Incorporating Environmental and Social Factors into Prudential Financial Risk Assessments

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In June 2023, the North Carolina General Assembly overrode Governor Roy Cooper's veto of Session Law 2023-64, restricting the consideration of environmental and social factors in state investment bodies such as pension funds. However, the text does not entirely exclude such elements. Instead, it provides for considering environmental and social factors when "they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." These factors shall only "reflect a prudent assessment of their impact on risk and return."[1] This paragraph, far from closing the door on assessing environmental and social risk, allows for such assessments in line with longstanding financial professional practices and with the North Carolina Retirement System's mission to "preserve and protect this benefit for current and future public employees in North Carolina" and "maintain the integrity and sustainability of the North Carolina Retirement Systems."[2]

Environmental and Social Risk: Potential Liability

A plain reading of the statute follows long-standing legal precedent on material information that presents "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[3] Risk management has been a critical concern of Congress and the Securities and Exchange Commission (SEC) since the collapse of high-profile corporations due to fraudulent financial statements and auditing practices in the early 2000s. The 2002 Sarbanes-Oxley Act, the primary response to said securities fraud, specifically appropriated funds to the SEC for officials dedicated to risk management and held executives directly liable for misleading material statements.[4]

Certain environmental and social investing information can reasonably alter investors' financial decision-making if disclosed. Specifically, environmental and social processes create regulatory, economic, and litigation risks which, if left unaddressed, present significant liability

[1] "Session Law 2023-64." Sec. 2: 5b. June 27, 2023. https://ncleg.gov/Sessions/2023/Bills/House/PDF/H750v4.pdf. See annex.
[2] "Handbook." *Teachers' and State Employees Retirement System*. December 2022, 1.https://www.myncretirement.com/documents/files/actives/tsers-handbook/open.
[3] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). https://www.law.cornell.edu/supremecourt/text/426/438.
[4] "Public Law No. 107-204 - Sarbanes-Oxley Act of 2002." House of Representatives. July 30, 2002, Title II, Sec. 302(a), Title VI, Sec. 35 (3). https://www.congress.gov/bill/107th-congress/house-bill/3763/text.

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for business executives and financial advisors alike.[5] The existing ability to report material climate-related risk is precisely why Republican-appointed members of the SEC have argued that additional SEC rulemaking is duplicative and, therefore, unnecessary.[6]

Additionally, qualified investment professionals have established several bodies that have laid out risk disclosure requirements in accounting, financial disclosure, and risk management. For example, the Financial Accounting Standards Board (FASB) has required reporting "factors that may affect an enterprise's liquidity or solvency" since 1978. FASB also establishes that management has a responsibility to protect enterprise resources "from unfavorable economic impacts of factors in the economy such as inflation or deflation and *technological and social* [emphasis ours] changes."[7] Concurrently, these risk factors pressure the enterprises' profitability, heightening the incentives for fraud and the importance of accurate disclosures.[8]

Climate-related Transition Risk, Risk Management, and North Carolina's Pension Fund:

An overly restrictive framing of what circumstances pension overseers can consider financial risk would violate risk management best practices since an inadequate framing likely leads to an insufficient response in the rest of the risk management process. The National Institute of Standards and Technology defines risk as an event that would have an "adverse impact" on operations and calls on entities to assess the "likelihood" of said impact and respond accordingly.[9]

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) Enterprise Risk Management Framework goes further. It seeks to "identify factors that represent not just risk, but change, and how that change could impact performance and necessitate a shift in

[5] "CEO, CFO and COO Duties to Hedge Regulatory, Economic and Litigation Events under Sarbanes Oxley, IASB and GAAP." *eTrios Commodities LLC White Paper*. Kenneth Watson (Catholic University Law School) and John Palmisano, eTrios Commodities, December 2013, 1, 13. See *Janus Capital Group, Inc. v. First Derivative Traders*. 564 U.S. 135 (2011). *Janus* still holds advisors liable for false information they propagate to intentionally defraud potential investors. *Lorenzo vs. Security and Exchange Commission* 139 S. Ct. 1094 (2019). https://www.supremecourt.gov/opinions/18pdf/17-1077_21o3.pdf.

[6] Hester M. Peirce. "We are Not the Securities and Environment Commission - At Least Not Yet." *Securities and Exchange Commission*. March 21, 2022. https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.

[7] Financial Accounting Standards Board, "Objectives of Financial Reporting by Business Enterprises." *Statement of Financial Accounting Concepts No. 1*, Secs. 49-50. https://www.fasb.org/document/blob?fileName=con1.pdf.

[8] "Incentives and Pressures (Appendix A: A76)." *General Principles and Responsibilities of The American Institute of CPAs and Chartered Institute of Management Accountants (AU-C Section 200)*, 205-206. https://www.aicpa-cima.com/resources/download/aicpa-statements-on-auditing-standards-currently-effective.

[9] "Appendix B." *Managing Information Security Risk: Organization, Mission, and Information System View (Special Publication 800-39)*. National Institute of Standards and Technology. May 2011, 6, B7. https://nvlpubs.nist.gov/nistpubs/Legacy/SP/nistspecialpublication800-39.pdf.

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strategy."[10] COSO establishes "risk avoidance, reduction, sharing, and acceptance" as legitimate response strategies that an organization should integrate into its mission. Such responses should recognize that risk is "multidirectional…in which almost any component can and does influence another."[11] Financial and environmental risks, thus, cannot be so easily separated because environmental changes, many of which scientific evidence suggests are likely to occur, influence both short-term financial reporting and long-term business strategy.

The North Carolina Pension Fund is the tenth largest defined benefits pension in the United States, with over $100 billion in assets.[12] It is a critical institution in regional and national financial stability and, as such, should be encouraged to take necessary microprudential measures to assess material climate risk as they would any other material financial risk under Dodd-Frank and subsequent guidance.[13] Transition and physical operational risks are the two most prominent climate-related financial risks to institutions and portfolios. Since they comprise multiple companies across geographies, investment portfolios are most exposed to transition risk. Shifting legal requirements encouraging a transition away from fossil fuels or the drop in demand for fossil fuels as countries transition are two of the most prominent examples of climate-related transition risks. Transition risk involves the risk originating from climate-driven policy or market changes that could decrease asset value or a complete phaseout of asset value ("stranded asset"). In addition to fulfilling the spirit of recent systemic regulations, considering financially material environmental risks conform to long-standing professional standards (e.g., the transition risk is the potential risk of the very "technological and social changes" FASB cites).

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[10] "Enterprise Risk Management Integrating with Strategy and Performance: Executive Summary." *Committee of Sponsoring Organizations of the Treadway Commission*. June 2017, 2. https://www.coso.org/_files/ugd/3059fc_61ea5985b03c4293960642fdce408eaa.pdf.

[11] "Enterprise Risk Management —Integrated Framework." *Committee of Sponsoring Organizations of the Treadway Commission*. September 2004, 4. https://www.coso.org/_files/ugd/3059fc_ae81f45d98474c9188045cbacbd510bf.pdf. The International Organization for Standardization (ISO) also established several options for responding to transition risks. Legitimate responses include "not to start or continue with the activity that gives rise to the risk", "informed" risk retention, "removing the risk source", increasing risk to pursue an opportunity, changing risk impact or probability, and risk sharing." 3.8.1.Risk Treatment." *International Organization for Standardization*. 73 (2009). https://www.iso.org/obp/ui/#iso:std:iso:guide:73:ed-1:v1:en.

[12] "P&I 1,000 largest retirement plans 2022." *Pensions and Investments*. https://www.pionline.com/pi-1000-largest-retirement-plans/2022. Accessed December 30, 2023.

[13] The 2010 Dodd-Frank Act has set up an advisory body, the Financial Stability Oversight Council (FSOC) to assess " risks to the financial stability of the United States that could arise from the *material* [emphasis mine] financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies." *Public Law 111-203*. July 21, 2010, Sec. 112(a). https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf. In its latest report, the FSOC recommended that state governments "allow investors and financial institutions to better incorporate climate-related financial risks in their investment and lending decisions." "Financial Stability Oversight Committee Annual Report: 2023." *Department of the Treasury*, 11. https://home.treasury.gov/system/files/261/FSOC2023AnnualReport.pdf. The Pension Fund is also a non-banking critical source of financial support for local and state communities which often service disadvantaged populations. See *Public Law 111-203*, Sec. 113(d-e).

Though risk acceptance or increased risk appetite is occasionally appropriate, the costs of growing risks, even to pursue immediate opportunities, would likely be high. For example, consumers in North Carolina and South Carolina risk being stuck with a $4.8 billion bill to pay for stranded natural gas facilities that could be retired before their costs are wholly depreciated. Furthermore, North Carolina's Duke Energy consumers are footing 75 percent of the $4 billion required to clean up the coal ash polluting the state's rivers. Only in January 2022 did electricity provider Duke Energy relent from an insistence that customers bear the total cost of environmental remediation, meaning its investors will be paying $1 billion towards the clean-up. Another movement is afoot to securitize the decommissioning of Duke's brown assets in the Carolinas, pushing the payment burden onto investors. The possible asset impairment and financial duties to clean up environmental damages put the investments of Duke's shareholders at risk and endanger its stakeholders, increasing its litigation, operational, and reputational risks.[14] Similarly, refusing to transition misses important energy transition and innovation opportunities.

There are practical steps any financial institution with $100+ billion in assets can take to assess risk. The Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) laid out said strategies in an October 2023 guidance. Climate scenario analysis to spot physical and transition risks to their assets is a practical step perfectly tailored to the North Carolina pension fund. At $111.80 billion in assets, it qualifies as the type of large financial institution for which these agencies drafted the guidance.[15] We conducted a scenario analysis below using a Paris Agreement Capital Transition Assessment (PACTA) scenario analysis tool to assess how benchmarked fund holdings in carbon-intensive sectors will fare by the end of this decade.

North Carolina's portfolio will likely suffer significant disruption, though aligned with projected policy shifts in critical sectors. As shown below, the equities in the NC Pension Fund's weighted MSCI ACWI IMI Net benchmark have a moderate risk of technological and regulatory disruption should national and international businesses shift toward 2030 emissions reduction targets.[16] Equities with a score higher than 1.5 (Transition Disruption Metric, or TDM) will likely experience significant technological and regulatory disruption under likely policy scenarios. The MSCI ACWI IMI Net has a score of 2.59 TDM. Under the current regulatory trajectory, the pension fund would likely transition very smoothly from coal. Under the current regulatory framework, the portfolio would experience mild disruption in a transition from oil and high disruption from natural

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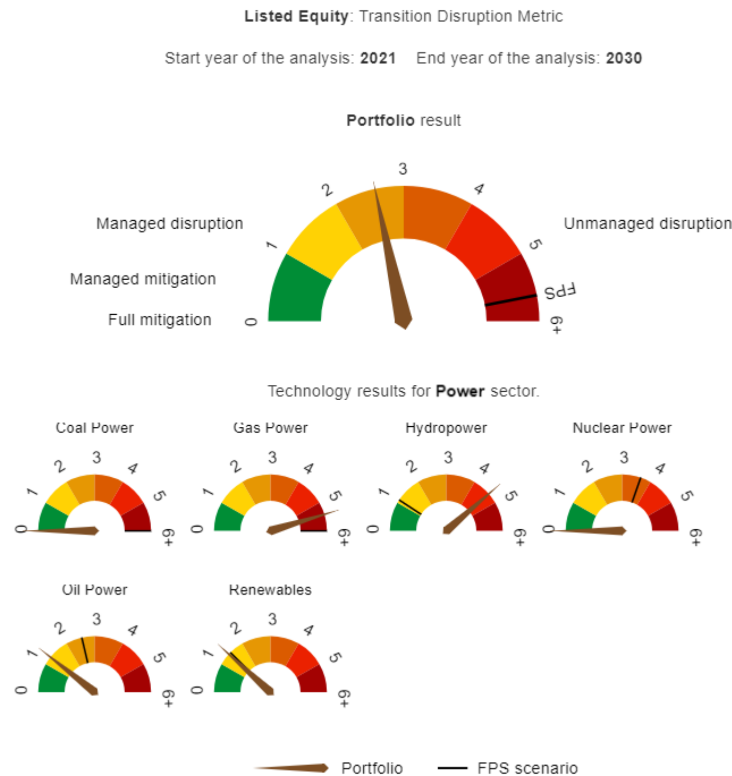
[14] Jane Duscherer and Steven Hyland Jr., "Investing in the Age of Accelerated Climate Change" *ValueWalk.com*. August 22, 2021. https://www.valuewalk.com/investing-age-accelerated-climate-change/.
[15] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, "Principles for Climate-Related Financial Risk Management for Large Financial Institutions.", 1. https://www.occ.gov/news-issuances/news-releases/2023/nr-ia-2023-118a.pdf.
[16] The North Carolina Department of State Treasurer lays out its benchmarking method in "Quarterly Investment Report for the Period Ending September 30, 2023." *North Carolina Department of State Treasurer*. November 30, 2023. https://www.nctreasurer.com/documents/files/imdinvestmentreports/quarterly-investment-report-3rd-quarter-2023/open.

gas. The portfolio would have a very smooth transition to nuclear power, a relatively smooth transition to renewables, and would struggle to transition to hydropower, if at all.

Figure 1:



Source: [Transition Monitor](#) (Paris Agreement Capital Transition Assessment).

GAAP, IFRS, and Transition Risk

Are the transition risks described above too indirect or speculative to merit financial disclosure according to acceptable professional practice? Two major reporting standards suggest not. General Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS) both consider environmental liabilities and potential litigation to be a loss contingency, a "set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."[17] The more likely the risk is to occur, the greater the burden to disclose the risk.

[17] Jonathan Schiff, Allen Schiff, Hannah Rozen, "Accounting for Contingencies: Disclosure of Future Business Risks." *Management Accounting Quarterly* 13, No. 3 (Spring 2012): 2-3.

Especially as a state institution, the pension fund faces indirect discrimination-related litigation risk. If invested in large financial institutions that service low- and moderate-income communities, the funds face potential losses stemming from said institutions' litigation risk should said institutions improperly measure their climate risk. The OCC guidance notes that "the adverse effects of climate change could also include a potentially disproportionate impact on the financially vulnerable, including low-and-moderate income (LMI) and other underserved consumers and communities." LMIs have less access to insurance and other adaptation resources, live in geographically vulnerable areas, and are more exposed to transitions requiring tertiary education or high-skilled manufacturing. The unique risks facing LMIs could heighten reputational risks for the Pension Fund should relevant financial institutions' adjustments to heightened climate risk not comply with the Fair Housing Act (1968) and Equal Credit Opportunity Act (1974).[18]

Litigation risk based on discrimination or perceived climate inaction is not speculative. Companies perceived as contributing to climate change-related financial loss face increasing legal threats. Between June 2022 and May 2023, United States courts received 29 suits seeking to hold corporations directly liable for the perceived climate-related harm of their products. Cities and states filed twenty of these cases, meaning the legal battles that make it to court will likely present material costs to companies.[19] Similarly, regulatory action is pending despite concerns over the politicization of environmental and social disclosures. The U.S. Senate introduced bipartisan legislation mandating industry carbon intensity disclosure in June 2023.[20]

Conclusion:

Regulatory shock awaits investors who need to properly factor environmental and social factors such as climate into their investment decisions. National politicians across the political spectrum agree that data helps investors make specific decisions and manage risk. Such disclosures provide reputational benefits to U.S. manufacturers by highlighting the United States' competitive edge in manufacturing innovation.

Session Law 2023-64 encourages the consideration of relevant environmental and social factors, which are already standard disclosure practices among qualified investment professionals. While a measured view of uncertain risks should prevail when crafting risk responses, the State of North Carolina needs to continue to consider environmental and social

[18] "Principles for Climate-Related Financial Risk Management for Large Financial Institutions." 8. https://www.occ.gov/news-issuances/news-releases/2023/nr-ia-2023-118a.pdf. "Ruchi Avtar, Kristian Blickle, Rajashri Chakrabarti, Janavi Janakiraman, Maxim Pinkovskiy, "Understanding the Linkages between Climate Change and Inequality in the United States." *Federal Reserve Bank of New York*. No. 991. November 2021. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr991.pdf?sc_lang=en.

[19] Joana Setzer and Catherine Higham, "Global trends in climate change litigation: 2023 snapshot." *London School of Economics*, 5. https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2023/06/Global_trends_in_climate_change_litigation_2023_snapshot.pdf.

[20] "S.1863 - PROVE IT Act of 2023." *United States Senate*. June 7, 2023. https://www.congress.gov/bill/118th-congress/senate-bill/1863/text?s=1&r=44.

financial risk to protect the $111.80 billion in assets that secure the retirement of over 1 million North Carolinians who earned it from years of dedicated work.

Please send all comments and questions to Travis Knoll (tknoll@commonweal.com) and Steven Hyland Jr. (shyland@commonwealadvisors.com).

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2023

SESSION LAW 2023-64
HOUSE BILL 750

AN ACT TO ADDRESS THE USE OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CRITERIA BY STATE AGENCIES AND STATE PENSION PLAN FIDUCIARIES.

The General Assembly of North Carolina enacts:

SECTION 1.(a) Article 10 of Chapter 143 of the General Statutes is amended by adding a new section to read:

"**§ 143-162.6. Use of ESG and ETI prohibited in employment decisions.**

(a) As used in this section, "environmental, social, and governance (ESG) criteria" or "economically targeted investments (ETI) requirements" means using a set of standards to screen potential investments based upon the perceived impact to the environment and the social relationships between a company's employees and the community. The term also includes how a company's leadership is structured in support of those standards.

(b) No State agency, political subdivision of the State, trust, committee, or commission of any political subdivision of the State shall use, enforce, provide data for use in, or otherwise participate in the creation or use of ESG or ETI policies related to hiring, firing, or evaluating employees.

(c) Except as allowed by law, ESG, ETI, or related criteria shall not be considered in the awarding of State contracts."

SECTION 1.(b) This section is effective when it becomes law.

SECTION 2. G.S. 147-69.7 reads as rewritten:

"**§ 147-69.7. Discharge of duties to funds.**

…

(b) In investing and managing assets of the fund pursuant to subsection (a) of this section, the State Treasurer:

(1) Shall consider the following circumstances:
  a. General economic conditions.
  b. The possible effect of inflation or deflation.
  c. The role that each investment or course of action plays within the overall portfolio of the fund.
  d. The expected total return from income and the appreciation of capital.
  e. Needs for liquidity, regularity of income, and preservation or appreciation of capital.
  f. With respect to the Retirement Systems defined in G.S. 147-69.2(b)(8) and any other pension plans, the adequacy of funding for the Retirement Systems based on reasonable actuarial factors.
  g. The purpose of the fund, if established.

(2) Shall diversify the investments of the fund unless the State Treasurer reasonably determines that, because of special circumstances, including applicable investment restrictions, it is clearly prudent not to do so.

(3) Shall make a reasonable effort to verify facts relevant to the investment and management of assets of the funds.

(4) Shall invest only in those investments authorized by law consistent with the provisions of Article 6 of Chapter 146 of the General Statutes.

(5) ~~May consider benefits created by an investment in addition to investment return only if the State Treasurer determines that the investment providing these collateral benefits would be prudent even without collateral benefits.~~Shall, in the evaluation of an investment, or evaluation or exercise of any right appurtenant to an investment, consider only pecuniary factors:

a. For the purposes of this section, a pecuniary factor is a factor that has a material effect on the financial risk or financial return of an investment based on appropriate investment horizons consistent with the purpose of the fund, if established.

b. Environmental or social considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The weight given to those factors shall solely reflect a prudent assessment of their impact on risk and return.

(6) May, in the evaluation or exercise of any right appurtenant to an investment, reasonably conclude that not exercising such a right is in the best interest of the fund's beneficiaries.

…."

SECTION 3. If any section or provision of this act is declared unconstitutional or invalid by the courts, it does not affect the validity of this act as a whole or any part other than the part declared to be unconstitutional or invalid.

SECTION 4. This act is effective when it becomes law.

In the General Assembly read three times and ratified this the 14th day of June, 2023.

s/ Phil Berger
President Pro Tempore of the Senate

s/ Tim Moore
Speaker of the House of Representatives

VETO Roy Cooper
Governor

Became law notwithstanding the objections of the Governor at 4:27 p.m. this 27th day of June, 2023.

s/ Ms. Sarah Holland
Senate Principal Clerk

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