Shame! Half the room hadn’t heard of our Risk Alert on climate-related risks

Mike Clark

26 October 2018
IFoA issued a Risk Alert on climate-related risks last year

How would you describe your level of engagement with it?

A: What Risk Alert?

B: I think a colleague may have mentioned it to me, but I’ve not taken any further action.

C: I’ve read the Risk Alert, and have a sense of what it says.

D: Prompted by the Risk Alert, I have integrated climate risk into some of my professional work.

E: No need for the Risk Alert – I was already doing that!
Today’s Agenda

• The IFoA Risk Alert on climate-related risks

• How are policymakers and regulators responding to climate change?
  – UK and globally

• How are investors managing climate change risk (and opportunity)?

• What initiatives are in place?

• What are the lawyers doing?

• How might we develop our thinking about investments and risk?
IFoA Risk Alert

Supporting DB and DC Guides published, others to come

RISK ALERT
Climate-Related Risks

KEY MESSAGE
Actuaries should ensure that they understand, and are clear in communicating, the extent to which they have taken account of climate-related risks in any relevant decisions, calculations or advice.

Source: IFoA, 12 May 2017
A powerful global start

Nations Unies
Conférence sur les Changements Climatiques 2015
COP21/CMP11
Paris, France

Institute and Faculty of Actuaries

26 October 2018
Key Goals of the Paris Agreement

• A strong signal to political and economic actors, everywhere
  – 2 degree goal, plus 1.5 degree aspiration
  – Nationally Determined Contributions
  – 5-yearly review process: ratchet effect
  – Art 2.1c on financial flows

• Has stimulated extensive policymaking and regulatory work at the national, regional and global level…

• …which is accelerating
Task Force on Climate-related Financial Disclosures

Recommendations are generating extensive activity

Core Elements of Recommended Climate-Related Financial Disclosures

- **Governance**
  - The organization's governance around climate-related risks and opportunities

- **Strategy**
  - The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning

- **Risk Management**
  - The processes used by the organization to identify, assess, and manage climate-related risks

- **Metrics and Targets**
  - The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Source: TCFD
Climate Change Act 2008 (UK)

• Requires government to set quinquennial carbon emissions budgets
• Established Committee on Climate Change
  – Provides independent advice to government
• Established an Adaptation Reporting Power (ARP), exercised by Defra
  – Quinquennial power, Round 3 (ARP3) is underway
  – Bank of England report on insurance and climate change (ARP2)
    • Expect ARP3 update from BoE
  – FRC, tPR and FCA invited by Defra to report under ARP3
    • (To date) FRC have confirmed they will report
Green Finance…Taskforce and EAC inquiry

Green Finance inquiry
What about Europe?

EUROPEAN COMMISSION
Action Plan: Financing Sustainable Growth

Legislative proposals:
- Taxonomy
- Investor Duties/Disclosures: Fiduciary Duty
- Low carbon benchmarks
- Sustainability: advice/products
Switzerland (Ins/Pen) and California (Ins) regulators
Assessing financial organisations’ alignment with the Paris Goals

Take Goal e.g. 2 Degrees
Apply scenario e.g. IEA
Apply to companies
Evaluate portfolio
BoE/PRA: Consultation on Draft Supervisory Statement
Banks and insurers: Managing financial risks of climate change well?

• Desired PRA outcome is that firms take a strategic approach to managing the financial risks of climate change

• PRA’s proposed expectations cover:
  – Embed consideration of the financial risks in governance arrangements
  – Incorporate the financial risks into existing risk management practice
  – Use (long term) scenario analysis to inform strategy, risk assessments and identification
  – Develop an approach to the disclosure on these financial risks

• Window for an orderly transition “is finite and closing”

• Excessive accumulation of financial risks in investment portfolio?
  – Firms should not rely on existence of liquid market to sell assets

26 October 2018
# EAC letter to top 25 UK pension funds: Evaluation

<table>
<thead>
<tr>
<th>Issue</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Considered at Board level</td>
<td>12</td>
</tr>
<tr>
<td>Listed at least one action on climate risk</td>
<td>20</td>
</tr>
<tr>
<td>Discussed climate risk with actuary</td>
<td>12</td>
</tr>
<tr>
<td>Committed to report in line with TCFD</td>
<td>7</td>
</tr>
<tr>
<td>Considering whether to report in line with TCFD</td>
<td>8</td>
</tr>
<tr>
<td>No plans to report in line with TCFD</td>
<td>10</td>
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<tr>
<td>More engaged</td>
<td>11</td>
</tr>
<tr>
<td>Engaged</td>
<td>10</td>
</tr>
<tr>
<td>Less engaged</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: House of Commons Environmental Audit Committee
Investment Regulations: DWP consultation on changes

*Trustees to set out their policy (in SIP)*…

- …in relation to financially material considerations including…those arising from ESG considerations, including climate change

- …in relation to the stewardship of the investments, including engagement with investee firms and the exercise of voting rights associated with the investment

And for DC schemes, Trustees to:

- prepare or update their default strategy to set out how they take account of financially material considerations, including those arising from ESG risks, including climate change

And then: Produce an implementation report setting out how they acted on the principles in the SIP

Source: Consultation on clarifying and strengthening trustees’ investment duties (DWP, June 2018)
Asset owner activity

- Growth in climate-aware resources and capabilities
- Insurer (and bank) risk management embracing liabilities and assets
- Evolving investment strategies, based on the asset owner investment beliefs
- Low carbon portfolios
  - HSBC (LGIM), NEST (UBS)
- Disinvestment from coal and tar sands, wider fossil fuel divestment
- Increased focus on ownership activity: proxy and engagement
- TCFD reporting, actual and commitments
- Regulatory interest in DC Independent Governance Committees

26 October 2018
Collective Engagement – Aggregating ownership power
A helpful guide
Initiatives, Initiatives, Initiatives
Risky Business: actuaries, inv. consultants, auditors
Interventions using existing law and regulation

• Three insurance firms reported to FCA for failure to disclose climate risks in their annual reports

• Four UK companies reported to the FRC over perceived failures to address climate change trends and risks in their reports to shareholders.

• Plus letter to the auditors of the four companies

• Letters to trustees of 14 pension schemes as follow up to (25) letters written by House of Commons’ Environmental Audit Committee (EAC) as part of their Green Finance inquiry

• Member of Shell pension fund may go to the Ombudsman (maladministration) unless fund can show it is managing its climate-related risk
All Swans are Black in the Dark

How good are financial markets at pricing long term risk?

Source: Generation Foundation, 2 degrees Investing Initiative
So what issues *should* asset owners consider?

Source: The Investment Integration Project
*Systems-Level Considerations and the Long-Term Investor (Lydenberg)*
Two ways to think about risk and value

Finance Theory Metrics/Models
- beta, alpha
- Expected return, standard deviation, covariance
- Efficient Markets Hypothesis
- CAPM (Capital Asset Pricing Model)
- Tracking Error
Modern Portfolio v2.0?

systemic risk

alpha beta
Summary

• Extensive policymaker and regulator activity around climate change

• Climate change risk is a strategic issue

• Investors developing their capabilities, strategies and activity

• Legal risk increasing

• Do we need to develop our thinking?

• *How will you view the Risk Alert tomorrow?*
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