A4S Pensions Deep Dive

Ensuring decision-useful climate scenarios in the investment decision-making process

Top tips for pension funds:

1. **Challenge conventional thinking**. Ask advisers, investment consultants and asset managers who are using long term temperature pathway scenarios whether this really provides a clear understanding of the impact of climate and how it interacts with macro and financial variables. If you are given numbers on expected return input to 2050, question the process used to calculate this.

2. **Develop a new scenario-thinking culture with a focus on shorter-term horizons (eg 2030) and realistic narratives**. These scenarios should integrate climate science on physical (including tail) risks with transition risks within broader macroeconomic, technological, and geopolitical contexts.

3. **Clearly distinguish between financial materiality and impact**. Financial materiality scenarios (ie inbound risk) should include transition risks from policy delays or failure. Similarly, scenarios for impact (ie outbound risks) should be used to ensure that realistic, achievable interim targets are set.

4. **Start scenario development with rich, flexible narratives** – starting with a very high-level view of how the climate transition could play out and the dimensions we would need to consider in the next five to ten years eg policy intervention and technological developments. Next build models with sufficient flexibility to capture the key insights of the narratives, such as described here.

5. **Adopt a more forward-looking approach to asset allocation** that accounts for both the downside physical tail risks (and the associated need for adaptation and resilience) and upside technological tail risks. Embedding narratives into the strategic asset allocation process is explored in more detail here.

6. **Educate your executive office, in-house team and/or service providers to think differently about asset allocation.** For example, why and how to move beyond performance benchmarks and backwards-looking risk metrics; and re-thinking mandate design and bottom-up process integration.

7. **Include in your policy engagement or 'macro-stewardship' activities**.
"Policymakers and regulators are keenly interested in analysing the short-term impact of climate change and mitigation policies on the real economy, individual financial institutions, and the broader financial system" (NGFS, Conceptual note on short-term climate scenarios, 2023). Therefore, encouraging them to adopt a similar approach will help facilitate the production of more relevant scenario sets.

Further reading:

A4S produced resources:

- European Deep Dive recording: Ensuring Decision-Useful Climate Scenarios In The Investment Decision-Making Process
- Q&A: A narrative approach to climate scenario analysis at USS
- Webinar recording: Using a narrative scenario approach for asset allocation

External resources:

- Carbon Tracker: Loading the DICE Against Pensions
- USS and University of Exeter: No Time to Lose – New Scenario Narratives for Action on Climate Change
- Institute and Faculty of Actuaries: The Emperor's New Climate Scenarios
- Carbon Tracker: Challenging the Systemic Under-pricing of Climate Damages Within the Global Financial System