Full name
Principal Officer
Name of Pension Fund
By email: xxxxxxxxxx

5 April 2019

Dear Xxxxx

Legal duty on the board of the [Name of pension fund] to take climate change into account when making investment decisions

We are writing to you to draw your attention to a legal opinion on the question of whether the boards of South African pension and provident funds are required under South African law to take into account climate-related risks and opportunities when making investment-related decisions on behalf of their funds. The legal opinion was commissioned by Just Share NPC and ClientEarth.

Just Share NPC[1] is a non-profit South African shareholder activism and responsible investment organisation. Just Share promotes the use of investor power for a more inclusive, resilient and sustainable economy. Climate change will disproportionately affect those who are already the most vulnerable members of our society, and therefore severely exacerbate South Africa's inequality crisis. Tackling climate change should therefore be a key priority for South African investors.

ClientEarth[2] is a non-profit environmental law organisation based in London, Brussels, Berlin, Madrid, Warsaw, New York and Beijing. ClientEarth uses the power of the law to develop legal strategies and tools to address major environmental issues. ClientEarth's climate finance programme has been conducting legal analysis on the legal duties of pension schemes to consider climate risk since 2015.

Just Share and ClientEarth commissioned law firm Fasken to provide the legal opinion (the "legal opinion"), which was prepared by top pension lawyer Rosemary Hunter.

The legal opinion is unequivocal in finding that a failure to consider material financial risks arising from climate change would likely amount to a breach of duty by the board of a pension fund, under both the common law principles and, for those funds subject to the PFA, in terms of Regulation 28 of the PFA[3].

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[1] www.justshare.org.za
[2] www.clientearth.org
[3] The Preamble to Regulation 28 states that:
"A fund has a fiduciary duty to act in the best interest of its members whose benefits depend on the responsible management of fund assets. This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn adequate risk adjusted returns suitable for the fund's specific member profile, liquidity needs and liabilities. 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 and 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".

This is true both for funds regulated by the Pension Funds Act, 1956 (PFA) and for those, like the Government Employees Pension Fund (GEPF), that are not.

The full opinion, including an executive summary, is attached. In this letter, we draw your attention to your key legal duties as the board of a South African pension fund. We also highlight the latest developments relating to investment risks and opportunities stemming from climate change, of which you should be aware, and we provide some guidance as to what steps you must take to comply with your legal duties, and protect the **[Name of pension fund].**

Your legal duties as the board of the [Name of pension fund]

It is now globally accepted that climate change will pose serious financial risks to many classes of investments in the short, medium and long term (more detail in this regard is provided in the next section). As such, it is a factor which may materially affect the long term performance of your fund's assets.

You must exercise the powers of the fund in the best interests of the fund, which means for the sole purpose of fulfilling its objects over the long term. Decisions relating to the investment of the fund's assets must therefore be taken with due regard for the risks, both long-term and short-term, associated with those investments. These include climate-related risks.

Your fund's dependence on you for the proper exercise of the fund's powers and fulfilment of its duties, means that you occupy a position of trust, and owe a fiduciary duty (duty of loyalty) to the fund when acting in your capacity as the board. In other words, you owe the duties of good faith, care and diligence to the fund and you must act as you think that the fund would act, in fulfilment of its best interests described above, if the fund did not need the board to act as its 'directing mind and will'.

You derive your powers from legislation, including the Constitution, and the rules of the fund. You do not derive them from any 'mandate' given by those who elected or appointed you.

In exercising the powers of a fund, you must protect the existing rights of the fund's members, but are not entitled to advance their interests if this would be inconsistent with your fiduciary duty to the fund. The interests of the fund's members and their dependents, and future members of the fund, must be viewed as a whole and treated as subordinate to those of the fund itself, particularly as they may not always coincide.

This means that, although it may be to the advantage of some of a fund's current members for it to take certain actions in the short-term, if it is evident from information before you that it would not be in the long-term interests of the fund for it to take such actions, then you may not take them on its behalf. Instead, you must ensure that the fund follows the course of action best aligned with its long-term interests.

Regulation 2(c)(ix) requires that "*a fund and its board must at all times … 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.*"

If you fail to properly consider relevant information, or, having considered it, fail to give it appropriate weight when making decisions, then you will be acting in breach of your duty to act in the fund's best interests. A failure to take into account risks associated with factors such as climate change, which may be relevant to the likely long-term performance of a specific investment, or the fund's investments as a whole, is likely to amount to a breach of your duty of care and diligence.

Each board member must apply his or her mind to the issues before the board, including the likely environmental, social and governance (ESG) risks associated with any particular investment. A board member may not leave this to other board members or delegate the duty to third parties. He or she cannot remain ignorant when compliance with these duties means that he or she must seek information, nor can he or she blindly accept information and advice from third parties.

You must therefore take all reasonable steps to acquire the information in relation to the risks associated with climate change as you may require in order to make informed decisions when exercising the fund's investment powers. This information would include current, published and widely available evidence, including the evidence specifically referred to in this letter, on:

- The financial risks of climate change (in particular, those associated with the coal, oil and gas industries);
- The increasing number of investment opportunities arising from the transition to a low-carbon economy; and
- The actions taken by your peers and other investors to manage climate risk and take advantage of low-carbon investment opportunities.

Investment risk and opportunity

As far back as 2011, the South African Government recognised the potentially catastrophic impacts that climate change can have on South Africa in the medium to long-term. The *Climate Change Response White Paper*[4] stated that:

"Even under emission scenarios that are more conservative than current international emission trends, it has been predicted that by mid-century the South African coast will warm by around 1 to 2°C and the interior by around 2 to 3°C. By 2100, warming is projected to reach around 3 to 4°C along the coast, and 6 to 7°C in the interior. ***With such temperature increases, life as we know it will change completely****…"* (our emphasis).

The Paris Agreement on Climate Change, which the South African government has ratified[5], recognises that the transition to a low-carbon economy must be a **"just transition"**, in other words, **one which is resilient, drives job creation, reduces inequality and builds social stability**.

[4] Published by the Department of Environmental Affairs. A copy of the white paper may be found at https://www.environment.gov.za/sites/default/files/legislations/national_climatechange_response_whitepaper.pdf

[5] https://www.environment.gov.za/mediarelease/southafrica_ratifies_parisagreement

In 2015 the South African government led the way by incorporating the just transition into its Nationally Determined Contribution to the Paris Agreement, which said that "an inclusive and just transition requires time and well planned low-carbon and climate resilient development"[6].

The South African government's 2018 Third National Communication (TNC) to the United Nations Framework Convention on Climate Change (UNFCCC) states:

"South Africa has been warming significantly over the period 1931-2015. ***Over the western parts of the country, including much of the Western and Northern Cape, and also in the east over Gauteng, Limpopo and the east coast of KwaZulu-Natal, the observed rate of warming has been 2 °C/century or even higher – in the order of twice the global rate of temperature increase.*** *Associated increases in the annual number of hot days have also occurred, but there have been decreases in the annual number of cold nights over most of the country.*

There is strong evidence of statistically significant increases in rainfall occurring over the southern interior regions, extending from the western interior of the Eastern Cape and eastern interior of the Western Cape northwards into the central interior region of the Northern Cape, over the period 1921-2015. Extreme daily rainfall events have increased over these same areas, with these increases also being statistically significant and extending northwards into North West, the Free State and Gauteng. Over Limpopo there is strong evidence of statistically significant decreases in annual rainfall totals."[7]

And that:

"***For Africa, global warming could translate into an increase in temperature by as much as 6°C in some areas, with sub-Saharan Africa a region identified as being most vulnerable to drought and climate change-induced impacts*** *(IPCC, 2014). Climate change will also likely increase the frequency and magnitude of many extreme weather events. The impacts of such a climate will include increased natural disasters that will cause damage to infrastructure and have diverse socio-economic impacts, with significant effects on agriculture and rural livelihoods (World Bank, 2013)*"[8] (our emphasis).

This is not a "potential scenario" anymore. As we write this letter, a vast area of Mozambique has been completely decimated by Cyclone Idai, the worst tropical cyclone on record in the Southern Hemisphere[9].

South Africa is therefore particularly vulnerable to the physical risks of climate change. Its existing poverty, inequality and unemployment make it particularly vulnerable also to the significant social disruptions that unmanaged climate change will generate. In short, if we do not take urgent steps to manage climate risk, climate change will severely exacerbate South Africa's many existing social challenges.

The Paris Agreement also recognises that in order for its goals to be achieved, finance flows must be consistent with low-carbon and climate-resilient development. **Institutional investors have a key**

[6] https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/South%20Africa%20First/South%20Africa.pdf
[7] South Africa's Third National Communication to the UNFCCC, March 2018 at page 12
[8] *Ibid,* at page 124
[9] https://mg.co.za/article/2019-03-22-00-cyclone-idai-after-the-floods-the-famine-and-then-more-of-the-same

role to play in this. In South Africa, as the opinion attached shows, our legal framework is remarkably supportive of this role. Unfortunately, however, the pace of change at present is far too slow to ensure that we meet our commitments under the Paris Agreement.

Summarised below are key findings from relevant research with which you should familiarise yourselves, and discuss with your investment advisors. Understanding this research is part of your core duty to apply your mind to the issues before you, including the likely ESG risks associated with any particular investment.

Financial risks related to climate change are already materialising and wider financial stability is at risk if action is delayed.

The Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) divides climate-related financial risks into two major categories.[10] Firstly, "risks related to the *transition* to a lower-carbon economy" and secondly, "risks related to the *physical* impacts of climate change". Transition risks include: policy and legal risks; technology risk; market risk and reputation risk. Physical risks "can be event driven (acute) or longer-term shifts (chronic) in climate patterns".

South Africa's TNC states:

"The impacts of climate change on overall economic growth are predominantly negative (Treasury, 2014). Understanding the economic impacts of climate change is necessary for informing long term planning and policy making (Treasury, 2014). ***Climate change will specifically impact on growth, job creation and inequality.*** *GDP expected losses induced by climate change over the next 35 years range from R 217 billion to R 651 billion, with a median loss of R 259 billion (DEA, 2014). The economic implications of climate change will have a significant impact on the ability to maintain economic growth into the future. It could also increase unemployment and inequality at sub-national and sector-based levels. This is particularly evident in the agricultural sector where unskilled labourers are unable to make the transition from agriculture to other sectors of the economy (DEA, 2014)"*[11] (our emphasis).

Further afield, independent European financial services company Kepler Cheuvreux have found that risks arising from climate change may materialise sooner and more quickly than anticipated, citing the rapid decline in the share prices of European power utilities and the business challenges resulting from policy or technological breakthroughs.[12]

The Bank of England has highlighted the systemic financial risks that it sees arising from an abrupt re-pricing of financial assets if companies and investors fail to take a proactive approach to the energy transition.[13]

The World Economic Forum's *Global Risks Report 2019* cites "extreme weather and climate-change policy failures as the gravest threats" over a ten-year horizon.[14]

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[10] TCFD Final Report, June 2017, at page B-5
[11] South Africa's Third National Communication to the UNFCCC, March 2018 at page 53
[12] Kepler Cheuvreux, (January 2018), 'Investor Primer to Transition Risk Analysis'
[13] Bank of England (2017), 'The Bank of England's response to climate change', Quarterly Bulletin Q2
[14] https://www.weforum.org/reports/the-global-risks-report-2019

Fossil fuel and carbon intensive assets are highly exposed to climate risks

Global analysts are increasingly recommending that investors tilt portfolios heavily or entirely away from poorly performing fossil fuel assets. Coal is highlighted as a particularly poor investment, with, for example, 54% of coal power assets in the EU already experiencing negative cash flow, predicted to rise to 97% by 2030. Operating costs for coal are also predicted to be higher than the average lifetime costs for onshore wind by 2024 and solar power by 2027.[15]

Financial assets in high-carbon sectors are most likely to be affected by the risks of transitioning to a low-carbon economy (via changes in regulation and social and market shifts to cleaner and increasingly cheaper alternatives). They are also among the most exposed to the physical risks of climate change (due, for example, to the sensitivity of coal-fired power stations to increases in temperature, and their high reliance on vast quantities of water).

Climate risk is not adequately priced into the market

The short-term nature of financial analysis (often provided on the basis of 1 to 3 year forecasts) means that risks expected to affect company cash flows and valuations over longer timeframes, including many of the most serious impacts of climate change, are not properly captured. Analysis by the *2 Degrees Investing Initiative* also indicates that the lack of available data from companies is a critical obstacle preventing climate change-related risks being well understood or properly priced into markets.[16]

Climate-aware investing does not mean giving up returns

Investment managers GMO have analysed the performance of the S&P 500 and its predecessor, the S&P 90, from 1926 to 2017. Over that 90-year period, the impact on performance of excluding any of the 10 main market sectors was negligible.[17] This conclusion is supported by the five-year performance (to 2016) of two MSCI low-carbon indices, which demonstrates that there are no negative impacts of excluding high-carbon stocks from an otherwise diversified portfolio. In fact, both MSCI low carbon indices yielded returns that were slightly better than the benchmark ACWI index (over the same timeframe), while significantly reducing associated carbon emissions.[18]

Research released by BlackRock, the world's biggest asset manager, in February 2019[19], shows that sustainable indices have the same risk and return characteristics as traditional benchmarks. The research also found "that global companies that have reduced their carbon footprints the most every year have outperformed the carbon laggards"[20].

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[15] David Schlissel, IEEFA, (2017), 'Can the US coal industry come back', in Forum, Issue 111, The Oxford Institute for Energy Studies. https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/01/OEF-111.pdf

[16] 2 degrees Investing Initiative and Generation Foundation (2017) 'All swans are Black in the Dark: How the short-term focus of financial analysis does not shed light on long term risks'

[17] See discussion at: https://www.advisorperspectives.com/articles/2017/12/21/jeremy-grantham-and-lucas-white-on-climate-change-investing Data presentation at: https://www.advisorperspectives.com/pdfs/SP-Indices1.pdf

[18] MSCI (Sept 2016), 'Fossil Fuel Divestment: a practical introduction'

[19] Sustainability: The future of investing - https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainability-future-investing-jan-2019.pdf

[20] https://www.ft.com/content/4ae3f8b6-247c-11e9-b20d-5376ca5216eb

Taking account of climate risk will help to protect your portfolio as a whole from future losses

Analysis by the Economist Intelligence Unit has found that whilst impacts on Value at Risk as a result of climate change will be significant, due to anticipated weak growth and low asset returns across the whole economy, taking steps to mitigate climate change can halve the losses experienced.[21]

Income and capital growth can be achieved through a lower-carbon investment tilt

Research from the International Renewable Energy Agency forecasts that by 2020 all renewable power technologies will be competitive with fossil fuel generation on a cost basis, with many renewables projects significantly cheaper.[22] Analysts have highlighted infrastructure related to renewable energy production as an attractive alternative income stream to fossil fuel companies.

Steps you must take now to comply with your legal duties to consider climate risk in making investment decisions

A. Evaluate the evidence, establish the correct governance procedures, and take advice

- Analyse the [Name of pension fund]'s exposure to physical and transitional climate risks. This should include conducting forward-looking assessments in line with the Recommendations of the TCFD and considering relevant political and regulatory developments.
- Ensure that there are appropriate internal governance structures to oversee strategy development and undertake a materiality assessment of climate change-related risks (transition, physical and liability risks) to your portfolio.
- Establish investment beliefs that will help to guide strategy in relation to practical decision-making on asset allocation, performance objectives and selection and retention of asset managers.
- Ensure that your investment beliefs are integrated into your investment policy statement.
- In the appointment of appropriately qualified and authorised third party investment managers to exercise some or all of the fund's investment powers:
    - Ensure that the terms of appointment bind the investment manager to comply with the fund's investment policy statement and legal duties, including its policies in relation to the application of ESG factors to the assessment of investments; and
    - Monitor and supervise the conduct by such investment managers of their functions and the fulfilment of their duties.
- If necessary, the board should make it a condition of its appointment of an investment manager that that manager procures the approval of the Financial Service Conduct Authority (FSCA) of the conclusion of an agreement between them on terms incorporating such duties.

[21] Economist Intelligence Unit (2015), 'The cost of inaction: recognising the value at risk from climate change'
[22] IRENA (2017), 'Renewable Power Generation Costs in 2017'

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B. Reallocate assets in line with investment beliefs

- Instruct the fund's investment managers to reallocate capital and cease investment of new capital into coal operations and risky fossil fuel assets.
- Move the fund's passive investments into products tracking low-carbon indices.
- Proactively seek out investment opportunities in low-carbon sectors.

C. Pursue active stewardship and engagement

- Set clear voting policies stating when the fund will vote against directors, auditors and/or accounts when companies do not show progress against publicly specified targets.
- Set out clear public expectations that portfolio companies must demonstrate they are aligning their business strategy with the goals of the Paris agreement (with transparency over the benchmark scenario used and acknowledgment where this is considered to be insufficient to meet the Paris goal of limiting global temperature rises to 1.5 degrees).
- When engaging with companies in high-carbon sectors, set a timeline by which specific changes have been made – include "time served" where engagement has been ongoing for a number of years. Timelines should be specified, e.g. medium-term means 5 years, long-term means 10 years etc. Within these timelines, annual milestones for progress should be specified and escalation strategies put in place where these milestones are not being met.
- Publicly demand that portfolio company directors are "climate competent" and that more than one director on the board has a proven understanding of climate issues.
- Require portfolio companies to be transparent about lobbying and membership of industry associations where this serves to weaken climate obligations. You should request that companies withdraw membership from industry associations where positions taken conflict with those of the company.
- Join investor initiatives like Climate Action 100+[23], which aims "to ensure that the world's largest corporate greenhouse gas emitters take necessary action on climate change." **The companies targeted by the initiative "include 100 'systematically important emitters' accounting for two-thirds of annual global industrial emissions", including Sasol Limited.** More than 300 investors with more than USD$33 trillion in assets under management have signed on to date, but there is only one South African signatory.

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[23] http://www.climateaction100.org/

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D. Communicate your approach

The PFA *Draft Directive on Sustainability reporting and disclosure requirements*, published by the then-Financial Services Board in March 2018, will require much more transparent practices by pension fund boards than has thus far been the case.

You should proactively implement the requirements of the Draft Directive – at a minimum – in anticipation of it becoming law. This includes making your investment policy statement, mandates to financial service providers, and reports on how the board has ensured the sustainable long-term performance of its assets, publicly available.

Conclusion

It is important to understand that integrating climate risk into your investment decisions does not just mean more focus on the "E" in environmental, social and governance factors. The social, environmental and governance risks that we face must be managed holistically, in accordance with the just transition's "focus on the management of the social aspects of climate change in the workplace and wider community so that rapid decarbonisation is achieved in ways that contribute to inclusive and resilient growth"[24].

Pension and provident funds are important social actors. Factoring climate risk into investment decisions in a manner that helps drive the just transition provides a way for you to contribute to important societal goals, and is fully consistent with your fiduciary duties.

We would welcome the opportunity to meet with you to discuss the legal opinion and the contents of this letter.

Yours sincerely,

Tracey Davies
Executive Director
Just Share NPC

Danielle Lawson
Lawyer, Climate Programme
ClientEarth

[24] Grantham Research Institute on Climate Change and the Environment, *Climate change and the just transition: a guide for investor action* at page 10 http://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2018/11/IJT-guidance-for-investors_web-spreads.pdf