy as a whole. Adaptation will require innovative thinking and new business models, particularly as these risks have not been adequately priced for by government, companies or investors.

2. A Just Transition

The concept of a "Just Transition" for workers and communities, as the world's economy responds to climate change, was included in the 2015 Paris Agreement on Climate Change. This guide proposes four pillars to achieving environmentally sustainable economies for all:

1. Social dialogue;
2. Social protection;
3. Employment; and
4. Rights at work.

The just transition theme has been adopted by an increasing number of environmental organisations, groups affiliated with organised labour, and grassroots organisations, and has different meanings for different people. What has become evident, however, is that this is not an overnight event. It requires careful planning, implementation and oversight by government, with the support of industry. The finance industry can play a key role in building the required sustainable socio-economic structures, by:

- Financing products and services that take into account a just transition where applicable;
- Considering how potential investee companies are adapting their business models to consider climate-related risks;
- Engaging fossil fuel companies, in particular, to determine a pathway to a just transition;
- Ensuring that the just transition roadmap is inclusive and takes into account the human element; and
- Engaging with banks on their existing exposure and funding to fossil fuel industries, amongst others.

Civil society and finance institutions need to work together. Currently, there is a mismatch between the two. We need to close this gap, and scale projects to make them feasible from a risk-return perspective, while taking those impacted into account. With the current crisis facing

Eskom, creating scale in the renewable energy sector is vital, and suitable policies, regulation and projects on the ground to support the move to a low carbon economy are urgently required.

These are some issues hampering progress:

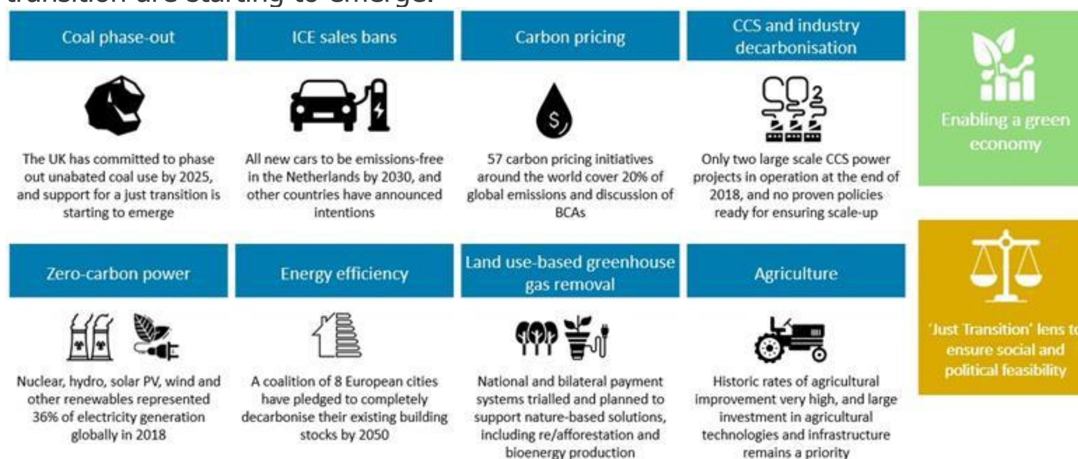
- **Mis-pricing of assets: "**Inadequate information about [climate] risks can lead to a mispricing of assets and misallocation of capital…" (postulated by Mark Carney in 2015). The pricing of carbon will impact cost of capital in the future.
- **Mis-direction:** the Rio de Janeiro Earth Summit in 1992 incorrectly framed climate change as an environmental issue, instead of framing it as an issue affecting society as a whole.
- **Resistance**: companies are no longer refuting the science, but are now trying to delay the longevity of the fossil fuel companies. The resistance comes from those who say that the world needs these industries for a functioning economy - but these companies are not doing anything to shift their business models to cleaner or climate-friendly alternatives.
- **Divergence:** the big question is: what scale of change is required? A lack of consensus fragments and dilutes efforts to make a headway.

3. The Inevitable Policy Response

Fiona Reynolds, CEO of the United Nations-supported Principles for Responsible Investment (PRI) states "We should not bury our heads in the sand but we should be part of the solution - otherwise solutions will be imposed upon us. We recognise that a transition will take time and we will be invested in carbon intensive assets for a while since we can't divest immediately, but we have a role to play in terms of engaging companies and assessing these risks as institutional investors. Profit can't be comprised at the expense of people and the planet since there will be no jobs on a dead planet."

The PRI deems that government action to tackle climate change has been insufficient to achieve the commitments made under the Paris Agreement. Yet, as the realities of climate change become increasingly apparent, it is inevitable that governments will be forced to act more decisively than they have to date. In response, the Inevitable Policy Response (IPR) project was launched in Sept 2018.

According to this IPR, the most likely policy levers (see below) to secure an accelerated and just transition are starting to emerge.



Source: PRI

The PRI encourages investor signatories to engage in forward-looking analysis and strategic planning to better prepare for transition and mitigate financial losses associated with the IPR. Careful attention is recommended for strategic asset allocation, portfolio structure, governance approaches, and risk management responses. Specific actions include:

- Preparation of an IPR plan;
- Reviewing the role of the investment committee on IPR;
- Asking asset consultants to build capability and understanding of IPR;
- Asking credit ratings agencies to incorporate IPR;
- Amending service provider mandates for IPR with new incentives; and
- Forming collaborative leadership groups to discuss the asset owner role during IPR.

Preceding this, the Task Force on Climate-Related Financial Disclosures (TCFD) was set up in 2015 by the Financial Stability Board to develop voluntary, consistent, climate-related financial risk disclosures for use by companies, banks and investors when providing information to stakeholders.

Source: PRI

In 2018, as part of its programme on championing climate action, the PRI introduced the above TCFD-aligned indicators to its Reporting Framework. Despite the indicators being voluntary at present, it is the PRI's intention to make certain indicators mandatory to report but voluntary to disclose from 2020 onwards.

4. A Call for Divestment

Globally, there is a call for divestment in fossil fuels, with this movement growing daily. The divestment campaign was launched in 2011 by student activists in the US, starting with 40 campuses and increasing to over 400. As a result, over 11 trillion US dollars has been divested from coal to date, demonstrating the power of collective political action to make a difference.

It is not enough to divest only, but is equally important to invest in new energy technologies, and to ensure a just and equitable transition. For pension funds, divestment forms one part of a range of strategies, and can mean engagement and partial divestment running concurrently. It can be achieved by decarbonising a portfolio over a period of time and not necessarily immediately; however, late movers will be left with the stranded assets.

Divestment is not a one-size-fits-all process. For pension funds, it can include various options, such as:

- Recognising and understanding their exposure to carbon intensive assets;
- Deciding not to hold shares in companies that produce fossil fuels;
- Demonstrating active ownership by engaging with investee companies and holding them accountable;
- Being vocal on industry policy discussions and regulation, and working with academics in terms of research.

5. Just Share Report and Fasken Opinion

The Just Share Report and Fasken Opinion (report), both published in April 2019, discussed the duty of South African pension fund boards to take climate change into account when making investment decisions.

Futuregrowth has provided comment on these reports, which outlines the legal and fiduciary duty of pension funds as set by regulation, versus the ability of trustees to make choices regarding the type of investments they hold or exclude, within the ambit of their funds' long-term objectives.

Steps pension funds can take to assess the risk of climate change:

- Ensure that trustees are 'climate competent';
- Pursue active stewardship and engagement with companies in high-carbon sectors;
- Assess the carbon footprint of their investments; and
- Develop a climate policy and investment strategy with clear, measurable targets.

FSCA Guidance Note for Sustainability reporting for Pension Funds

During June 2019 we saw the release of the Financial Sector Conduct Authority (FSCA) Guidance Note (GN) on Sustainability reporting for Pension Funds. This approach, according to the FSCA, will enable flexibility and is intended to assist funds in complying with the requirements of Regulation 28 of the Pension Funds Act.

Regulation 28 requires funds to consider ESG criteria when making investments, and the GN provides an enabling environment to effect these reporting requirements. It paves the way for all pension funds to report on their ESG integration strategy and active ownership policy in their investment position statements. Significantly, funds holding assets that "limit" the application of ESG factors should explain how this limitation is to the advantage of the fund and its members. Alternatively, the fund should spell out what it intends doing to correct the situation and, if no remedial action is planned, the reasons for this.

The GN covers three main focus areas:

1. **Investment Policy**
   Funds should reflect in their investment policy statement how their general investment philosophy and objectives seek to ensure the sustainability of their assets (with a recommended list of inclusions).
2. **Disclosure of information**
   Funds should make their investment policy statement available to their members and include it on their website. They should also inform members and stakeholders annually of any changes to the policy.
3. **Reporting**
   Funds are requested to report to the relevant reporting authority monitoring compliance, on the extent to which their investment policy statement reflects the matters set out in the GN (which include a list of recommended disclosures).

As pension funds adjust to the GN, asset managers can expect to see more pressure to evidence responsible investment practices and to disclose the outcomes of their stewardship of their assets.

The full guidance note, Sustainability of investments and assets (retirement funds), is available on the FSCA website.

Conclusion

According to the CDP Carbon Majors Report released in 2017, a total of 100 companies are responsible for 71% of global emissions. The social license of coal and oil companies is running out, with investors recognising that they have a moral and fiduciary duty to take action and engage government and companies on these issues.

Furthermore, transition risks will impact future cash flows and balance sheets - and investment returns. It is no longer just a theory that inadequate information about climate risks can lead to a mispricing of assets and misallocation of capital.

Climate risk is a reality we can no longer ignore. Our response as institutional investors should be to price for these risks; engage companies on the risks they face; and determine how companies are mitigating these risks and planning to transition their businesses into sustainable alternative solutions.

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