Climate Change's Impact on Asset Management

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1.1 degrees Celsius. That is how much Earth's temperature has increased on average in the last 140 years[1]. 1.1 degrees may not feel like a considerable change. After all that is how much the human body heats up during a jog. But in the last several decades, this 1.1 degrees variance has resulted in extreme weather patterns around the world unleashing vast forest fires and break-ups of polar icecaps the size of small countries. The key contributor to increasing global temperatures is greenhouse gases (GHGs) unleashed by human activity. In particular, carbon dioxide persists in the atmosphere for hundreds of years which means if no policy action is taken to reduce such gases, the warming effects may remain irreversible for the next several decades potentially making catastrophic weather events the norm[2].

Governments around the world have begun to take notice and some have agreed a coordinated policy response is necessary, resulting in the adoption of the Paris Agreement in 2015 that aims to limit global temperature increases to 2 degrees relative to pre-industrial levels[3]. Central bankers and financial regulators in the UK and EU have gone a step further to indicate that the physical, liability and transition risks of climate change could result in a systematic risk to the financial industry and that ultimately a coordinated response from both the public and private sectors would be needed to thwart what is increasingly viewed as a "green swan" across the horizon[4]. To address such risks, the Financial Stability Board (FSB) led by former Bank of England Governor Mark Carney set-up the Task Force on Climate-related Financial Disclosure (TCFD) that aims to encourage companies to improve disclosure on the business' resilience to climate change risks, which this paper will discuss in more depth later.

For institutional investors, climate change poses both risks and opportunities to the assets and portfolios they manage. On the one hand, climate change risks may have material impact to the portfolio and the valuation of its underlying assets suggesting that addressing such issues runs core to their fiduciary duties to clients. On the other hand, climate change may be seen as risk mitigating (beta) and opportunity creating factors (alpha) to improve risk adjusted returns over the mid to long-term investment horizon. Hence, this prospect for long-term sustainable returns is seen as one of the key drivers fueling the strong global demand for ESG investing in the last several years. Between 2013 and 2018, the number of ESG mandated equity portfolios have increased 75% to just above 1,400 funds globally with roughly US$400 billion in assets under management[5].

Globally, the EU has traditionally been a leader in ESG integrated investing but in recent years, Japan has come to the forefront of this movement led by the Government Pension Investment Fund (GPIF) that seeks to integrate ESG factors and sustainability into the management of the world's biggest pool of pension fund assets. As part of those efforts, the GPIF became a signatory of the UN-backed Principles of Responsible Investing (PRI) in 2015, which acted as a wake-up call to Japanese investors to consider ESG integration more seriously. Between 2016 and 2019, Japanese sustainable investing mandates witnessed a 2.5x increase in inflows and today constitutes 56% of total assets under management in Japan[6]. GPIF also acknowledges climate change as a material risk to its investment time horizon spanning decades. As a result, in 2018, it became a supporter of TCFD and Climate Change 100+ --an investor action group engaging the world's biggest emitters of GHGs.

In response to the increased pressure by GPIF and its external asset managers to address climate change risks, Japanese companies led by large-cap issuers have responded by publicly stating their support for TCFD reporting by joining the TCFD Consortium that aims to educate companies on reporting requirements. Today, the Consortium boasts more than 200 companies and organization, which is the highest number of supporting members of any country in the world[7]. However, it is worth noting that while backing TCFD reporting is certainly a positive step in the right direction; that move in itself is not the objective. Eventually Japanese companies will have to walk the talk and communicate to stakeholders the resilience of their business models in a 2 degrees scenario. Unfortunately, engagements with many of those large cap issuers have revealed that companies are struggling to comply with key components of the framework most notably the Scenario Analysis that provides a quantitative assessment of how businesses will survive in a 2 degrees scenario. Divisions within the organization tasked with the Analysis have expressed difficulties setting key parameters while also facing challenges gaining cooperation from other departments that that may become directly affected by transition risks. As a result, we have witnessed a substantial increase in TCFD supporters but only a handful of these companies have actually become fully compliant with the reporting standards. This is a somewhat concerning trend given Japan, the world's 5th biggest emitter of GHGs, has faced increased criticisms for its inadequate action on meeting the 2030 targets of the Paris Agreement. In particular, the Ministry of Environment's announcement in March to reduce carbon emissions in FY2030 by 26% versus FY2013 has been described as inadequate given global temperatures would end up exceeding 3 degrees under the current scenario[8].

So, what do investors expect of companies under these circumstances? First, companies need to have their own long-term strategy and vision as well as a governance framework to oversee the implementation of action plans to manage climate change risks[9]. This cannot be a pet project of any particular division or employee and management needs to take ownership. This will help facilitate inter-division cooperation and sharing of information but also ensure that proper checks are in place as the plan is executed. Second, companies should not get bogged down by the quantitative scenario analysis and should consider undertaking the qualitative assessment first. Once this analysis is completed, it should be up to management led by the CEO, COO and CFO to explain their findings clearly focusing on how the business model may be affected under various scenarios. Whatever long-term response the CEO lays out, the COO and CFO should support the explanation with how those responses may affect the organization and its capital management. It would also be ideal to have supplemental commentary from the Chief Sustainability Officer. Fourth, companies should regularly report their progress on their policy responses either in the Integrated or Sustainability Reports to increase accountability with easy to understand KPIs and medium-to-longer-term targets that are 2 degree aligned. And lastly, compensation committees should consider whether to link a portion of management pay to the management of the abovementioned risks.

※The views and opinions included in this material belong to the author and do not necessarily mirror the views and opinions of the strategy, organization, and or company that he belongs.●

Note 1: Climate Risk and Response: Physical hazards and socioeconomic impacts (McKinsey Global Institute, January 2020) P.8
Note 2: Ibid, P.10
Note 3: The Paris Agreement, United Nations Climate Change https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement
Note 4: Bolton, Patrick et al. *The green swan: central banking and financial stability in the age of climate change* (Bank or International Settlements, 2020) P.27
Note 5: Sustainable Finance: Looking Farther (International Monetary Fund, October 2019) P.87
Note 6: T Sustainable assets under management report 2019 (Japan Sustainable Investment Forum, March 2020) P.7

Note 7: TCFD Consortium Membership List
(TCFD Consortium, March 2020)
https://tcfd-consortium.jp/en/member_list
Note 8: Climate Action Tracker, Japan (April 2020)
https://climateactiontracker.org/countries/japan/
Note 9: Technical supplement – the use of scenario analysis in disclosure of climate-related risks and opportunities
(The Task Force on Climate-related Financial Disclosures, July 2017)