

November 2017

Risky business

Climate change and
professional liability risks for
DB investment consultants

ClientEarth is Europe's leading environmental law organisation.

We are lawyers working at the interface of law, science and policy. Using the power of the law, we develop legal strategies and tools to address major environmental issues.

Today's investment decisions will affect the planet for decades to come. Our Company and Financial Project uses the law to drive greater integration of climate-related financial risks into the management decisions of influential economic actors.

Our aim is to minimise the risk to the economy and to investors from climate change and to support a rapid shift of capital toward green investments.

Acknowledgements

This Discussion Paper is for information only. It has been produced by ClientEarth with the generous support of Friends Provident Foundation and the Children's Investment Fund Foundation.

ClientEarth would also like to acknowledge and thank the many individuals who reviewed and provided invaluable comments on early drafts of the Discussion Paper.

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Contents

Climate risk in UK defined benefit pension schemes	3
Climate risk is a professional liability risk for investment consultants	3
Climate risk: what is it?	4
The new reality: defined benefit pension schemes in the UK must consider and manage climate risk	6
Investment and climate risk: an overview	
Statement of investment principles	
Asset allocation	
Asset manager selection, mandates and monitoring	
Climate risk management for trustees	13
Investment consultants' legal and professional duties	14
Climate liability: are investment consultants at risk?	16
Legal liability	
Investment consultants have clear legal duties of skill and care	
Regulatory sanctions	
Action points: rising to the challenge, managing the risk	21
Endnotes	22

Abbreviations

- AMNT – Association of Member Nominated Trustees
- BoE – Bank of England
- CFA – Chartered Financial Analyst
- DB – Defined Benefit
- ESG – Environment, social and governance
- IFoA – Institute and Faculty of Actuaries
- IORP II – EU Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (2016)
- PPF – Pension Protection Fund
- TCFD – Task Force on Climate-related Financial Disclosures
- tPR – the Pensions Regulator
- UK – United Kingdom
- UKSIF – UK Sustainable Investment and Finance Association



Climate risk in UK defined benefit pension schemes

Climate change is creating significant and material financial risks and opportunities for many investors, now and into the future. This is accepted wisdom for major market actors and financial regulators alike.

“Investors can no longer ignore climate change. Some may question the science behind it, but all are faced with a swelling tide of climate-related regulations and technological disruption.”

BlackRock, ‘Adapting Portfolios to Climate Change’ (2016)

“A wholesale reassessment of prospects, as climate-related risks are re-evaluated, could destabilise markets, spark a pro-cyclical crystallisation of losses and lead to a persistent tightening of financial conditions: a climate Minsky moment.”

Mark Carney, Governor of the Bank of England, ‘Resolving the Climate Paradox’ (2016)

Despite the clear signals, action by the UK’s multibillion pound defined benefit (DB) pensions sector to address these risks has been slow. While a select group of leaders are busy setting the new industry standard, the majority are lagging.

Misconceptions about the implications of climate risk are persistent within the industry.¹ The financial implications are often poorly understood and, for many trustees, climate change is still sidelined as just another ‘ethical’ or ‘non-financial’ issue. Others turn a blind eye altogether, or hope asset managers or advisers have it covered. In doing so, they may be exposing scheme funding to excessive risk, breaching core legal duties and facing significant liability risks as a result.

Climate risk is a professional liability risk for investment consultants

In light of this new reality, investment consultants working in the UK’s DB pensions sector must consider how climate risk affects the advice they are providing to their clients. Quickly evolving industry practice, new guidance issued by the Pensions Regulator (tPR),² and greater regulatory scrutiny looming on the horizon mean they too may now face increasing reputational, legal and ultimately commercial risks if they do not.

To best serve their clients and minimise any potential liability, investment consultants will need to understand how climate risk affects their existing legal and professional duties.

If a scheme’s financial position deteriorates because of a failure to consider or manage climate risk, investment consultants may become a prime target for costly and reputationally damaging litigation. With the industry already under the microscope, even before loss crystallises, consultants who fail to consider climate risk may face increased risks of regulatory intervention.

This paper aims to draw these issues to the attention of investment consultants, trustees and the broader investment community. Its objective is to improve visibility and clarity about legal issues relating to climate risk for investment consultants, and to ensure that climate risk is better managed by the UK’s DB pension sector – ultimately, better protecting workers’ pensions, strengthening the UK’s financial stability and minimising some of the worst impacts of climate change.

Climate risk: what is it?

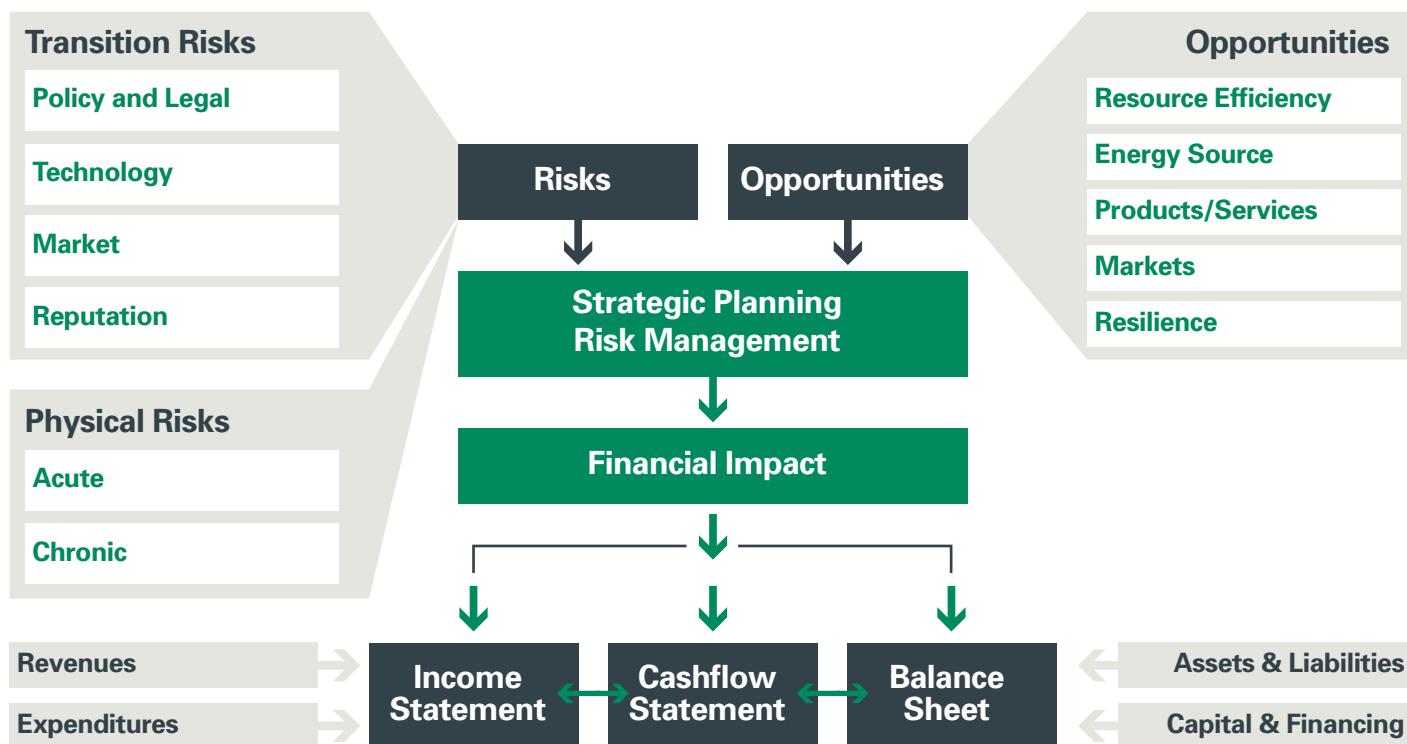
It is now widely accepted that climate change will create physical, social and economic disruption on an unprecedented scale. With roughly 1°C of global warming already driven by human activity, the physical impacts of climate change are being felt now.³ Droughts are becoming more extreme, storms are increasing in severity and sea levels are rising. These impacts are projected to increase dramatically into the future, even under the most optimistic scenarios.⁴

The impacts of climate change are not just physical. Efforts to address and adjust to its effects are fundamentally reshaping economies. Decisive actions by governments, companies and civil society, combined with sharply declining renewable energy costs and shifting consumer preferences are rapidly accelerating the transition to a low-carbon economy.⁵ For companies and industries that cannot or do not adjust, falling share prices, asset write-downs and bankruptcies are an immediate reality.⁶

Beyond impacts at the firm or even portfolio level there is also concern that climate risk may have systemic impacts, causing a drag on growth and financial returns across the global economy – particularly where action to address its physical impacts is not accelerated.⁷

These trends have real and obvious consequences for investors – particularly those with long-term investment horizons and liabilities, including many DB pension schemes. Significant work is now being undertaken by many organisations to better understand and manage the financial impacts⁸ and to integrate these insights into financial analysis, portfolio design and investment strategy.⁹

Figure 1 Climate-Related Risks, Opportunities and Financial Impact



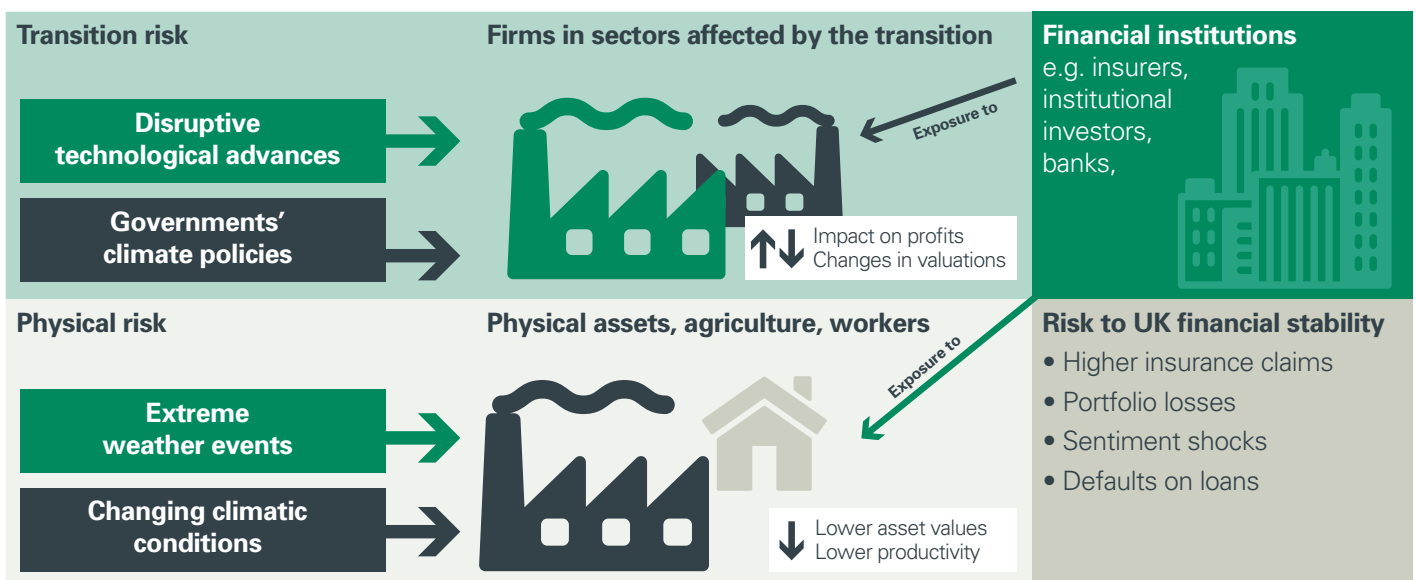
Explainer: a climate risk taxonomy

The most widely adopted taxonomy to describe climate risk, now adopted by the Bank of England (BoE) and the industry-led Task Force on Climate-related Financial Disclosures (TCFD), divides climate risk into two broad categories – physical risks and transition risks:

Physical risks refer to risks arising from the direct physical impacts of climate change. These may be driven by specific events, including increased severity of extreme weather events, or by longer-term shifts in climate patterns, including sea level rise or chronic heatwaves. The financial impacts of these risks could include losses from damage to assets and supply chain disruption; reductions or disruption to production capacity; increased operating and input costs; and increased insurance premiums.

Transition risks refer to risks arising from the transition to a low-carbon economy. Extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change are well underway. They are already having financial impacts. Policy changes and new regulation are driving write-offs and balance sheet impairments; disruptive technology is creating new competitive pressures; and consumer demand for low-carbon and sustainable products is shifting markets.

Figure 2 Primary channels for climate-related financial risks



Source: Bank of England (2017)

The new reality: DB pension schemes in the UK must consider and manage climate risk

The key objective for trustees of DB pension schemes is to pay the benefits that have been promised to scheme members. To meet their legal obligations, trustees of DB pension schemes must ensure there is a robust and integrated approach to identifying, assessing, monitoring and addressing risks that might threaten this objective.¹⁰

As set out in tPR's Code of Practice on Funding Defined Benefits, these risks must be addressed across three separate strands – 'investment', 'funding' and 'the employer covenant'.¹¹ Climate risk may have implications for all three. However, it is the investment strand that will be most relevant for investment consultants.

When providing advice to pension scheme trustees, investment consultants must understand their clients' legal duties and provide their advice accordingly.¹² In order to discharge their own legal duties, investment consultants should have a clear understanding of the implications of climate risk for the legal duties of the trustees.

Of particular relevance for investment consultants will be the legal duties of trustees in relation to investment generally as well as in relation to specific issues that investment consultants typically advise on, including: preparation of the statement of investment principles (SIP); decisions about strategic asset allocation; and selecting, mandating and monitoring asset managers.

Investment and climate risk: an overview

When making decisions about investments, trustees of DB pension schemes have clear legal duties to act in the best interests of scheme members.¹³ In doing so, they must act prudently¹⁴ and take into account factors that are financially material to investment performance – regardless of whether or not that factor might sometimes be regarded as an environmental, social and governance (ESG) issue.¹⁵ Specifically in relation to climate risk, this requirement was the subject of a legal opinion by Keith Bryant QC and James Rickards in November 2016.¹⁶

They concluded that:

"If the risks associated with climate change are financially material to a particular investment decision then it is clear, we think, beyond reasonable argument that the law permits and requires the trustees to take those risks into account when making that investment decision."

Climate risk is now widely viewed as a financially material factor by many investors. This is the view taken by the Institutional Investors Group on Climate Change (IIGCC), whose members represent over £20 trillion in assets.¹⁷ It is supported by equivalent views in recent reports by investment managers and consultants, such as BlackRock,¹⁸ Mercer¹⁹ and Schroders.²⁰ Recent guidance by tPR also singles out climate change as a risk that 'could be financially significant both over the short term and the longer term' for DB pension schemes.²¹

"Most investments in pension schemes are exposed to long-term financial risks, which may include risks around long-term sustainability. These can relate to factors such as climate change, responsible business practices and corporate governance. We expect you to assess the financial materiality of these factors and to allow for them accordingly in the development and implementation of your investment strategy."

The Pensions Regulator, 'A Quick Guide to Defined Benefit Investment' (2017)



In light of this mounting evidence, there is now clearly an emerging consensus that trustees must, at the very least, consider whether climate risk has material financial implications for their scheme. If it does, they are legally required to address it. Depending on the particular structure of the scheme, this may include considering climate risk when:

- **Setting** investment beliefs and preparing a SIP;
- **Determining** strategic asset allocation;
- **Selecting, mandating and monitoring** the activities of investment managers; and
- **Undertaking or directing** stewardship activities.²²

Because climate risk is projected to have economy-wide and systemic financial impacts over the coming years and decades, it must also be considered as a portfolio-wide, strategic issue. This means that pension scheme trustees may not be able to discharge all legal duties for managing climate risk simply by delegating management of that risk to external managers, who only manage a portion of the portfolio, often over relatively short time periods.



Photo credit: Lou Goetzmann

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How big a risk/return impact could climate change have on a portfolio, and when might that happen? Our investment modelling has demonstrated the following:

1. Climate change, under the scenarios modelled, will inevitably have an impact on investment returns, so investors need to view it as a new return variable.
2. Industry-sector impacts will be the most meaningful. For example, depending on the climate scenario which plays out, the average annual returns from the coal sub-sector could fall by anywhere between 18% and 74% over the next 35 years, with effects more pronounced over the coming decade (eroding between 26% and 138% of average annual returns).
3. Asset class return impacts could also be material – varying widely by climate change scenario. For example, a 2°C scenario could see return benefits for emerging market equities, infrastructure, real estate, timber and agriculture. A 4°C scenario could negatively impact emerging market equities, real estate, timber and agriculture. Growth assets are more sensitive to climate risks than defensive assets.

Statement of investment principles

Under UK pensions law, pension scheme trustees must ensure that a statement of investment principles (SIP) for the scheme is prepared and maintained.²³ The SIP must be reviewed (and, if necessary, revised), at least every three years and after any significant change in investment policy.²⁴ The SIP must cover the trustees' policy for meeting their statutory investment duties,²⁵ as well as a range of other matters, including: the balance between different kinds of investment; how risk is managed and measured; expected returns; realising investments; and the extent to which they take into account social, environmental and ethical factors.²⁶

Before preparing the SIP, the trustees must obtain written advice from 'a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of such schemes.'²⁷ Typically, the trustees will engage an investment consultant for this purpose.

Ultimately, it is up to the trustees (taking into account advice from their advisers) how investment beliefs are set and what is included in the SIP. Many factors can impact investments over the long-term. However, where a factor is financially material, the trustees are legally required to take it into account. In its most recent Investment Guidance for Defined Benefit Pensions Schemes, tPR specifically highlights the example of climate change as an issue that trustees might consider in setting the investment beliefs that will inform their SIP:

"Climate change could be a long-term risk for the scheme and has the potential to impact the scheme's investment strategy."²⁸

The Guidance also includes an extensive example of how such a belief might be reflected in the SIP²⁹ (see below). While this guidance is not explicitly mandatory, it is a clear indicator of the regulator's expectations about how climate risk should be considered and taken into account. Investment consultants advising on the SIP will need to be aware of it.

“

The trustees of ABC Scheme set an investment strategy to deliver a required level of return over the long-term. When reviewing the statement of investment principles (SIP), the trustees consider market developments and conclude that climate risk is financially material to the investment strategy. They set out the following investment belief: 'As long-term investors, we believe climate risk has the potential to significantly affect the value of our investments.' They develop this belief in the SIP as follows:

- We expect fund managers to have integrated climate risk into their risk analysis and investment process.
- We will try to ensure that we manage all new and existing investment arrangements in a way that takes account of climate risk.
- In monitoring the performance of our fund managers, we will also regularly consider how they are performing with reference to climate risk issues.

In addition, the trustees decide to report annually to members on how the climate risk policy 10 has been applied.

Asset allocation

UK pensions law sets out a range of specific requirements that constrain pension scheme trustees' discretion to invest scheme assets.³⁰ Among other things, these include requirements to ensure the scheme assets are properly diversified, so as to avoid concentrations of risk in the portfolio.³¹ Depending on a scheme's funding position, this may require diversification across asset classes, geographies, managers and sectors.³²

Because of the technical nature of the asset allocation process, trustees are legally required to obtain professional advice before making any decisions on these issues.³³ Again, they will typically engage an investment consultant for this purpose. Having taken advice, the ultimate decision about asset allocation rests with the trustees. However, if a factor is financially material, they are legally required to take this into account.³⁴

In relation to climate risk, a number of industry and academic reports have now identified the implications that climate change may have for strategic asset allocation.³⁵ As these reports point out, different asset classes, geographies and sectors may have different sensitivities to climate risk, with correspondingly uneven impacts on risks and returns. For example, emerging market equities and real estate may be particularly exposed under certain scenarios.³⁶

How trustees address these risks and opportunities through asset allocation decisions will be particular to individual scheme circumstances. Nonetheless, the process that the investment consultant uses to advise the trustees should enable those risks and opportunities to be identified on a forward-looking basis.

Investment consultants often use scenario analysis to test asset allocations for how they may perform in the future based on historical experiences of asset class returns under different economic scenarios. Often, however, a transformative transition to a low-carbon economy and the increase in physical damages expected due to climate change are not captured in historical models. As recommended by the TCFD, forward-looking climate scenario analysis is increasingly required to address these issues and is rapidly becoming the new industry expectation.³⁷

Where trustees do identify climate risk as financially material to the scheme under potential climate change scenarios, they will need to have a process in place for taking it into account.³⁸

By way of example, some trustees may directly adjust their allocations, often to include a percentage allocation to lower-carbon or more sustainable options within asset classes, to reduce climate risk and identify opportunities across their portfolio.³⁹



Asset manager selection, mandates and monitoring

Because trustees generally do not choose specific investments themselves,⁴⁰ they will usually delegate this power to authorised asset managers.⁴¹ The asset managers will then take responsibility for the day-to-day management of the portion of assets they are allocated, in accordance with the instructions set out in the relevant investment mandate and applicable legal requirements.⁴²

In order to meet their own legal duties, when selecting, mandating and monitoring asset managers, trustees must take reasonable steps to satisfy themselves that each manager has the appropriate knowledge and experience to manage the investments and is competently complying with relevant legal requirements.⁴³ The trustees will also need to obtain and consider professional advice throughout this process and investment consultants are usually heavily involved.⁴⁴ Where the trustees have identified climate risk as being a material financial risk to the scheme this may need to be taken into account at each stage of the appointment process.

Selection

If trustees have identified climate risk as a material financial risk in their SIP, they must, so far as reasonably practicable, ensure that the investment managers they select are capable of investing the scheme assets in a way that addresses that risk.⁴⁵ Some asset managers already integrate climate risk factors directly into their investment process or offer particular funds or products that do so. However, many do not.

When selecting asset managers, trustees should work with their consultants to understand how and to what extent the managers they appoint are taking climate risk into account, particularly for those asset classes identified as being higher risk priorities. Selection will be of particular relevance for assets that are being allocated to a pooled fund, as the ability to negotiate terms of the mandate may be more limited.

Mandates

When reviewing or entering into a new mandate with an asset manager, particularly for segregated mandates, trustees may need to consider the extent to which the terms of the mandate sufficiently reflect their investment beliefs in relation to climate risk. In this respect, the trustees and, to the extent relevant, their consultant, may need to ensure that the mandate:

- requires the manager to integrate climate risk assessment into its investment strategy;
- aligns incentives and benchmarks with long-term risks and opportunities, such as those presented by climate change; and
- requires that engagement and voting processes be aligned with the scheme's governance and engagement strategy on climate risk.⁴⁶

Monitoring

If trustees have selected an asset manager based on their climate risk management credentials or have included climate risk requirements directly within the mandate, they may need to ensure they or their appointed consultant are actively monitoring performance against these matters. This may include requiring regular reporting against specific indicators as well as direct engagement and consultations.

Increasing duties on the horizon – IORP II

Currently, schemes with 100 or more members are already required to describe the extent (if at all) to which social, environmental and ethical factors are taken into account.⁴⁷ With the implementation of EU legislation on workplace pension schemes (IORP II) on the horizon, duties in relation to ESG factors are set to increase, including with specific reference to climate change issues.

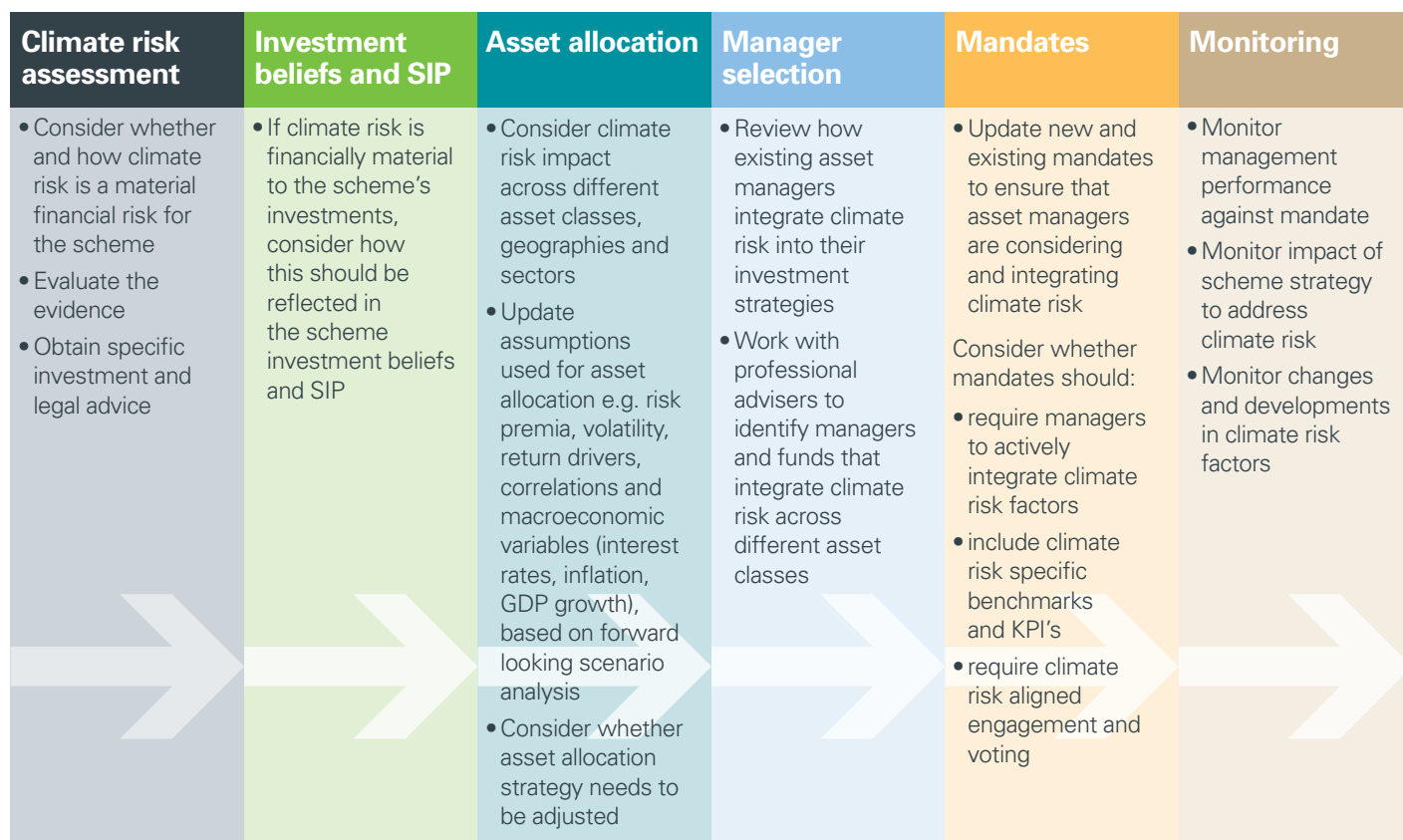
The revised EU Directive, IORP II, sets out requirements for schemes to take account of ESG factors in a variety of ways – in their scheme governance in relation to investment decisions, in the scheme's risk management function, and in the new three-yearly 'own risk assessment' requirement.⁴⁸

In relation to the documented risk assessment, IORP II states that 'where environmental, social and governance factors are considered in investment decisions' the assessment must include 'an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change (i.e. stranded asset risk)'.⁴⁹

It remains uncertain whether, and how far, the UK will continue to comply with EU Directives post-Brexit. The timing of IORP II implementation (probably early 2019) is also unknown. However, assuming that the UK will either be required to, or will agree to implement IORP II, it is clear that climate risk will need to be even more explicitly addressed by scheme trustees in the very near future.



Climate risk management for trustees



Investment consultants' legal and professional duties

DB pension schemes across the UK rely heavily on the advice of investment consultants.

Historically, investment consultants have primarily provided strategic advice to trustees about investment strategies, asset allocation and asset manager selection. Increasingly, they also provide a range of additional services in relation to investment management, including manager research and analysis and reporting on asset manager performance.⁵⁰

Although trustees will usually have ultimate responsibility for making decisions on these issues, investment consultants' advice will often be highly influential.⁵¹ Currently, a significant portion of the advice provided by investment consultants is not subject to direct regulatory oversight. In particular, general advice on investment strategy, asset allocation, and asset manager research and selection may fall outside the regulatory perimeter.⁵²

This lack of direct regulation does not mean that the existing regulatory framework for pensions and financial services has no bearing on consultants' activities.

Consultants will generally have clear contractual and common law duties that will require them to understand the regulatory framework relevant to any advice they are providing – this will necessarily include an understanding of trustees' legal obligations, particularly in relation to investment.⁵³ If trustees have legal duties to consider and address climate risk, consultants will need to have regard to these when providing their advice (see examples in **Table 1**).

In general terms, this requirement has also now been publicly recognised by 12 of the UK's largest investment consulting firms. In a statement convened by the Association of Member Nominated Trustees (AMNT) and the UK Sustainable Investment and Finance Association (UKSIF), these firms refer to recent guidance by tPR regarding the financial materiality of long-term sustainability risks, which explicitly refers to climate change.⁵⁴ They acknowledge that it puts both trustees and investment consultants under an obligation to react and publicly commit to drawing the guidance to trustees' attention.⁵⁵

At the individual level, investment consultants who are members of the Institute and Faculty of Actuaries (IFoA) or the Chartered Financial Analyst (CFA) Institute will also be subject to a range of professional duties and standards issued by these bodies (see examples in **Table 2**).⁵⁶

These may also be incorporated in contractual arrangements by reference or implication. Both of these organisations are increasing their focus on climate risk issues.



Photo credit: Martin Dusek

"Actuaries should ensure that they understand, and are clear in communicating, the extent to which they have taken account of climate-related risks in any relevant decisions, calculations or advice."

IFoA, 'Risk Alert: Climate-Related Risks' (May 2017)

"There is a risk that some climate-sensitive assets, most notably fossil fuel reserves, could suffer from write-offs or downward revaluations, or conversion to liabilities largely because of regulation. If financial markets do not price the risks of stranded assets, investment performance could be affected."

CFA Institute, 'Environmental, Social and Governance Issues in Investing' (October 2015)

Table 1. Investment consultants' legal duties: climate risk implications

Example legal duty	Possible climate risk implications
<p>The consultant must provide the services with due care, skill and diligence.</p> <p>Source: Common contract clause/negligence.</p>	<p>The consultant must provide their services to the standard reasonably to be expected of a competent investment consultant providing the same services. This is a deliberately flexible requirement which will change with industry practice and new regulation.⁵⁷</p> <p>As consensus builds among industry and regulators, and consultants increasingly consider climate risk in their work and advice, those that do not may breach this standard.</p>
<p>In providing services to the trustees, the consultant must have regard to, and comply with, all laws, statutes, regulations, codes of conduct, regulatory guidance and professional standards relevant to the provision of the services.</p> <p>Source: Common contract clause/negligence.</p>	<p>In providing advice, the consultant must understand and consider the legal and regulatory framework applicable to UK DB pension schemes and trustees' duties.</p> <p>This will include any legal duties that the trustees may have to consider and address factors that are financially material to the scheme – including climate risk.</p>

Table 2. Relevant professional standards: climate risk implications

Examples of relevant standards	Possible climate risk implications
<p>'Members must exercise diligence, independence, and thoroughness in analysing investments, making investment recommendations, and taking investment actions'</p> <p>Source: CFA Institute, Rules of Procedure and Professional Conduct, [V,A1]).</p>	<p>CFA Institute members who become aware of climate risk factors should diligently, thoroughly and independently consider whether it has implications for how they analyse investments or make investment recommendations.</p>
<p>Members providing advice to pension schemes must be familiar with any relevant legislation and regulatory guidance including codes of practice.</p> <p>Source: IFOA, Actuarial Profession Standard P1 [1].</p>	<p>IFoA members providing advice to pension scheme trustees must be familiar with the relevant legal framework – this may include trustees' general legal duties to consider and manage material financial risks, as well as specific statements in recent tPR guidance relating to climate risk.⁵⁸</p>

Climate liability: are investment consultants at risk?

With climate change receiving increased interest and scrutiny from regulators and investors alike, investment consultants who fail to consider and take into account climate risk in their work and advice may now face increasing risks of legal liability and regulatory action.

Legal liability

As the financial impacts of climate risk become an increasing reality across the economy, litigation risk is also rising. Recent years have already seen an increase in climate-related litigation being brought before the courts.⁵⁹ While pension schemes have so far largely escaped attention, where climate risk materialises and threatens scheme funding, litigation is sure to follow. When it does, investment consultants, along with other professional advisers, may become a prime target for parties that have suffered loss – including scheme members, employer sponsors, trustees, the PPF and any insurers standing behind these actors.

“Climate change litigation has moved from theoretical to real, as companies globally are increasingly being investigated and fined for failing to appropriately disclose the risks posed to their businesses by climate change.”

Herbert Smith Freehills (2017)

Investment consultants have clear legal duties of skill and care

Just like other professionals, investment consultants advising DB pension schemes will generally owe duties of care in contract and negligence to their clients (see Table 1).⁶⁰ Where investment consultants fail to meet the relevant standard, they may be subject to claims for breach of contract or negligence.

Where a claim is brought against an investment consultant for a breach of a duty of care, the standard that will apply will generally be that of ‘the reasonable skill and care of an ordinary skilled person carrying out the same engagement’.⁶¹ This is a deliberately flexible standard that has been held by the courts to evolve and develop in line with changing regulations, professional standards and industry practice.⁶²

Ultimately, the content of the relevant standard of skill and care that will apply in any particular circumstance will be a matter for a court to decide. However, in relation to climate risk, the current direction of travel for investment consultants advising DB pension schemes is clear.

Climate risk features heavily in recent guidance provided by tPR;⁶³ 12 of the UK’s leading investment consulting firms have publicly committed to bring this guidance to trustees attention;⁶⁴ the IFoA has now directly drawn its members’ attention to the issue;⁶⁵ and consultants are already updating their advice to clients accordingly.⁶⁶

These are all clear indicators of an emerging industry standard, which investment consultants must be aware of in order to confidently discharge their legal duties.

Investment consultants will generally have clear legal duties to understand their trustee clients’ legal duties, including in relation to climate risk, and to take this into account in their own advice where it is relevant. This will likely require careful consideration of climate risk implications for all investment-related decisions on which investment consultants advise.

In addition to their legal duty of care, it is likely that in some cases investment consultants will also owe fiduciary duties of loyalty, which will require particular vigilance in relation to potential conflicts of interest.⁶⁷ Investment consultants should also be aware that where trustees have breached their fiduciary duties in relation to a particular issue, the investment consultant may also be at risk of liability if they are found to have assisted in the breach, and in doing so, failed to act honestly.⁶⁸

Historically, instances of investment consultants being held liable by the courts for breaches of these duties have been limited. But with funding difficulties now becoming a reality across the sector, increasing examples of trustees seeking to recover against investment consultants are coming to light.⁶⁹ Where financial losses can be linked to climate risk factors and an investment consultant has failed to consider and advise on these issues, they may become a potential target for recovery.

The evolving role of investment consultants

In addition to traditional investment consulting services, many consulting firms are now offering more extensive 'fiduciary management' services. These appointments take a variety of forms but will often involve the consultant taking greater responsibility (involving potentially greater liability exposure) for selecting, appointing and monitoring asset managers on behalf of the trustees, and some responsibility for other functions, such as portfolio construction and risk management.⁷⁰

In taking on these additional duties, investment consultants may be agreeing to undertake many duties that would otherwise need to be discharged by the trustees – including in relation to climate risk. The scope of the relevant duties will depend on the terms of the management agreement. However, such arrangements may require consultants to have an even greater understanding of how climate risk might impact investments as well as other sources of risk for the scheme, including funding risks and risks to the employer covenant.

Limits of limitations

Often, investment consultants may seek to exclude or limit liability under their contract with the trustees to minimise their own liability exposure. While there is no outright prohibition against consultants doing so, if they are contracting under standard terms and conditions then the exclusion or limitation will only be effective to the extent that it is reasonable.⁷¹

This may prevent consultants from using their bargaining power to exclude or limit liability for failing to act with due care, skill and diligence, or not providing their advice in line with the relevant regulatory framework. If pension trustees were to enter into such an agreement without ensuring appropriate risk coverage, they might be in breach of their own duties to act in the best interests of the scheme's members.



Regulatory sanctions

Across the UK, regulators for the financial sector and associated professional services are increasingly taking action to address failures to consider climate risk by those they regulate.⁷² Where they are failing to act, civil society is stepping in to provide additional oversight – identifying and reporting or referring firms or organisations that are lagging behind.⁷³

Currently, investment consultant firms may be able to structure their advice in a way that is not directly regulated. However, in light of recent recommendations by the Financial Conduct Authority (FCA) to bring investment consultants within the regulatory perimeter, this may be about to change.⁷⁴ As regulated firms, investment consultants would need to be prepared for increased oversight and a significant extension of their legal and professional duties. In line with other entities subject to existing financial regulation, this may include increased duties to act in the best interests of clients and greater restrictions on exclusions and limitations of liability.⁷⁵

Individual consultants that are members of the CFA Institute or the IFoA may also be subject to disciplinary action where a failure to consider climate risk can be tied to a breach of professional rules or standards or some other form of misconduct (see Table 2).⁷⁶ The risks of regulatory intervention may be more significant for firms or individuals that have publicly recognised the materiality of climate risk but have failed to incorporate this into internal processes and client advice.



“[W]e believe it is in the interest of investors with medium to long-term investment horizons to explore the stranded assets argument in the context of their own portfolios.”

Towers Watson, ‘Fossil fuels: exploring the stranded assets debate’ (2015)

“Climate change is an environmental, social and economic risk, expected to have its greatest impact in the long-term. But to address it, and avoid dangerous temperature increases, change is needed now. Investors cannot therefore assume that economic growth will continue to be heavily reliant on an energy sector powered predominantly by fossil fuels. This presents asset owners and investment managers with both risks and opportunities.”

Mercer, ‘Investing in a time of climate change’ (2015)

Liability hypothetical

Freshco Occupational Pension Scheme and WMA

2017 **Freshco plc is a multinational company listed on the main market of the London Stock Exchange.** Its primary business is retailing groceries and other general merchandise. It operates a defined benefit occupational pension scheme that is now closed to new members (Freshco Scheme). The Scheme is operating with a significant deficit and a recovery plan has been put in place by the trustees.

Taking into account advice provided by their investment consultant, WMA Advisers, the trustees have adopted an investment strategy that allocates a significant proportion of the Scheme's portfolio to return seeking assets. Among other things, the Scheme's statement of investment principles (SIP) states that:

"The trustees believes that environmental, social and governance (ESG) factors can have an impact on the performance of the scheme's investments, and that management of ESG risks and exploitation of ESG opportunities can add value to its portfolio."

Climate risk is not specifically referred to in the SIP, nor considered in the course of asset allocation or manager selection. WMA also does not raise the issue of climate risk with the trustees at any point in the course of their engagement.

2022 **Over the past five years, the combined impacts of government regulation to limit greenhouse gas emissions, decreasing costs of renewable energy and greening consumer demand have had a disruptive effect across the global economy.**

Many companies across the fossil fuel value chain are facing financial difficulties with direct negative impacts on share prices and dividends.

This disruption has also negatively impacted a wide range of investors – including the Freshco Scheme. While some of their peers took steps to integrate climate risk throughout their investment processes and weathered the storm, the Freshco Scheme has consistently failed to meet its investment return targets leading to a significant increase in its funding deficit. This in turn is placing increasing pressure on the Freshco plc balance sheet, requiring increased contributions to the Scheme and directly impacting dividends.

In an attempt to recover some of their losses and respond to growing public and employee pressure regarding the health of the Scheme, the company's performance and the strength of the covenant, the Freshco Scheme and Freshco plc jointly commence legal proceedings against a wide range of advisers and asset managers for the scheme – including against WMA Advisers.

One of the heads of claim against WMA Advisers is that by failing to consider the implications of climate risk when providing their advice, they breached their contractual duties to provide their services with due care, skill and diligence. As evidence of the standard of care and skill expected of a reasonable investment consultant providing the same services, the claimants present expert opinions from other consultants that advised on climate risk; guidance and risk alerts from tPR, IFoA, CFA Institute and Bank of England; and industry publications from other major investment consultants and asset managers.



Action points: rising to the challenge, managing the risk

To minimise the risks of reputational damage, regulatory sanctions, legal liability and ultimately commercial impacts, investment consultants advising DB pension schemes must now understand, and be clear in communicating, the extent to which they have taken climate risk into account in advising their clients. **To best protect themselves and their clients, investment consultants advising UK DB pension fund clients should consider the following action points:**

1

Understand climate risk and its financial implications – see, for example:

- **Bank of England**, 'The Bank of England's Response to Climate Change' (2017)
- **Task Force on Climate-related Financial Disclosures**, 'Final Report' (2017)
- **BlackRock**, 'Adapting Portfolios to Climate Change' (2016)
- **Mercer**, 'Investing in a Time of Climate Change' (2015).

2

Understand the implications of recent guidance by tPR in relation to the financial materiality of long-term sustainability issues, including climate risk.

3

Carefully consider implications of climate risk for assumptions and models including scenario analysis, used in developing investment beliefs and strategies, asset allocation and manager selection strategies.

4

Draw recent guidance by tPR regarding climate risk issues to the attention of UK pension fund clients by putting consideration of climate risk on trustee meeting agendas, issuing briefings and/or holding training sessions.

5

Where relevant, clearly communicate to trustees any limitations of assumptions or advice in relation to climate risk.

6

Include liability limitation or coverage clauses which explicitly address climate risk in contractual and professional indemnity insurance documentation.

Endnotes

- 1 See, e.g., Mercer, 'European Asset Allocation Survey' (2017), 29.
- 2 See, The Pensions Regulator, 'A Quick Guide to Defined Benefit Investment' (August 2017), 2; The Pensions Regulator, 'Regulatory Guidance, DB Investment: Investing to Fund DB' (March 2017) 23.
- 3 NASA, 'Global Temperature', <https://climate.nasa.gov/vital-signs/global-temperature/> (accessed 14 August 2017); UK Met Office, 'Global climate in context as the world approaches 1°C above pre-industrial for the first time', (2015).
- 4 See Intergovernmental Panel on Climate Change, 'IPCC Fifth Assessment Report – Climate Change 2014: Synthesis Report' (2014); Christiana Figueres et al. 'Three Years to Safeguard our Climate', *Nature* (28 June 2017).
- 5 See Task Force on Climate-related Financial Disclosures, 'Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures' (June 2017); Bank of England, 'The Bank of England's Response to Climate Change' (June 2017).
- 6 See Moody's, 'Oil and gas industry faces significant credit risks from carbon transition' (2017); Wood Mackenzie 'Positioning for the future: benchmark upstream corporate carbon emissions and value at risk' (2017); International Renewable Energy Agency, 'Stranded assets and renewables: How the energy transition affects the value of energy reserves, buildings and capital stock' (2017).
- 7 See Cambridge Institute for Sustainability Leadership, 'Unhedgeable risk: how climate change sentiment impacts investment' (2015).
- 8 See Cambridge Institute for Sustainability Leadership, 'Unhedgeable risk: how climate change sentiment impacts investment' (2015); Simon Dietz et al., 'Climate value at risk of global financial assets', *Nature: Climate Change* (2016); G20 Green Finance Study Group, 'Enhancing environmental risk assessment in financial decision-making' (2017).
- 9 See, e.g., Mercer, 'A climate for change: a trustee's guide to understanding and addressing climate risk' (2005); Mercer, 'Climate change scenarios – for strategic asset allocation' (2011); Institutional Investors Group on Climate Change (IIGCC), 'Climate change investment solutions: a guide for asset owners' (2015); BlackRock, 'Adapting portfolios to climate change: implications and strategies for all investors' (September 2016); Mercer 'Investing in a time of climate change' (2015); Mercer, 'Climate Change Investment Risk Management for US Public Defined Benefit Plan Trustees' (2016).
- 10 The Pensions Regulator, Code of Practice No.3, Funding Defined Benefits (July 2014) [36]–[60]; The Pensions Regulator, 'Regulatory Guidance, Integrated Risk Management' (December 2015).
- 11 Occupational Pensions Scheme (Investment) Regulations 2005 SI 2005 No 3378, reg 4(2); The Pensions Regulator, 'Code of Practice on Funding Defined Benefits' (July 2014).
- 12 The relevant service agreement will generally require the investment consultant to consider and provide their advice in accordance with relevant legal requirements; see also, Pensions Act 1995, ss 35(3), 36(3); The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 4.
- 13 UK Law Commission, 'Fiduciary Duties of Investment Intermediaries' (2014), chapter 6.
- 14 Pensions Act 1995, s 36; Occupational Pensions Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 4.
- 15 The Pensions Regulator, 'Regulatory Guidance, DB Investment: Investing to Fund DB' (March 2017).
- 16 Keith Bryant QC and James Rickards, 'The legal duties of pension fund trustees in relation to climate change' (2016).
- 17 See Institutional Investors Group on Climate Change (IIGCC), 'Climate change investment solutions: A guide for asset owners' (2015).
- 18 BlackRock 'Adapting Portfolios to Climate Change: Implications and Strategies for all Investors' (September 2016).
- 19 Mercer, 'Climate Change Investment Risk Management for US Public Defined Benefit Plan Trustees' (2016); Mercer 'Investing in a time of climate change' (2015); Mercer, 'Climate change scenarios – implications for strategic asset allocation' (2011); Mercer 'A climate for change: A trustee's guide to understanding and addressing climate risk' (2005).
- 20 Schroders 'Responding to climate change risk in portfolio management' (2015).
- 21 The Pensions Regulator, 'Regulatory Guidance, DB Investment: Investing to Fund DB' (March 2017); The Pensions Regulator, 'A Quick Guide to Defined Benefit Investment' (2017) 2.
- 22 See, e.g., Mercer, 'Climate change scenarios – implications for strategic asset allocation' (2011); Institutional Investors Group on Climate Change (IIGCC), 'Climate change investment solutions: a guide for asset owners' (2015); BlackRock, 'Adapting portfolios to climate change: implications and strategies for all investors' (September 2016).
- 23 Pensions Act 1995, s 35(1); local authority and small schemes are excluded from this requirement: The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 6.
- 24 Pensions Act 1995, s 35(1)(b); The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 2(1).
- 25 Pensions Act 1995 ss 35(4), 36; The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), regs 2(3)(a), 4.
- 26 Pensions Act 1995 s 35(4); The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 2(3)(b).
- 27 Pensions Act 1995, s 36; The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 2(2)(a).
- 28 TPR, 'Investment Guidance for Defined Benefit Pensions Schemes' (March 2017), 22.
- 29 This issue is further addressed in the Pensions Regulator, 'A Quick Guide to Defined Benefit Investment' (August 2017).
- 30 The Occupational Pension Schemes (Investment) Regulations 2005, reg 4.
- 31 The Occupational Pension Schemes (Investment) Regulations 2005, reg 4.
- 32 The Pensions Regulator, 'Investment Guidance for Defined Benefit Pensions Schemes' (March 2017), 58; how the trustees decide to allocate their assets may also have a significant impact on investment returns. Some studies have indicated that it is the overall asset allocation decision that has the dominant influence (along with scheme cost) in determining investment returns: see, e.g., Vanguard, 'The Asset Allocation Debate: Provocative Questions, Enduring Realities' (2006); Roger Ibbotson, 'The Importance of Asset Allocation', *The Financial Analysts Journal* (2010); Financial Conduct Authority, 'Asset Management Market Study: Interim Report' (November 2016), [8.39].
- 33 Pensions Act 1995, s 36(3); Re Whiteley (1886) 33 ChD 347.
- 34 The Pensions Regulator, 'Regulatory Guidance, DB Investment: Investing to Fund DB' (March 2017).
- 35 See, e.g., Mercer, 'Climate Change Scenarios – implications for strategic asset allocation' (2011); Asset Owners Disclosure Project, 'Climate Risk Management: Best Practice Methodology' (2011); Cambridge Institute for Sustainability

- Leadership, 'Unhedgeable risk: how climate change sentiment impacts investment' (2015); Mercer, 'Investing in a time of Climate Change' (2015); EY, Climate Change: The Investment Perspective' (2016); Allianz Global Investors, 'Climate Risk Investment Positioning' (March 2017); Allianz Global Investors, 'Integration of Climate Risks into Portfolio Strategy' (July 2017); OECD, 'Investment governance and the integration of environmental, social and governance factors' (2017).
- 36 See, e.g., Mercer Investing in a time of climate change' (2015), 7.
 - 37 See further, Task Force on Climate-related Financial Disclosures, 'Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures' (June 2017).
 - 38 See Pensions Act 1995, ss 34(4); 36; The Occupational Pension Schemes (Investment) Regulations 2005, reg 4.
 - 39 See, further, Asset Owners Disclosure Project, 'Climate Risk Management: Best Practice Methodology' (2011) [2.4].
 - 40 Most day-to-day investment activities carried out on behalf of an occupational pension scheme are regulated activities: see tPR, 'Investment Guidance for Defined Benefit Pension Schemes (March 2017), 5; see further: Financial Services and Markets Act 2000, s 22 and sch 2, para 6; Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544, art 37.
 - 41 See Pensions Act 1995, s 34(2); under section 47(2) of the Pensions Act 1995, where an occupational pension scheme has assets including investments, an asset manager must be appointed.
 - 42 See The Law Commission, 'Fiduciary Duties of Investment Intermediaries' (30 June 2014).
 - 43 Pensions Act 1995, ss 34(4); 36; The Occupational Pension Schemes (Investment) Regulations 2005, reg 4.
 - 44 Pensions Act 1995, s 36(3)–(4); Re Whiteley (1886) 33 ChD 347.
 - 45 Pensions Act 1995, s 36(5).
 - 46 See IIGCC, 'Climate change investment solutions: a guide for asset owners' (2015).
 - 47 Pensions Act 1995 s 35(4); The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 2(3).
 - 48 EU Directive on the activities and supervision of institutions for occupational retirement provision (IORP) (2016/2341) (IORP II), arts 19, 21, 25, 28, 30, 41.
 - 49 IORP II, art 28.
 - 50 See Law Commission, 'Fiduciary Duties of Investment Intermediaries' (Law Com No 350, 30 June 2014) [11.41].
 - 51 P Myrers, Institutional Investment in the United Kingdom: A Review (March 2001) paras 3.42–3.43; Law Commission, 'Fiduciary Duties of Investment Intermediaries' (Law Com No 350, 30 June 2014) [11.42]; Anna Tilba and Terry McNulty, 'Engaged versus Disengaged Ownership: The Case of Pension funds in the UK', 21 (2) Corporate Governance: An International Review (2013), 173; Financial Conduct Authority, Asset Management Market study: Interim Report (November 2016), 140–170.
 - 52 See Financial Conduct Authority, 'Asset Management Market Study: Provisional decision to make a market investigation reference on investment consultancy services (2016), [2.7].
 - 53 The relevant service agreement will generally require the investment consultant to consider and provide their advice in accordance with relevant legal requirements; see also, Pensions Act 1995, ss 35(3), 36(3); The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), reg 4.
 - 54 See, The Pensions Regulator, 'A Quick Guide to Defined Benefit Investment' (August 2017), 2.
 - 55 See AMNT and UKSIF Press Release, 'UK investment consultants publicly back UK Pensions Regulator guidance to consider environmental and social issues' (25 September 2017).
 - 56 In addition, the Actuaries Code, makes clear that 'actuaries must take care that the advice or services they deliver are appropriate to the instructions and needs of the client, including the legal duties and other rules which may govern the matter, having due regard to others ... such as members of a pension scheme': IFoA, The Actuaries' Code, v 2.0 (2013), [2.4].
 - 57 See further, Jackson & Powell on Professional Liability (8th Ed, 2017) [17-090].
 - 58 See TPR, 'Investment Guidance for Defined Benefit Pensions Schemes' (March 2017), 22.
 - 59 See, Peter Seley, 'Emerging Trends in Climate Change Litigation', Law 360, March 7, 2016; Task Force on Climate-related Financial Disclosures, 'Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures' (June 2017) 5.
 - 60 See Jackson & Powell on Professional Liability (8th Ed, 2017).
 - 61 There have been very few cases where the standard of care applicable to investment consultants has been considered. Recent authoritative commentary suggests that contemporary courts will be most likely to apply an approach consistent with the standard applied for other professionals: see, e.g., Jackson & Powell on Professional Liability (8th Ed, 2017), [18-036].
 - 62 See Jackson & Powell on Professional Liability (8th Ed, 2017), [18-036].
 - 63 See the Pensions Regulator, 'Regulatory Guidance, DB Investment: Investing to Fund DB' (March 2017); the Pensions Regulator, 'A Quick Guide to Defined Benefit Investment' (August 2017), 2.
 - 64 See AMNT and UKSIF Press Release, 'UK investment consultants publicly back UK Pensions Regulator guidance to consider environmental and social issues' (25 September 2017).
 - 65 (IFoA) 'Risk Alert: Climate Related Risks' (12 May 2017).
 - 66 See, e.g., Lane, Clark and Peacock, 'A guide to climate-related risks: climate change and the implications for pension schemes' (August 2017).
 - 67 See, e.g., Daly v Sydney Stock Exchange Ltd, (1986) 160 CLR 37, as discussed in The Law Commission, 'Fiduciary Duties of Investment Intermediaries' (2014), 183-187.
 - 68 See, e.g., Barlow Clowes v Eurotrust [2006] 1 All ER 333.
 - 69 See, e.g., Investment and Pensions Europe, 'Consultants and pension funds: when disagreements arise' (March 2015).
 - 70 Financial Conduct Authority, 'Asset Management Market study: Interim Report (November 2016), [8.9].
 - 71 See Unfair Contract Terms Act 1977, s 3.
 - 72 See, e.g., Bank of England, 'The Bank of England's Response to Climate Change' (June 2017).
 - 73 See, e.g., ClientEarth, 'Four out of five UK local council pension funds silent on climate risk despite warning' (9 May 2017) <https://www.clientearth.org/80-local-council-pension-funds-silent-climate-riskdespite-warning/>.
 - 74 Financial Conduct Authority, 'Asset Management Market Study: Final Report' (June 2017).
 - 75 See, e.g., Financial Conduct Authority, Conduct of Business Sourcebook (COBS) [2.1.1] – [2.1.3].
 - 76 See Institute and Faculty of Actuaries, 'Disciplinary Scheme' (Effective 1 June 2016); CFA Institute, 'Rules of Procedure for Procedure for Professional Conduct (1 December 2015).

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ClientEarth is funded by the generous support of philanthropic foundations, institutional donors and engaged individuals.

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