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Office of Regulations and Interpretations, Employee Benefits Security Administration
Room N-5655, U.S. Department of Labor
200 Constitution Avenue NW, Washington, DC 20210

Attention: Request for Information on Possible Agency Action

RE: Z-RIN 1210-ZA30

To Whom It May Concern:

We are writing in respect of the Request for Information on Possible Agency Actions to Protect Life Savings and Pensions from Threats of Climate-Related Financial Risk (the "Request").

The Shareholder Commons (TSC) is a nonprofit advocate for diversified investors. B Lab U.S. & Canada is one of six global partners in the B Lab global network. B Lab U.S. & Canada works to foster and mobilize a growing community of people and businesses working toward a more fair and inclusive economy in the United States and Canada.

A. Introduction

We submit this letter to respond to the Request. The primary focus of the request is to gain an understanding of whether the Employee Benefits Security Administration (EBSA) might take action to protect the retirement savings of U.S. workers and their families from climate-related financial risk.

1. Alpha v. beta

The climate-related financial risk to which investors are subject can be divided between two value perspectives: (1) company-specific risks that potentially affect the relative performance of individual companies ("alpha") and (2) systematic risks that potentially affect the performance of the markets as a whole, chiefly by threatening the performance of the global economy ("beta.")¹

¹ "Beta" in this sense differs from the formal use of the term in the financial literature, where it refers to the specific risk of a security or securities not attributable to the market. More recently, literature addressing the importance of broad market returns to diversified investors has used the term to refer to the overall return of the market, in contrast to alpha, which is the performance of a

2. *Security selection v. stewardship*

In addition to the two levels of investment risk, there are two primary methods by which investors can seek to mitigate them. The first involves choosing securities that effectively mitigate the risk: if any investor believes that a certain security presents a risk, that security can be avoided or underweighted in a portfolio, or other securities can be purchased that include risks that are not correlated, thereby hedging the risk (“security selection”). A climate-related example of security selection to reduce climate risk would be divesting or underweighting companies that emitted large amounts of carbon, to address risk that such businesses will eventually be subject to additional costs through regulatory, tax, reputational, or other costs.

Alternatively, investors can seek to mitigate climate-related risk by using their rights as investors to change company behavior to lower the risk a company poses to the financial performance of other companies in an investor’s portfolio (“stewardship.”) A climate-related example of stewardship would be last year’s campaign at Exxon Mobil to replace some of the directors with directors more likely to address the company’s capital allocation to continued fossil fuel investment. The explicit aim of this campaign was to address the company-specific risk created by this allocation strategy. It is also possible that some investors believed that the continued investment by a major petroleum exploration company posed a beta threat as well.

3. *Pathways for mitigating climate risk*

Table 1 matches the two types of risk with the two types of mitigation. It also addresses how each possible combination of strategy and value perspective can address both *physical risks* (risks that a changing climate presents to financial performance) and *transition risk* (risk that the expected decarbonization of the economy presents to financial performance).

particular security or portfolio in comparison to overall market return. See, e.g., Jon Lukomnik & James P. Hawley, *Moving beyond Modern Portfolio Theory: Investing that Matters* (April 30, 2021).

Table 1

	ALPHA: RISKS TO THE PERFORMANCE OF INDIVIDUAL COMPANIES IN A PORTFOLIO	BETA: RISKS TO THE ECONOMY THAT WILL BE FELT ACROSS THE PORTFOLIO
SECURITY SELECTION	Security selection to address company-specific risks involves avoiding companies that are more exposed to physical or transition risk and choosing companies with less such exposure.	Security selection on the secondary markets is generally not an appropriate method for addressing physical or transition risks that climate change imposes on the economy, because other owners may permit the company to continue its practices. Such divestment strategies can be counterproductive, leaving the control of large GHG-emitting companies in the hands of owners not concerned with climate risk. Denying companies new funding, however, can address beta concerns by raising the cost of capital.
STEWARDSHIP	Voting and engaging with individual companies can induce them to address both physical and transition risks.	Shareholders can engage with companies and vote their shares to push companies to end practices that, even if profitable for the company, threaten the economy, and thus overall market returns.

The left two quadrants, highlighted in orange, reflect how EBSA can consider actions to address the climate-related risks to individual company performance with changes that empower investors to better use information about physical and transition risks to protect individual companies’ enterprise value. This may involve prompting better information or emphasizing the important connection between these risks and long-term performance.

The right two quadrants reflect that beta issues can be addressed best through stewardship (at least with respect to the secondary markets for previously issued securities). We discussed this at length in a prior comment letter regarding a proposed rule, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*.² That comment showed that beta is the most important factor in determining financial returns for long-term, diversified investors, who make up most of the beneficiaries of the plans administered under ESBA’s authority. This conclusion is illustrated in Table 1’s lower right quadrant. We urge EBSA to take action that empowers ERISA plan fiduciaries and FIRTB to engage in beta stewardship that will protect the climate and, consequently, the returns of diversified portfolios.

² <https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00299.pdf>

4. *The importance of beta stewardship*

In the prior comment, we demonstrated that the relationship between GDP, social and environmental systems, and market returns means systematic threats to beta cannot be avoided simply by picking stocks that will outperform the market when the failure of climate and other systems undermines the economy. Diversified investors cannot avoid certain common risks almost all companies face. These are the risks to the social and environmental systems in which the economy is embedded. One recent work explained that these systematic risks inevitably “swamp” any alpha strategy:

It is not that alpha does not matter to an investor (although investors only want positive alpha, which is impossible on a total market basis), but that the impact of the market return driven by systematic risk swamps virtually any possible scenario created by skillful analysis or trading or portfolio construction.³

A new report from the international law firm Freshfields Bruckhaus Deringer explains how the reality of systemic risk reverberates in investment trustees’ fiduciary duty across jurisdictions and how diversification is insufficient to meet the challenge:

In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from system-wide risks created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial and wider systems on which investment performance relies. If risks of this sort materialised, they would therefore damage the performance of a portfolio as a whole and all portfolios exposed to those systems.⁴

5. *Climate change as beta risk*

Climate change represents the quintessential beta risk. A 2021 report by Swiss Re, the world’s largest reinsurer, examined likely temperature scenarios and estimated the impact of those scenarios on GDP as of 2050.⁵ Working with current country-by-country climate mitigation pledges, they determined that warming by 2050 was likely to be 2.0-2.6°C, with 3.2°C as a severe but potential trajectory. They also concluded that action could still be taken to limit warming in that time frame to well below 2.0°C, an outcome that many have concluded is the upper limit to prevent a critical level of economic damage.

³ See *supra*, n.1, Chapter 5 (emphasis added).

⁴ *A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making* (2021). The report, which ran to 558 pages, studied the law of jurisdictions significant to global capital markets, including the United States, and the conclusions cited in this comment letter extend to U.S. trustee law.

⁵ *The Economics Of Climate Change: No Action Not An Option* (2021) <https://www.swissre.com/dam/jcr:e73ee7c3-7f83-4c17-a2b8-8ef23a8d3312/swiss-re-institute-expertise-publication-economics-of-climate-change.pdf>, Pg. 28-30

Swiss Re estimated that the latter trajectory, which would mean crossing the 1.5°C threshold by mid-century, would result in a 4.2 percent GDP loss compared to no climate change (0°C of warming), while a 2.0°C trajectory would lead to an 11 percent GDP decline. On the higher end, Swiss Re estimated losses of 13.9 percent would be realized by 2050 at 2.6°C, and using the most severe but still possible scenario of 3.2°C, losses to GDP would reach 18.1 percent globally.

These GDP differentials are critical to investors: as established in the ground-breaking study, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors*, the value of a diversified portfolio of equities is directly proportional to GDP.⁶ Thus, the reductions in GDP described in the Swiss Re report imply trends toward similar reductions in equity portfolio value over time. This relationship holds because common equity represents a right to future cash flows from companies, so that ownership of a portfolio of equities represents the right to the future cash flows of the proportion of the economy that those shares represent. Of course, the multiples at which shares trade may rise and fall, but over the long term, the relationship between portfolio price and GDP is linear.⁷ Moreover, the climate trajectory can be changed only by changing the way business operates. In the United States, for example, 87 percent of total GHG emissions come from the transportation, electricity generation, industrial, and agricultural sectors,⁸ all heavily driven by decisions investor-owned corporations make.

In short, the greatest financial risk to the savers whom ESBA is charged with protecting comes from companies emitting carbon to maximize their internal returns, but in so doing, putting the entire economy at risk. With that perspective in mind, we turn to the Request's specific questions.

B. Answers to Specific Questions

Question 1. General Principles for Addressing Climate-related risk under ERISA and FERSA

Regulations and guidance under ERISA and FERSA should clarify that it is incumbent upon ERISA fiduciaries and the FRTIB to consider whether they can improve the returns of their respective plan participants with climate stewardship designed to improve the impact that individual portfolio companies have on other components of the portfolios in which plan participants are invested.

As we showed in our prior comment letter, asset managers often ignore beta issues, instead focusing on alpha:

⁶ PRI, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* (2011), available at https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf

⁷ *Id.* ("the relationship between GDP and the price of the portfolio of a [long-term, diversified investor] is linear in the long term.") The cited work extends only to the equity portion of an investor's portfolio, but because its premise is the observation that the value of companies equals the value of their future cash flows, we believe that its logic should extend to the debt portion of portfolios as well, because the total return on companies financed with outside capital is equal to the combined cash flows to both debt and equity. Accordingly, an investor's entire debt and equity portfolio, not just the latter, should move together with the value investable universe those companies compose. This reinforces the importance to investors of using their influence to ensure that companies do not degrade broad economic value.

⁸ U.S. Environmental Protection Agency, Sources of Greenhouse Gas Emissions, available at <https://www.epa.gov/ghgemissions/sources-greenhouse-gas-emissions>

Many plan fiduciaries rely on asset managers for both security selection and stewardship services. Review of large asset managers' public statements demonstrates that they restrict ESG stewardship to matters that affect the alpha individual companies achieve while ignoring the effect their proxy voting and other stewardship activities have on beta.⁹

For example, BlackRock, the world's largest asset manager and a manager of Thrift Savings Plan ("TSP") funds, recently published its 2030 net-zero statement, which claimed that, as an asset manager, it had no responsibility to help decarbonize the economy:

BlackRock's role in the [energy] transition is as a fiduciary to our clients. Our role is to help them navigate investment risks and opportunities, not to engineer a specific decarbonization outcome in the real economy.¹⁰

Yet decarbonizing the economy is possibly the greatest investment opportunity available to BlackRock's clients such as TSP. Preserving Earth's climate system is not separate from investing; it will be a key value driver of GDP, upon which diversified portfolio performance depends. If BlackRock's control over TSP assets creates the potential for it to help engineer real-economy decarbonization to secure the retirements of plan participants, why would BlackRock choose not to pursue such an effort? As the Freshfields memorandum discussed above shows, stewardship designed to reduce GHG emissions and other corporate conduct that undermines diversified portfolio value falls squarely within BlackRock's duty as a fiduciary.¹¹

ESBA should clarify that beta stewardship is incumbent upon such managers.

Question 9. Permissible Thrift Savings Plan Investment Decisions

It is critical that the TSP, the world's largest defined contribution plan, not categorically exclude securities that carry climate risk if doing so limits its opportunity to influence those companies through stewardship. Such exclusions threaten workers saving for retirement in two ways: First, by reducing diversification, exclusion hinders savers' ability to invest at the efficient frontier, where they can choose from the best available alternative combinations of risk and return. Second, by limiting the TSP's influence over companies with large carbon footprints, exclusion reduces its ability to participate with other shareholders in stewarding companies toward the lower emissions necessary to improve likely beta, and thus likely long-term returns overall for TSP beneficiaries.

Question 10. FRTIB Audits

EBSA's audit of FRTIB should include an evaluation of risks that portfolio company behavior poses to plan participants through impact on the social and environmental systems that support a healthy economy.

⁹ See *supra*, n.2.

¹⁰ <https://www.blackrock.com/corporate/about-us/our-2021-sustainability-update/2030-net-zero-statement>

¹¹ See *supra*, n.4.

The audits should determine whether TSP is engaging in adequate stewardship efforts to limit such behaviors. The audits should inquire as to what internal controls ensure that TSP activity to promote the alpha received by TSP participants does not come at the expense of beta in a manner that will reduce participants' absolute returns.

Question 12. Climate Risk Data

FRTIB should collect data regarding the threat that individual choices by portfolio companies that maximize their own alpha might increase climate-related risk to diversified TSP participants. FRTIB should use these data to determine whether TSP should participate in stewardship that opposes these choices to protect the value of retirement savings, regardless of the impact on financial returns at individual companies.

Question 13. Asset Manager Policies

FRTIB should collect data from asset managers to determine whether these asset managers are focusing on the alpha that they deliver (whether through security selection or cost savings) to the detriment of market beta and TSP participants, who rely on healthy social and environmental systems to support the their diversified portfolios' value.

Question 14. Asset Manager Actions

Asset managers must prioritize the factors that will be most determinative of TSP participants' portfolio performance. These factors will not necessarily maximize the relative performance of such managers in comparison to their peers, because the factors critical to long-term portfolio performance affect all diversified portfolios equally. FRTIB must ensure that asset managers are not incentivized to prioritize alpha over beta.

Questions 15 & 16. Indices and Climate Risk

FRTIB should hesitate to rely upon the discovery of indices that "account for climate risk" as a method for reducing that risk. The physical risks of climate change threaten the entire economy and cannot be diversified or hedged away. By seeking to avoid the companies most at risk from a transition to a low-carbon economy, TSP may simultaneously increase its risk through (1) lowering its diversification and (2) surrendering the opportunity to steward companies away from the behaviors that increase the physical risks of climate change.

Question 17. Incentives

Internal and external personnel should not be incentivized with remuneration or other benefits based on the achievement of alpha without safeguards in place to ensure that alpha was not prioritized over beta. Such priorities would put personnel interests above participants' interests.

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For all the reasons expressed and in the manner described in this letter, we urge that the ESBA take action to ensure that TSP and ERISA plans are managed not just to account for the effect of climate-related risk to the companies in their portfolios, but also the effect the companies in their portfolios have on climate change, to the extent climate change affects their diversified portfolios' overall financial performance. Such guidance will encourage fiduciaries and asset managers to serve plan participants and their beneficiaries better.

Sincerely,



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