ClientEarth

To: Ms Liz Airey
Chair of Trustees
Rolls-Royce Pension Scheme
Pension Department JH19
PO Box 31
Derby
DE24 8BJ

10 August 2018

Dear Ms Airey,

Obligations to consider climate risk in relation to the investments of the Rolls-Royce Pension Scheme

We are writing[1] to you following the correspondence you have had with the House of Commons' Environmental Audit Committee. In a letter dated 28 February 2018, the Chair of the Committee asked you for information on how the Rolls-Royce Pension Scheme (the "scheme") is managing and reporting on climate risk. We share the Committee's concern that a failure to think strategically about climate change may create risk for beneficiaries.

We note that in your response to the EAC you state that the trustee considers ESG issues where they may be financially material and that the scheme's investment managers are expected to take account of financially material ESG issues (although you do not specify whether this expectation is reflected in formal mandates). We also note your comment that you consider the scheme's exposure to climate risk to be limited as a result of most investments being in liability-driven and fixed interest assets.

We are concerned that you, as scheme trustees, may be failing to take sufficient steps to address climate risk (not least as a result of considering climate risk within ESG rather than as a separate risk) and therefore failing to manage the scheme's investments in a manner consistent with members' best interests. In doing so, you are potentially putting members' retirement outcomes at risk and exposing yourselves to the possibility of legal challenges for breach of your fiduciary duties.

Your legal obligations in respect of climate risk are not static - advances in the evidence available on the financial risks of climate change, along with rapidly evolving market standards in responses to climate change-related risks, will be relevant to how a court would weigh your actions against your legal duties.

[1] ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw. We are lawyers working to research the legal implications of climate change-related financial risk for a wide spectrum of market participants including companies, investors (including pension funds and banks), company directors and regulators.

In responding to the Committee's request for information on how the scheme is managing climate risk, you were asked to reflect on what steps you are currently taking, or have taken. With the proper fulfilment of your legal duties in mind, we have set out in section 4 of this letter the steps that you should now be taking in order to safeguard the scheme's assets and ensure that you are acting in accordance with your legal duties.

1 Your legal duties as trustee

You are required to act in the best interests of members when making investment decisions.[2] Climate change is now widely acknowledged as a potentially material investment risk and you are expected to consider the exposure of the scheme's assets and scheme sponsor to climate risk when discharging your duties as a fiduciary.[3]

As scheme trustees, the law permits you discretion when making investment decisions. You are required to act reasonably, and to take into account all relevant matters, whilst setting aside irrelevant matters.[4] 'Irrelevant matters' would be your own personal, moral and political opinions on climate change.[5] 'Relevant matters' would be the current, published and widely available evidence, including the evidence specifically referred to in this letter, on:

- The financial risks of climate change (in particular, those associated with the coal, oil and gas industries);
- The increasing number of investment opportunities arising from the transition to a low carbon economy; and
- The actions taken by your peers and other investors to manage climate risk and take advantage of low-carbon investment opportunities.

Should you fail to take these relevant matters into account, in a reasonable manner, you could be held liable for breach of duty.

2 Investment risk and opportunity[6]

Climate change may pose material financial risks to the scheme's investments in the short, medium and long term. At the same time, the transition to a low-carbon economy presents significant investment opportunities that may help to mitigate the broader economic risks posed by climate change and boost the scheme's long-term returns, whilst providing an income stream in the shorter-term.

Summarised below are key findings from relevant research (refer to enclosed report for full summary of research) which you should familiarise yourself with and discuss with your

[2] The Occupational Pension Schemes (Investment) Regulations 2005, Reg 4(2)
[3] The Government's recent response to the Law Commission's report on pensions and social investing made it clear that climate risk presents material investment risks for pension schemes and should not be discounted as a purely ethical issue.
[4] Harris v Lord Shuttleworth [1994] ICR 991
[5] Keith Bryant QC: https://www.clientearth.org/pension-trustees-face-legal-challenge-ignoring-climate-risk-leading-qc-confirms/ , p.9
[6] Please note that the findings set out in this section are based on current evidence, which are likely to continue to evolve at a rapid pace. As a scheme trustee, you are expected to have in place appropriate monitoring and risk management procedures to stay abreast of these developments.

investment advisers. Familiarising yourself with these issues should be considered part of your core duty to invest in a manner designed to ensure the security, quality, liquidity and profitability of the portfolio as a whole.[7]

- **Financial risks related to climate change are already materialising and wider financial stability is at risk if action is delayed**

  Analysts Kepler Cheuvreux have found that risks arising from climate change may materialise sooner and more quickly than anticipated, citing the rapid decline in the share prices of European power utilities and the business challenges resulting from policy or technological breakthroughs.[8] In addition, the Bank of England has highlighted the systemic financial risks that they see arising from an abrupt re-pricing of financial assets if companies and investors fail to take a proactive approach to the energy transition.[9]

- **Fossil fuel and carbon intensive assets are highly exposed to climate risks**

  Analysts are increasingly recommending that investors tilt portfolios heavily or entirely away from poorly performing fossil fuel assets. Coal is highlighted as a particularly poor investment with 54% of coal power assets in the EU already experiencing negative cash flow, predicted to rise to 97% by 2030. Operating costs for coal are also predicted to be higher than the average lifetime cost for onshore wind by 2024 and solar power by 2027.[10]

  Financial assets in high-carbon sectors are most likely to be affected by the risks of transitioning to a low-carbon economy (via changes in regulation and social and market shifts to cleaner and increasingly cheaper alternatives) but are also among the most exposed to the physical risks of climate change (due to the location of power stations and oil and gas refineries in coastal areas or offshore).

- **Climate risk is not adequately priced into the market**

  The short-term nature of financial analysis (often provided on the basis of 1 to 3 year forecasts) means that risks expected to affect company cash flows and valuations over longer timeframes, including many of the most serious impacts of climate change, are not properly captured. Analysis by the 2 Degrees Investing Initiative also indicates that the lack of available data from companies is a critical obstacle preventing climate change-related risks being well understood or properly priced into markets.[11]

- **Climate-aware investing does not entail giving up returns by limiting diversification of assets or the ability to track a major index**

  Investment managers GMO have analysed the performance of the S&P 500 and its predecessor, the S&P 90, from 1926 to 2017. Over that 90-year period, the

[7] The Occupational Pension Schemes (Investment) Regulations 2005, Reg 4(3) and 4(4)
[8] Kepler Cheuvreux, (January 2018), 'Investor Primer to Transition Risk Analysis'
[9] Bank of England (2017), 'The Bank of England's response to climate change', Quarterly Bulletin Q2
[10] David Schlissel, IEEFA, (2017), 'Can the US coal industry come back', in Forum, Issue 111, The Oxford Institute for Energy Studies. https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/01/OEF-111.pdf
[11] 2 degrees Investing Initiative and Generation Foundation (2017) 'All swans are Black in the Dark: How the short-term focus of financial analysis does not shed light on long term risks'.

impact on performance of excluding any of the 10 main market sectors was negligible.[12]This conclusion is supported by the five-year performance (to 2016) of two MSCI low-carbon indices, which demonstrates that there are no negative impacts of excluding high-carbon stocks from an otherwise diversified portfolio. In fact, both MSCI low carbon indices yielded returns that were slightly better than the benchmark MSCI ACWI index (over the same timeframe), while significantly reducing associated carbon emissions.[13]

- **Taking account of climate risk will help to protect your portfolio as a whole from future losses**

  Analysis by the Economist Intelligence Unit has found that whilst impacts on Value at Risk as a result of climate change will be significant, due to anticipated weak growth and low asset returns across the whole economy, taking steps to mitigate climate change can halve the losses experienced.[14]

- **Income and capital growth can be achieved through a lower-carbon investment tilt**

  Research from the International Renewable Energy Agency forecasts that by 2020 all renewable power technologies will be competitive with fossil fuel generation on a cost basis, with many renewables projects significantly cheaper.[15] Analysts have highlighted infrastructure related to renewable energy production as an attractive alternative income stream to oil and gas companies.

3 What is the current market standard on climate risk?

ClientEarth and the advisory firm Sustineri have undertaken a review (see full report enclosed) across the investment sector in a number of OECD countries to assess the emerging market standards - in accordance with the “ordinary prudent person test” - for managing climate risk.

This review analysed, through a wide range of reports and material in the public domain, how 30 asset owners – representing a cross-section of structure, size and geography (limited to OECD, excluding the US)[16] – are addressing climate-related financial risk. The report produced the following key findings:

- **Fiduciary duty** and a focus on **risk-adjusted returns** over the longer-term are key drivers in the approach taken by asset owners towards climate risk, with some asset owners also emphasising the short-to medium-term investment risks posed by climate change. This approach is linked to a recognition that climate change is a **material**

[12] See discussion at: https://www.advisorperspectives.com/articles/2017/12/21/jeremy-grantham-and-lucas-white-on-climate-change-investing . Data presentation at: https://www.advisorperspectives.com/pdfs/SP-Indices1.pdf
[13] MSCI (Sept 2016), ‘Fossil Fuel Divestment: a practical introduction’.

[14] Economist Intelligence Unit (2015), ‘The cost of inaction: recognising the value at risk from climate change’.
[15] IRENA (2017), ‘Renewable Power Generation Costs in 2017’.
[16] The US was excluded from the analysis based on the view that asset owners from that region are operating under a unique set of circumstances, driven by the federal government’s decision to withdraw from the Paris Climate Agreement and the absence of a nationally-driven climate agenda that is out of step with the rest of the world.

financial risk and the need therefore to safeguard the resilience of the portfolio over multiple time horizons.

- **Governance** structures around climate change are becoming more robust, with the majority of funds reviewed **highlighted climate-related risk in their reporting documentation**, either directly in their Annual Report, in a supplementary sustainability disclosure, or through engagement with regulatory or industry bodies.

- **Risk Management** practices, such as the use of data analytics tools and climate-audits for external managers, demonstrate a growing commitment to identifying and taking action on climate-related risks and opportunities. For example, since 2016 the SEI Metrics project has **stress-tested investment portfolios** worth over USD 3 trillion for alignment with the Paris agreement.[17] Funds with more robust climate-related practices have adopted **targets**, such as reductions in portfolio carbon emissions or capital allocations to low-emissions investments, which they measure alongside financial targets.

- **Stewardship practices** are an important piece of asset owners' overall response to climate risk, including through investor initiatives such as Climate Action 100+ which represents assets equivalent to 33% of global assets under management. There is also evidence of engagement being practiced in combination with exclusion policies. This analysis has shown that 67% of the asset owners reviewed have divestment policies in place. Beyond this analysis, investors more widely are shifting away from high-carbon assets: to date, investors representing USD 6 trillion in assets under management have made commitments to divest from fossil fuel assets with pension funds accounting for half of this figure.[18]

4 Actions you should take now to protect the scheme

Given the economic analyses and changing market standards set out above, you should take action now to position the scheme to benefit from the transition to a low-carbon economy and avoid the significant losses that may occur from a failure to mitigate climate risk. Although you may have already taken some of these actions, you should ensure that the fund is continuing to develop its approach to addressing climate risk and adopting a proactive and forward-looking policy.

4.1 Evaluate the evidence, establish the correct governance, take advice

- Analyse the fund's exposure to physical and transitional risks (both in relation to the fund's assets and the sponsor's employer covenant). **Conduct forward-looking assessments** in line with the TCFD recommendations and consider relevant political and regulatory developments.

- Ensure there are appropriate **internal governance structures** to oversee strategy development and undertake a materiality assessment of climate change-

[17] https://2degrees-investing.org/sei-metrics/
[18] https://www.divestinvest.org/

related risks (transition, physical and liability risks) on your portfolio. This oversight should support the mainstreaming of climate risk across investment and portfolio decision-making.

- Ensure that both existing and new mandates with professional advisors, including investment consultants, risk consultants, auditors, actuaries and accountants, require that **appropriately qualified advice** will be given on climate risk exposure.

4.2 Establish investment beliefs and align with strategies and policies

- **Establish investment beliefs** that will help to guide strategy in relation to practical decision-making on asset allocation, performance objectives and selection and retention of asset managers.

- **Integrate climate change** into the scheme's investment beliefs and investment policies, for example by amending the statement of investment principles.

4.3 Reallocate assets in line with investment beliefs

- Instruct the scheme's investment managers to **reallocate capital** and cease investment of new capital into coal operations and risky fossil fuel assets, including tar sands, arctic exploration, ultra-deep-water drilling and all related infrastructure.

- Move the scheme's **passive investments** into products tracking low-carbon indices.

- **Proactively seek out investment opportunities** in low-carbon sectors, bearing in mind that these opportunities may include non-equities, such as real assets, infrastructure and private equity.

4.4 Pursue active stewardship and engagement

- Set clear **voting policies** stating when the scheme will vote against directors, auditors and/or accounts when companies do not show progress against publicly specified targets.

- Set out **clear public expectations** that portfolio companies must demonstrate they are aligning their business strategy with the goals of the Paris agreement (with transparency over the benchmark scenario used and acknowledgement where this is considered to be insufficient to meet the Paris goal of limiting global temperature rises to 1.5 degrees).

- When choosing to engage with companies in high-carbon sectors, **set a timeline** by which specific changes must have been made – include 'time-served' where engagement has been ongoing for a number of years. Timelines should be specified; for example, medium-term means 5 years, long-term means 10 years. Within these timelines, annual milestones for progress should be specified and escalation strategies put in place where these milestones are not being met.

ClientEarth

- Publicly **demand that portfolio company directors are 'climate competent'** and that more than one director on the board has a proven understanding of climate issues.

- Require portfolio companies to **be transparent around lobbying** and membership of trade associations where this serves to weaken climate obligations. You should request that companies withdraw membership of trade associations where positions taken conflict with those of the company.

4.5 Communicate your approach in line with the market

- Disclose to scheme members and regulators using the **TCFD framework**.

- Seek to continually improve your reporting process in order to **contribute to a meaningful market standard for reporting on climate**.

5 Confirm that you are taking action

In setting out your legal duties and the available evidence on the financial risks of climate change, as well as the investment opportunities related to the transition to a low-carbon economy, we have put you on notice as to the implications of these issues for the scheme. Should you fail to take these factors into account in your strategic investment decisions, a member of the scheme may rely on this failure as evidence of breach of duty in any future action against you. Given the rapidly evolving market response to climate risk, the possibility of a claim being made against you for taking insufficient steps on climate risk is increasing.

We invite you to make a public statement to members of the scheme to confirm to them that you are committed to taking the actions outlined in section 4 above and to securing the best outcome for the scheme's investments in the long-term. We would be happy to discuss the contents of this letter with you further, should you find this helpful.

If you would like to discuss the contents of this letter, please contact Joanne Etherton (jetherton@clientearth.org) or Danielle Lawson (dlawson@clientearth.org).

Yours sincerely,

ClientEarth