



# Moving towards climate resilient investments

Workshop Output/ Main Findings:

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# Background and starting point

## Purpose of the workshop

Every day, millions of Euros are invested around the globe financing climate change. Even though it is widely understood that the outcome would be a global catastrophe, investors have only started to realize that climate change constitutes an important source of risk that they should monitor and manage in order to protect the long term value of their investments. In addition, thanks to initiatives as 350.org, the 2° investing initiative, and the WWF “seize your power” campaign, a sensitized public as well as regulators are starting to increase the pressure from the outside. Translating the awareness into an actionable strategy still remains a massive task. The reasons are diverse and reach from practical methodical challenges, to lack of information, low materiality for investment returns, to structural and regulatory hurdles.

WWF Switzerland in collaboration with UNEP FI, Climate-KIC, The 2° Investing Initiative and South Pole Carbon have invited asset owners and asset managers to an exploratory and interactive peer-workshop on the thematic of “Moving towards climate resilient investments” on March 11th to 12th, 2014, in Zurich at the Bloomberg Auditorium. Over 50 participants from the financial industry around the world have discussed these challenges in a 1.5 days interactive workshop that has specifically addressed the business models of banks, asset managers and asset owners and focused on peer learning, interactive discussions and sharing of best practices.

## Overview and Structure

As a first step, the workshop has looked at bringing different stakeholders from the financial industry together to assess and establish the status quo on investments and climate impact as well as learn from each other’s best practices and experience how to overcome the main challenges. The aim of the workshop was to answer the following questions:

1. What is the status quo and state-of-the-art in carbon impact measurement? (workshop 1)
2. What are the main challenges for financial institutions to measure carbon impact, reduce exposure towards carbon intensive investment and develop consistent strategies towards climate resilient portfolios? (workshop 2a and 2b on Indices)
3. What are the main opportunities? (workshop 3)

For each workshop, the participants have received different inputs through short presentations from key speakers from the industry and the civil society as well as concrete cases as basis for discussion. For each session, the participants were asked to work in three groups and were assigned some questions to be answered during the group discussion and to be presented into a plenary discussion at the end of each session.

## Main outcomes

Financial Institutions are not more questioning the “why” they should start integrating climate risks in their investments. The main discussion is now focusing around “how” they should do it.

We are currently confronted with paradoxical situations:

1. Increasing scientific evidence of the effects of climate change and at the same time regulatory uncertainties.
2. Political consensus to take measures to stay below 2-degrees of global warming and at the same time financial markets investing into a business-as-usual pathway, which will take us way beyond 2-degrees of global warming.

The participants identify the following key challenges from a return-focused investor perspective:

1. Materiality of climate change: in order to change investment and financial flows it is crucial to show materiality of climate related risks over the investment timeframe in question.
2. Timing issues: Climate change risks and opportunities materialize over a long-term perspective, while the investment focus is largely shorter-term.

The following key action points could be identified:

- There is a need for a “Stern-report 2.0” for the finance and investment community: If today they believe that a 2-degree-pathway is betting on unlikely regulatory changes, financial institutions should know what the alternative looks like: The business as usual scenario– i.e. the 6

degree scenario – with macroeconomic and microeconomic modelling including physical risks.

- Moving towards climate resilient portfolios involves the acknowledgement that carbon accounting is necessary step, but only a starting point. It requires a systemic understanding of the implications of a carbon constraint world for the real economy and significant consideration of financed emissions.
- There are still many challenges for Financial Institutions that want to integrate climate risks, but there was largely a joint agreement that these challenges should and can be overcome.

## Workshop 1: From Status Quo to State-Of-The-Art in climate impact measurement

### The Case: Foundation Cariplo

- Foundation Cariplo, a charitable foundation from Milano Italy, has started a project to measure its investment climate impact.
- Foundation's investments are inspired by criteria of social responsibility.
- This project is described as journey to start measuring environmental externalities.
- South Pole and CDP contrasted the 2'000 title portfolio against the benchmark, identified hot spots, key climate impact contributors as well as a detailed analysis regarding climate strategies as well as individual risks and opportunities of the underlying holdings in facing climate change.
- Cariplo now has an “engagement list” with specific topics to help companies that they own in improving, as well as a set of recommendations to make their investments more climate resilient.
- This detailed analysis is pioneering a forward-looking approach to identifying companies that are part of the solution, not the problem of climate change.

### What is the value of carbon accounting?

- The rationale for carbon accounting/ screening the portfolio suggests itself in the case of a **charitable foundation** to ensure that investments are not contradicting the organizations mission and to avoid associated reputational risk.
- For large **institutional investors**, e.g. insurance companies, the business case needs to be made more clearly A) In terms of enhanced risk management, investors would not only like to know how much CO<sub>2</sub> there is in the portfolio but what this means in terms of risks. B) Showing a clear link between carbon performance and financial performance. It has been pointed out that more studies backing investment results might help making these two cases. C) The “fiduciary duty” needs a widening in scope from pure investment risk/return optimization to the alignment of the investor's societal mission (such as preserving pension money for future retirees)

with the investment impact (destroying that very future).

- For **banks and asset managers**, climate impact transparency will only become a mainstream topic if a.) clients demand it or b.) the regulator requires this.
- It was pointed out that often, banks and asset managers hide behind a lack of demand for a sustainable investment product, climate transparency etc. However, the dynamic, especially in the retail and private banking world, seems also to be supply driven: If projects/products would be pushed more, there would be more demand.
- Training, “champions” and top management push might help here.

### What are the methodological challenges?

- The participants discussed that the approach as presented in the case is only a first step. However, it is an important one, as most investors usually don't know about their climate impact, and Cariplo took a leading role here. The result showed that the portfolio was responsible for less greenhouse gas emissions than the benchmark. However, it was acknowledged that this result was rather coincidental as ghg emissions are not yet a factor of managing the Foundation's fund.
- There have been some debates around the methodological challenges of carbon accounting in general: questionable data quality of existing scope 1&2 carbon data, lack of internationally agreed methodology for scope 3 (especially to assess carbon emissions of financial institutions) and no global reporting standards on ESG more generally.
- Participants are hoping that the current initiatives of the GHG Protocol (global), Ademe (France) and VfU (Germany) will help solve the Scope discussions.
- The key issue among providers is the often poor quality of data from companies on climate impact. This is in their view is the biggest impediment. For a quant manager for example, to systematically integrate carbon data

in their decision making process relies on this<sup>1</sup>.

- It has been noted that ESG rating agencies often don't use the best available company carbon data. Specialized carbon data providers, however, can complement ESG ratings with validated and approximated climate impact information.
- There is little incentive for ESG data providers to further enhanced existing carbon accounting methodologies as there is not enough demand from either asset managers or asset owners (data is a commodity which is not paid fairly for and hence it is difficult to further invest in improving methodologies)

### What is needed to go beyond carbon accounting?

- The participants discussed that the next step to in order to develop climate resilient portfolios would have to reflect the adaptive capacities of sectors or companies. This was, to some extent, pioneered in the Cariplo assessment.
- Further, to integrate carbon related risks and opportunities requires going beyond carbon accounting to a structural and systemic understanding of how a carbon constraint world could look like (and what would be the effects on different sectors and asset classes).
- It was discussed, whether it would be needed to have regulatory incentives or demand to integrate climate (ESG) risks into the investment process.
- The necessity for Financial Institutions to know what the business as usual scenario would look like. i.e. a 6 degree scenario was discussed.

## Workshop 2 a) Overcoming the main barriers to private capital reallocation

### Case Banco Itau

- Itau asset management has developed its ESG-integration approach since 2004.
- The integration of climate aspects (and ESG more generally) into the valuation of equities has been ongoing since 2010, currently Banco Itau is developing a fixed income methodology.
- As a result, climate change impacts on sectors and (Brazilian) companies are assessed and made available.
- At Itau, there has been high-level buy-in for the ESG-integration approach. The CEO was

completely convinced and fully behind the concept of sustainability integration.

- The main barrier was to convince portfolio managers to integrate ESG considerations as they usually have a more short term view. Today, 90% of the PMs integrate the ESG information.
- Next steps: Integration into the portfolio allocation (vs. now only in the equity valuation).

### What are your experiences in integrating climate aspects into investment strategies?

- There is a difference between equity portfolio and fixed income (tracking error are not very stable, so there is a need to change frequently (Build portfolio on tracking error budget (0.5% tracking error).
- Most Portfolio Managers do not integrate CC in their decision today.
- Asset Owners pay attention to it, but it remains often unclear how Asset Managers implement it.
- Few Asset Managers integrate ESG data – Reactive approach – Only if there is a lot of pressure from Asset Owners!
- In order to have a climate change mitigation effect, there is a need for active ownership (dialogue to raise awareness and get companies aligned with a 2C° world).
- Today, if at all, asset managers integrate climate /ESG into one single process step: Company analysis. Integration '2.0' would mean a better understanding of climate impacts into all steps of the investment process: Macro analysis, asset allocation, investment selection, risk analysis, positioning, etc.

### How to convince the key stakeholders?

- CEO/high level commitment seems to be a necessary pre-condition.
- Within asset management it is crucial to convince portfolio managers.
- The openness to integrate climate aspects varies, usually there are a few examples of colleagues who integrate the information voluntarily. They can be used as good examples.
- Incentive systems should be adjusted to reward integration of climate/ ESG aspects.
- Investment guidelines should be specified regarding ESG integration and climate risks & opportunities.
- Recruit the right people!
- Champion systems help, if there is critical mass of champions in several departments.
- As pre-conditions to get the buy-in from sales, is an alignment with client interests. This can be shown through better client profiling and communication.
- There is a carbon alpha: we need to start thinking about what derives the carbon alpha strategy and tell the positive story.
- External pressure helps!

<sup>1</sup> However, there are already work-around. South Pole, for example, externally validates and cleans out not trustworthy data.

- More academic research and studies would help.

## Workshop 2 b) Overcoming the barriers related to indices

### Assumption regarding the use of indices

“Cap-weighted indices are a questionable tool for long-term investors seeking broad diversification, but most investors keep using them mostly to manage reputational risks”.

### Debate 1: What future for the cap-weighted oligopoly?

**Scenario A:** “The use of cap-weighted indices is supported by a strong rationale. Smart beta indices are the buzz, but Cap-Weighted indices will remain the norm in 5-10 years”

- The participants of this workshop assume that there will not be a lot of change in 5-10 years. As additional stabilizing factor, the participants highlight that regulators increasingly use cap-weighted indices as standard for regulation.
- A huge advantage of cap-weighted indices is their “objective market view” and replicable approach.
- The status quo cap-weights oligopoly could also be a good entry point to introduce environmental aspects.

**Scenario B:** “Using cap-weighted indices in a changing world (energy transition, technologies) might lead to poor diversification and breaches in the duty of care for LT investors. The end of the cap-weighted indices era is closer than people think.”

- Automatic exposure to bubbles = under-performance vs. Smart beta
- Bias towards large caps and developed markets = missed opportunities
- Bias to certain industries and technologies = lack of diversification and overexposure to oil & gas (Carbon bubble)
- Market prices given by short term investors does not reflect view on long-term valuation
- Systemic risk related to herd behavior (oligopoly)
- Regulatory aspects: going forward regulators will look at different indices when they become aware of the flaws of cap-weighted indices.
- There is a need to make regulators aware of the opportunities and risks of cap. weighted indices.

As a conclusion, the participants agree that most probably in the future there will be new

and different indices but cap-weighted indices will continue to play a role. More than in the equity space, the participants see a need for urgent change regarding the dominance of cap-weighted indices in fixed income.

### Debate 2: Towards low-carbon mainstream benchmarks

“To date, no low-carbon index has been a blockbuster. But the buzz around stranded assets, the research on smart beta, and the dynamic of COP21 create opportunities for innovation”

**A. Cap-weighting rules;** Rational: whether you like it or not there is no future for indices with high tracking error vs a cap-weighted benchmark. Solution: Minimize carbon footprint & tracking error mostly via best-in-class. Amundi presents the following case:

- The Nordic pension fund AP4 has taken a new approach to find an answer to the current climate change dilemma (political consensus about the need for action and lack of action in financial markets) combining low carbon and low tracking error in a fund.
- The basic principles are optimization of the weighting to reduce the tracking error and regular rebalancing.
- This strategy allows to wait for the right timing and be prepared. In a carbon constrained world, the fund will outperform.

**B. Fossil-free index;** Rational: The buzz on stranded assets create a demand, the narrative is simple. Solution: Exclusion of fossil-assets while managing the risk metrics.

- Investors flocking to a fossil-free index could create the indirect effect of reducing the inordinate lobbying power of the fossil fuel incumbent companies, which is currently stymieing effective global climate legislation.
- A fossil-free index will have the advantage to be less sensitive to exogenous variables as increasing coal and oil prices.
- It will put an increasing focus on the Stranded Assets thematic.
- The index would be constructed on stable and clear rules but it will need to be reweighted to minimize tracking error.
- Participants discuss the need for engagement: It was discussed, whether divesting from CO<sub>2</sub> intensive companies will solve the problem, as other investors come in. On the other side it was mentioned that there has been a lot of engagement with companies like BP and Shell over the years without resulting in fundamental change of their business-model towards a decarbonization pathway. Another critical example is the tobacco industry, which is excluded from most portfolios but remains one of the best performing industries.
- It has been suggested to create an “index based on engagement approach” to get companies align with a 2C world.

**C. Fundamental 2°-index;** Rational: a cap-weighted index is a bad proxy for «buying the market» in a changing economy. Solution: A smart beta 2°-index aiming at ‘forward-looking’ broad diversification (sectors, energy tech.)

- The beauty of this approach is, that it is more flexible and enables a smoother energy transition.
- A forward looking approach that helps capturing risks that are currently overlooked.
- There is a need to define a 2-C pathway and what this means on a sector and company level, reflecting regional differences.
- A fundamental Index would represent a positive answer to the existing problem of Climate Change: somebody has to finance the energy transition today and there is a strong need to set the right incentives.
- An index actually helping in picking “undervalued” companies today

**D. Broad Picture;** Rational: You miss the target: herd behavior, short-termism and principal-agent concerns are the main problems. Solution: regulation on the use of benchmarks and incentives for institutional investors to set carbon reduction targets.

- There is currently a timing mismatch between the short-termism of finance and the long-term materiality of climate change effects.
- We are confronted to an oligopoly situation regarding indices especially in fixed income; and this mono-culture incurs systemic risks.
- The level of financial / ESG literacy of investors is currently low.
- We need regulatory action! In order to:
- Incentivize long-term investments (through tax incentives nationally)
- Create an anti-trust regulation on finance (at EU and US level)
- Oblige Financial Institutions to embed financial shocks in their risk models (ex: BIS)
- Incentivize diversity through for ex. more tax for lower tracking error (equity only).
- Foster transparency: e.g. climate impact (national level, EU level...)

## Workshop 3: Opportunities in building climate resilient portfolios

A summary of the main findings from the panel and plenary discussion:

- Materiality of climate issues not entirely clear to the financial community. Susi Partners, a fund manager for green infrastructure funds comments: “For our asset owners, the more

relevant is risk correlation and good performance, and less about how many Co2 there is per \$ of their investment. That is why our product appeals to all investors and we stop positioning it as a “green” product.”

- Within the real estate asset management there seem to be very clear business-case for decarbonizing the portfolio, as the example of Credit Suisse shows: less energy consumption brings down extra costs for tenants and higher occupancy rates. The remaining barriers are regulatory and agency problem (beneficiaries of energy efficiency investments are the tenants and not the owner)
- Within Wealth Management, there seem to be a new generation of wealth owners arriving that is more educated on the topic and ready to adopt innovative strategies. Ivo Knoepfel presented the case of an Asian Family Office that decided to integrate climate change in its entire portfolio by using a multi-pronged strategy (support/avoid/engage). The decision was motivated by the very long-term view of the investor and by their strong conviction.
- Research into how a 6 degree of climate change scenario would look like – applied to the investment industry. How much of this will come out of the Mercer coordinated project?
- Time frame of investment horizon is still seen as one of the most important barriers that prohibit moving towards climate resilient portfolios. This requires much more fundamental changes than individual financial actors can do.
- Participants point out repeatedly, that there is a need for a global agreement to overcome the current paradox of evidence for climate change and financial markets betting against climate action. A clear solution, if it comes, would be a global adaptation of (national) carbon tax schemes.
- Investors need to play a much bigger role and should raise their voice in the run-up to the negotiations in Paris. In order to trigger this, there is a need to articulate the risks of a 6C° route, because 90% of the investors still do not see it coming. A Stern-report 2.0 which targets the investor community is urgently needed, as we have only 5-10 years before irreversible effect start to quick-in.
- Finally, it was pointed out, that it is not about just waiting until the COP decision but to act now. In this is the very self-interest of a financial actor with a longer-term perspective: to understand better the implication of climate change and of a carbon constrained world on their portfolio.