TRANSCRIPT - PENSIONS FOR PURPOSE PODCAST SERIES 2, EPISODE 3
How can investors be realistic about climate change?

Laasya Shekaran: Hello everyone, welcome back to the Pensions for Purpose Podcast. I'm your host Laasya Shekaran, and today I am joined by not one, but two brilliant guests, Tegs Harding and Roger Mattingly from IGG.

Tegs and Roger are both professional trustees and they sit on a range of defined benefit, hybrid, and defined contribution pension trustee boards, including DC master trusts, and they have a lot of experience working with these trustee boards and pension schemes to incorporate sustainability risks and opportunities, and particularly considering climate change. Tegs and Roger, welcome to the podcast, we're really, really happy to have you join us today.

My Pensions for Purpose co-host for today's episode is David Brown, who in addition to being part of the Pensions for Purpose team, is also a professional trustee himself, welcome, David.

David Brown: Good morning, it is great to be here again.

Laasya Shekaran: Now, today's conversation is going to be a really interesting one, because we're going to be talking about how investors can be realistic about climate change. So are investors being realistic about the likely climate trajectories we face, and what this means for their investment strategies. Are they being realistic about what they can do to address this, and what's actually going to make the biggest difference, and how does all of this fit into a political backdrop, where there are sort of major world leaders pulling away from their climate commitments. So Tegs, let's start at the beginning, and take a stock take of where we are today. What does the current environment look like when it comes to our climate pathway?

Tegs Harding: Firstly, if you look around and read the news, you can see the impact of extreme weather events around the world, from Los Angeles to Valencia and then knock on impacts that is having on the insurance sector. So we're starting to see the impact of this on the economy now and if you look at what the climate scientists are saying there is more evidence out there, that warming is going faster than people had expected. In particular, 1.5°C target is now in our rearview mirror sadly and accelerating faster.

January 2025 has been the warmest on record, despite the fact we're in an El Nino event, which is a cooling event, so the data is off the charts and climate scientists are becoming increasingly alarmed about what they're seeing.

I think if you combine that with the geopolitical factors that we're seeing around the world, so Trump has taken the US out of the Paris Agreement. Asset managers and banks have followed suit in terms of disbanding or leaving their climate committees that we're working together on, and some of those issues you're seeing the ripples from. I think it's becoming increasingly apparent that the world is not transitioning as fast as it needs to, and it's certainly not looking likely that we're going to see a large and accelerated transition in the short- to medium-term.

What that means for pension trustees is the next question, which I think is really important and this is what my boards are doing, just taking stock and truly trying to look at that question, of if we got the right measures of climate risk here in a world that isn't transitioning, what is my portfolio going to do, which bits are going to be resilient, which bits aren't, what does it mean for members and member outcomes.

Laasya Shekaran: Yeah, I think that's a really important point, perhaps we're focusing on the wrong thing, what do we do to prevent the climate trajectory of more than 1.5°C, when we know that's the realistic direction that we're going. We've already passed 1.5°C, how do we adapt to that Roger, do you think that investors are currently understanding the full level of risk that climate change poses to their pension schemes and particularly the financial risk of it all?

Roger Mattingly: So the short answer is no, it's becoming very evident. It's been portrayed in numerous press articles that the current scenarios being hypothetical constructs, not actual predictions of what the future will hold, which are bordering on nonsense in the respect that they are showing a very limited impact in a hothouse world, where the impact on the economy and the impact on markets could be catastrophic. In fact, if you compare the likes of the network for greening financial systems scenarios with the increasingly compelling output from the Institute of Faculty of Actuaries and the University of Exeter Climatology department, they are increasingly showing 50% plus impact on global GDP. Those are almost certainly the more realistic outcomes of the risk that climate represents. Of course it isn't. It's the physical risk, it's a transition risk, systemic risks and it is also the non-linear tipping point risks that could accelerate exponentially these risks.

At the moment as Tegs has just highlighted, in some quarters of the world they are being effectively denied. So, it's imperative these are financial risks, these are not non-financial risks and that has come out very clearly in in recent opinions, legal opinions. So, it is imperative that trustees take these risks seriously, that they take them materially into account and in my strong view, it's a dereliction of trustee duty for them not to do so.

Laasya Shekaran: Yeah, I think that's a really strong statement and we'll certainly get into that sort of legal discussion around non-financial versus financial factors later on. But I wonder on the scenario analysis point, I mean the network for greening the financial system scenarios, is still pretty mainstream. They're used quite widely across industry and perhaps even within government. Do those scenarios need to more closely align themselves with those that the IFOA have produced or sort of how do we go about making sure that mainstream scenarios are being realistic about this?

Roger Mattingly: The whole subject of climate change reporting needs an overhaul. My understanding was the DWP were going to consult on this a while ago. That is, in my view, long overdue now. These sequence of reports that are coming out of the University of Exeter and the universities superannuation scheme, has been involved as have The Institute and Faculty of Actuaries, the latest one being the planet solvency ‘Finding our balance with nature’, but it's one of four of these reports, and it's becoming very obvious they need to be more real world in terms of those scenarios, stating the obvious; the longer the time horizon, the more speculative the numbers become.

I think increasingly there is a desire to use shorter time horizons. The great thing about being pairs of trustees and DC master trusts, for example, is we can take a long-term time horizon, and. We can take an almost infinite time horizon, but looking 50-100 years ahead it is quite meaningless in terms of the real world. What is very evident that's coming out of those reports, and the academia that's going into those reports is that there is a need to take shorter term time horizon. For example, a rolling ten years focus on not just climate itself, but the vicissitudes of politics. Markets and extreme weather events and non-linear tipping events that can completely upend the current scenarios and projections as well.

So yes, there is an absolute need. If we've also got the subject of universal ownership and the larger these schemes become, the more obviously they become universal owners, even things like the Mansion House compact creates some universal ownership, where these schemes are representative of the global markets effectively. You've got this double materiality of a lot of these investments are impacting the climate, but they've also got the impact of the climate on those firms themselves and those companies and those investments. It is stating the obvious, this is a very complex situation. However, just because it's complex, doesn't mean that trustee boards shouldn't get their heads around it and take it very seriously.

David Brown: Very wise words Roger and I think it is very complex, but it's not something we can kick into long grass. It's something we need to pay attention to today. I think listening to your comments and notes from Tegs, earlier really reminded me of Charles Handy's frog analogy, where if you put a frog in hot water it will jump out immediately, but if you put the frog into cold water and temperatures then raise gradually, it would be unaware of the danger until it's far too late. I do feel that at society level we are very close to that position today and action is needed at every level. Clearly today our focus is on the investment. So the question I want to put to you Roger, is what should investors be doing to better address the realities of climate risk?

Roger Mattingly: We'll start now thinking very seriously about the how they report. At the moment, the Task Force on Climate-related Financial Disclosures (TCFD) reporting is a regulatory disclosure document. It's not a working document or it's not at least the working document it should be. The question that you ask at the end of completing one of these reports is ’so what?’ and that needs to change and this work. These documents need to become proper risk management documents.

So I am, as I say, very keen in the absence of immediate change in in the laws and regulations in terms of TCFD reporting, TCFD itself has been disbanded and is now they've been taken over by the International Financial Reporting Standards, but the regulation still required TCFD reporting, and I think for the next 12 months at least that will continue as is with these nonsense scenarios.

Beyond that, I do think there's a real onus on trustees to start to make these more meaningful, to start to take on these pearls of wisdom from the world of academia. To start, to impose best practise also being reported back by the pension regulator, in particular in their latest Master Trust Bulletin in December, when they have reported back some very positive, some very pertinent points out of their review of last year's TCFD reports. I think it's just imperative that trustees get a very good understanding of all of this. They cannot put their heads in the sand, they have to take this seriously and have to understand it because if they don't understand it, they cannot challenge the advice that's been given.

For those who aren't totally in the know as far as universal ownership is concerned, it is and I quote as I've got the definition here, it is ‘where asset owners effectively own a slice of the global economy’. Of course, that does require scale, and it does require breadth of exposures and increasingly that means a global a global breadth, and also it tends to require a long-term time horizon. That is with mainly properly talking about DC and increasingly, about DC master trusts here. The volume of scale that they will have in terms of assets, but there is still a lot in in defined benefit schemes and some of those now have very short time horizons, because they're going to the insurance market. So it does, time horizons are fairly critical to all of this.

Laasya Shekaran: I do wonder if we're thinking about time horizons correctly for those DB schemes that are going to insure us in the near term, because their members are still going to be around for longer than that.

Roger Mattingly: Yeah, I couldn't agree more. I think that the needs to be away of joining up the investment strategies of occupational pension schemes outside the bulk annuity market and what bulk annuity providers want as assets. Of course that is driven largely by regulation.

David Brown: I think that's a really good point that we've discussed there, in terms of the long-term nature of all pension schemes, even defined benefit schemes are close to maturity is just a change in ownership. The liabilities remain, the assets remain, it’s key, we don't lose sight of that long term nature. One of the other points you picked up on Roger, was around TCFD reporting.

I want to turn to Tegs now, and think about sustainability reporting more generally, whether this be at TCFD level of a pension scheme or international financial reporting standards for sustainability and enterprise level. Separately, we also have developments such as the TNFD, which is also closely related to climate. So we've all these developments around reporting in the background. Do you think it's currently fit for purpose?

Tegs Harding:
Again, I think the short answer is no. I think whether you're talking at a pension scheme level or asset manager level or in even at enterprise level, the reporting should be a summary of the activity that has been done to invest capital in the transition and engage to help affect the transition. Where what we've got to is the reporting is an industry in and of itself. So boards are spending all of their government's budget just completing the TCFD statements, asset managers are hugely absorbed in getting together the data for that rather than actually carrying out research or engagement activity.

We really need to get to a place where it is just a list of the actions people have taken over the year, and fundamentally this is a capital allocation problem. Asset owners need to allocate capital to the transition. Enterprises need to allocate capital, so they can transition, and that's what needs to happen and that is not what is being encouraged under the current framework.

I think some of the metrics that you're encouraged to use don't necessarily help that mindset. The biggest one being that the narrow focus on emissions intensity. Particularly in a world that isn't transitioning or isn't transitioning in the short to medium term, it's not obvious that the highest emitters are going to be the ones that are financially hit in the short term, because there just isn't that transition risk that mechanism of the carbon price isn't coming through. That's what underpins a lot of the modelling and the assumptions about how we've thought about it to date. That just needs to shift and I completely agree with what Roger said earlier. Shift your focus to a little bit nearer term and really think about what are the levers that you've got to pull. How can I best allocate my resources, particularly in this geopolitical climate. Some leavers might be more effective than others, so let's really just think about what I can do and what's going to be most effective to do right now, but nine times out often, that's going to be to allocate my capital differently.

Laasya Shekaran: Yeah, absolutely. I can relate to a lot of what you're saying about sustainability reporting, because I've spent a lot of time writing those reports and often doing the first draft of them and oh my gosh, the amount of time it takes to do it, you just feel like perhaps this time could be better used. As you say, working on the engagements or thinking about a capital allocation and it's like we've got it the wrong way round. As you say, you do all the actions and the reporting should just be a short, straightforward task that follows it, but as somebody who's been writing those, it definitely doesn't feel like that. While you're spending hours and hours clawing through the numbers and writing pages and pages of text that nobody's going to read eventually.

Tegs Harding: Yeah exactly and that ultimately isn't useful if you're still basing it off NGFS scenarios which we know are fantasy.

Laasya Shekaran: So let's talk a little bit more about the fact that climate change is so financially material, because there's often this misconception that ESG or sustainability or climate change is non-financial in nature. I take a lot of issue with this, we've just talked about how financially relevant it is. Roger, how do we address this misconception? Because I know you've been doing lots of thinking about this.

Roger Mattingly: It is a misconception and the spectrum of interpretation of fiduciary duty has been too narrow amongst a lot of trustee boards or a lot of trustees who dare I say are stuck in their ways, who are not open minded and who think that investing in some of the assets and the environment that we're talking about, is a risk and I think there's an element of history there that they saw the sort of tree hugging mentality of the likes of swampy, many decades ago, etc. If you think of an ethical type investment that has been around for decades, there was always this theory that if you invested with that mindset that you were sacrificing performance. That mindset has not gone away with a lot of trustees in my, as I say, strong opinion.

My mantra with all my trustee boards is that we are very open minded. That doesn't mean we agree to everything, but we are very open minded and so where we are in terms of the spectrum of fiduciary duty is that we believe that the spectrum is what is much wider than is currently being used and interpreted. We have the Financial Markets Law Committee's report of last year that echoes that, and I quote ‘within that framework, sustainability is therefore for consideration in all pension schemes. The relevant entry point for consideration of sustainability in the context of pension funds is as a financial factor rather than as a non-financial factor’. This is about risk management, it is about risk adjusted returns and climate is not the risk of transition and physical climate change are not the only non-financial relevant factors, they are financial relevant factors.

I have another legal opinion in front of me extending to seven pages that makes it very clear and that will be further accentuated in weeks to come, that other financial factors, including the environment into which members retire.

Now obviously, most of our members will retire in the UK, so you could argue that that creates nationalistic investment, and you've got to be careful that you don't compromise in terms of diversification and non-correlation by taking that approach. This is what you should be taking into consideration. It doesn't mean that you have to invest in that way. As a trustee board, you must take these matters into consideration and I use the word must, because I increasingly think it. It is at the very least it should be at the word should. There's a distinction between standard of living in retirement and quality of life. Quality of life shouldn't be part of this equation. It is about standard of living and what you don't want to find is that you've maximised members pots, and you find that inflation is going through the roof, the world is burning and all the individuals retirement income is being used on healthcare, on other costs, on inflation, standard of living, inflationary standard of living and actually they have very little to actually retire on, so to speak. So it is imperative I think increasingly that this wider spectrum of fiduciary duty recognition is adopted and embedded within trustee boards.

David Brown: I loved your comments Roger around the fact that it's not detrimental to return investing with a climate objective in mind, and in fact that's actually consistent with research we've undertaken at Pensions for Purpose through our Impact Lens work that we do. Also more generally and local market, we have a government that's wanting to grow the economy. UK's, net-zero economy grew by 9% in 2023. While the overall economy only grew by 0.1%, so it can deliver the growth. To the domestic agenda, it can deliver the returns that we need for our pension fund members, so it can be part of a win win solution and at addressing some of the systemic challenges we face today. So, moving on to Tegs now, I wanted to explore around climate change and the financing gap. So, when it comes to, we know there's a huge transition we need. We know we need to transition existing investments, and in terms of that climate financing gap, there are different sources available to say that it could be in the range of 6 to $7 trillion annually through to 2050. So, with this huge opportunity to tap into, how can investors use that capital allocation approach to address this?

Tegs Harding: I completely agree with you, a lot of this is going to be solved by investing money in the right places. If we just look at what the UK needs to do to transition, it's really practical stuff. We need to put insulation in our homes and we need to find the money to do that, we need to lay cables so that we can upgrade the grid, it's really simple, practical physical things that we need to invest in. I think if we shifted our mindset and people understood that a little bit better you would see a little bit more progress. You've got three levers as an asset owner, you've got direct capital investment in things like renewable energy for that you do need an illiquidity budget, because there aren't liquid versions of these things that you can invest in at the moment, so you do need that. You've got an indirect route, using your influence, or and the influence of your asset manager to try and influence the way that enterprises themselves are allocating capital. You need to be really realistic about the extent to which that that is possible. The extent to which your influence might differ geographically with different jurisdictions and then be really targeted with that. So, to really try and make that effort meaningful.

Lastly, I think we really need some innovation in the way that as an industry we allocate capital, and that's because there's still widespread use of broad market capitalisation-based indices. Whenever we're investing along those market lines, we are not allocating money to the transition, and those risks will keep stacking up now. That isn't easy because, as we just discussed a little while back on how it's not the high emitters that are the problem here, because they're not going to be represented of the risk in a world that is transitioning slower than we than we want. So how do we construct a broad index which is resilient, which invests in adaptation. All those kinds of questions are unanswered at the moment, so I think another thing that asset owners can do is really lean on their consultants or dare I say it, get different consultants, to try and innovate with some of these problems.

David Brown: I think the innovation and those steps you made I think are critically important. I look at the backdrop of these sustainable development goals report for 2024, saying that global progress is alarmingly insufficient. So anything we can do in our asset owner roles is going to be a step in the right direction.

Laasya Shekaran: Actually, it leaves me on quite a hopeful note, because I do think that as a pensions industry that's responsible for a lot of capital, that represents a lot of members. We do have the ability to address this financing gap and do it in a way that delivers returns, and what I've realised just in the month and a half I've been at Pensions to Purpose, is how many asset managers there are that are working on making this all investable, whether it's energy transition or other areas across different asset classes. I guess it's a self-selecting group that I get to meet asset owners who are also keen on allocating in this way, so a lot of the time when we talk about climate change, it can feel doom and gloom, but I think once we talk about capital allocation and the impact we can have as a pensions industry, I actually feel quite hopeful and optimistic.

Tegs Harding: Yeah I think for me that the biggest sign of hope is the fact that DC schemes are moving in mass into illiquid assets which give them the opportunity and the impetus and the right objectives to allocate money to the transition. I think that's the ray of hope in all of this.

Laasya Shekaran: Brilliant, thank you so much for joining us today. Tegs and Roger, before we let you go, what's one thing you want listeners to take away from this conversation?

Roger Mattingly: Narrowing it down to one thing is quite challenging, but I would just urge trustee boards to not abrogate their duties and make sure that they are taking climate and these other areas into their risk management. If you invest in companies that themselves are managing these risks and behaving themselves as corporate entities, then in the medium to long term, I strongly believe they will outperform. So these are relevant financial factors, they should at the very least even must be taken into account into consideration, and also we haven't touched upon it in too much detail, but climate risks are inextricably linked to nature and biodiversity challenges and risks, and it's imperative that as the overhaul of the reporting happens which I hope it will, that that is increasingly embedded within that reporting.

Laasya Shekaran: Yeah, really important. I like that it was basically telling trustees, do your job properly and think about climate change, because it's part of your responsibilities. Tegs, how about you?

Tegs Harding: I think it's just recognising where we are, unfortunately we're not on track with the ambition set out in the Paris Agreement and it looks like the ambition is also slowing if you look around the world. So ask yourself what that means, how resilient are your investments going to be and are you using the right measures to assess that, because it's not obvious to me that emissions intensity measures climate risk in a portfolio that well anymore.

Roger Mattingly: Can I just add one final comment from me. There's a brilliant line in the Financial Markets Law Committee report that says pension funds should not fear liability. It would be very easy when you see the headlines of a Texas federal judge ruling in the American Airlines that they violated their fiduciary duties by insufficiently overseeing ESG by the investment manager. When you hear that Trump has now reversed the law about plastic straws and that he wants to help the US get access to its liquid gold reserves and drill baby drill, it's imperative that we as trustees, do the right thing and we're not derailed by these sort of headlines.

Laasya Shekaran:
I think that's really important to remember and that's a good note to finish the episode on. Thank you both so much for joining us today. Listeners, if you want to make sure you never miss an episode, hit the follow button and remember you can find us wherever you get your podcasts. Thank you for listening and we'll see you on the next one.