Financial Institutions and Climate Change
Summary findings by the Climate Disclosure Standards Board (CDSB)[1]

This document summarises[2] the main findings of a major report by CDSB entitled, **"Financial Institutions, Taking Greenhouse Gas Emissions into Account."** The report was commissioned and funded by the UK Department of Environment, Food and Rural Affairs (DEFRA) as part of their research into the contribution that greenhouse gas reporting makes to the UK achieving its climate change objectives[3]. CDSB is grateful to Defra for the funding and support it has provided for CDSB's work and to Dr Matthew Haigh the lead author of the report.

The report presents the results of an investigation into how financial institutions take account of environmental considerations in making investment decisions. Although the investigation did not find any evidence of environmental data being used for portfolio allocation decisions, the level of investor interest in environmental data is robust and the lobbying activities by companies and others for stronger policy measures suggest that a broad-scale market movement towards environmental investing is possible.

Research themes and methods

The investigation was conducted through interviews[4], a questionnaire and other research[5]. Interviews were held with thirty-three professionals working in financial institutions, service organizations and media organisations in North America, Europe, Japan and Australia. The research covers various themes including:

- Investors' motivations, intended and actual behaviour in relation to environmental investing;
- The relationship between investment "style", "function" and environmental investing (these phrases are defined below);
- The relative importance for investors of different sources of information about climate change and what types of information they regard as important;
- Investors' perceptions of the quality of climate change related information and whether there is a correlation between quality and use of information;
- The way in which geographic focus influences investors' attitudes towards and use of climate change related information;
- Investors' processes in using climate change-related information including decision-making approaches and evaluation criteria.

[1] For more information, see "About CDSB" at the end of this document
[2] This summary document highlights findings from the report that are likely to be of interest to general readers. No reliance should be placed or decisions based on the summary.
[3] http://www.defra.gov.uk/environment/business/reporting/pdf/corporate-reporting101130.pdf
[4] For details of interviews and the parties involved see paragraph 4.3
[5] The detailed research methods are set out in part 4 of the report.

Definitions used in the report

Investment style/mandate

The report distinguishes between:

- *Passive, index driven investment*
  The report finds that investors in this category take account of environmental data only to the extent that it affects immediate revenue streams.
- *Active, green investors* - with an express mandate to invest in companies and projects that seek to mitigate greenhouse gas emissions.
  Investors in this category regard company environmental reports as important and direct attention to attributes of individual stocks such as qualitative information about company environmental programmes and how management identifies and addresses environmental and reputational risks.

Investment function

Various investment functions are taken into account in the report including fiduciaries of insurance companies and pension schemes (eg: boards of governors, trustees), fund managers, portfolio managers, analysts, asset owners, investment managers and advisors, information providers and private equity investors and other functionaries. The various investment functions can be summarised as follows:

- Fiduciary
- Advisory
- Funds management
- Governance
- Other

Information sources

The report considers how information from four main sources is used:

- Carbon Disclosure Project data
- Subscriptions based data
- Company earnings reports
- Sustainability reports

Types of information valued by investors

The report distinguishes between:

- *Firm specific information* over which a reporting organisation has a degree of control, including company projects and company provided information; and
- *Non-firm specific information* associated with revenue generating activities, including carbon price[6] (in three ranges US $20 - $50, $50 - $100, $100 +), carbon taxes and subsidies for company usage of renewable energy sources.

[6] Carbon price is defined on page 16 of the report

Summary findings

"…investors appear ready to use company supplied environmental data if they are supplied with the reasons, including wealth-increasing rationale and then shown how…" (5.3)

- **Demand for and use of information -** Demand from investors for company-issued environmental reports is robust, but use of the reports is limited.

- **Correlation between quality and use of information –** Although nearly 60% of respondents of respondents are dissatisfied (in varying degrees) with company carbon reports in terms of their appropriateness, completeness and reliability for portfolio analysis, no statistically significant correlation was found between the use of company carbon reports (from all four information sources) and satisfaction with those reports. "…investors claim to use company carbon reports [with substantial frequency] regardless of their adjudged fitness for purpose…."

- **Geographic influences -** Distinct differences in usage of carbon emissions data appear between region-centric and globally focused investors. The report notes a particular lack of usage of information by respondents focussing on the European region. The evidence suggests that globally focused investors place higher values on company carbon reports than do single nation focused investors. The report speculates that there are likely to be costs involved for global investors if cross country data reporting standards are inconsistent.

- **Correlation between investment function and use of information -** No significant patterns of correlation were found between investment function and use of environmental data. However there is "..some evidence that fiduciaries and their agents are motivated by fiduciary responsibility to perform climate change-related risk assessments.." and that environmental investing policy pronouncements concern fiduciaries more so than other roles in capital markets.

- **Correlation between investment style and types of information regarded as important-** The report notes clear differences between the way in which environmental considerations are taken into account by index and active investors respectively, particularly regarding the type of information they consider to be important (see below). The largest different between investment style mandates relates to the importance investors place on carbon prices (page 26). Index-hugging passive style investors place significantly more importance on non-firm specific, revenue-related information, particularly carbon price and the availability of subsidies for energy use, than do green investors. No significant difference was found in the way that firm-specific information is used by index and active investors respectively.

- **Use of environmental information for portfolio allocation -** None of the questionnaire respondents had used environmental information to guide portfolio allocation levels;

- **Approach to environmental investing -** No institution participating in the study had formulated a systematic approach to environmental investing;

- **Market and peer behaviour** – The report notes a widespread perception that most financial institutions have not used environmental considerations in their analyses and this has served to

discourage investors from identifying and adopting environmental investing approaches (page 37). The report suggests that the scale of environmental investing is expected to grow only if the entire market would first swing towards it and that without structural intervention of some sort, an impasse is likely to remain. The absence of minimum institutional conditions for environmental investing discourages financial institutions from including climate related risks as data points in portfolio construction.

- **Definitions and characterisation of climate information –** All interviewees struggled to define "environmental considerations" and related risks and there was no agreement on the asset class to which environmental risks and opportunities belong.

- **Carbon price** – The report states that investors need to expect that carbon prices and options on carbon prices will behave in ways consistent with commodities and derivative asset markets and that the instruments to which carbon prices attach will trade in volumes beyond minimum trading thresholds (page 46). The report goes on to state that "the primary reason for investors' reluctance to take up the climate change policy agenda may be the low carbon price attained and thin fungibility observed in carbon trading markets" (page 51). One interviewee said "*Carbon reports currently don't allow us to make investment decisions, but we anticipate that they will once we have a price. In the absence of a clear carbon price, the impact of CO2 emissions is really speculative. W don't want to go here at the moment" (page 38)*

- **Information format and presentation platform** - Although interviewees agreed that environmental risks are important, all had struggled to design strategies for identifying and managing their concerns. This is partly because financial institutions have been unable to determine the relevance of company provided data. This is compounded by the fact that the main information providers used by the capital markets have not supplied relevant data in formats that financial institutions might use to put valuations on environmental data and in accordance with market practice. One interviewee said *"My portfolio managers would probably prefer it (environmental data) in Bloomberg because that is the tool they are using" (page 41).* It was noted by some interviewees that the publication of CDP data on Bloomberg has established the legitimacy of environmental investing (Page 41).

- **Optimal planning horizon** - Evidence from one interviewee was that any risk presenting beyond a five year horizon was discarded from current investment considerations. The combination of uncertainty about when, where and to what extent climate change will have impacts and the time anticipated to enact legislation is a barrier to the uptake of environmental investing (page 42).

- **Public policy limitations** - Many participants in the research cited lack of public policy requirements, uncertainty about the direction of public policy and the absence of remedies for parties that might benefit from environmental information as barriers to the uptake of environmental investing. Summary findings on matters related to public policy are presented in a separate section below.

- **Tension between environmental concern and fiduciary duty -** The concerns raised may be summed up in the following comment by an interviewee - *"I think we should all ask ourselves why we should be doing this? Because it is outside our fiduciary responsibilities to adopt any sort*

of messaging strategy targeting to save the world or anything like that. We are here to make money for the benefit of our organizations, our pensioners and our membership. That's what it's all about…" (Page 39).

- **Lack of minimum requirements for environmental investing –** A list of specific information requirements for environmentally themed investing is set out on page 17 of the report – the findings suggest that these requirements are not present:
    - The investor needs to have enough information to assess how company sustainable development and environmental protection programmes are operationalised in company business models;
    - Each company should provide purpose oriented information on sustainable development and eco-efficiency so that investors can integrate economic and environmental performance indicators;
    - This information should be sufficient to allow the investor to develop eco-efficiency indicators which can be used to determine the exposure of the environmental component of an investor's overall portfolio to movements in their portfolio returns;
    - The information can in turn be used to determine the investors' overall effective asset mix, how effectively individual fund managers have performed their functions and the extent to which value has been added through active management.

Recommendations for encouraging greater uptake of environmental investing

- One participant summed up his recommendations as follows: *"Effective climate regulation from an investor's perspective would be provision of short and long term performance targets, market based practices that set up robust carbon prices and stimuli to the renewable energy industry. Comprehensive information disclosure on a standardised disclosure platform is number two and targeted governmental intervention for market development is probably number three."(Page 35)*
- The report calls for policy makers and regulatory agencies to:
    - provide clearer signals on the gravity of portfolio exposures to climate change and environmental risks;
    - support a stable trading market; (page 51)
    - introduce environmental investing policy measures centring on the relationships between financial institutions and the companies in which they invest. Effective policy prescriptions will be those that are tailored to the types of investment mandates held by financial institutions (distinguishing index from green investors) and that distinguish information items used by financial institutions (firm specific and non firm specific);
    - encourage a legal re-conceptualisation of fiduciary requirements that connect asset value and portfolio exposure to environmental and regulatory risks;
    - require financial institutions to disclose how their exposures to environmental risk influence portfolio risk and to demonstrate deployment of environmental considerations in organizational articles of association and as a contractual requirement for service providers (page 52);
    - support professional education programmes to the investment industry to cover environmental, social and long-term governance risks.

- Based on the findings above, other measures to improve uptake of environmental investing might include making relevant, consistent, assured data, prepared by reference to standardised frameworks available in familiar modes and information channels, such that the information meets investors' minimum information requirements (as set out on page 13 of the report);

The role of policy

In section 3, the report examines various policy pronouncements issued around the world that encourage financial institutions to recognise environmental considerations. The report observes that "in a period of intense concern for the stability of capital markets, the hope of regulators and supervisors has been that by requiring financial institutions, such as pension funds and insurance companies to take into account environmental consideration, those institutions will be better placed to manage investment risks."

Various examples of policy pronouncements are given including:

- The Australian Securities and Investments Commission requirement that where a product has an investment component, the Product Disclosure Statement must disclose "the extent to which labour standards or environments, social or ethical considerations are taken into account in the selection, retention or realisation of the investment";
- Rules under the British Pension Act 1995 which require (since July 2000) that trustees disclose their policies on social investment in their Statements of Investment Principles. Similar provisions apply in France and Germany;
- In Denmark financial institutions are required to describe the processes by which they identify and use environmental considerations.

The report observes (page 10) that generally these policy pronouncements neither mandate strict compliance nor offer economic incentives for compliance, in particular:

- Compliance is met if the financial institution discloses that it does (or does not) take environmental considerations into account. The report suggests that this encourages disclosures that consist merely of boilerplate statements that environmental considerations are taken into account to the extent that they are judged to be material;
- Except in the case of Denmark, terms such as "environmental responsibility" and "environmental considerations" are not defined. The report observes that a requirement to take environmental considerations into account is paradoxical if the regulator agency mandating the requirement does not specify the meaning of environmental considerations;
- Except in Denmark there is no requirement for independent assurance of information disclosures about environmental considerations;
- Guidelines on the implementation of policies are not sufficiently prescriptive and they allow product issuers to determine the content and format of the required disclosures. This in turn has led investor associations (such as the ABI and others in the case of UK requirements on disclosures in Statements of Investment Principles) to prescribe uniform reporting approaches.

Section 5.3 of the report includes research findings on the "policy theme". One interviewee commented that "Regulation has to be tighter on companies if we're going to see some kind of results. At the moment, we don't have any evidence that we're doing anything to reduce carbon

emissions" (Page 35). All interviewees "considered current policy requirements as unimportant" because:

- Data resulting from policy measures cannot be used to construct risk premia across a range of asset classes;
- Policy requirements do not promote the use of privately managed capital flows for carbon emissions reduction efforts and environmental management *"the bulk of money needed for carbon emissions reductions should come from private sources. Now that's not going to happen if not supported by very, very strong policies and very, very committed targets and very, very ambitious policies set up by national governments and housed in national treaties.."* (page 35);
- Policies have not been co-ordinated within and across jurisdictions, have vacillated over the last ten years and have not been tailored appropriately to the capital markets (page 33);
- Concerns of social justice and collective morality tussle with fiduciary principles of wealth accretion and risk management – therefore policies are needed to support the creation of large scale renewable energy facilities and help countries that need it about how they can be assisted to choose green technologies.

Whilst some interviewees were concerned that stricter regulation might encourage companies to flee to low regulation environments, generally institutions have been lobbying for more regulation on mandating carbon reporting and providing economic incentives. One interviewee said *"Governments should provide the right kind of subsidies so that investors – long term investors – will bring their acts and their money to the table" (page 35)*

Similarly, the report makes the following comments about policy interventions. "The carbon emissions data disclosure process can impact policy decisions on a number of levels. Voluntary disclosure by a firm has reputation effects on firm environmental performance but it is not associated with firm value (Clarkson et al., 2010). The economic impact of voluntary disclosures will arise, thus, when public perceptions are sufficiently correlated with investors' concerns about firm value, or put another way, when public perceptions about emissions data are no different than investors' perceptions. Rather than simply wait for this to occur, policies mandating disclosures of carbon emissions data might mediate the shift, providing a legitimate measurement for assessing emissions reductions, and bridging the two forms of information valued by investors: firm-specific and non-firm-specific information".

CDSB's strategy for addressing the report findings

CDSB's strategy and work plan[7] includes various work streams designed to address the findings of the report, including:

- Further research and engagement with stakeholder through CDSB's engagement programmes;
- Technical research into how companies set organizational boundaries and prepare climate change related information when subject to rules in multiple jurisdictions (page 40) – this research is designed to help financial institutions to interpret disclosures;
- Development of the Climate Change Reporting Framework to further align with accounting models with which organizations and investors are already familiar – "*It is difficult to comprehend something that is not in companies' accounting models"* (page 33);

[7] Available on www.cdsb-global.org

- Develop with CDP and other partners global interactive data standards to support presentation and analysis of information through information channels and in formats familiar to investors;
- Continuing work with policy makers and international organizations to influence policy development to support greater uptake of environmental investing.

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