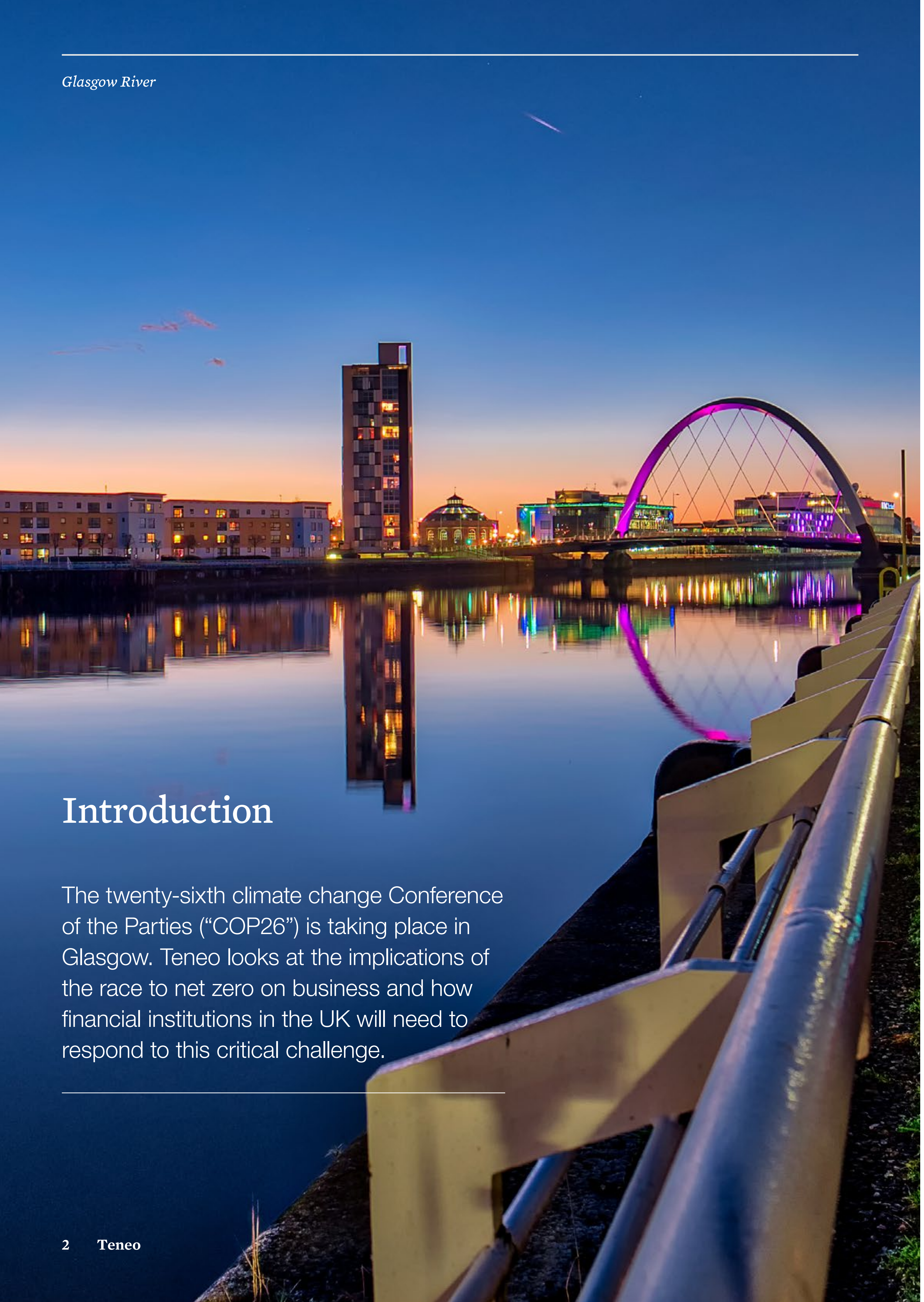
Teneo

The Global CEO Advisory Firm

The Impact of Climate Change on Financial Services

Teneo Insights

November 2021



Introduction

The twenty-sixth climate change Conference of the Parties ("COP26") is taking place in Glasgow. Teneo looks at the implications of the race to net zero on business and how financial institutions in the UK will need to respond to this critical challenge.

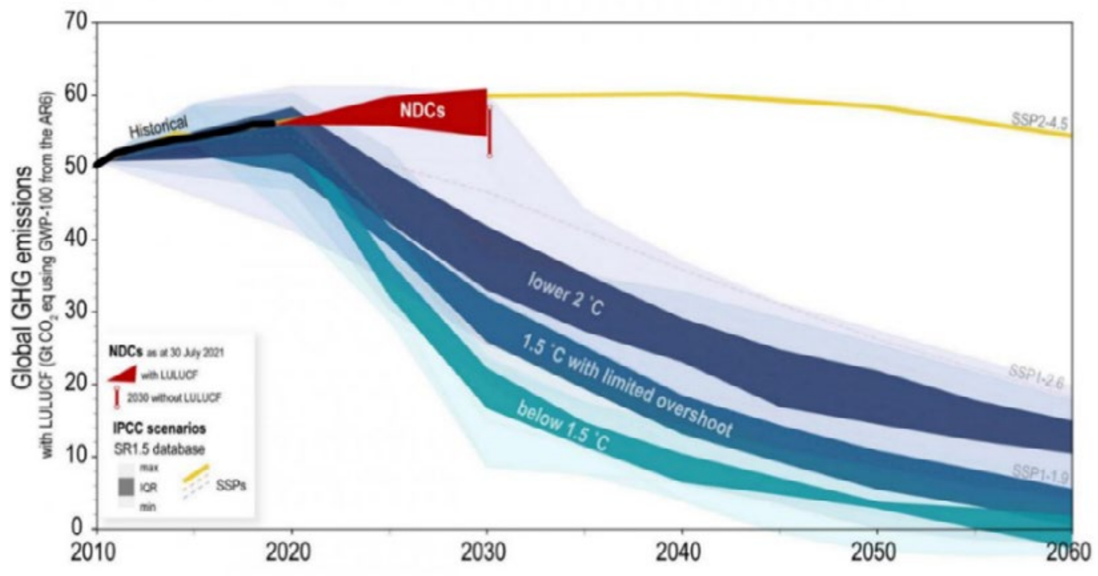
After decades of warnings from scientists and activists, the climate has finally become a major focus for governments and businesses around the world. Independent bodies, industry networks and taskforces have been mobilised to address the daunting task of limiting the temperature increase of the planet by emitting less greenhouse gases than we remove. In a report produced ahead of COP26, the United Nations ("UN") secretariat concluded that, based on the targets in the current Nationally Determined Contributions ("NDCs"), there will need to be 'a significant increase in the level of ambition' or a 'significant overachievement of the latest NDCs', or 'a combination of both, in order to attain cost-optimal emission levels'[1]. In short, the current goals set by the 191 parties of the Paris Climate Agreement will not achieve net zero emissions by 2050.

Until recent years, climate change has generally been dismissed as a slow-moving and invisible, threat. Now, predictions that seemed like abstract, unrelatable concepts to most have manifested themselves as an increase in extreme weather events across the planet witnessed by everyone. The Western Cape drought, Australian bush fires, heatwaves on most continents, and increasing occurrences of hurricanes, typhoons and floods are all attributed to human influence by Carbon Brief, a UK-based company focused on climate data and policies. The tangible impacts of the climate crisis cannot be ignored any longer.

Addressing the climate crisis will involve global collaboration across political, social, and economic activities. Financial institutions serve all aspects of human life – whether as providers of capital and liquidity or managers of risk – and the importance of actions taken by the industry in tackling the climate crisis cannot be overstated. Whilst significant progress has been made in vital areas such as data analytics and disclosure, the industry must recognize that not enough has been done to achieve net zero. The focus must be on data, reporting and standards, but also action. What practical steps must financial services firms take to support businesses and communities in this transition and be a catalyst for change?

Alongside the challenges facing the financial services sector there is enormous opportunity to provide new and innovative products and solutions that meet the needs of consumers within the physical limits of the planet whilst supporting the global economy. The transition to net zero will be costly, but less so than the continued destabilisation of the planet's ecosystem.

Figure 1*



Source: Appendix pg 13

The context for finance

Whilst the challenge ahead is rightly described as a transition that will span many years, the need to move faster and to do more in the short term is only intensifying – demonstrated in the lead up to COP26 by politicians discussing big, bold plans for 2030 in addition to those for 2050. The conference will be an accelerant for business and finance to mitigate the risks (such as stranded assets, radical shifts in valuation and direct climate impacts) as well as to drive and benefit from the opportunities presented by the energy transition.

Asset owners and managers face increasing scrutiny as regulatory requirements and shareholder expectations for Environmental, Social and Governance ("ESG") commitments evolve at break-neck speed. Without paying close attention to how supply chains in underlying companies are impacting the environment, the risk of being caught in a greenwashing scandal is high and costly. Balancing stretch goals and promises to shareholders with material action will require excellent strategic prioritisation and communication.

"For tips relating to U.S. sustainability reporting, take a look at Teneo's Insights piece 'We Are Living in a Material World: The State of U.S. Sustainability Reporting', which analyses 200 reports published by S&P 500 companies this year, and lays out 10 practical considerations.

It is likely that there will be technological innovation and adoption inflection points which will have significant business and, by extension, financial implications. The risk versus return, and therefore cost, of capital profiles will differ across the new technologies needed. This, alongside the capital investment requirements of high upfront costs leading to low operating costs, presents risks and opportunities for the financial sector.

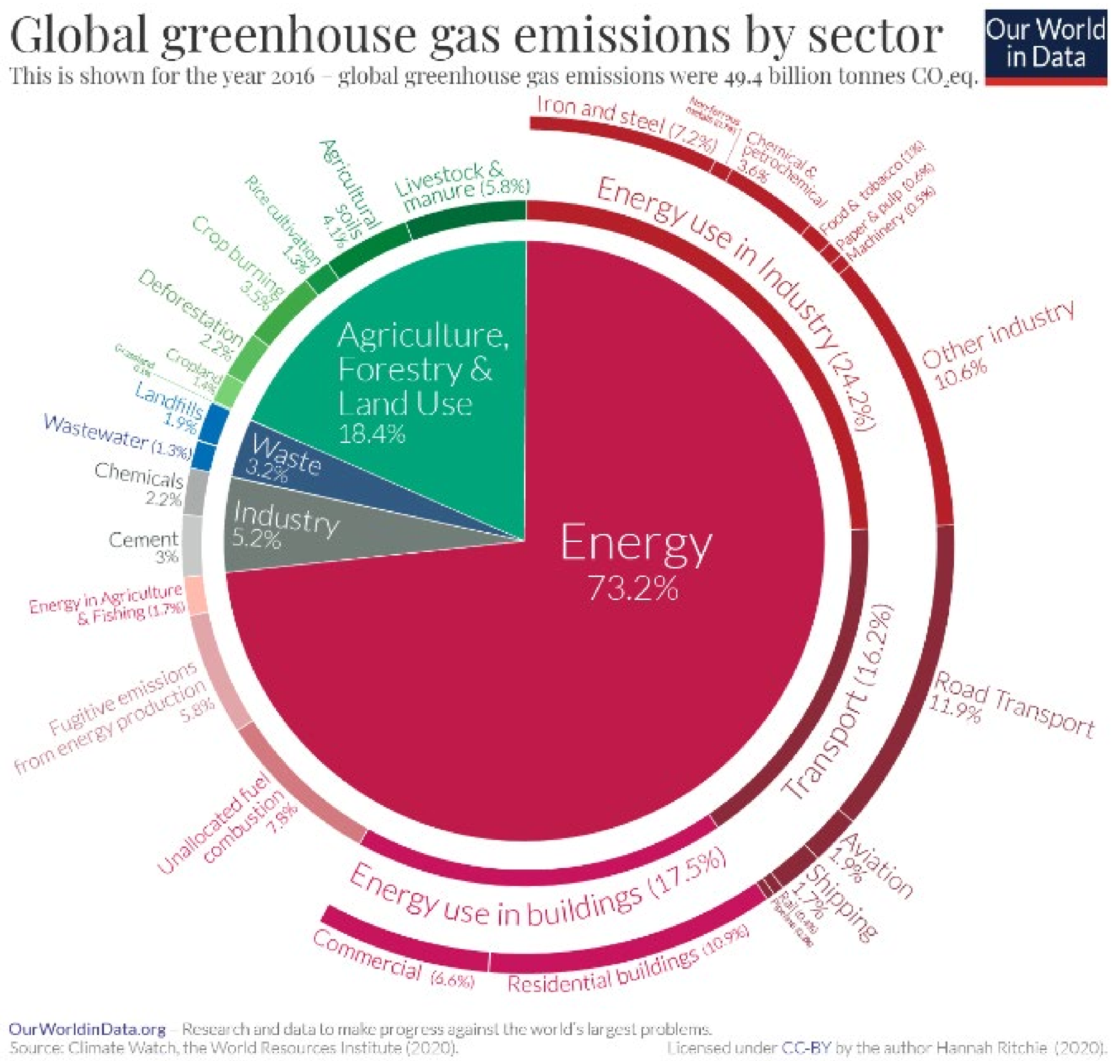
Financial institutions are a source of pressure on corporates as well as also being under pressure themselves from multiple stakeholders, including regulators, non-governmental organisations, and asset owners. The exposure of financial firms to climate activist investors has intensified as these funds have become more aggressive and successful in their activities. One prominent example is Engine No.1, a small and relatively new climate activist investor which, with a holding of 0.02% in ExxonMobil, managed to mobilise other shareholders (such as BlackRock and Vanguard) at the company's annual general meeting to replace three board members. It also enacted a more meaningful climate risk strategy, arguing that the oil and gas giant 'risks continued long-term value destruction and ultimate irrelevance'[2] without more ambitious goals.

Though divestment has become a popular talking point for activists, this does not solve the problem of what to do with carbon-intensive assets. The public push for asset disposal is a simplistic and reactionary response that will only make valuable fossil fuel assets more attractive to private companies, national oil companies, and hedge funds who may be less concerned about the associated reputational issues if they can continue to secure attractive returns, even if these are at the cost of meeting the net zero ambition. Financial services firms have a real opportunity to support the task of responsibly winding down assets that no longer serve us and ensuring visibility over managing the costs of remediating the environment.

Coal, cars, and trees

Energy, transport, and agriculture are seen to be the most polluting sectors. Decarbonising these sectors will have a profound impact on substantial parts of the global economy in the coming years. At COP26, the UK presidency will be seeking commitments from nations on coal, cars, and trees. Financial services firms must respond to the needs of their customers to support the transition.

Figure 2[3]



Coal

COP26 goal: building on the UN secretary general stressing the urgency of the situation in April, the UK presidency will be seeking commitments from developed nations to phase out coal by 2030 and from developing nations by 2040

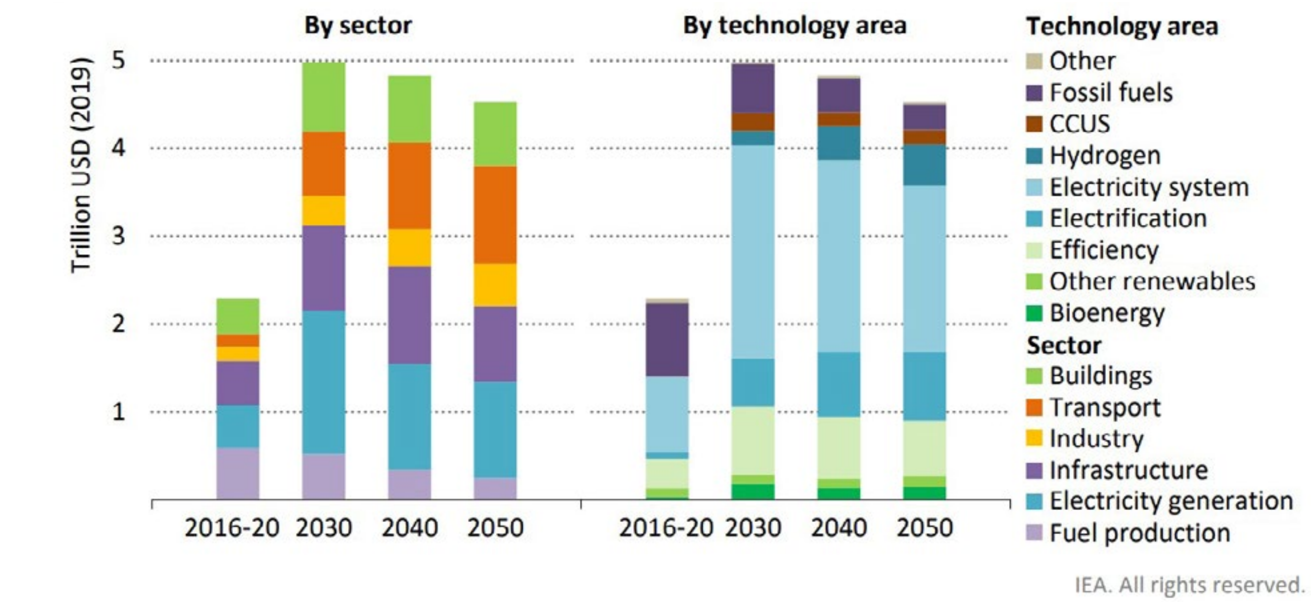
- As business models evolve to reduce dependency on fossil fuels, lenders and insurers will need to adapt their proposition to remain relevant and competitive by supporting customers in their transition towards renewable energy sources and away from carbon intensive activities. Across the globe, businesses and communities will remain reliant on fossil fuels for years to come. It is not therefore possible to simply 'switch off' large parts of the energy sector. Financial institutions will need to support both the energy sector and its consumers in an orderly wind-down of carbon-intensive activities whilst transitioning to more sustainable activities. This will present opportunities for those parts of the financial services industry which have expertise in managing non-core assets and legacy exposures.

- The climate crisis may represent a watershed moment for general insurers. The already generally poor public perception of the insurance industry and the value of its products has been further damaged by the perceived response of some insurers to the payment of some claims arising from the global pandemic. Climate crisis activists have directed protests at the London insurance market, demanding the industry does more to withdraw cover for 'dirty industries' such as coal mining. Investors will expect a commitment towards net zero and to demonstrate effectiveness in decarbonizing the economy.

- China's announcement at the UN General Assembly in September that they will cease involvement with any new coal-fired power stations overseas could help to bend the emissions curve, even if it is undermined in the short term by its recent instructions to increase local production to resolve a domestic energy crisis. Whilst this may not be lasting – coal market volatility makes the stability of renewables even more attractive – these bumps in the road will continue as long as there is financial and legal precedent to continue funding new exploration or development of fossil fuel plants. As reported in the Financial Times[4] , members of the Glasgow Financial Alliance for Net Zero ("GFANZ"), who represent a large number of the world's banking industry, have proven unwilling to commit to more prescriptive targets proposed by the International Energy Agency ("IEA"), which includes no new financing for new fossil fuel exploration and infrastructure projects, in favour of recommendations from the Intergovernmental Panel on Climate Change ("IPCC") that are not as strict. Though the hesitancy here is in large part due to the focus on a 'just' green transition, a term coined by GFANZ champion Mark Carney, and the insistence that abandoning fossil fuels too quickly and without a reliable plan will increase energy prices and cause irresponsible damage to economies. Regulators have a critical role; to discourage or outright ban any new financing of fossil fuels.

- Coal and other fossil fuels today play an essential role in base load generation and moving away from them will require more than double the current levels of investment in renewables in order to meet net zero emissions by 2050, according to the IEA[5]. This gives investors ample opportunity for investment in renewable energy generation, storage and grid management, and the development of hydrogen and nuclear technologies. Since the start of the last decade, listed renewable power portfolios outperformed listed fossil fuel portfolios with both higher returns and lower volatility, illustrating that these investments can be good for investment returns as well as the environment. The importance of stable returns and income generation in the context of serving the needs of ever-increasing retiree numbers cannot be overstated.

Figure 3*: Annual average capital investment in the NZE



Source: Appendix pg 13

Cars

COP26 goal: commit to phasing out new petrol and diesel cars by 2035

- Domestic transport is the largest emitting sector in the UK, producing 27% of the country's total GHG emissions in 2019[6]. Decisive and timely regulation restricting new combustion engines means that electric vehicles ("EVs") will be the only option for consumers and manufacturers in the UK by 2035. The IEA has concluded that the EV share of new car sales globally must increase from 5% to 60% by 2030[7]. EV manufacturing and charging infrastructure has enormous potential rewards for investors who act quickly. Prices for lithium are increasing, new plants are coming online across China and Japan, and with demand set to overtake supply by 2027, the window for maximising gain is open.

- Government policy to influence consumer and business behaviour will be vital to reduce this sector's huge contribution to overall emissions reduction. Subsidies and tax benefits have already been introduced for individuals and businesses who install charging infrastructure but expanding government incentives to manufacturing companies would reduce cost and increase demand for the switch to EVs.

- A consequence of the phase out activities proposed by developed countries will be the continued growth of the export market for second-hand polluting cars to developing countries. With individual car ownership increasing in emerging nations, ensuring that these markets grow sustainably is vital. This will require regulation in developed countries to limit the export of polluting cars in favour of recycling and disposal, and blended finance options provided by private capital for emerging nations to develop green public transport as an attractive alternative.

Trees

COP26 goal: commit to reversing deforestation by 2030

- Tropical deforestation accounts for up to 15% of net global carbon emissions each year, making it one of the key factors in the climate crisis – with the production of cattle products, timber, palm oil and soy as the biggest drivers. For companies whose supply chain is connected to deforestation, failing to find sustainable alternatives could put turnover at risk due to the declining availability and increasing prices of these commodities, as well as the costs associated with adapting operations to be 'forest friendly'.

- The cost of deforestation can also be observed in the devastating effect that it has on biodiversity loss and human rights. This activity is connected to a number of the UN's Sustainable Development Goals ("SDGs"), which also links the decreasing space for nature and wildlife to increasing the risk of diseases like COVID-19[8] . Along with the regulation of fossil fuel financing, governments and regulators have a responsibility to hold the banking community accountable for the financing of deforestation – which produced profits of $1.74 billion for the world's biggest banks since the Paris Climate Agreement in 2015, as estimated by human rights organisation Global Witness[9].

- Teneo has enormous expertise in the ESG space. For more information, take a look at our ESG proposition,[10] which details the integrated service we offer for all ESG needs, in addition to market-leading insights through podcasts, thought pieces and a fortnightly ESG newsletter.

- The environmental non-profit organisation Global Canopy reports[11] that as of January 2021, 'Four of the world's five biggest asset managers – which provide US$1.1 trillion to the most influential companies in forest risk supply chains – still have no policy in place to tackle this problem in their portfolios.' Asset managers that are demonstrating practical commitment to ending deforestation include AXA IM which expanded its policies on this in June 2021. As well as excluding the investment in companies involved in major land use controversies or in causing biodiversity loss due to soy, cattle and timber, they detailed standards regarding the management of forests in its portfolio, and clear definitions of measurement for its policies.

- Investing in sustainable forestry is not only good for the planet, as UK-based Foresight Group is hoping to prove with its new fund – Foresight Sustainable Forestry Company Plc. After careful observation of the forestry market in the UK over the last 5 years, the company expects to provide investment returns of 'more than CPI + 5% per annum on a rolling five-year basis', without compromising its ESG credentials[12].

Governance in the UK

A crucial theme across all activities in the transition to net zero is that the partnership between governments, regulators, and the private sector - particularly as firms are spending more time talking about ESG externally. Governments and regulators need to be driving ambition but also holding companies to account for their commitments.

HM Treasury published its Green Finance Paper in October 2021, outlining how the government plans to deliver on its first phase to green the financial system, 'informing investors and consumers'. This includes roadmaps for legislation and collaboration with the Financial Conduct Authority ("FCA"), covering how sustainable finance is defined and measured. As greenwashing continues to be a concern, the government is considering bringing ESG data and rating providers within the scope of FCA regulation. This could resolve complaints from most stakeholders that definitions and benchmarks are inconsistent and would force companies whose reporting is vague to provide evidence to back up their claims. Further information is due to be communicated in 2022.

Financial services firms are required to embed climate change risk assessments into their risk frameworks by the end of this year. In June 2020, the Prudential Regulation Authority ("PRA") noted several gaps in its thematic review of firms, including a lack of understanding of climate-related financial risk and how it relates to a firm's activities; gaps in scenario analysis capabilities; and underdeveloped risk management processes. The PRA has recently said that it will consider changes to banks' capital requirements to allow for climate change risks.

Progress has been made by the FCA on the Chancellor's requirement that companies across the entire economy disclose data aligned with the Taskforce on Climate-related Financial Disclosures ("TCFD"). The UK regulator completed a consultation session on requiring TCFD-aligned disclosures from insurers, asset managers and pension providers in September 2021, with another consultation session regarding the role of financial advisors expected in 2022. However, further progress could be made by industry, according to the TCFD's 2021 Status Report[13], which found that only 50% of firms disclosed their climate-related risks and opportunities in 2020. Though the UK regulator's roadmap for aligning reporting with the TCFD was positively highlighted in the report – when it comes to UK company disclosure, there is still a long way to go.

Outside of finance, on 19 October the UK government published its long-awaited net zero strategy ahead of COP26. Though the strategy is not perfect – critics have pointed out that many of the pathways do not include actions or clear measures for the impact of policies – a detailed strategy from the country that initiated the first industrial revolution could have significant influence on the rest of the world.

How can Teneo help?

Teneo is uniquely positioned to assist financial services firms both in relation to the formulation and embedding of their climate change response, communication strategy with stakeholders, and the repositioning and restructuring of their portfolios. Our focus here in the context of COP26 is naturally on the environmental dimension, but our support also spans social considerations – such as supply chain, employment, and community – which are inextricably linked to environmental matters. The focus across offerings to our clients will at all times be about managing risk and seizing the enormous opportunities.

Restructuring

- Supporting businesses and financial services in the transition with the orderly wind-down or exit from non-core / non-green assets and lines of business.
- Responding to the consequences of accelerated transition, dealing with stranded assets and crises caused by climate-related events.

Consulting

- Developing industry leading ESG policies and strategy to embed these values through the business.
- Analysing climate change impact through the supply chains and advising on green transformation.

Strategy & communications

- Advising clients about how to optimise communication of their sustainability positioning and initiatives in the context of peer and investor practices and policies to protect and enhance individual and corporate reputation through.
- Formal articulation of sustainability policies and ambitions.
- Effective sustainability reporting and disclosure.
- Proactive – and if necessary reactive – communications from these foundations to influence key stakeholders (e.g. NGOs, ratings agencies).

If any of these issues resonate with you, please contact Teneo's team of situational and sector experts below:

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Appendix

1
United Nations Framework Convention on Climate Change, Nationally determined contributions under the Paris Agreement. Synthesis report by the secretariat

2
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Hannah Ritchie and Max Roser (2020) - "CO and Greenhouse Gas Emissions". Published online at OurWorldInData.org

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Big banks resist most direct road map to net zero emissions Owen Walker and Stephen Morris, Financial Times October 2021

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IEA (2021), Net Zero by 2050, IEA, Paris https://www.iea.org/reports/net-zero-by-2050

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Taskforce for Financial Climate-related Disclosures, 2021 Status Report

Fig 1: Source
Comparison of global emissions under scenarios assessed in the Intergovernmental Panel on Climate Change Special Report on Global Warming of 1.5 °C with total global emissions according to NDCs1 (September 2021)

Fig 3: Source
Investment required in the global energy transformation to meet the net zero emissions ("NZE") scenario laid out by the International Energy Agency ("IEA") by 2050.

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