Thinking about climate risk yet?

"Those with much shorter time horizons cannot ignore the issues"
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The headlines are dominated currently by record-breaking temperatures and out of control wildfires in numerous places around the world. Are we now beginning to see the devastating physical effects of climate change on a daily basis?

Since the 2016 Paris agreement, climate-related issues have moved up many corporate agendas. Just over a year ago the Institute & Faculty of Actuaries issued a risk alert on climate-related risks, encouraging all actuaries to consider how climate change might have an impact on their advice.

An understandable initial reaction was to assume that this risk alert was directed at those members of the profession advising on premiums and reserving for insurance products with an element of cover against extreme weather. The relevance for those advising on pensions was perhaps less obvious, at least until you delve a little deeper.

Types of risk

It is very easy to view climate risk solely in terms of the physical damage to property and infrastructure caused by extreme weather events. However, in a speech back in 2015, Bank of England Governor, Mark Carney, identified climate-related risks as falling into three basic categories: physical, transitional and liability.

Transitional risks are beginning to emerge, as the consequences of government policies and other behavioural changes to minimise the impact of climate change. A recent example is the policy shift away from purely petrol and diesel vehicles in the UK by 2040.

Liability risk relates to the financial and reputational impact arising from potential future legal actions against organisations whose historical actions (or lack of action) may have exacerbated a climate-related issue.

Impact on pension schemes.

Those with longer term investment horizons such as pension schemes, and particularly defined contribution schemes, are most at risk of the financial implications of climate change.

However, investors with much shorter time horizons cannot ignore the issues, since they could also be affected if markets price in climate-related risks more quickly. Clearly all pension trustees will need to think about the extent to which their investment portfolio could be adversely affected by the impact of climate change. But what about other areas?

Employer risk

The direct impact on the sustainability of the sponsoring employer needs to be considered. Could it affect a sponsor's ability to fund the scheme? How well could its business model adapt to changes in government policy driven by climate change? For example, if your sponsoring employer is already part of the electric car industry, it is probably better placed than one that would struggle to adapt to a lower carbon world.

Longevity risk

What are the implications for mortality projections? It is well-known that heat waves and severe cold snaps result in a higher than average number of deaths over the period. However, there are also expected to be some health benefits as a result of actions taken to limit climate change; less pollution and better air quality is expected to reduce the numbers of deaths, particularly from respiratory-related diseases. Quite how these two opposing effects offset each other remains to be seen, but many expect the overall impact of climate change to have a limited impact on life expectancy.

What should trustees do?

A good place to start is to think about what climate-related risks might affect either the scheme's investment portfolio or the strength of the sponsoring employer's covenant. Any risks and any mitigations should be included within the scheme's risk register.

The scheme's statement of investment principles may also need to be reviewed and updated to reflect any changes in approach or strategy.

Trustee checklist

The UK Sustainable Investment and Finance Association (UKSIF) has identified five risks in the transition to a low carbon economy. They have produced a helpful checklist for pension scheme trustees to consider the risks to their scheme.

Further details can be found at: http://uksif.org/resources/a-checklist-for-pension-trustees/

Risks identified by the UKSIF	
Political	Action from policy makers to reduce greenhouse gas emissions, impacting the value of high-carbon assets
Legal	Litigation claims brought against companies for failing to mitigate against climate change or disclose material financial risks
Technology	New technologies affecting the competitiveness of certain organisations
Market	Shifts in supply and demand for products and services as the market increasingly takes account of climate risks and opportunities
Reputational	Climate change has been identified as a potential source of reputational risk tied to changing customer or community perceptions of an organisation