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# PENSION FUND PORTFOLIOS AND WATER RISK

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WWF

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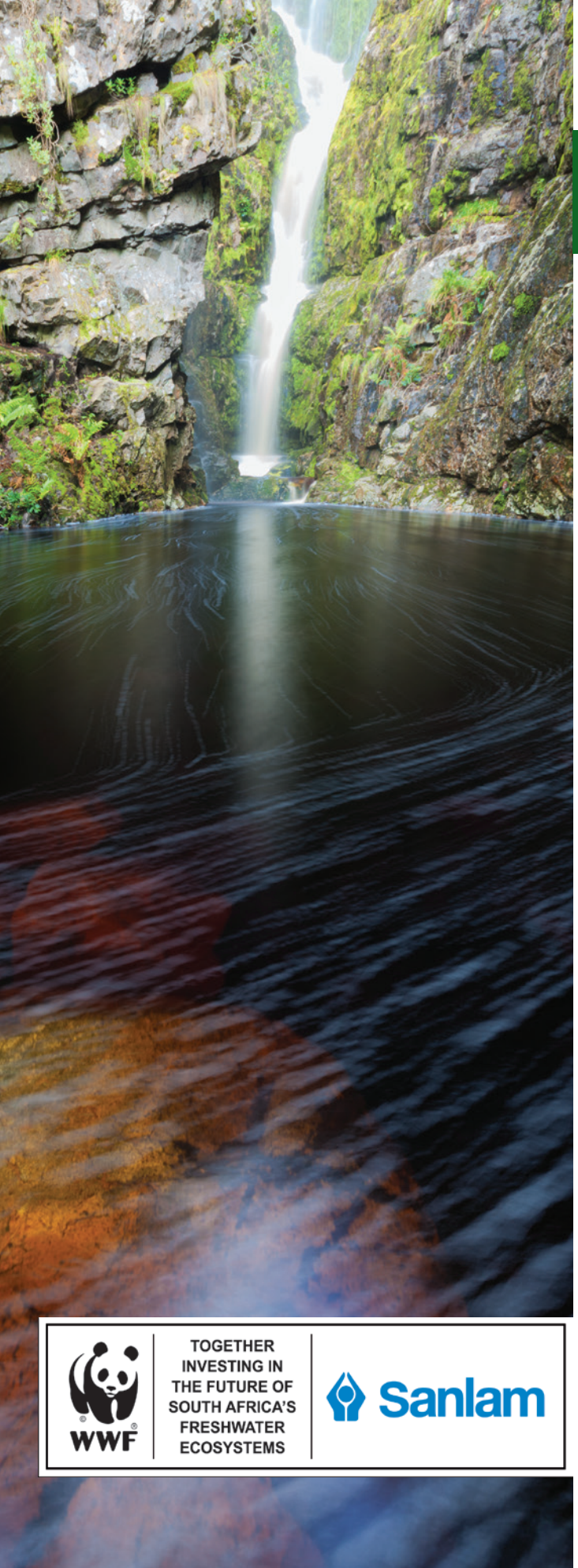


# ABOUT WWF

WWF is one of the world's largest and most experienced conservation organisations, with over 5 million supporters and a global network active in more than 100 countries. WWF's mission is to stop the degradation of the planet's natural environment and to build a future in which people live in harmony with nature.

WWF has worked with the finance sector for more than a decade via innovative collaborations that seek to integrate ESG (environmental, social and governance) risks and opportunities into mainstream finance so as to redirect financial flows to support the global sustainable development agenda.

Our approach to sustainable finance leverages WWF's conservation expertise – as well as our partnerships with companies on key issues such as water, energy, climate and food – to drive sustainability. Positioned at the cutting-edge of sustainable finance internationally, WWF contributes directly to leading initiatives, including the European Commission's Technical Expert Group on Sustainable Finance and the development of international green bonds standards.

WWF also works directly with some of the largest asset owners in the world on decarbonising investment portfolios. This has allowed us to strengthen lending and investment criteria for key industry sectors, provide insights and data on environmental and social risks, fulfil critical research gaps, help unlock innovations in sustainable finance products and convene key stakeholders to progress the sustainable finance agenda.

The Sustainable Finance team within the WWF, made up of over 80 professionals globally, is key to driving this agenda into mainstream financial markets by collaborating with investors, asset allocators, banks, regulators and other relevant industry bodies globally.

This Today's Trustee Special Edition supplement has been sponsored through the WWF Sanlam Partnership.

***"The nature of business is changing as sustainability is being integrated into everything a business does."*** **– WWF South Africa**

Today's global environmental and social challenges we face are too big, too interconnected and too urgent for any one organisation to solve alone. Business drives much of the global economy, so companies and investors have a specific responsibility to ensure that the natural resources and ecosystems that underpin their businesses are used sustainably.

The WWF Sustainable Finance team works with financial institutions to ensure that environmental opportunities and risks are being integrated into the decision-making process by both companies and investors. The incorporation of ESG issues into mainstream business will lead to more sustainable investment opportunities being created and financial institutions becoming better stewards of the world's natural resources. Increasingly, the financial services industry is recognising that ESG issues can — and do — have financial implications.

**WWF Sanlam Partnership**

The WWF Sanlam partnership, established in 2007, was created to encourage South African business, society and government to focus on water scarcity and security. This has resulted in the funding of several successful fresh water and marine projects aimed at preserving South Africa's water systems. The partnership has seen significant success in highlighting the linkages between better management of water risk, and driving better insurance and investment management.

"Since its launch in 2007, the WWF Sanlam Partnership has been described as a highly innovative, visionary and pioneering partnership. In our view, it has not only delivered significant conservation impact, but has also delivered a strong institutional foundation and innovative approach upon which to build. It continues to provide a unique platform for leaders to address the management of our finite water resources."

***Morné du Plessis, CEO: WWF South Africa***

WWF's vision is to inspire people to live in harmony with nature. We need to plan and build our future economic growth in harmony with our water source areas. We hope that through the WWF Sanlam partnership and in partnering with other like-minded partners in this space, South Africans will develop a better understanding and appreciation of our country's water challenges and our different roles in ensuring a water-secure future for our country.

**Resilient and Sustainable Investment portfolios: Frameworks for Responsible Investment**

In a new report by WWF titled *Resilient and Sustainable Investment Portfolios* the focus is on tools and frameworks for asset managers. While all actors in the financial system have a role to play, asset managers wield considerable influence as shareholders over multiple companies across a range of sectors and geographies. Via financial decision-making processes, from stock selection, monitoring, engagement and proxy voting, through to the development of green investment products, asset managers can encourage companies to adopt science-based sustainability practices that will ensure businesses operate within planetary boundaries and contribute to sustainable development.

The goal of this report is to support the asset management industry in this regard by providing a framework that outlines WWF's perspective on responsible investment for listed equities — one that is not only holistic in its procedural rigour but rooted in the scientific consensus and criteria underlying the environmental and social issues at hand.

A handful of leading asset managers globally have recognised this potential and are integrating sustainability, or ESG, factors into their core businesses using science-based criteria — what we refer to as responsible investment. They understand that by doing so they can provide part of the solution to, rather than exacerbate, the crisis facing humanity, and simultaneously improve their ability to manage risk and returns to create resilient portfolios. As such, they have taken significant steps to addressing sustainability through their investments. However, there remains room for industry leaders to improve by more deeply incorporating science into decision-making processes and an urgent need for the rest of the industry to catch up.

By making use of the framework for either self-assessment or benchmarking against peers, multiple stakeholders along the investment supply chain can help move the asset management industry forward on responsible investment. In doing so, financial capital can be deployed in a way that protects and preserves both natural and social capital.

To this end, WWF-SA and Six Capitals ESG Advisory have formed a strategic partnership which supports the integration of the "E" in ESG. This initiative will see WWF-SA and Six Capitals ESG Advisory jointly develop Environmental metrics, standards, advice, reporting and investment solutions that support the South African investment industry in the transition towards an improved model of environmental stewardship. Examples of other criteria, frameworks and tools that the investment industry can use in their assessment and integration of the E in ESG can be found on page 4.

**Retirement funds and asset owners can use these frameworks to:**

- Assess if the environmental and social impacts related to the deployment of their capital aligns with their values and those of their beneficiaries;
- Understand if asset managers are incorporating science-based criteria to maximise investment portfolio resilience to climate and other ESG risks;
- Enhance sustainability criteria and improve transparency around expectations from external managers in their investment mandates;
- Complement consultant assessments and benefit from a more complete perspective when evaluating external managers' responsible investment capabilities and awarding mandates;
- Form the basis for engaging with external managers over performance on responsible investment.

**Asset managers (including internal managers of asset owners) can use these frameworks to:**

- Assess their own responsible investment capabilities and identify gaps and areas for improvement;
- Demonstrate how their investment decisions and engagement activities can influence portfolio companies to adopt more sustainable operating practices and increase the resilience of their business models;
- Structure and improve disclosures on responsible investment, thereby improving accountability to stakeholders, including clients, shareholders, regulators and civil society.

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2. https://www.wwf.org.za/
3. https://tinyurl.com/y4cagsb4
4. http://wwf.panda.org/our_work/finance/
5. https://tinyurl.com/y6rlxk83
6. https://www.sixcapitals.co.za

There are numerous science based criteria, tools and methodologies for assessing and integrating environmental and social risks into the investment process, and the table below lists several widely used examples. Investors that use them fundamentally improve their ability to price risk and allocate capital in ways that are consistent with supporting sustainable development while protecting natural capital and strengthening portfolio resilience. These criteria, tools and methodologies address varied issues, and many link data on companies' physical assets (e.g. plants, mines, concessions, infrastructure, etc.) with scientific data on environmental or social issues. This permits users to assess a company's exposure to such risks, often in geospatially explicit ways, and often in terms of financial impacts. - WWF Resilient and Sustainable Portfolios 2019.

**Summary of science based criteria, tools and methodologies for assessing environmental risks**

| ORGANIZATIONS | NAME | DESCRIPTION | ISSUE ADDRESSED |
|---|---|---|---|
| WORLD RESOURCES INSTITUTE | Global Forest Watch / Global Forest Watch Pro | ■ Assesses and monitors deforestation and fire risk based on user uploaded locations of concessions and other physical assets | DEFORESTATION, BIODIVERSITY LOSS, WORLD HERITAGE SITES |
| WWF | WWF-SIGHT Analytics | ■ Offers overlays of protected areas such as World Heritage Sites and Key Biodiversity Areas with user uploaded locations of concessions or other physical assets | |
| 2° Investing Initiative | Paris Agreement Capital Transition Assessment (PACTA) | ■ Uses asset-level data with known capital expenditure plans to assess investor portfolio alignment with International Energy Agency technology/fuel mixes associated with different climate scenarios | CLIMATE CHANGE |
| CDP DISCLOSURE INSIGHT ACTION, WWF, WORLD RESOURCES INSTITUTE, UN GLOBAL COMPACT | Science Based Targets initiative (SBTi) | ■ Helps corporations identify pathways and set targets for decarbonization that are aligned with emissions reductions required to achieve a well-below 2°C warming scenario<br>■ Methodology under development for financial institutions | |
| WWF | WWF Water Risk Filter | ■ Assesses exposure to different types of water risk based on user uploaded asset location data | WATER |
| WORLD RESOURCES INSTITUTE | WRI Aqueduct | ■ Assesses exposure to different types of water risk based on user uploaded asset location data | |
| NATURAL CAPITAL FINANCE ALLIANCE, UNEP FINANCE INITIATIVE, global canopy | Corporate Bonds Water Credit Risk Tool | ■ Assesses impact of water stress on corporate credit ratings | |
| | Drought Stress Testing Tool | ■ Shows impact of different drought scenarios on banks' loan portfolios | |
| | Exploring Natural Capital Opportunities, Risks and Exposure (ENCORE) | ■ Identifies business risks arising from economic dependencies on natural capital | MULTIPLE |
| global canopy | Soft Commodity Risk Platform (SCRIPT) | ■ Benchmarks companies on the strength of their soft commodity production, sourcing or financing policies<br>■ Assesses portfolio exposure to deforestation, biodiversity loss and other soft commodity sector risks (e.g. climate, human/labour/community rights) | |
| MULTI-STAKEHOLDER | Sustainability certification | ■ Multi-stakeholder, independent third-party assured certification standards that indicate sustainability best practices (e.g. ISEAL Alliance members) | |

## SOURCE:

WWF Resilient and Sustainable Portfolios 2019 page (17)
http://awsassets.panda.org/downloads/wwf_sustainable_finance_report.pdf

# WWF
# SUSTAINABLE FINANCE

# PENSION FUND PORTFOLIOS AND WATER RISK

## THIS TOPIC IS COVERED IN TODAY'S TRUSTEE MAGAZINE:

1. https://www.totrust.co.za/first-word-editorials-edition-july-september-2019/
2. https://www.totrust.co.za/article/responsible-investment-2-editorials-edition-december-2015-february-2016/
3. https://www.totrust.co.za/article/sustainability-2-editorials-edition-april-june-2016/

**Why is water important?**

South African cities, such as Cape Town, Port Elizabeth, Durban and Johannesburg, have in the last five years each experienced drought and severe water stress. Most recently, and perhaps most severely, the City of Cape Town experienced the worst drought in over 100 years, resulting in strict water restrictions and significant concern being expressed by city residents, local and national government and the business community.

Incidents of drought and water shortages have affected millions of South Africans. This has brought the true value of this natural resource to the forefront of people's minds, as water scarcity increasingly becomes an issue that can no longer be ignored. Our dependence on water extends beyond our biological or sanitation needs, as it has an economic value across all its competing uses. Water poses both an economic and social purpose, requiring both business and civil society to become better water stewards by becoming water wise and protecting our shared water resources.

Water therefore plays a crucial role in South Africa's economic growth and development, serving as a primary input to production and the basis for sustaining life and the environment. This resource should therefore be recognised as an economic and social good.

**What is water risk?**

Approximately 70% of our planet is made up of water. However, only an estimated 2.5% of this is freshwater. From our freshwater sources, less than 1% is easily accessible to support the planet's 7.7bn people.

Water is a finite resource and a basic need in South Africa. According to a 2017 WWF SA report, titled *Together investigating the future of South Africa's water supply,* the demand for water is expected to increase by 32% in 2030 relative to 2016 due to increased population growth, industrial development and urbanisation. It also forecasts that South Africa will reach a water deficit of 17% by 2030.

According to an online article published by the World Economic Forum in April 2019, water risk is ranked as the fourth-highest risk from a likely negative impact perspective to doing business. The uncertainty of the future supply and availability of water places significant risk on water-intensive industries such as agriculture, mining and manufacturing. The scale and nature of water risk will vary from one industry sector to another. These risks fall into three categories – physical, regulatory and reputational risks – with each posing a financial risk to a business and its investors.

**I. Physical Risk**

The relative freshwater scarcity, extreme weather events and

projected impacts of climate change on water accessibility create uncertainty about reliable water availability in the future. According to the WWF SA report, the projected climate change impacts on freshwater availability in South Africa are rated as one of the highest risks for businesses because rainfall patterns in South Africa will increasingly vary. The western part of South Africa is expected to become drier, while wetter conditions are projected for the eastern part of the country. Changing rainfall patterns will also impact the type of crops that can be grown across the country, as well as the overall food security in South Africa.

The other component to physical risks resulting from water scarcity is the state of South Africa's ageing water infrastructure systems. Second to the recent droughts and water crisis, South Africa's water infrastructure has increasingly been put under the spotlight. According to the department of water and sanitation there is a maintenance backlog of approximately R10bn, which could increase water prices in the future. Physical risk will be at an even higher level if sufficient and necessary water infrastructure maintenance does not prevent any further ageing and erosion of South Africa's bulk water infrastructure system.

**II. Regulation**

The South African water sector is governed by legislation and regulations that enable the creation and management of institutions and policies for water management at both national and provincial level. However, most of the legal regulations are not fully enforced. Poor enforcement of water-related legal frameworks, such as water-use licences for metals and mining companies, can put further strain on an already constrained water supply in such regions. The risks for people and business are not only supply related, but also include the potential financial losses for those businesses who do not comply with water rules and regulations and will be subject to forced shutdowns and/or significant fines and penalties.

**III. Reputational risks**

Reputational risk becomes more apparent as people become fully aware of their basic human right of access to clean water. Growth in water demand due to population growth and increased urbanisation will require water to be redirected from rural water catchments to urban water catchments. As a result, there will be increased competition between business and communities on a number of water-influenced socioeconomic factors, such as prioritising clean and healthy water for human consumption to meet human basic needs.

Reputational risk also comes into play when perception around water use, pollution and corporate behaviour on water usage may have negative impacts on a company's brand, influencing the purchasing decisions of its consumers. When the actions of a company are poorly executed, understood or communicated with local stakeholders, the consequence is that the brand, and perceptions of it, may suffer, resulting in unnecessary financial losses to the company and its shareholders.

## WATER STEWARDSHIP

Water stewardship is a new way of thinking about water management, which encourages water use efficiency and improving management of water-related activities. Increasingly, business dependency on freshwater is being recognised and understood. There is also an appreciation of the positive role business can play in overcoming the water challenges we face.

To improve sustainable management practices of water-related activities, it is imperative to form effective partnerships with the private sector, public sector, NGOs and local and national government to mobilise resources and map out roles that different stakeholders can play in, for example, critical river catchments. The private sector is increasingly showing interest in forming partnerships to formulate mitigation initiatives to reduce shared water risks.

**How should investors respond?**

It is most important that the business sector understands and evaluates its exposure to water risk, as it can have a serious impact on business operations. For example, according to a Cape Chamber of Commerce survey, the estimated impact of Day Zero on Cape Town business was the following:

- More than 6.7% of businesses were expected to shut down on Day Zero due to not being able to function without municipal water supply;
- 11% would have had to send their staff home;
- 79.4% believed the situation was a significant threat to their business operations.

Businesses should strategically evaluate their supply chain, including customer vulnerability, to determine what can be affected by water risk. This will help business understand where in the water value chain water risk points are so that the relevant mitigation and adaption actions can be taken.

A key first step in reducing water scarcity risks is to have a better understanding of the freshwater ecosystems in which companies operate, and to seek to optimise the range of goods and services these ecosystems provide to a broad range of stakeholders.

The second step would be to assess water risk across investment portfolios and proactively engage investee companies to manage water-related risks. Tools such as the WWF Water Risk Filter (available at https://waterriskfilter.panda.org/) and the Carbon Disclosure Project can be used to assess water risk for specific industries in specific locations in relation to various risk drivers. More information on water-related environmental, social and governance (ESG) issues and improved water risk management may be achieved through increased company engagement through water stewardship activities on the part of retirement and pension funds.

**Why is this important for trustees?**

According to ASISA, South Africa's retirement fund industry is worth approximately R3.6tr, representing approximately 40% of the South African savings industry. This number includes the Government Employees Pension Fund assets (approximately R1.9tr). As investors and shareholders of these assets, the ultimate beneficiaries of these funds have significant power to engage asset managers and corporates on any issues that may impact the long-term performance of their investments. The UN Principles for Responsible Investment (PRI) refer to such engagement as active ownership, which is a core component of being a responsible investor. In this context, active ownership refers to being an active shareholder through:

- Exercising the right to vote proxies at investee company AGMs for example; and
- Engaging with companies to address any material issues of an environmental, social or governance (ESG) nature that may impact the long-term value and return of an asset.

Active and engaged shareholders can be very effective in influencing

## THE CARBON DISCLOSURE PROJECT (CDP)

The Carbon Disclosure Project (CDP), runs a global disclosure system that enables companies to measure and manage their environmental impacts. Areas of focus include climate and water. There are a number of South African companies that participate in this project and therefore publicly disclose water and carbon data on an annual basis. If a company uses a significant amount of water in its operations, it is global best practice to participate in the CDP or similar initiatives and to seek to improve its outcomes year-on-year, and to learn from peer reviews and sector leaders in an effort to improve performance.

For more info on the CDP, visit:
https://www.cdp.net/en/info/about-us

companies' behaviour in addressing water risks so as to ensure value creation over the long term. Further to this, Regulation 28 of the Pension Funds Act makes responsible investment a regulatory requirement by stipulating that pension fund trustees must *"give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance (ESG) character."* The Guidance Note on Sustainability of Investments and Assets issued in June 2019 by the Financial Sector Conduct Authority (FSCA) builds on this regulation and seeks to encourage better disclosure and transparency by retirement and pension funds in this regard.

It is evident that ESG issues, such as water risk, should be considered in pension funds' investment and active ownership processes. Trustees, being elected guardians of these assets, have a crucial role to play in ensuring that, as per their fiduciary duty, they are engaged and active investors across their portfolio of investments.

**What can trustees do?**

There are a number of ways trustees can ensure that water risk is appropriately addressed in their funds. These include the following:

**1. Ensure that ESG factors are incorporated within the fund's investment policy, philosophy and investment management process.**

The fund's investment policy, philosophy and process should specifically address how ESG issues, such as water risk, are considered in the investment process where such issues may have long-term financial implications on underlying investee companies. Such considerations should also be included in the investment mandate provided to the underlying asset manager/s contracted to manage the pension fund's assets. Regular monitoring and reporting by investment managers to the pension fund should give the board of trustees confidence that such issues are being appropriately addressed by their service providers.

**2. Ensure that your fund has an active ownership policy and process in place.**

An active ownership policy should be developed to encompass both proxy voting and engagement responsibilities with investee companies. A proxy voting policy acts as a guideline for how a fund's shares should be voted by their investment manager/s. These guidelines should address pertinent issues of an ESG nature that may come up for shareholder approval at a company's annual general meeting (AGM)

The fund should also understand the nature of the engagements on ESG issues between investment managers and the companies in which they invest and the outcomes from such engagements.

Some possible questions that relate to water scarcity and water risk that a trustee may want to address with investment managers / investee companies could include:

- Does the company adequately disclose its water consumption in its annual or integrated report? If its operations use a significant amount of water or its suppliers do, are water consumption volumes sufficiently disclosed?
- How has the company's water consumption changed year-on-year and what measures are in place to reduce water consumption and/or to conserve or recycle water?
- Does the company make disclosures to CDP and CDP water?

**3. Assess your fund's water footprint**

Understand your fund's exposure to and reliance on water at overall portfolio level. This analysis should identify companies within your investment portfolio that are most exposed to water scarcity and water risk; understand which investee companies are leaders and/or laggards in managing their water risk; and which are compliant/non-compliant with environmental laws etc. This holistic analysis can help in understanding how the fund is impacted by water scarcity and water risk across its investment portfolio and also provide powerful information to engage asset managers and investee companies on the management of such ESG risks.

**4. Consider allocating assets to investments that have a specific mandate in place that addresses water stewardship / water resilience as a key outcome.**

As per Regulation 28, a fund may invest a portion of its portfolio in unlisted assets. In some instances, these alternative assets may have specific environmental or social impacts over and above risk and return objectives. A number of impact funds that have such a dual mandate are available in South Africa. Trustees could consider consulting their investment consultants and investment managers to learn more about these types of investments.

## REFERENCES:

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To learn more about this topic, hosted in partnership with the ASISA Academy, please visit Today's Trustee Education: www.totrust.co.za/accessyourcourses/ or contact us on education@totrust.co.za

# OVERVIEW OF FSCA GUIDANC
## SUSTAINABILITY OF INVESTMENTS AND
## INVESTMENT POLICY STATEMENT (IPS)

## 1. PURPOSE OF THE GUIDANCE NOTE

To provide **guidance to boards of funds** on how the board must comply with Regulation 28(2)(b) read with Regulation 28(2)(c)(ix), in particular how its **in** as reflected in its **investment policy statement**, seeks to ensure the **sustainability of its investments and assets,** and to set out the **Authority's expectatio reporting on issues of sustainability.**

## 2. BACKGROUND TO THE GUIDANCE NOTE

2.1 Regulation 28(2)(b) of the regulations to the Act requires all funds to have an investment policy statement and Regulation 28(2)(c)(ix) requires that boards of funds consider ESG factors before investing in an asset.

2.2 Regulation 28 promotes responsible investing of fund assets, based on a sustainable, long-term, risk-aligned and liability-driven investment philosophy. The preamble to Regulation 28 sets out the expectations of funds when they are investing their assets:

*"Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social or governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment."*

2.3 This requirement to consider the sustainability of a fund's assets is repeated in the principle contained in Regulation 28(2)(c)(ix), which states that a fund and its board must:

*"Before making an investment in and while invested in an asset consider any factor which may materially affect the sustainable long term performance of the asset including, but not limited to, those of an environmental, social and governance character."*

## 3. SUSTAINABILITY OF INVEST
## IN THE CONTEXT OF A RETIRE
## INVESTMENT POLICY STATEM

3.1 The sustainability of the assets of a fund is
investment policy statement. To this end, i
read with Regulation 28(2)(c)(ix), a fund sh
statement how its general investment philo
sustainability of its assets, including (but n

(a) when the investment policy statement
(b) how often the investment policy state
(c) how the fund intends to monitor and e
asset which it owns and which it is int
which ESG factors have been conside
thereof on the assets of the fund; and
(d) its active ownership policy.

3.2 Where a fund holds assets that limit the ap
criteria or the full application of an active o
statement should also state the reasons as
of both the pension fund and its membersh
statement should set out the remedial acti
rectify the position. Where no remedial act
should set out the reasons therefore.

3.3 The Authority would also expect a fund's in
matters referred to in paragraph 3.1 will, to
relevant investment mandate(s).

FSCA
Financial Sector Conduct Authority

This document is only a summary extract of the Guidance Note and should be read in conjunction w
Guidance Note available on the FSCA website https://www.fsca.co.za

# CE NOTE 1 OF 2019 (PFA):
## ASSETS IN THE CONTEXT OF A RETIREMENT FUND'S

vestment philosophy and objectives,
ons regarding disclosure and

## TMENTS AND ASSETS
## EMENT FUND'S
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a key factor that should inform its
n order to comply with Regulation 28(2)(b)
ould reflect in its investment policy
osophy and objectives seeks to ensure the
ot limited to) the following:

t was approved and by whom;
ment will be reviewed;
evaluate the ongoing sustainability of the
tending to acquire, including the extent to
red by the fund, and the potential impact

plication of ESG factors, sustainability
wnership policy, the investment policy
s to why this limitation is to the advantage
hip. Alternatively, the investment policy
on the fund has taken or intends taking to
ion is being considered or taken, the fund

vestment policy to stipulate that the
the extent applicable, be reflected in the

ith the full

## 4. DISCLOSURE OF INFORMATION TO STAKEHOLDERS

4.1 In the interest of transparency, accountability and the fair treatment of its members, every fund is encouraged to:

(a) make its investment policy statement or an abridged version thereof available on request and at no cost to each member and, if applicable, to each participating employer. Where an abridged investment policy statement is provided it would be acceptable if it only reflects those assets relating to the specific category of members, but the requirements of paragraph 4 in relation to those assets should preferably be contained in the abridged statement;
(b) make a copy of its investment policy statement, as well as information as set out in paragraph 4, available on the website. A fund's investment policy should be accessible to any person, whether or not a member; and
(c) at least on an annual basis, provide a copy of or inform stakeholders that the investment policy statement and any changes thereto is available on its website. Where there is a representative union in respect of the members of the fund as advised by the employers participating in the fund, such communication should preferably be addressed to the representative union.

4.2 The Authority encourages transparent disclosure by funds to stakeholders on all matters relating to sustainability.

## 5. REPORTING

5.1 In order for the Authority to monitor compliance with Regulation 28(2)(b) read with Regulation 28(2)(c)(ix), funds are requested to report on the extent to which its investment policy statement reflects the matters set out in this Guidance Notice.

5.2 In the interest of transparency, accountability and fair treatment of its members, the board of a fund is encouraged to adopt sustainable reporting practices and to include details of:

(a) how its investment policy statement reflects the matters set out in this Guidance Notice;
(b) any significant changes in its investment policy statement during the reporting period, specifically including any changes relating to matters addressed in paragraph 4;

by note in the Report by the Board of the Fund in the prescribed annual financial statements referred to in section 15(1) of the Act as well as in its annual report to members or in any other appropriate communication to its members.

5.3 It would be prudent for the board of a fund to include the following information, where possible, by note in the financial statements:

(a) confirmation that every member who has requested a copy of the investment policy statement has been provided with such a copy;
(b) confirmation of any change to the investment policy statement from the previous year, including specifically any changes relating to matters set out in paragraph 4;
(c) assets held in compliance with this Guidance Notice and the class of the asset as per Annexure B to Schedule I of the prescribed financial statements; and
(d) value of assets held in compliance with this Guidance Notice.

# PENSION FUND PORTFOLIOS AND CLIMATE RISK:

# INVESTING RESPONSIBLY TO MITIGATE CLIMATE RISK

## IN BRIEF:

This article provides high-level guidance for retirement fund trustees and fund members as to the duties of South African pension fund boards in accounting for climate-related risks and opportunities when investing on behalf of their fund and its members.

## THIS TOPIC IS COVERED IN TODAY'S TRUSTEE MAGAZINE:

1. https://www.totrust.co.za/article/currents-editorials-edition-july-september-2019/
2. https://www.totrust.co.za/article/cover-story-editorials-edition-april-june-2016/
3. https://www.totrust.co.za/article/responsible-investment-2-editorials-edition-december-2015-february-2016/
4. https://www.totrust.co.za/article/sanlam-investments-expert-opinions-edition-april-june-2016/

**Climate-change risk: Legal obligations of retirement and provident funds**

A recent legal opinion commissioned by ClientEarth and Just Share NPC, published in April 2019, found that boards of pension or provident funds (hereafter referred to as "boards") are required by South African law to incorporate climate-related risks and opportunities into their investment decision-making processes when investing on behalf of their funds. Furthermore, the legal opinion also argued that failure to include material environmental, social and governance (ESG) risks, such as climate change, into investment decisions would likely result in a breach of fiduciary duty by the board, under both common law principles and Regulation 28 of the Pension Funds Act (PFA). Therefore, given the principles of Regulation 28, boards have a legal obligation to consider climate risk when making investments as it relates to pension fund investment portfolios.

# WHAT EXPERTS SAY: "THE VALUE AT RISK TO GLOBAL MANAGEABLE ASSETS FROM CLIMATE CHANGE, IN PRESENT VALUE TERMS, IS CALCULATED AT $4.2TR."

***The Economist***

Regulation 28 of the Pension Funds Act, 1956

Regulation 28 under the PFA encourages the responsible investing of fund assets, grounded in a sustainable, long-term, risk-aligned and liability-driven investment philosophy. Moreover, regulation 28(2)(b) of the Act instructs that all funds need to have an investment policy statement and regulation 28(2)(c)(ix) indicates that the boards of funds should consider ESG factors before investing in an asset.

A number of principles included in Regulation 28 set out the responsibilities and duties assigned to the fund and its board. A fundamental principle applicable to a board, or anyone to whom any investment-related powers and functions of a fund has been assigned (such as those of asset managers or asset consultants), is the following:

*"Before making an investment in and while invested in an asset, [the board must] consider any factor which may materially affect the sustainable long-term performance of the asset including, but not limited to, those of an environmental, social and governance character." – Regulation 28 (2)(c)(ix)*

Given that climate risk poses a material risk likely to have an impact on the long-term performance of an asset, it is clear that climate change risk must be considered in the investment decision-making process before an investment is made – as well as while the fund remains invested in an asset.

**Actionable steps for South African pension fund boards**

The following steps have been proposed in the legal opinion by ClientEarth and Just Share NPC to provide trustees with specific guidance in terms of recommended steps trustees should take to ensure they are in compliance with their fiduciary obligations:

- The board needs to ensure that it has sufficient knowledge, sourced through expert advice, on climate change risk as it relates to the investments held by the fund.
- The board must have a good grasp of its fund's portfolio carbon footprint through understanding which investments are at increased risk to climate change and what investment opportunities going forward can contribute to transitioning to a low-carbon economy.
- Boards need to ensure that a climate change policy is developed in order to ensure that climate change risks are identified and managed accordingly.
- The climate change policy needs to be sufficiently communicated to service providers, such as fund managers appointed to responsibly manage the fund's assets on behalf of the fund. Asset managers and consultants need to be given a clear mandate with regards implementing this policy.
- The board's trustees need to promote active ownership through engaging with companies operating in carbon-intensive industries.
- The board's investment policy needs to be developed in a manner that promotes accountability through the implementation of clear, measurable targets that work towards transitioning to a low-carbon economy.

## REFERENCES:

1. Moneyweb 2017, *King IV report as far as RI funds are concerned.*
2. *Understanding South African Financial Markets (5th edition), Retirement Funds. Pages 165 -167.*

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# CLIMATE RISK AND YOUR RETIREMENT FUND'S INVESTMENTS

## IN BRIEF:

A case study of Standard Bank's 2019 AGM and the shareholder resolution requiring Standard Bank to adopt and publicly disclose a policy on its lending to coal-fired power stations and coal mining operations.

In April 2019 two Standard Bank minority shareholders, the RAITH Foundation and the South African shareholder activist, Theo Botha, with support from Just Share NPC, tabled Standard Bank's very first resolution on climate change risk. This was the first climate risk-related shareholder resolution to be tabled in South Africa.

According to an article by Paul Verney, published in May 2019 on Responsible-Investor.com, the resolution was tabled by "shareholders holding less than 0.001% of the company's issued ordinary share capital". As reported by Just Share NPC in April, the resolution requested shareholder approval requiring Standard Bank to:

(a) [Resolution 10.1] report to shareholders by the end of November 2019, at reasonable cost and omitting proprietary information, its assessment of the greenhouse gas emissions resulting from its financing portfolio and its exposure to climate change risk in its lending, investing and financing activities including:

(i) the amount and percentage of carbon-related assets relative to total assets, and

(ii) a description of any significant concentrations of credit exposure to carbon-related assets;

and

(b) [Resolution 10.2] adopt and publicly disclose a policy on lending to coal-fired power projects and coal mining activities.

Resolution 10.2 received 55% support of the shareholder votes exercised, according to Verney and Just Share NPC, and therefore became binding on the company. This is the first time that a South African bank – or any listed South African company – has faced a shareholder resolution on a climate-related issue.

Resolution 10.1, which received 38% support of the shareholder votes exercised, did not pass and thus did not become binding on Standard Bank. While Resolution 10.1 was not passed, it had received significant support, with 38% of shareholders voting in favour, indicating strong shareholder demand for improved climate risk-related disclosure from Standard Bank.

While Standard Bank had recommended that its shareholders should not vote in favour of the proposed resolutions, Standard Bank acknowledged the following:

- Standard Bank acknowledged that it was well within the rights of its shareholders to table a resolution to be put to vote at the bank's AGM; and
- Standard Bank was cognisant of the fact that, as a company operating in Africa, the bank was well aware of the climate risks and negative impacts of climate change on the continent. The issue was therefore one that required international attention, given its global nature which calls on all countries and stakeholders to play their part; and
- Institutional investors, such as pension and retirement funds through their investee companies, play a pivotal role in terms of proactively addressing matters such as greenhouse gas emissions through their lending and financing practices, as relayed in Standard Bank's *Shareholder information and notice of annual general meeting*

Standard Bank's argument in motivating its shareholders not to support the proposed shareholder resolutions, was that:

- The banking sector in particular was a heavily regulated industry, both locally and internationally, and was therefore considered to already have a number of reporting requirements that already addressed and reported on the bank's lending exposures to the bank's regulatory authorities.
- Companies that have operations in South Africa are already required by law [as per the National Greenhouse Gas Emission Reporting Regulation pursuant to the National Environmental Management Act No. 39 of 2004 (Air Quality Act)] to report on their carbon emissions on an annual basis. Therefore, the bank was of the view that the most effective way of coordinating carbon reduction strategies was via already established international and national frameworks.
- The methodologies required to measure carbon intensity across various portfolios are diverse, and therefore there was no standard methodological approach for such measurement, as shared in its *Shareholder information and notice of annual general meeting*.
- Further to this, the bank was also of the view that it "currently has various measures in place to manage environmental, social and governance (ESG) risk in its lending practices, and the details of these measures were set out in the company's ESG report," as stated in its *Shareholder information and notice of annual general meeting*.

**Post-AGM publication of Standard Bank's Coal-Fired Power Finance Policy**

On 31 July 2019, Standard Bank announced the release of its Coal-Fired Power Finance Policy. This requirement arose from the obligation imposed on Standard Bank by the 55% of shareholders who voted in favour of this shareholder resolution tabled at its AGM on 30 May 2019. Standard Bank confirmed that its new policy was aligned with the principles and standards for coal-fired power finance contained in the latest OECD Annex VI sector understanding on export credits for coal-fired electricity generation projects, dated January 2019.

The policy applies across the consolidated banking operations of the Standard Bank Group, excluding Liberty. Furthermore, the policy applies to direct finance of new coal-fired electricity generation plants without operational carbon capture and storage or carbon capture and utilisation technology. To be eligible for direct finance, coal-fired power plants must meet maximum emission and plant size parameters that are linked to the level of development of the country in which the coal-powered electricity generation plant is to be constructed.

In addition to the minimum eligibility requirements, direct finance of new coal-fired power generation in African economies requires enhanced due diligence, the specific details of which are provided in the policy. Lastly, all transactions considered under the policy are required to be reported to Standard Bank's Head of Group Environmental & Social Risk and Finance for enhanced due diligence. Post-finance monitoring is also required on an ongoing basis.

**Other South African banks and climate risk developments**

**Absa Bank:**
Subsequent to the Standard Bank AGM in May 2019, Absa Bank at its own AGM on 4 June 2019 announced that it intends to start the process of allocating significant resources in coming to grips with climate change and the risks that climate change poses to Absa's financing and lending portfolios, as reported by Warren Thompson for Business Day.

**FirstRand Limited:**
On 5 August, Just Share NPC and the RAITH Foundation submitted a climate risk resolution to FirstRand Limited. FirstRand's AGM takes place on 28 November 2019 in Johannesburg. Similar to the Standard Bank resolution, the resolution calls for improved disclosure on FirstRand's exposure to climate-related risks, and for it to adopt and publicly disclose a policy on lending to fossil fuel-related projects.

## THIS TOPIC IS COVERED IN TODAY'S TRUSTEE MAGAZINE:

1. https://www.totrust.co.za/article/responsible-investment-2-editorials-edition-december-2015-february-2016/
2. https://www.totrust.co.za/article/cover-story-editorials-edition-august-october-2018

## REFERENCES:

1. Moneyweb 2017, *King IV report as far as RI funds are concerned.*
2. *Understanding South African Financial Markets* (5th Edition), *Retirement Funds*. Pages 165 -167.

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# PENSION FUNDS AND CLIMATE RISK

**WHY PENSION FUNDS MUST INVEST RESPONSIBLY FOR CLIMATE RESILIENCE**

## WHAT IS THE PROBLEM?

**Climate change poses a systemic risk to people, the environment and the economy.**

Temperature increases above 1.5°C have the potential to change life as we know it in South Africa completely.

The Paris Agreement on climate change recognises that there is an **urgent need for a fast and just transition** to a resilient low-carbon economy that will drive job creation, reduce inequality and build social stability.

**But this will not happen without urgent collaborative action from all of us.**

In South Africa, our law supports **strong action** by institutional investors like pension funds to tackle climate change and drive **inclusive economic prosperity**.

**But pension funds have not yet risen to the challenge: they need to do much more, much faster.**

## WHY ARE PENSION FUNDS IMPORTANT?

Pension funds are **influential actors** in our financial system. Their decisions have broad impacts on society, and they are **bound by strict duties** and responsibilities to consider the nature of those impacts.

**Climate change may pose serious financial risks to pension investments in the short, medium and long term.**

At the same time, the transition to a low-carbon economy presents **significant investment opportunities** that can help to mitigate the broader economic risks posed by climate change and boost pension funds' long-term returns.

ClientEarth and Just Share NPC commissioned a legal opinion from Fasken, written by SA's top pension lawyers, which makes it very clear that South African pension fund boards are **legally required to consider climate risks** in making investment decisions.

We've written to pension fund boards across SA setting out the findings of the legal opinion, as well as steps that pension funds must take now to make sure they are complying with their legal duties.

## HOW DOES THIS AFFECT YOU?

**The savings of millions of South Africans are invested in pension funds which must sustain them in retirement.**

Pension fund boards who manage these savings are doing so on behalf of workers, communities and beneficiaries who all have an interest in ensuring:

- That their retirement benefits are not jeopardised by over-reliance on high-carbon investments which pose serious financial risks; and
- That the world they retire into is not dominated by climate catastrophe and social and political instability.

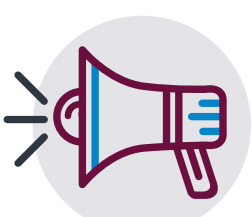
# WHAT MUST PENSION FUNDS DO?

At the very least, pension fund boards must:

**Ensure that they are "climate competent",** i.e. take appropriate advice, analyse and fully understand the climate risks and opportunities in relation to their funds.

**Assess the carbon footprint** of their fund's portfolio, and identify investments which are vulnerable to climate risk and those which can contribute to a just transition to a low-carbon economy.

**Develop a clear climate policy** which explains the fund's understanding of climate risk, and how the board identifies and manages it.



**Communicate this policy** to asset managers and consultants who manage the fund's investments on its behalf, and make sure that they are appropriately mandated and incentivised to implement the policy.

**Pursue active stewardship and engagement with companies in high-carbon sectors**, including by setting clear voting policies and engagement escalation timelines; and regularly disclose to members how they are managing climate risk.

**Develop an investment strategy with clear, measurable targets** to remove portfolio carbon risk and leverage low carbon opportunities.

See the full list of recommendations for pension fund boards, and download the legal opinion and letters to pension funds at www.justshare.org.za

JUST SHARE
Investor power for a fairer South Africa

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# INTRODUCTION TO SOUTH AFRICA'S CARBON TAX

In May 2019, President Cyril Ramaphosa signed into law the Carbon Tax Act, the latest in the South African government's efforts to limit the impact of climate change. The aim of the tax is to incentivise companies to reduce carbon emissions as well as to shift consumer and investor behaviour towards supporting companies with lower carbon emissions.

There are many sources of carbon emissions, but the most common are those from fossil fuel combustion in transportation, heating, industry and electricity generation – roughly 1kg of carbon dioxide ($CO_2$) is emitted for every kilowatt hour (kWh) of electricity generated in South Africa.

South Africa ratified the United Nations Framework Convention on Climate Change (UNFCC)'s Paris Agreement in 2016 and South Africa's new carbon tax is seen as a way in which the country can ensure that it meets its objectives under the Paris Agreement. The act is in favour of the "polluter-pays-principle" and incentivises particularly large South African carbon-emitting companies to take into account the negative externalities of their productive activities.

**The Paris Agreement seeks to:**

1. Combat climate change globally by keeping the global temperature rise since pre-industrial levels to well below 2˚C above pre-industrial levels before the turn of the century and;
2. Pursue efforts to limit the temperature increase even further to 1.5°C.
3. Strengthen the ability of countries to deal with the impacts of climate change.

Each country that endorses the Paris Agreement must come forward with its best efforts to reduce carbon emissions through locally appropriate activities outlined in documents called Nationally Determined Contributions (NDCs). The newly introduced Carbon Tax is one activity mentioned in South Africa's NDC.

**How the tax works**

Private and public sector entities surpassing a certain threshold of emissions (specified in the National GHG Emissions Reporting Regulations) will be taxed. A carbon tax of R120 will be charged for every tonne of carbon emissions released by those entities that exceed certain thresholds. The tax will be rolled out in phases, with the first phase being from 1 June 2019 to 31 December 2022 and the second phase from 2023 to 2030. The first phase of the tax will cover Scope 1 emissions (direct emissions from owned or controlled sources) only from stationary sources in certain sectors. Most land-use and agriculture emissions are excluded, as are emissions from residential use and the waste sector. Transport emissions will be covered by a levy on the price of fuel.

Emissions

- Scope 1 emissions are those emissions that stem directly from the activities of an organisation or are under their control. These usually include emissions from company vehicles or company facilities.
- Scope 2, or indirect emissions, stem from the electricity purchased and used by the organisation. These emissions arise when the energy is produced and is eventually used by the organisation.
- Scope 3 emissions are all other indirect emissions that stem from an organisation's activities that come from sources they neither own nor control. These include emissions associated with business travel, procurement, and waste and water, for example.

In addition to the tax, qualifying companies will be given a variety of tax-free emissions allowances in this first phase. Among these is a basic tax-free allowance of 60% for all activities; a 10% allowance for process and fugitive emissions (these are emissions that result from unintended releases of gas); a maximum 10% allowance for companies that use carbon offsets to reduce their tax liability; a 5% performance allowance for those entities that have an emissions intensity below a sector benchmark; and an additional allowance of 10% for trade-exposed sectors. A 5% carbon budget allowance is granted to qualifying entities that participate in the voluntary first phase of the Department of Environment, Forestry, and Fisheries (DEFF) carbon budgets.

**Why a carbon tax?**

It is generally accepted by economists that a carbon tax is a cost-effective and economically efficient means for reducing carbon emissions. A carbon tax allows the government to put a price on carbon emissions and to shift the cost of pollution from society to the companies that are producing it.

Investors, creditors and consumers will increasingly find low-carbon-intensive products and companies more attractive because they are subject to less carbon tax. Some companies will most likely attempt to pass on the cost of the new carbon tax to their customers which will, in turn, likely cause customers to switch to buying from companies with low(er) carbon emissions because such products will be cheaper. Innovative companies that are able to reduce their carbon emissions will most likely outperform their less innovative peers over time.

The rest of the world is fast moving towards a low-carbon economy. Due to the high carbon intensity of South Africa's economy, given our reliance on Eskom and coal-fired power stations, our high-carbon produced merchandise will look less attractive – both for investment and export purposes. In future, some countries may put trade barriers in place against products made in countries where little to no effort is made to reduce carbon emissions, implying a greater need for these kinds of interventions in South Africa.

Lastly, the short-term costs associated with the carbon tax will be trumped by the long-term costs of inaction. The impact of climate change, like the changing rainfall patterns that adversely affect the agricultural sector, is already causing some commodity prices to rise – regardless of the imposition of the carbon tax. By taxing and reducing carbon emissions now, the future cost of climate change on society can be reduced.

## THIS TOPIC IS COVERED IN TODAY'S TRUSTEE MAGAZINE:

1. https://www.totrust.co.za/article/first-word-editorials-edition-november-2018-january-2019
2. https://www.totrust.co.za/article/sustainability-2-editorials-edition-april-june-2016
3. https://www.totrust.co.za/article/responsible-investment-2-editorials-edition-december-2015-february-2016

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1. The Carbon Report. *The proposed South African carbon tax*. Available: http://www.thecarbonreport.co.za/the-proposed-south-african-carbon-tax/.
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7. SECTION 37C DEATH BENEFITS
8. INVESTMENT MANAGEMENT COSTS & FEES
9. DEFAULT REGULATIONS
10. PRIVATE EQUITY

> *"Brilliant, thank you. I learned so much and would definitely be reading up a bit more to try and further my understanding on investments."*

> *"The workshop was an eye-opener for understanding the markets. I will be able to make informed contributions as well as informed decisions in the trustee meetings."*

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**Please select the correct answer by marking the correct box below each question.**

Example: Water Stewardship is best described as an environmental / social / governance issue

- [x] Environmental issue
- [ ] Social issue
- [ ] Governance issue

**Introduction to the carbon tax**

Q1: What is the aim of the carbon tax?

- [ ] To incentivise companies to increase carbon emissions
- [ ] To shift consumer and investor behaviour towards supporting companies with increasing carbon emissions
- [ ] To incentivise companies to reduce carbon emissions as well as to shift consumer and investor behaviour towards supporting companies with lower carbon emissions
- [ ] To incentivise government to monitor their water usage and carbon emissions

**When does the carbon tax come into effect?**

Q2: True or false? The tax will be rolled out in phases, with the first phase being from 1 June 2019 to 31 December 2022 and the second phase from 2023 to 2030.

- [ ] True
- [ ] False

**How the tax works**

Q3: Private and public sector entities surpassing a certain threshold of emissions (specified in the National GHG Emissions Reporting Regulations) will be taxed. Which of the following statements is the correct one?

- [ ] A carbon tax of R1 000 will be charged for every tonne of carbon emissions released by these entities that exceed certain thresholds.
- [ ] A carbon tax of R120 will be charged for every kilo tonne of carbon emissions released by these entities that exceed certain thresholds.
- [ ] A carbon tax of R1 000 will be charged for every mega tonne of carbon emissions released by these entities that exceed certain thresholds.
- [ ] A carbon tax of R120 will be charged for every tonne of carbon emissions released by these entities that exceed certain thresholds.

**ESG guidance for pension funds**

Q4: What did the Financial Sector Conduct Authority (FSCA) issue recently to encourage better ESG disclosure and transparency by retirement and pension funds?

- [ ] The Directive on Incorporation of Water Related Risks in Retirement Funds
- [ ] The Guidance Note on the Impact of Carbon Tax on Retirement Funds
- [ ] The Guidance Note on Sustainability of Investments and Assets
- [ ] The Directive on Environmental Stewardship for Retirement Funds

**The role of active ownership by pension funds and retirement funds**

Q5: Proxy voting and engagement is important for institutional investors as:

- [ ] They have no shareholder rights in their investee companies
- [ ] They play a pivotal role in terms of proactively addressing matters such as greenhouse gas emissions through their investee companies' lending and financing practices
- [ ] They have no impact on investee companies when it comes to ESG issues such as greenhouse gas emissions
- [ ] Regulation 28 legally requires them to publish proxy voting and engagement reports on an annual basis

**Climate-change risk: Legal obligations of retirement and provident funds**

Q6: Which statement is correct regarding climate change and the role of boards?

- [ ] Given the principles of Regulation 28 and that climate change poses a material risk likely to have an impact on the long-term performance of an asset, boards have a legal obligation to consider climate risk when making investments.
- [ ] Climate change poses no material risk to the long-term performance of an asset; therefore, it is irrelevant to boards when making investment decisions.
- [ ] There is currently no regulation in place requiring boards to consider issues such as the impact of climate change on investments.
- [ ] Boards should delegate all climate-related issues to their fund managers as it is not their duty or expertise to consider such matters.

**Q7: True or false?** In April 2019, two of Standard Bank's minority shareholders tabled Standard Bank's very first resolution on climate change risk. This was the first climate risk-related shareholder resolution to be tabled in South Africa.

- [ ] True
- [ ] False

**Actionable steps for South African pension funds**

Q8: What policy should boards have in place to ensure that climate change risks are identified and monitored?

- [ ] Board Code of Conduct Policy
- [ ] Ethical Leadership Policy
- [ ] Climate Change Policy
- [ ] Conflict of Interest Policy