Climate risk – the investors' perspective

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In a follow-up to her November 2017 article on the role company secretaries can play in addressing climate risk, Maya de Souza, Senior Manager – Policy Research, Business Environment Council Ltd, looks at a powerful driver for better climate risk management – investor pressure.

In my previous article, I explained why company secretaries need to start ensuring climate risk is on their board's agenda, the importance of thinking over longer-term horizons to ensure social well-being, and the benefits of transparency and disclosure for healthy markets. This article now looks at these issues from the finance sector perspective.

There are few of us here in Hong Kong who will have missed the increasing excitement about Hong Kong becoming a centre of green finance, catching the wave, but what is this all really about? Is it just about the sell-side: issuing green bonds and developing green projects that require finance? What about the buy-side, often referred to as responsible or impact investment? Is that one of those changes where catching the wave will be great, but being under it potentially crushing?

In this article, I explain why this shift to greening finance is critical globally and in Hong Kong, and what this involves in practice with reference to the 'buy-side' or responsible investment. This is not only about corporates issuing green investment instruments, like green bonds, but about investors taking into account environmental considerations in their investment decisions and engaging with the companies they invest in. I draw on the views that arose from a recent workshop by the Business Environment Council Ltd (BEC) on how to factor climate risk into decision-making.

To continue with the surfing analogy, we can all see the wave of responsible investment coming. It's not so far away any more. The report by the People's Bank of China (PBC) and the United Nations Environment Programme (UNEP), Establishing China's Green Financial System (PBC/UNEP report), was one of the early signs in this region. Though it shouldn't be forgotten that the Asia Responsible Investment Association, set up here in Hong Kong, preceded this by many years. The Principles for Responsible Investment (PRI) have also been around for some time. But the PBC/UNEP report was still vastly influential as it reflected China's recognition that capital needed to be harnessed to ensure a substantial shift away from existing infrastructure. It brought the finance sector centre stage in terms of protecting our environment and ensuring a stable climate.

The PBC/UNEP report covered green bonds, which we are beginning to be familiar with locally. But it went way beyond this, covering green rating systems and a green stock index. These initiatives are strongly connected with responsible investment. Hong Kong's Financial Services Development Council has established a Green Finance Working Group. Its recommendations as to early action by the government and other institutions on green bond issuance have been taken up – and also to some extent by the buy-side.

So is the green finance wave growing?

The latest figures show that 80% of investors are now factoring environmental, social and governance (ESG) considerations into investment decisions. Hong Kong also has its own Sustainable Finance Initiative seeking to catalyse investor action. Action specifically about climate is also on the increase. Climate Action 100+ is a five-year initiative led by investors to engage with the world's largest corporate greenhouse gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures. To date, 279 investors with nearly US$30 trillion in assets under management have signed on to the initiative.

But why is this happening? Firstly, the finance sector has come to realise that climate risk is not about doing good or reducing impact to avoid bad publicity. It is essentially about managing financial risk, taking on board the dependency of social and economic well-being on a healthy environment. This was the message of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) report. Put simply, the message of this report is that climate change creates two broad risks: physical impacts and transitional risk relating to changing policy and behaviour. If these risks are not factored into valuations, asset values may be entirely incorrect. We see increasing recognition of climate risk being financial risk at a senior level within asset management companies. For example, just at the end of April 2018, Helen Morrissey, Director, Legal & General Investment Management, said, 'Climate change risk is a financial risk – in the last six years, coal companies have lost 75% of their value.'

Secondly, more and more institutional investors, especially from Europe and Australia but also increasingly in Asia, are beginning to factor in social and environmental responsibility as expectations within the investor community change or the social 'licence to operate' evolves. It is in part about recognising the wider social welfare of beneficiaries. For example, in terms of pension fund beneficiaries, having a regular income but high vulnerability to extreme weather may not be in their best interests. The rules on director and trustee fiduciary duties are changing, so that it is becoming quite clear that non-financial risks can be taken into account by trustees and in some cases must be taken into account as they are in fact financial risks. For example UNEP's recent report says 'failing to consider long-term investment value drivers, which include ESG issues, in investment practice is a failure of fiduciary duty.' 124 signatories from 22 countries have already signed a statement acknowledging this duty, including five from Hong Kong.

So if Hong Kong investors fail to factor in climate risk they could be holding assets simply not worth their apparent value.

But of course factoring in climate risk isn't an easy process. How do you decide when a company is climate resilient? How do you get the information you need? Organisations like PRI and the Investor Group on Climate Change are providing tools and guidance. In December 2017, for example, the Asia Investor Group on Climate Change (AIGCC) published its Guide on Integrating Climate into Investor Strategy (AIGCC Guide).

At a recent workshop held in March this year by the BEC, in partnership with AIGCC, PRI, International Capital Market Association and Hong Kong Institute of Qualified Environmental Professionals, asset managers were brought together to help develop their understanding of how to factor in risk. The most important tool brought into the discussion was the framework put forward by the TCFD, which sets out four primary considerations relating to companies and provides detailed guidance on how to take each on board:

- governance
- strategy
- risk management, and
- metrics and targets.

The learning that emerged from the workshop, drawing on the explanation of the TCFD and other tools, is summarised below as six key steps for an asset manager to take.

1. Map your portfolio

A good starting point is to map your portfolio and assess the basics: this is the carbon footprint of your investment portfolio, the geographical location of your assets and key climate risks that may impact them, and some policy mapping too. But remember the latter can change quickly. There are many ways to understand your carbon footprint with a number of indicators that can be used, from nature of company activity, for example mining, to CO2 emissions per unit of output. As to an initial understanding of physical risks in different parts of the world, the Intergovernmental Panel on Climate Change scenarios are the best place to begin.

2. Assess the strategies of individual companies

Adopt a forward-looking assessment approach that takes into account the plans and strategies of individual companies. This aligns with the TCFD approach to look at the company's targets and strategies. CDP (previously Carbon Disclosure Project) data and MSCI analyses can also be helpful. Specific questions include whether the company has robust plans to reduce its greenhouse gas emissions.

3. Assess companies' climate risk resilience

Look at the readiness of individual companies to cope with climate risk. This includes looking at its governance, which means considering amongst other things whether the board is taking responsibility for action on this front – is it providing strategic oversight on climate risk? Practical questions to ask include what is on the risk register, whether the company has any climate relevant key performance indicators and whether it has third-party verification of data.

4. Understand companies' risk exposure

Use stress-testing methodologies such as scenario analysis to understand the risk exposure of individual companies. Uncertainty can lead to investors ignoring these considerations – but these tools try to remedy this, offering a means of understanding a range of scenarios and exploring resilience within those different scenarios. It's about taking on board what some call 'black swans', but which are more like 'black elephants' – as people are aware of them but may prefer to ignore, as they are complex and hard to address. There are many practical issues here including understanding insurance availability and its limitations.

5. Develop your investment strategy

Managing risk well involves not only understanding it and evaluating it but developing a robust strategic position in response. The AIGCC Guide mentioned above sets out a neat and simple four-component framework for a strategy covering:

people, policies, processes and public disclosure. Questions here would include when to divest or not invest and when to actively engage with companies. We heard from participants that in some cases active engagement can be just as impactful. It may also involve developing targets for investment in non-fossil fuel power or policies as to certain exposed sectors.

6. Be transparent

The need for transparency follows from all the above. The importance of approaching this with integrity and accuracy was emphasised at the workshop.

Riding the wave

So to be ready for the wave and avoid being overly exposed to risk. It is important that Hong Kong's finance sector – asset owners, asset managers and analysts – equips itself with the knowledge and know-how needed. This is to assess how climate risk affects investment portfolios and how to develop strategies to minimise risk and identify opportunities. Both physical and transitional risks need to be taken into account: in effect, climate change in its full sense needs to be incorporated into risk management and strategy. As to how to do this, tools and frameworks have been developed. It is now a question of investors beginning – learning by doing – using risk assessment frameworks for their funds and putting in place strategies to manage risk and capture opportunities.

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The author's previous article 'Climate change – not my problem?' is available in the November 2017 edition of e-CSj: http://csj.hkics.org.hk.

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