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Climate Crunch: Climate risks and investment strategies

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ESG integration is paving the way forward

Integrating environmental, social and governance (ESG) factors into the core of investment strategies and decision-making is becoming a reality. ESG criteria have made their way to institutional investors' active investment strategies as well as passive strategies, for example in the growth of exchange-traded funds (ETFs) considering ESG criteria. The financial industry's adoption of ESG strategies is a clear and positive indication that sustainability factors are no longer considered in isolation.

Instead of only seeking positive ESG-linked benefits as attributes on top of traditional investment strategies and evaluation, investors are increasingly interested in how ESG aspects link to the core business. Sustainable investment practices are applied increasingly as part of mainstream asset management practices - and not primarily because of environmental concerns but due to their higher potential to provide future returns. In 2018 a Bank of America Merrill Lynch report showed that **adopting ESG metrics as part of investment strategies and analysis is likely to reflect positively in portfolio performance by decreasing risk while providing similar or higher returns.**

Climate risks topping the agenda

Similarly to ESG criteria, climate change-related risks are gaining recognition for their importance in investment decisions. The threat climate change poses to businesses and investors alike is becoming increasingly evident, as highlighted by the World Economic Forum's annual Global Risks Report earlier this year. The report identified climate change related risks such as extreme weather events, natural disasters and the failure of climate change mitigation and adaptation among the most critical risks of our time both in terms of impact and likelihood. A failure to consider the negative impacts climate change poses on company's assets, operations, revenues and capital expenditure, may lead to significant misjudgement of a company's risk profile. One recent example was Pacific Gas and Electric Company (PG&E) filing for bankruptcy in early 2019 due to severe wildfires in California.

Investors are currently failing to fully price in physical climate risks and their effect on investment portfolios according to a BlackRock study from earlier this year. In essence, **climate-related risks and opportunities should be included in investment analysis and strategic decisions alongside usual return, risk and cost assessments to avoid over or underestimating investment's value.** Since the publication of the recommendations by the Financial Stability Board's (FSB) Task-Force on Climate-related Financial Disclosures (TCFD), sustainable investing professionals have been dedicating increasing efforts to identifying climate risks and opportunities in investment portfolios. Yet, when aiming to assess climate-related risks in investment portfolios, **investors frequently face the challenge of data limitations and a lack of company reported information.** This happens because the concept of materiality guides many of the existing non-financial reporting frameworks; what is considered material and significant varies across sectors and companies. For example, not all companies have identified climate risks as financially material and thus do not disclose on their potential financial impact. **This creates a challenge for investors when assessing portfolio climate risks as the analysis cannot solely depend on the information provided by corporate disclosures.** More corporates are beginning to disclose on financially material climate-related risks, however progress needs to be made for investors to have sufficient - and comparable - information available.

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Regulatory push, voluntary market initiatives and emerging recommendations for the application of best-practice approaches are driving action towards better climate risk disclosure and integration in investment strategies and decision-making. Recent examples of such external drivers include PRI announcement to make reporting on TCFD-related indicators obligatory for PRI signatories in 2020. In June 2019, the European Commission updated the guidelines on non-financial reporting by adding a specific supplement on reporting climate-related information, complementing the existing Non-Financial Reporting Directive (NFRD). Although currently voluntary, further regulation may require disclosing on climate-related risks on a mandatory basis in the future.

More than anything, priority shifts such as encouraging - and requiring for - increased financial disclosure on climate-related risks have notable cascade effects. Investors are called upon to assess and report on their investments' alignment with the Paris Agreement and to identify to what degree investee companies are on a 1.5°C-2°C temperature change pathway. This creates pressure - but also an opportunity - for investors to engage with portfolio companies to ensure risks are being identified and communicated, and that adequate mitigation and adaptation strategies are in place. **Mainstreaming climate risk assessment is vital for well-informed investment analysis and decision making**, but also to guide structured engagement on the topic of climate change.

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Bridging the data gap

As with everything, it is necessary to identify risks in order to mitigate them. Be it the risk of wildfire, accident, theft or anything that might negatively affect 'business as usual'. What seems normal practice for avoiding the potential negative impacts of everyday risks is only starting to become a reality in the wider world of finance when it comes to risks related to climate change. Yet, the common everyday logic applies to climate risks alike - the starting point in many cases is to specifically pinpoint the investments most at risk due to climate change. To identify and locate portfolio climate risks, many **investors are considering how different temperature change pathways might affect their investments' core business and operations in the future**. Instead of using historical data as the primary indicator for the direction of future events, **forward-looking scenario-based climate risk assessments enable investors to identify companies most exposed to climate risks in 2025, 2040 and beyond while considering different temperature change scenarios.** The results of such an analysis can be integrated as part of investment strategies or used to inform positive opportunities screening. But how to identify the risks and know how to avoid or reduce the risks in practice?

If you didn't know where to start and which data to trust, you would most likely save the effort and not do it. But as soon as something happens, you would probably regret that decision. With the help of technical and analytical solutions created in the intersection of climate modeling and portfolio analysis, the industry can go a long way in quantifying the risks. So how to identify and mitigate the risks imposed by climate change in the short, medium and long term? **South Pole has contributed to bridging the information gap by providing dynamic climate risk analysis and solutions applicable in both investor and corporate context.** The climate risk assessment tool developed by South Pole produces high-quality analytical outputs that inform and enable investors to integrate transition and physical risks into investment strategies, decision-making, reporting and stakeholder dialogue. The solutions have been developed based on market needs, offering a quick and efficient method for preparing inputs for TCFD-aligned disclosure or reporting climate risk related indicators to PRI.

Accelerating action through collaboration and innovation

Limiting temperature rise to 1.5°C above pre-industrial levels is a daunting task which requires urgent deviation away from carbon-intensive activities. A recent report by the European Central Bank on climate change and financial stability suggested that “climate change-related risks have the potential to become systemic for the euro area, in particular if markets are not pricing the risks correctly”. Measuring and internalising climate risks in investment practices is a step in the right direction. Although many financial industry actors are already advancing significantly in making climate risk analysis part of their risk assessment and investment decision-making processes, more concrete action is needed to reduce the risks but also to tap into the multi-trillion dollar opportunities associated to transition to a low-carbon, climate resilient economy.

Climate action can be further accelerated through collaboration and innovative solutions. Integrating forward-looking scenario-based risk assessments into investment strategies and decision-making, enables investors to move beyond carbon footprint and stranded asset-based assessments. **A simple shift from historic data based indicators to forward-looking analysis and indicators presents an opportunity for investors to advance meaningful engagement activities with investee companies and identify future-ready investments.**

South Pole’s climate risk solutions provide investors with climate risk metrics and analysis enabling deeper engagement between investor and investee company on the topic of climate change. As a practical example of extending climate risk analysis beyond the usual equity analysis, South Pole collaborated with Affirmative Investment Management (AIM), a dedicated impact bond asset manager, to analyse physical risks of green bond investments. Although green bonds are usually considered for their positive impact, it does not make green investments immune to negative impacts of climate change. Therefore investors should be aware of climate risks related to green bond investments. Climate risk analysis offered by South Pole is an efficient means to identify investments and projects most at risk and engage with the issuer to understand whether they have the capacity and ability to adapt to the risks identified.

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Seizing new opportunities

Forward-looking scenario based climate risk assessments do not only highlight risks but also enable identifying sustainable investment opportunities by singling out low-risk profile companies that may already be taking adaptive measures and adjusting their strategies to be aligned with a low carbon and climate resilient economy.

There is immense value in informing investment decisions now by adding climate-related risk criteria into the mix and tapping into new opportunities. **With the right data and analytical capabilities at their disposal, investors become well positioned to account for climate-related risks and opportunities as part of investment strategies and decision-making.**

To learn more about South Pole's practical climate risk solutions for investors or to request a sample report or a demo contact:

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