

Climate change policy

September 2019



Introduction

The People's Pension (the Scheme) is a defined contribution (DC) master trust open to all UK employers. We have over 4 million members and grow by more than £1bn in contributions annually. As an open and growing master trust, we have a long-term investment outlook.

This direction is over a longer period of time than many UK pension funds, given the majority of defined benefit plans are closed. Because of this we must consider and react appropriately to all risks that are likely to be material over the long term.

We have a policy on responsible investment which outlines our approach to all environmental, social, and governance (ESG) issues whether or not they're financially material. In the policy we highlight the need to prioritise research on ESG issues by their materiality. This policy on climate change reflects that prioritisation. We accept that climate change is likely to be the most financially material of the ESG issues as it will affect every business sector and geographical area.

Climate risks

Climate change poses a number of risks to the value of our members' pension pots. These have the potential to compound and lead to significant permanent losses. The Bank of England's Prudential Regulation Authority¹ reported on three primary risk factors that are likely to materialise as the temperature rises. They are:



Physical risk:

These result from the potential for more frequent or severe extreme weather events (droughts, flooding, prolonged hot and cold periods) as well as the steady increase in global sea levels and changing prevailing climate. These could cause disruption to businesses holding or relying on physical infrastructure.



Transition risk:

These are associated with the economy moving towards a low carbon economy. Some sectors are going to require significant investment in new infrastructure or face penal incentives from government and civil society that will harm their current business model.



Liability risk:

These come from people or businesses seeking compensation for losses they may have suffered as a result of physical or transition risks. These may be third-party liabilities (ie those seeking compensation for damages of physical risks) or direct liabilities (ie those seeking compensation for financial losses).

While there are a number of ways to capture the range of risks, we believe these primary risks are useful and will adopt them for this and subsequent policies.

In addition to increased risk of loss, we also recognise the opportunities that will arise in businesses supporting the transition to the low carbon economy. Companies which are more successful in the research, development and scaling of climate-related technologies stand to gain in this transition. Likewise, companies with better environmental performance in their sector may lead to long-term cost savings relative to their peers. Climate risk encompasses both downside (loss) and upside (gain) events for business.

Our fiduciary duty

The Trustee of The People's Pension (Trustee) acts as fiduciary over the savings held in the Scheme. Our policy on responsible investment sets out at a high level the steps we need to undertake to carry out our fiduciary duty in respect of ESG issues.

The first step is an overall prioritisation of ESG issues to select the ones most likely to be considered to be financially material to member outcomes. Our initial focus on climate change through this policy is because we consider climate change to be the most likely to be material. The reasons for this are set out in the next section.

The second step is to research the issue and understand:

1. whether the issue is likely to affect asset values
2. whether we've sufficient confidence that data on companies will enable us to alter portfolios to improve member outcomes.

Where we believe the risk is material and that we've sufficient insight from data into how to protect or benefit member investments we're obliged to act. This policy sets out why we've prioritised action on climate change and the research we'll carry out to seek to improve member outcomes.

Where we don't believe the risk is material, or where we don't have confidence that data is available that will give us insight into improving returns, we can either:

1. exclude the issue from our portfolios if it affects a small proportion of our assets
2. engage with investee companies on the issue and changes we would like to see if it's widespread.

The prioritisation of climate change risk

A greenhouse gas (GHG) is a gas that absorbs the thermal infrared radiation emitted by the Earth, warming the lower atmosphere. GHGs are generally measured in CO₂ equivalents, the quantity of CO₂ that would have the same warming potential, so that consistent assessments of temperature rises and other effects can be made.

Different gases have different warming strengths and will remain in the atmosphere for different lengths of time. Not all GHGs are equal and the finer detail of our approach may have to incorporate this point.

Human activities since the beginning of the industrial revolution have produced a large increase in the atmospheric concentration of GHGs, and CO₂ emissions are currently the highest in history². A wide range of scientific and governmental bodies have confirmed that this is the cause of the rising global temperature. Global temperature and climate risks are predicted to increase dramatically in the 21st century unless GHG emissions are reduced significantly. There is increasing consumer, corporate and regulatory pressure to shift business models in a way that allows for a smooth transition to a low-carbon economy. In response to this, numerous organisations have been established and existing organisations and regulators are now developing their own recommendations for those under their responsibility.

Intergovernmental Panel on Climate Change (IPCC)

The IPCC was formed in 1988 and is a global body of the world's leading climate scientists. It's a collaboration between the World Meteorological Office (WMO) and the United Nations (UN) Environment Programme (UNEP). It publishes regular reports gathering the current scientific literature reviewing climate science. Its current consensus is that global warming above pre-industrial levels should be kept below 1.5°C³. The IPCC predicts that based on 2010 levels, emissions of CO₂ and its equivalents will need to decline approximately 45% by 2030 and be at net zero by 2050 to limit the warming to 1.5°C.

The prioritisation of climate change risk (continued)

The UN Framework Convention on Climate Change (UNFCCC)

The UN has convened an annual 'Conference of the Parties' (COP) since 1995 aiming to bring all governments around the world together to agree how to address climate change. This has resulted in a number of agreements, but the most recent and widest-reaching was the Paris Agreement signed in 2015. This is a major driving force in the conversation on how to begin to tackle climate change. The goal of policymakers who negotiated the agreement is for countries to submit carbon reduction pledges in an effort to keep global temperatures well below 2°C above pre-industrial levels.

The Committee on Climate Change (CCC)

The Climate Change Act (2008) made the UK the first country to establish a long-term legally binding framework to cut carbon emissions. It contained a target requiring emissions reductions of 80% by 2050 compared to 1990 with five-yearly carbon budgets acting as stepping stones towards this target. The Act also created the Committee on Climate Change (CCC) to advise the UK government and devolved administrations on tackling and preparing for climate change. The CCC is independent of government to ensure a long-term apolitical process is in place. Since the introduction of the CCC, there have been policy proposals globally to combat climate change and this is likely to continue. According to the CCC, as of 2017, the UK has met or is on track to meet the first three carbon budgets but not the fourth, which covers 2023-27. In 2019, based on recommendations from the CCC, the UK passed laws that contained a revised target of net zero GHG emissions by 2050. To meet the carbon budgets and an updated 2050 target, further reductions are needed which may lead to more challenging requirements on UK industries within the next few years. The CCC regularly reports on the progress made in reducing GHG emissions and has a prominent role in advising further UK strategy.

UK government and regulators

The Bank of England has highlighted the fact that climate change, and society's responses to it present financial risks which impact upon the Bank's objectives. The Financial Conduct Authority (FCA) has confirmed that it believes climate change to be a material factor in the financial performance of pension funds and has proposed plans to require all financial services entities to report publicly on how they manage climate risks. In addition to this, it's consulting on how best to ensure issuers of securities disclose appropriate climate related information.

In 2018, the Department for Work and Pensions (DWP) announced plans for all trust-based schemes to be required to explain how they take account of financially material considerations including, but not limited to, those arising from ESG considerations, including climate change.

Task Force on Climate-related Financial Disclosures (TCFD)

The Financial Stability Board launched the TCFD in 2017 and proposed a list of voluntary risk disclosures in four key areas:

- governance
- strategy
- risk management
- metrics and targets.

The TCFD has over 500 supporters consisting of companies, industry associations and governments. The companies represent a broad range of sectors including financial firms responsible for assets of nearly \$100 trillion as of September 2018.

Our climate change policy

The Trustee relies on expert opinion from IPCC, UNFCCC, CCC and UK government and regulators in concluding that climate change poses a material financial risk to the value of members' savings. While the scientific evidence is compelling, we acknowledge that there is still debate around the politics and process of addressing climate change.

We acknowledge that while potentially challenging, we support the objective set through the UNFCCC, COP and IPCC processes of keeping warming compared to pre-industrial levels below 1.5°C and our policy is aligned to this objective. Likewise, we recognise the role of the IPCC in defining the emissions pathways that should achieve this target. In future, should the objective be altered by the UNFCCC or IPCC we will review this policy.

We have a fiduciary duty to consider all material financial risks when making investment decisions and we make no distinction in this between our default and self-select funds. We must manage climate change risks across all member options as best we can, recognising our greatest scale and ability to influence investments ourselves is in the default funds.

In addition to the financial costs associated with the transition to a low carbon economy, we accept that there is also a potential social cost for workers, communities, and countries as this shift takes place. We will make efforts to ensure that this social cost is shared fairly by integrating the workforce and social dimension into our processes. For this reason, we have signed the Statement of Investor Commitment to Support a Just Transition on Climate Change that has been prepared by the Principles of Responsible Investment (PRI).

Process

We're able to approach climate risk recognising we're a growing fund whose size is still primarily driven by contribution inflows rather than pension payments or returns. Assuming our membership stays similar in the future, this means:

- By 2030 when the IPCC states emissions need to have dropped by 45% relative to 2010 levels, we'll have received contributions of circa £40bn compared to around £5bn today.
- By 2050 when the IPCC states the global economy needs to be not emitting any GHGs at all, we'll have received contributions of circa £100bn compared to around £5bn today.

This means that the sooner we can research and find investments for net zero emissions portfolios, the fewer legacy assets we'll have to deal with in achieving the IPCC's recommended emissions pathways.

We've taken initial steps to reduce fossil fuel reserves and carbon intensive companies by investing in a multi-factor fund which screens out higher exposures to these, but this is only a start. We know because of our growth that we don't need to over-react and risk financial value in the short-term, but at the same time we recognise the significant amount of research that needs to be carried out by all stakeholders to create a broad and diversified portfolio representing the whole economy with net zero GHG emissions. This is our task over the coming years.

In keeping with our Policy on responsible investment, the broad steps we intend to take are:

- research on the risks and opportunities highlighted by better data
- engage with investee companies and exchanges to ensure our data requirements are met
- progressively make low carbon investments, firstly by focussing on getting investments that could make the contribution flow into a net zero emissions portfolio. Secondly, by dealing with legacy high-carbon assets in the portfolio.

Any approach we develop and implement now is likely to need adjusting and evolve as we grow, the market develops, and as new evidence is published. We'll keep this policy under review as our research process proceeds, and in any case every three years.

Net emissions reduction

There are several ways in which a net emissions reduction can be achieved. We will research the best option(s) for achieving this. One possibility is to apply a tilt to create a low carbon fund.

Tilting is the practice of increasing or decreasing the weighting of a specific factor within the fund compared to the parent index. An example of this would be where the index is roughly followed but there is a slightly higher percentage given to companies with low carbon emissions and a lower percentage invested in high carbon emitters.

The first step in the reduction began in December 2018 with a percentage of the portfolio being allocated to a multi-factor ESG + low carbon fund. This fund will both improve the ESG profile of the funds (climate change forms part of the 'E' component) and also use a tilt to reduce fossil fuel

Our climate change policy (continued)

reserves and carbon emission intensity. The low carbon tilt results in a reduction in the carbon emission intensity and potential emissions of at least 50% compared to the parent index.

Setting the timeframe

We believe it's important the portfolio eventually represents net zero carbon emissions. However, we don't believe that complete divestment from all carbon intensive sectors at this time would be in the best interest of our members, as it could negatively impact the eventual size of their pension pots.

We expect the portfolio to grow dramatically in the next few years and this will primarily come from contributions. In keeping with the IPCC's current emissions pathways our current aim is that from the mid-2020s we're able to make all future contributions into investments that have net zero GHG emissions. This will help us achieve the reduction of emissions by 45% relative to 2010 levels. As contributions go to net zero GHG emissions, this will reduce the overall percentage of the portfolio invested in companies that are high/medium GHG emitters. By reducing the carbon intensity of the portfolio in this way, it reduces the percentage of returns linked to carbon emissions and should allow for a smoother transition to a net zero emissions portfolio without some of the risks associated with mass divestment over a short period of time.

Engagement with security issuers, regulators and exchanges

There is currently a lack of disclosure of appropriate climate-related metrics in financial filings and we'll encourage disclosure becoming mandatory for all issuers of investment products. The recommendations of the TCFD provide a useful framework for this. Obtaining consistent quantitative data on GHG emissions is currently a difficult task especially with indirect emissions that occur in the value chain (GHG Protocol's Scope 3 emissions). Data collection methods and sources are continuously improving, and we'll work with data providers and asset managers to gain their insight on how to best address this issue and assess how we can manage climate change risks in the most effective way to improve the overall risk and return characteristics of the portfolio.

Our engagement is, therefore, on two topics:

1. We engage with providers of data and disclosure codes on the appropriate metrics of emissions and other features of climate change risks.
2. Through our investment managers we engage with the investee companies on the actions they're taking to address climate change risks.

As a large investor, we're likely to be currently invested in some of the companies that have assets that are at risk of becoming stranded in a low carbon scenario. 'Stranded assets' are assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities. Examples of the climate change risks that could alter asset values include:

- changes to regulations
- changes in costs/prices of fossil fuels and alternatives
- evolving social norms (changing consumer demand).

We'll look to identify those companies we believe have not taken the necessary steps that would allow them to provide sustainable financial returns in a low carbon economy and will attempt to work with them on issues that could have a material financial impact. Engagement is not always successful, and companies are not always willing to engage with shareholders on solutions to what they view as an issue. In the case of failed engagement with companies, further action may be required such as voting against current board members, reducing the amount invested, negotiating a change to the dividend, or removing them from the portfolio entirely.

Review & bibliography

We'll review this policy at least every three years or as our research produces outputs.

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