

Climate change: Implications for superannuation funds in Australia



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Background

Climate change is a topic that is so complex, politically charged and broad-reaching, that it is sometimes easier to become paralysed by the magnitude of the issue than think through the ramifications and potential solutions. However, as the science becomes clearer, ignoring it is no longer a viable option for governments and businesses around the world, with an increase in greenhouse gases linked to increasing temperatures, rising sea levels and more frequent and extreme weather events globally.

The latest Intergovernmental Panel on Climate Change report stated that climate change is now unequivocal and that it is extremely likely that is being caused by human activities, mainly the burning of fossil fuels (e.g. coal, oil or gas) and the reduction in forest cover.¹

In response to these concerns, international governments have set a goal to limit human induced global warming to well below two degrees above pre-industrial temperatures, aiming for 1.5 degrees, to avoid the worst impacts of climate change. Research by the Potsdam Institute has calculated that to reduce the chances of exceeding the two degrees warming globally, emissions would have to be kept within a 'carbon budget' of 886 gigatons of carbon dioxide (GtCO₂) between 2000 and 2050. However, they have revealed that 30% of this budget has already been used up in the first decade of this century.² Moreover, the Carbon Tracker, a leading carbon think tank, believes that the global financial markets may be carrying a 'carbon bubble' as the total known fossil fuel reserves of public and privately owned companies amounts to 2795 Gt CO₂, over three times the global cap. This has been analysed further by the UCL Institute for Sustainable Resources, which has found that globally, a third of all oil reserves, half of all known gas deposits and 82% of coal capacity would have to remain unused by 2050 if the world is to remain within the internationally agreed limit of two degrees.³ These findings assume no changes to efficiencies and no technical breakthrough in carbon capture and storage (CCS), however, progress in CCS has been slow to date.

These findings, along with the fact that fossil fuels face other potential headwinds from an increase in the use of renewable

energies and their decreasing costs versus fossil fuels, mean that undiversified energy companies could be significantly impacted, should the energy mix shift as governments take action to limit greenhouse gas emissions. The Carbon Tracker Initiative has conducted a risk assessment on the Australian fossil fuel industry and believes that the Australian thermal coal sector in particular is at risk of losing value and being left with 'stranded assets' if a global cap is placed on greenhouse gas emissions.⁴

In response to this 'stranded asset' debate, many fossil fuel companies have refuted claims that their reserves are at risk, and remain confident that the growing energy requirements of countries such as India and China will continue to bolster their businesses. However, in Australia, the price of a metric ton of coal is at a 5 year low, dropping from US\$132 in 2011 to \$60 in 2014, and Goldman Sachs has announced that thermal coal is in structural decline.⁵ The world's largest producer of seaborne thermal coal, Glencore, estimated in 2014 that falling prices and high costs rendered a third of Australian coalmines unprofitable. Despite these challenges, it is estimated that over the next decade, over US\$6 trillion is expected to be allocated to developing the fossil fuel industry and in 2012, fossil fuel companies spent US\$647 billion on exploration and development projects.⁶ It is clear therefore that the choices governments across the world are currently facing about how to meet escalating demands for energy while managing climate change are unprecedented.

What does this mean for superannuation funds in Australia?

The Asset Owners Disclosure Project (AODP) has estimated that 55% of superannuation and pension funds are invested in high-carbon assets or sectors greatly exposed to the impacts of climate change and climate-related regulation. Furthermore, the Climate Institute has stated that Australian superannuation funds have on average a 40% allocation to "climate sensitive" assets which represents approximately A\$500 billion of current and future retirees' money in 2015.⁷

1 IPCC, 2013. Climate Change 2013: The physical Science Basis, Summary for Policy Makers

2 Carbon Tracker, 2011. Unburnable Carbon – Are the world's financial markets carrying a carbon bubble?

3 McGlade, C and Elkins, P, 2015. The Geographical Distribution of Fossil Fuels Unused When limiting global warming to 2 degrees. Nature, Volume 517, P 187-190

4 Carbon Tracker and the Climate Institute, 2013. Unburnable Carbon: Australia's carbon bubble

5 Sanzillo, T, 2014. No need for new US Coal Ports: Institute for Energy Economics and Financial Analysis

6 Carbon Tracker and the Grantham Institute, 2013. Unburnable Carbon 2013: Wasted Capital and Stranded Assets

7 The Climate Institute, 2011. Asset Owners Disclosure Project (Australia) – Fund Survey results

The World Bank, Citigroup, HSBC and Mercer, amongst others, have warned of the financial risk climate change poses to fossil fuel investments. Mercer have released a number of reports outlining the magnitude of these risks and claim that climate change will be a significant source of portfolio risk for institutional investors to manage over the next 20 years. They found that the average annual returns from the coal subsector 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). Conversely, the renewables subsector could see average annual returns increase by between 6% and 54% over a 35 year period or between 4% and 97% over a 10 year period.⁸ In addition, Cambridge University has found that global investment portfolios could lose up to 45% of their value as a consequence of short-term shifts in climate change sentiment. The Cambridge report concluded that about half of this potential loss could be avoided through portfolio reallocation, while the other half is “unhedgeable”; meaning that investors cannot necessarily protect themselves from losses unless action on climate change is made at a system level.⁹

Given the socioeconomic dilemma of climate change, combined with the potential financial risks of investing in high carbon organisations – the following questions remain.

Are superannuation fund members concerned about climate change and their fund investing in fossil fuels?

A number of studies have been conducted in Australia in relation to super fund member views on climate change and fossil fuel investment. The Garnaut review conducted a meta-analysis of 22 studies in 2011 and found that 66% of Australians were concerned about climate change.¹⁰ A separate poll by Lonergan Research of 1314 Australians found 72% of respondents were concerned about their bank or super fund financing coal and gas, with almost half of respondents saying they would like their super fund or bank to be investing less or phasing out fossil fuel investments in the long term.¹¹

A similar survey of 1126 Australians conducted by the Australia Institute, found that one in four Australians would be willing to change their superannuation fund if it was found to be invested in coal or coal seam gas companies.¹² Converted into a dollar figure, this means that out of the nearly A\$1 trillion of managed superannuation in Australia, A\$247 billion could be shifted on the basis of concerns about the environmental impact of fossil fuels.

Climate activism has also become popular in Australia, with NGOs (including Greenpeace, 350.org, MarketForces, SuperSwitch.org) taking an increasing interest in fossil fuel investments by super funds and the big 4 banks and have been campaigning heavily in Australia and overseas. The Guardian newspaper in the UK has even developed its own ‘Keep it in the Ground’ campaign which actively promotes fossil fuel divestment and is urging the two of the largest charitable funds

in the world (The Wellcome Trust and the Gates Foundation) to shift their investments away from fossil fuels.

How are superannuation funds responding?

In response to the public concern and possible financial risks, some Australian superannuation funds have already taken a proactive step to limit or reduce their exposure to fossil fuels (mostly coal), including Local Government Super, First State Super, HESTA, Uniting Church, and Unisuper. Similarly, the recently established Future Super Fund has been set up on the premise that they will not invest in any fossil fuel companies or other companies that provide services or finance to significant fossil fuel projects. Many of these funds have cited growing interest from members regarding the impact of climate change on the world as well as growing concern about the financial risk of investing in fossil fuel companies.

The divestment movement has not only been limited to Australia. This movement has grown faster than any other divestment movement to date, with the number of institutions (including university endowment funds, sovereign wealth funds and pension funds) committing to divest rising from 181 in September 2014 to 436 in September 2015. These institutions represent an incredible US\$2.6 trillion of investments, including the world’s largest sovereign wealth fund held by Norway and two of the world’s largest pension funds, in California.

However, not all funds are tackling this issue head on, with many yet to acknowledge that climate change is a consideration for them. This is likely to be partly due to the lack of political agreement on this issue in Australia, with changing policies and changing leaders, leaving businesses with a confused message.

Regardless of the political debate, it remains clear that a section of the Australian public are concerned about climate change and are looking for their superannuation fund to proactively address risks associated with climate change. However, at the same time, it is interesting to note that the number of people who invest through so called ‘Socially Responsible Investment’ (SRI) funds that limit or exclude fossil fuels tend to be a minority versus more traditional funds which are typically invested in fossil funds. Why is this?

Lorna Tweedie from Colonial First State Global Asset Management, along with supervisor Jake Reynolds from the Cambridge Institute for Sustainability Leadership, explored this topic as part of the Cambridge University Masters of Sustainability Leadership program. A survey was conducted of 1000 members of a more ‘traditional fund’ to test the view of the membership base on the topic of climate change and investments in fossil fuels. Although the relatively low number of survey responses cannot be taken as representative of the whole membership base, the findings did support previous studies in this area. The key findings include:

- 73% of respondents were concerned about climate change

8 Mercer, 2015. Investing in a time of climate change

9 Cambridge Institute for Sustainability Leadership, 2015. Unhedgeable risk: how climate change sentiment impacts investment

10 Leviston et al, 2011. Australians’ views of climate change. CSIRO Report

11 Lonergan Research, 2013. Australian views on responsible investment

12 Denniss, 2013. Time to engaged with Super? It all depends on the proposal. The Australia Institute

- 48% were concerned that their pension fund may be contributing to climate change through investment in fossil fuel companies
- 55% were concerned that the financial performance of their fund will be impacted by climate change
- 61% would like their fund to reduce investments in fossil fuel companies
- 75% would consider moving all or part of their pension to a low carbon or clean energy fund

The most interesting component of the findings however, relate to the lack of action by members in changing their investments. Although most respondents did profess to care about these issues, only 3% of respondents had actually taken any action to review and move any of their funds. When this was explored further, the greatest barriers to action included a lack of available information on alternative options, and a lack of time to look at and compare the choices.

During follow-up interviews, it was revealed that members were overwhelmed with the complexity of the superannuation process, with many people stating that they were not aware of what companies they are actually invested in. The process for switching superannuation funds seems too complex and the lack of transparency from funds seems to lead to a lack of engagement from members. Members were frustrated with the lack of choice in environmental, social and governance (ESG) investment options and were seeking more choice and information from their fund.

There seems to be a lesson here about disclosure and simplicity. How do we make it easy for superannuation members to understand what companies they are invested in, to be more engaged in the superannuation process and help them invest in companies that align with their values?

Legislation could help. In Australia for example, there is legislation coming into place (targeted for mid-2016) that will mandate that all superannuation funds must disclose their portfolio holdings to their members. If implemented well, with simple, useful and easy to understand information, this could lead to members becoming more interested in their investments and keen to know where their money is going.

France have recently taken their disclosure requirements one step further, and have released draft legislation that will require institutional investors to disclose how they consider environmental, social and governance issues in decision-making processes. The requirements include reporting the risks of climate change associated with carbon-intensive assets and the opportunities to invest in low-carbon and renewable energy. Investors will also need to set targets to measure progress and explain if they are not achieved. This is a world first to introduce carbon reporting legislation for financial institutions and could set a precedent for other countries to follow suit.

It is therefore likely that climate change will become an increasingly important topic for superannuation funds and their members. One course of action that will be challenging is engaging with fund members to understand their needs and interests.

For funds just starting out on this journey, some key questions to consider could include:

Key questions

Do your investment beliefs/policies cover climate risk?

What is your current exposure to climate sensitive assets/stranded asset risk?

What actions can you put in place to address those risks?

Are you able to calculate your portfolio wide emissions?

Do you provide guidance to your fund managers on climate risk assessment?

What upside investment opportunities are available in the low carbon sector?

Is climate change a key concern for your members?

By developing a suitable framework to assess, address and disclose climate risks, funds not only ensure prudent fiduciary responsibility of their members' funds, but also ensure adequate preparation for the inevitable questions from members coming their way. For funds that have not considered these issues before, this is likely to require some trustee training and there are a number of consultancies offering specialist expertise in this area.

Conversely, funds that remain invested in fossil fuels but have not assessed the climate risks associated with their portfolio could be exposing themselves to legal challenges from NGOs and other concerned stakeholders. As an example, the Asset Owner Disclosure Project (AODP) launched the Climate and Pensions Legal Initiative in April 2015 which aims to work with superannuation fund members to challenge trustees and managers to fulfil their legal duty to protect investments from the financial risks posed by climate change. As at the time of writing, the AODP is preparing to launch legal action against the trustees of a large UK pension fund for their failure to manage their fiduciary duties by not managing the climate change risk within their fund. This is clearly no longer a topic that can be ignored.

In addition, the AODP conducts an annual survey and assessment of the world's 1000 largest asset owners about their management of climate risks and opportunities. The outcomes and rankings are published to allow members, stakeholders and industry to compare funds actions/disclosure on managing climate risk. Furthermore, the website Superswitch.org.au allows individuals to compare the level of revenue that super funds in Australia derive from fossil fuel extraction, transport or generation, with the aim of encouraging individuals to switch to funds with lower exposures. Therefore if individuals are concerned they can easily find out to what extent their fund is addressing ESG concerns.

Upon review, there are many funds in Australia that do actively consider climate risks, and as a result have rebalanced their

portfolios away from riskier investments. Others have even taken steps to publicly divest from fossil fuels altogether from some or all of their options. However, there are still a number of funds that are yet to consider climate risks and opportunities and this is a precarious position to be in (both from a legal and reputational perspective) given the global momentum in climate politics and public opinion.

Public interest is set to increase even further following the recent United Nations 2015 Climate Summit in Paris ('COP21'), which agreed the basis of a far-reaching climate stabilisation plan. Time will tell how the large volume of media interest and public debate generated by the summit, and its ensuing actions, will change the investment preferences of the general public. However,

it seems that a shift in public consciousness about climate change may well be occurring, with significant implications for superannuation funds. The Cambridge Institute for Sustainability Leadership is currently designing new research to explore the question of public demand for sustainable investment at a larger, international scale.

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