Systemic risks, such as climate change and biodiversity loss, pose a significant challenge to pension schemes and long-term investors. Our all-member event explored how effective management of these risks involves adopting impact investments, fulfilling fiduciary duties and integrating environmental considerations into investment strategies

All-member event blog

How do asset owners address systemic risk?

By Bruna Bauer

The world is undergoing unprecedented change, with the consequences of the climate crisis, social inequality and other systemic risks becoming increasingly evident. Pension schemes and other long-term asset owners are significantly impacted by these changes. We are beginning to see asset owners respond in two ways: firstly, by allocating capital to investments that have a positive impact and, secondly, by considering how their actions can improve the entire system, including through policy, advocacy and stewardship.

Richard Giles, Senior Director & Community Lead at *Pensions for Purpose*, invited *Gordian Advice, Hymans Robertson, Rebalance Earth* and the *Global Impact Investing Network (GIIN)* to discuss how to define systemic risks and the reasons and strategies for pension funds to address them.

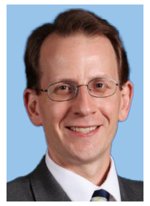
Defining systemic risks

Systemic risks are unhedgeable risks investors are exposed to and cannot avoid through their investment strategies. Climate change and biodiversity loss fit this definition.

Nick Spencer, Founder of *Gordian Advice*, explained the materiality of such risks in long-term returns and the ability to pay pensions make them of express interest to pension schemes. Although we tend to think of climate change as a long-term risk, markets can reprice overnight, making the discussion urgent. Despite such risks being unhedgeable, pension funds can still take positive actions to manage or mitigate their impact.

- Addressing long-term horizons: long-term systemic risks are often underestimated by markets. Trustees must engage with these risks, as they are often overlooked in benchmarks and by practitioners.
- Risk as opportunity: underappreciated risks offer options to invest and stay ahead of change. To benefit, we must identify and invest in positive shifts.

Pension funds concerns



Many investors feel caught between conflicting pressures when allocating to impact. **Sean Gilbert**, Chief Investor Network Officer at the *GIIN*, explained different interpretations of fiduciary duty make trustees cautious about the issues they can embrace. In addition, there is a broader sense that simply delivering financial returns is no longer sufficient, especially for future generations. The key challenge is integrating impact investments into a portfolio in a structured, defensible and appropriate manner for a pension institution.

Biodiversity loss as a systemic risk

Nature encompasses everything in the physical and non-physical world: mountains, glaciers, rivers, soil and all living things, which we call biodiversity.

Robert Gardner, CEO and co-founder of *Rebalance Earth*, shared an anecdote to illustrate the direct impact of climate change, biodiversity and nature loss. His sister's house was hit by Hurricane Beryl, the first hurricane to strike Texas in over 40 years. As a named storm, it caused her insurance excess to increase and reduced the value of her home.

Two critical aspects of biodiversity need our attention: abundance and richness.

- Abundance refers to the number of individuals, such as elephants, sharks and bees.
- Richness refers to the variety of species and their genetic diversity.

Since the 1970s, the weighted average of abundance and richness has decreased by 70%, meaning we are undermining the ecosystem's resilience and feedback mechanisms. As a consequence, there is a higher frequency and intensity of extreme events. In the UK, what was once a 1-in-100-year flood event now occurs every one in 10 years, a trend likely to worsen in the next 25 years. Climate change and extensive landscape alteration play significant roles: the UK has lost 90% of its seagrass, removed 800,000 to a million ponds from farms, leading to insect loss, and degraded its soil.

This generates significant consequences for society and the economy. In addition to high insurance costs and decreased property values, food security is a major concern. Poor-quality soil affects food production, reducing supply and increasing prices. Rob emphasised this is a risk we are already facing, and stressed that biodiversity loss and nature's decline impact us all, both as individuals and as businesses.

Time-scale and defining priorities

Sanjay Joshi, Impact Specialist at Hymans Robertson, explained that, as an investor, your strategic asset allocation is crucial, while stock picking is less so. Similarly, in impact investing, strategic themes are central, with execution important but secondary. Despite this, today's financial industry is lacking evidence-based methods for selecting priorities amongst impact themes.

While more research is needed, existing work highlights climate change and nature as central considerations; it also notes pandemics and artificial intelligence as systemic risks with significant implications for humanity.

Climate change and fiduciary duty

Sanjay mentioned we often view climate change risks as distant; however, they exist both in the future and as immediate, significant tail risks today, which will worsen over the years.

Historically, fiduciary duties were seen as optional in addressing systemic risks. However, the latest Financial Markets Law Committee paper states that pension assets and member safety should be protected from these risks. This creates a delicate balance: if you take extreme measures with minimal benefits to climate or nature at a high cost, you fail your fiduciary duties. Conversely, ignoring these systemic risks is equally negligent.

Nick complemented this thought by arguing the fundamental purpose of fiduciary duty is to pay pensions. Since these risks are material and financially relevant to this purpose, they should be considered. "It's not enough to think whether we're going to pay the next pensions, we need to think whether we're going to pay the last pension," he said.

Sean emphasised that fiduciary duty is not a binary choice between considering or overlooking certain issues. Instead, it involves a thoughtful process of making reasonable decisions while considering relevant timeframes. He highlighted that the purpose of a pension system is to provide members with a sense of security and enable them to live with comfort and dignity during retirement. Consequently issues that undermine this purpose, such as climate change, must be considered.

Choosing impact themes for investing

In simple terms, Sean listed three major steps pension funds can take to define impact themes for capital allocation:

1. Describe the problem you aim to solve (e.g., access to social housing), giving you the space to consider opportunities to address this.
2. Define the product types found in various asset classes that would help solve the issue (e.g., private debt, municipal bonds).
3. Communicate your priorities to asset managers to ensure they are taken into account – investments should meet financial criteria and address such issues.

Nature as part of the solution

First, identify the problem. Next, find the solution. Finally, implement it. Rob painted a concerning picture of the aftermath climate change is already causing.

In the UK, by 2030, climate change, nature loss and biodiversity loss could cut GDP by 8-12%. We need to address flood and drought risks; ironically, while we worry about the former the latter is also a threat.

Water is essential to industry and agriculture, while healthy soil is crucial for food production. UK supermarkets are aiming to source 65% of produce domestically but, despite all this, we lack a comprehensive food security strategy. Were we to lose bees and pollinating insects it would cost £1.8bn annually to hand pollinate.

According to the *Natural History Museum*, the UK is among the least biodiverse countries, ranking in the bottom 10% globally. We've altered our landscape by canalising 90% of our rivers, leading to a loss of insects and fish, and affecting flood and drought responses. Excessive pesticide and fertiliser use has degraded our soil, stripping it of carbon and its carrying capacity, thus reducing resilience.

While the UK can't change the global impact of climate change, we can adapt and mitigate our own response. Nature-based restoration can reduce material risks for companies, often at a lower cost than traditional infrastructure. Instead of spending more on the latter or relocating facilities, why not invest in nature?

For example, restoring rivers brings back insects and fish, boosts species abundance, supports agriculture and sequesters carbon. Cities like Manchester, which aims to be net-zero by 2038, have a great opportunity to combine grey and green solutions. The nature-based solution potential in Manchester alone is larger than the existing global voluntary carbon market.

Investing in nature as infrastructure provides financial returns for pension funds and creates sustainable cities and communities. Companies benefiting from nature-solution initiatives should contribute financially, leading to both environmental impact and financial gain, similar to traditional infrastructure investments.

Beyond capital allocation: policy and advocacy

Nick mentioned that investing in solutions to address the main issues we face helps to create resilience against climate change. He cited stewardship as a great source of influence, both at the asset level but also as 'macro-stewardship', where improvements in regulations at the government level are advocated. The power of collective action was also seen as crucial.

Sanjay drew attention to the importance of engaging asset managers, and presenting them with a clear, strong and ambitious vision. Sean added the need for specificity to this list, mentioning managers often leave meetings without much clarity about what asset owners want beyond a broad theme.

Demographics as a systemic risk

Nick mentioned some trends indicating demographics presents a substantial systemic change. For example, the *International Organisation for Migration* documented an increase in 41% in disaster displacements in 2022, compared to the annual average of the decade before. A less discussed topic is that Nigeria will become the world's fourth most populous country by 2050 and is likely to become the most populated by the end of the century. In this context, he highlighted the significance of the launch of the *Taskforce on Inequality and Social-related Financial Disclosures* in September 2024, a topic thoroughly explored at a previous *Pensions for Purpose* event.

All-member event blog

BREAKOUT ROOMS

Room 1 – how to scale impact investing

- Mobilise more capital to address climate solutions and biodiversity loss.
- Consolidation is key to achieving scale, whether in defined benefit schemes, wealth management or public sector initiatives. However, time is required for this to mature and generate impact.
- Focusing on areas with existing large capital pools like local government pension schemes and master trusts can accelerate impact.
- Sustainability ensures long-term financial returns and risk management for investors.
- Impact focuses on creating value through impact key performance indicators at the asset or corporate level, applicable in both public and private markets.

Room 2 – addressing systemic risks

Asset owners' challenges:

- Resource constraints and uncertainty in prioritisation.
- Value of collective action with similar-minded peers.
- Effective engagement with asset managers through clear plans and theories of change.

Systems change perspective:

- Address underlying political and economic systems.
- Avoidance of a narrow focus on symptoms (ie climate change, biodiversity loss).
- Role of investors in driving broader systems change.

Impact investing's role:

- Focus on companies that provide systemic solutions.
- Emphasise investments delivering high impact and strong financial returns.
- Financial resilience is a prerequisite for effective environmental and social impact.

Room 3 – what should the new UK government prioritise?

Long-term vision and incentives:

- Articulate a comprehensive vision beyond net zero, including nature conservation.
- Recognise the importance of clear market signals and regulatory consistency to mobilise private capital.
- Consider market-based approaches like carbon markets and environmental taxation to incentivise sustainable practices.
- Build public buy-in through clear, consistent policies supporting net-zero objectives.

Action plan for pension funds:

- Influence investee companies towards climate-aligned lobbying and policies.
- Leverage the UK's significant pension fund market (projected to reach £5tn) to drive impactful investments.
- Implementation.
- Engage with asset managers to ensure alignment with climate goals and effective stewardship of assets.

Impact Lens

Are you interested in learning more about how asset owners are addressing systemic risks? Our research includes published and commissioned reports. Through engagement with a range of stakeholders, we gather insights into the challenges of sustainable and impact investment. Impact Lens seeks to offer solutions and informed decisions on governance and investments.

Read *Pensions for Purpose*'s latest report, 'Navigating diversity, equity and inclusion – an asset owner perspective,' sponsored by *Jupiter Asset Management, or visit our Impact Lens section*.

We are seeking sponsorship for up-coming reports, please contact us if you're interested.

Join Pensions for Purpose

This event was open to all our members. If your organisation isn't a member you can attend an event before deciding whether to join. See our events.

More information on this topic?

Email Karen Shackleton or Bruna Bauer.

Click here to watch the event video and synopsis.

- ***Bruna Bauer is Research Manager at Pensions for Purpose***

Help for asset owners

Pensions for Purpose **offers bespoke pension committee training and facilitated workshops to help funds clarify their priorities, goals and how to achieve them. Our Knowledge Centre contains hundreds of articles on many topics, with over 300 articles on Paris Alignment, alone.**