
**Climate Change - A Risk
Management Challenge for
Institutional Investors**

by

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Executive Summary

FROM THE FOREWORD TO THE REPORT BY PETER MOON, CHIEF INVESTMENT OFFICER, USS LTD

The London Investment Office of the Universities Superannuation Scheme (USS) Ltd intends to commission a series of discussion papers to examine the relationship between corporate performance on social, environmental, ethical and governance issues and implications for long term investors.

It is hard to think of a bigger issue to address than climate change and whilst there may be different opinions about the ethics and some of the science of this issue, few would disagree with the statement that climate change has the potential to be a source of significant opportunity and risk for the corporate sector. A better understanding of the investment implications can only be of positive value for pension funds, other institutional investors, and their beneficiaries.

Whilst USS Ltd as an organisation, and you the reader, may not support every conclusion reached in this discussion paper, I am pleased to commend it for your active consideration. Some of the action points suggested can be undertaken by investors acting alone. But there are strong reasons for thinking that joint action in certain areas will be more effective and less costly. I know our Senior Adviser on Socially Responsible and Sustainable Investment, Dr Raj Thamotheram, would like to hear your views on this and he can be contacted at the address provided below.

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EXECUTIVE SUMMARY

Climate change is a major emerging risk management challenge for institutional investors. Institutional investors, and pension funds in particular, aim to provide pensions and other benefits through long term investment. They can also be seen as ‘universal investors’ in that, due to their size, they commonly invest across the whole economy. If climate change threatens economic development, and especially if there are many or significant impacts, it will also therefore be likely to undermine the ability of pension funds and other institutional investors to fulfill their aims, so it is in their interests to see that risks associated with climate change are minimised. Whilst this responsibility is widely shared, institutional investors are uniquely suited to take particular actions. This paper proposes ten such action points, together with the rationale for this approach.

But is climate change happening, will it have serious impacts, and how good is the science? This report bases its understanding of the subject on the Intergovernmental Panel on Climate Change (IPCC), the most authoritative global source of information on the issues. The IPCC’s three sets of Assessment Reports, the latest published in 2001, point to a range of serious potential outcomes from climate change that could cause great economic and social disruption.

Climate change could lead to any or all of the following risks: direct impacts such as sea level rise, droughts and floods; the possibility of sudden, major climate events; social and political risks at the national and international levels; and the threat to business from policy failures and sudden policy change.

As a risk management challenge, the optimal approach to climate change is one that takes significant action now to reduce the risks, as long as this does not involve disproportionate economic costs. A variety of evidence indicates that this is possible. There are a substantial number of options for emissions reduction at ‘negative cost’ in that they save money or generate above-average returns, and more will develop with research and development. Market-based measures are likely to be particularly effective means for mitigating climate change.

Significant reductions of the emissions that are driving climate change can be achieved through increased energy efficiency of production and service delivery, but this will need to be complemented with: substitution of high carbon with low carbon sources of energy (from fossil fuels to renewable energy); storage of CO₂, such as ground storage near power stations or through planting forests; and substitution and lifestyle changes, such as reduction of travel through use of video conferencing.

International action on climate change is desirable as the most effective way of reducing policy uncertainties and therefore business risks. While the Kyoto Protocol has

weaknesses, it is the best near term prospect of an international agreement. Regrettably, US participation appears unlikely, although there may be ways to address US concerns without seriously weakening the protocol. Overall, it is in institutional investors’ interests to engage to see this international process survive.

Longer term, however, more significant cuts in emissions beyond those agreed at Kyoto will become necessary. The IPCC has recommended cuts of 60% or more in rich countries to minimise the risk of major climate disruption. This has led to the idea of contraction and convergence, where emission rights are effectively allocated on a per capita basis globally, and rich world per capita emissions *contract* in order to *converge* with those in poor countries. This idea has gained broad and authoritative support in the UK and internationally and is likely to become a major bargaining position adopted by poor countries at climate negotiations.

Technology has a major role to play in reducing CO₂ emissions and developing cost-effective solutions. Despite uneven government support, progress in technology development has exceeded expectations. It will be most effective if governments, entrepreneurs, consumers and investors work together to achieve market transformation.

Many businesses are increasingly recognising the importance of climate change, though the response has again been patchy. Some are developing a range of activities to address it. These include CO₂ measuring, reporting and benchmarking initiatives, the use of emissions trading, and the consideration of business strategy and product development.

INSTITUTIONAL INVESTORS AND CLIMATE CHANGE: ACTION POINTS

So what can institutional investors do to better manage the risks and opportunities associated with climate change? This paper identifies ten actions, from specific measures such as the management of directly held property, to broader governance and engagement activities and, at the strategic level, active and positive involvement in the development of responsible public policy on climate change. These are summarised here.

Directly held property. Although generally a small proportion of the portfolio, this is the area where institutional investors face the most immediate exposure to climate change risks, and also where they potentially have most direct control. Thus some actions can be taken immediately:

Action Point 1. Review the portfolio's direct property investments for climate change risks and identify measures to mitigate risk exposures. These could include cost effective energy conservation strategies and procedures for assessing new developments or acquisitions, which might include considering the life cycle investment case for innovative climate-friendly buildings.

Governance and engagement. For institutional investors, engagement with investee companies on their exposure to, and management of, climate change related risks is probably the most effective place to start addressing climate change risks in the equity portfolio:

Action point 2. Engage with investee companies, particularly on the need to report on their climate change exposures and the management's response. Establish procedures for: selecting companies to engage with; following up with companies; and handling weak performance.

In order to make the fund's position consistent and transparent to investee companies, investors should develop a statement of good practice on climate change:

Action point 3. Produce a statement of what the fund considers to be broad principles of good practice for managing climate change risks in investee companies, in terms of assessment of climate risk exposures, corporate strategy (including involvement in public policy and political decision-making), and reporting.

Valuation and stock selection Climate risks, in all probability, are not being captured by existing financial analysis: analytical improvements could therefore provide additional information not currently captured in a firm's valuation. Such information and analysis is essential, and brokers have the greatest capacity among financial institutions to carry out such research:

Action point 4. Institutional investors should request that sell-side brokers comment on a company's relative exposures to climate related risks (environmental, product-related and policy-related) and the management's capabilities and positioning on climate change.

Sectoral analysis and asset allocation. There are marked differences in the climate risk exposures of, and also within, different sectors of the economy. As institutional investors

increase the sophistication of their approach to the management of climate change risks, they will be in a position to:

Action point 5. Examine the asset allocation of the fund to see if there is a significant over-weighting towards stocks with high climate change risk exposures. Consider the scope for 'win-win' action such as specialised 'pro-climate' investment opportunities that meet investment objectives while also reducing climate change risk exposures.

Implications for investment decision-making. Institutional investors need to improve their capacity to think about and act on climate change risks in order to be able to implement the measures outlined in this document. They therefore need to:

Action point 6. Enhance their own management capabilities for dealing with climate change by undertaking a programme of internal awareness-raising and learning on climate change.

They also need to show high level commitment and set a framework which encourages systematic action, review and development. Closely aligned to action point 3, institutional investors should:

Action point 7. Adopt a statement on climate change, possibly as part of any statement on socially responsible investment. This could cover some or all of the measures outlined here.

Universal investors and climate change. As 'universal investors', pension funds and others should see the climate threat to economic stability as a threat to their interests:

Action point 8. Institutional investors need to engage as a broad-based, long term voice in the development of policies and measures that seek to mitigate climate change.

Climate technology and its investors lack positive long term signals from governments:

Action point 9. Institutional investors should work with policy-makers on how to make climate-friendly investments, such as low carbon technologies and infrastructure, acceptable to investors.

A joint investors' initiative on climate change. Institutional investors should seek to involve other investors and develop joint action on the points above:

Action point 10. They should investigate the potential for a multi-investor initiative, with a mandate to address climate change policy. This will increase effectiveness while reducing costs.