EUROPEAN CENTRAL BANK

EUROSYSTEM

Shifting to an Investment Strategy that mitigates Climate Change Risks: practical considerations

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The views expressed are those of the presenter and not necessarily those of the ECB

Agenda

1. ECB Pension Funds; a short overview
2. Why shift to an investment strategy that mitigates climate change risks?
3. When to shift to a climate-change risks mitigating investment strategy
4. Discussion themes I
5. Sustainable Finance: main ongoing initiatives
6. Discussion theme II
7. Conclusion

The European Central Bank

- ECB is the **central bank of the euro area** with its mandate and tasks clearly defined by the Treaty

- Since 2014, **Banking Supervisor** for all banks in the euro area
- Separate EU-Institution
- Pension funds for staff: 1^{st}, 2^{nd}, 3^{rd} pillar
  - 1-2: **defined benefit**, funded by ECB and staff
  - 3: **defined contribution**, voluntary for staff
- Governed by **Pension Administrator**, Investment Committee and Oversight Committee
- **Passive** investment strategy, allocation reviewed every 3-5 years, by means of an Asset-Liability Management (ALM) study

1. ECB Pension Funds: a short overview (II)

- Assets under management: €1.35 billion
- About 3500 beneficiaries and 200 pensioners
- **Invested into 7 asset classes**, tracking selected benchmark indices:
  - Equity (Euro area, Other developed countries, Emerging markets)
  - Bonds (Euro corporate, Euro government, Euro inflation-linked)
  - Cash
- **Environmental, Social and Governance (ESG) considerations**:
  - Companies' exclusion policy: UN global compact and controversial weapons
  - Proxy voting policy (through the external asset managers)
- ALM study underway, including ways to potentially **integrate sustainable investment approaches** in the strategic asset allocations (defined benefit and defined contribution)

2. Why shift to an investment strategy that mitigates climate change risks?

- NGFS: climate-related risks are a **source of financial risks**
- Climate change will affect **all** economic agents (households, corporations, government) across all sectors and geographies, with potentially much larger **impact** than other structural changes
- **High degree of cer**tainty that some combination of physical and transition risks related to climate change will materialise
- **Actions today** determine magnitude and nature of future impacts
- Above a certain threshold, climate change will have **irreversible consequences** on our planet
- Climate change risks may materialise over a **longer** time horizon than is currently commonly used; as a consequence, **these discounted (huge) risks may not yet be fully priced in**
- Particularly relevant for **long-term investors: pension funds**
- Sustainable investments may be financially rational and also by far the most efficient way to **reduce one's own CO_2 footprin**t

- It may be advisable to consider such a shift in the **short term:**
  - Since the number of investors shifting to a climate-change risks mitigating investment strategy is expected to increase rapidly and substantially, with a concomitant effect on asset prices (also after the adoption of the EU Taxonomy and Green Bonds standard, which will reduce uncertainty and the risk of greenwashing).
  - Before legislative initiatives in this direction may substantially affect asset prices

- Climate-change risk mitigation versus general ESG considerations
  - Climate-change risk is not only the most substantial risk, but also the risk that is most unequivocally measurable (CO_2 emissions)
  - Not only direct emissions matter, but the whole value chain (supply chain, use of the product, end-of-life)

4. Related Discussion Themes I

i. How would a shift to a sustainable investment strategy work for:
   a. A defined contribution pension scheme;
   b. A defined benefit pension scheme?

ii. How would you see the interaction with beneficiaries and other stakeholders (e.g. Executive Board in case of the ECB) to ensure their support for a sustainable investment strategy for their pension fund? What road blocks may need to be overcome?

iii. What concrete choices should be made when shifting to a sustainable investment strategy?

iv. What can governments or the European Union do (even more) to stimulate the shift to a sustainable investment strategy (by pension funds)?

European Commission (I)

- Action Plan on Financing Sustainable Growth (2018)
  1. Establish EU Sustainable Taxonomy
  2. Create Standards and Labels
  3. Foster Investment in Sustainable Projects
  4. Incorporate Sustainability in Investment Advice
  5. Develop Sustainability Benchmarks
  6. Integrate Environmental, Social and Governance (ESG) Considerations in Ratings and Market Research
  7. Clarify Institutional Investors' and Asset Managers' Duties
  8. Incorporate Sustainability in Prudential Requirements
  9. Strengthen Sustainability Disclosure and Accounting
  10. Foster Sustainable Corporate Governance

European Commission (II)

- Technical Expert Group on Sustainable Finance
    1. Guidance on EU climate change taxonomy published in June 2019
    2. At the same time: Report on the first EU green bond standard
    5. Advice on methodologies for low-carbon benchmarks

7. Regulation on Disclosures relating to sustainable investments and sustainability risks, adopted in April 2019
8. Proposal, introducing consistency on how to integrate sustainability in the decision-making by institutional investors
9. Guidelines for companies to disclose climate risks (also: how their activities impact the climate), aligned with recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)

- Supporting global Coalition of Finance Ministers for Climate Action: incorporating climate change and environmental issues into the macro-economic policy agenda

Network on Greening the Financial System (NGFS)

- Group of Central Banks and Supervisors (incl. ECB) willing to contribute to the development of climate risk management in the financial sector and to mobilise finance to support the transition towards a sustainable economy
- Agrees that **climate-related risks are a source of financial risk**
- **6 Recommendations** (1-4 for central banks and supervisors):
  1. Integrating climate-related risks into financial stability monitoring and micro-supervision
  2. Integrating sustainability factors into own-portfolio management
  3. Bridging data gaps
  4. Building awareness and intellectual capacity and encouraging technical assistance and knowledge sharing
  5. Achieving robust and internationally consistent climate- and environment-related disclosure
  6. Supporting the development of a taxonomy of economic activities

Task Force on Climate-related Financial Disclosures

- Set up by the Financial Stability Board to develop voluntary, consistent, climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders -TCFD
- Considering physical, liability and transition risks associated with climate change and what constitutes effective financial disclosure across industries
- Recommendations:
  - Climate-related financial disclosures in mainstream annual financial filings
  - Disclose: 1. governance around climate-related risks and opportunities; 2. their impacts on strategy, businesses and financial planning; 3. how they are identified, assessed and managed; and 4. the metrics and targets used
  - Test strategy resilience to climate-related scenarios (+2°C and lower)
- **June 2019 2nd Status report:** steady increase in recommendations adoption, but difficulty to disclose scenario analysis assumptions and lack of standardised metrics and targets

What can governments, Central Banks and the European Union do (more) to stimulate the shift to a sustainable investment strategy (by pension funds)?

7. Conclusions

- Support for shifting to a climate-change risks mitigating investment strategy is increasing very rapidly
- Governments, central banks and supervisors are stepping up their efforts in this direction
- More and more companies are disclosing relevant information, but full harmonisation has not yet been reached
- Specific benchmark indices and dedicated funds are rapidly developing but there remains a need for publicly legislated standards (concepts, definitions and classifications)
- Considering a shift in the short term may be rational from a financial perspective, if only since the number of investors shifting to a climate-change risks mitigating investment strategy is expected to increase rapidly and substantially, with a concomitant effect on asset prices, and before legislative initiatives in this direction may substantially affect asset prices

Thank you for your attention

For further information or questions

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- **Defined-contribution pension funds**: Add such an asset class to the potential investment universe (NB: communication is key!)

- **Defined-benefit pension funds**: e.g. introduce a intra-sectoral ‘tilting’ strategy (overweighting vanguards and underweighting laggards by industry) in the equity and corporate bond portfolios

5. Communication with stakeholders

- Emphasise the (very) long-term nature of pension investments (remaining life expectancy of average beneficiary may be decades)
- Clarify that shifting to a climate-change risks mitigating investment strategy is likely to be financially rational, both in the longer term (when substantial risks may materialise) and in the short term (since increasingly more investors are considering such a shift)
- Potentially, undertake a quick survey among beneficiaries on their preferences, with just a few (preferably less than 5) multiple choice questions
- Potentially, specify with how much the ex ante tracking error is allowed to increase, to determine the achievable carbon intensity reduction
- Explain why a tilting strategy may be preferable to a strategy with only investments in (specific) ‘green’ equity and bonds, if only from a diversification perspective