Is natural capital the next area of focus for trustees?

Vishal Hindocha explains now is the right time for pension schemes to consider natural capital within its ESG considerations

When it comes to the environment, climate change and carbon emissions have been the main focus for investors, regulators, governments and the general public in the UK. However, last year the UK government, in its response to the Dasgupta review on the Economics of Biodiversity, said it will bring in a target on species abundance for 2030 to halt the decline of nature.[1] It plans to "leverage private sector finance to enhance our natural environment, encouraging private sector-led, market-based solutions". The areas of interests are "natural capital markets for carbon, water quality, biodiversity, natural flood alleviation and other ecosystem services". UK pension funds must be among the sources of capital the government is looking to in order to achieve this objective. The Pensions Minister, Guy Opperman, said in March he would reach out to pension funds about deforestation issues, stating that the UK is "putting forests front and centre of our global response to climate change".[2] But are trustees ready to discuss natural capital? Some schemes are breaking new ground on this topic but for the majority, it seems the discussion has not even started.

Natural capital – the next big focus?

We believe natural capital could be the next ESG related point of focus for pension schemes. Schemes who thoughtfully engage on it now potentially stand to benefit by understanding the risks and opportunities before the wider market can do so. But what is it and how can trustees assess its impact?

Natural capital is the world's stock of natural assets, including soil, air, water, grasslands, forests, wetlands, rocks, minerals and all living things. Collectively, these provide vital ecosystem services such as water for agriculture, natural filtration for clean drinking water, crop pollination, carbon sequestration and flood or storm protection. In monetary terms, these services are valued at USD 44 trillion a year and form the basis of half the world's GDP.[3]

Why focus on natural capital now?

While natural capital is worth considering in its own right, its link to climate change makes it all the more important right now. Meeting the goals of the Paris Agreement will require halting and indeed reversing nature loss. Land use and forestry changes amount to just under a quarter of human-caused greenhouse gas emissions.[4] Forests and oceans absorb vast amounts of carbon dioxide, but this capability is diminishing due to acidification, biodiversity loss and plastic pollution. As we approach various tipping points, the impact of this impairment of natural capital becomes more important.

The growing appreciation of natural capital could significantly impact the economics of many companies and, as investors, it is our job to price future risks and opportunities then turn those into an investment thesis today. The following framework shows how we are beginning to integrate natural capital into our fundamental analysis.

How to assess the impact of natural capital?

Our investment team formulated a three-step framework to analyse the risks and opportunities for companies in relation to natural capital.

The team's initial focus has been the food industry, given its high dependency on natural capital compared to other industries. The food industry also has the largest impact on natural resources, driven primarily by intensive and industrialised processes. Moves towards more sustainable food production are also likely to impact profit margins. If no such transition is made, the food sector's reliance on natural capital and ecosystem services makes it particularly vulnerable to deteriorating value derived from nature. This has implications for food sector companies and investors alike.

Step 1 - Identify high risk commodities in supply chains and understand their impacts on nature

The impact of a commodity on nature

depends on how much of the commodity is produced and demanded as well as the range and extent of negative outcomes that it creates.

We began by mapping the size of material natural capital impacts of food groups, such as beef, rice, corn and palm oil, against the type of impact (soil degradation, pollution, water scarcity/salinisation, biodiversity loss and emissions from land use).

We then identify companies we invest in with significant exposure directly to the biggest impacts and those whose supply chain they appear in.

Step 2 - Map the supply chain, local consumption and local resource stress

Natural capital impacts are often highly localised and driven by a variety of geographic factors including scarcity of resources, biodiversity, government policies and farming practices. This makes it hard to assess the impacts of global supply chains.

In addition to location, how much of a commodity is locally consumed and how resource intensive it is to produce also impacts its natural capital cost. For example, although it takes much more water to produce meat than to grow wheat, the water stress of wheat in India is much higher than in the US because wheat is an important part of the Indian diet and because of the severe water stress in the regions where Indian wheat is grown. Global supply chains therefore require us to map resource use, local scarcity and contribution to local diet.

We then map company-specific exposure before moving to the final step.

Step 3 - Assess areas to focus our stewardship efforts (high risk and high impact commodities)

The framework can guide us on where to focus our further analysis and engagement efforts. For example, higher water scores might be more meaningful than lower forestry scores because water stress is more material risk than deforestation for a particular company. This analysis may prompt us to ask companies questions such as:

- How do you evaluate and measure the natural capital risks in your supply chain, in particular relating to rice and sugar?
- Are the products or services you offer profitable if natural capital risks are priced in?
- Do you financially incentivise suppliers to change their natural capital and biodiversity practices? Do you financially incentivise your own management to do so?

Other ESG factors outside the scope of this framework will also influence our engagement efforts too. We track the progress made by companies and our ongoing engagements in a dedicated engagement tool.

Next steps for pension fund trustees? E of ESG should not only be about climate change

We believe trustees should consider discussing natural capital with their investment managers. We appreciate trustees have a lot on their plate in terms of regulatory requirements and many managers themselves are at an early stage of the learning curve.

We think natural capital, along with the ecosystem services it provides, poses a material systemic risk but also presents opportunities in several key sectors. Assessing these risks is harder than assessing those associated with climate change but we are encouraged to see more conversations starting to happen. Factors such as supply chain location, local consumption and local resource stress might all be considered. While the data are still largely unavailable or remain poor-quality, organisations such as the Science Based Targets for Nature (SBTN) and the Taskforce on Nature-related Financial Disclosures (TNFD) are beginning to gather momentum, providing more structured frameworks for assessing natural capital. Climate has been pushed onto trustee agendas in part by the government's requirements to report in line with the Task Force on Climate-related Financial Disclosures. Will the TNFD be built into reporting requirements in the future? TNFD is still at an early stage of development but it's certainly doing great work.

We believe engaging on natural capital presents an opportunity for pension funds. Investors who thoughtfully engage will potentially benefit by more accurately pricing relevant opportunities and risks before the wider market is able to do so. We hope to be able to share with you more insights into this topic as we continue along this journey.

Written by MFS Investment Management global head of sustainability strategy, Vishal Hindocha

In association with MFS

[1] HM Treasury The Economics of Biodiversity: The Dasgupta Review – Government Response, 2021
[2] Guy Opperman How your pensions can help tackle climate change, 2022
[3] WEF New Nature Economy Report, 2020.
[4] UNFCCC Introduction to Land Use.