Climate Issues for Corporate Issuers

Featuring:
***Simone Ruiz-Vergote**, ESG Researcher, MSCI*
***Sylvain Vanston**, ESG Researcher, MSCI*

Adam Bass (00:03):

This is MSCI Perspectives. Your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass. And today is December 9th, 2021. On today's program, we've spent a lot of time over the last few episodes looking at the COP26 climate conference, including our latest episode where Oliver Marchand, MSCI's head of climate risk research walked us through the implications for the world and for investors. Today, we'll hear another vital perspective that of corporates, companies. After all, once you drill down from the grand pronouncements from conference attendees and governments, that's where a lot of the real work takes place. So what did COP26 mean for companies? To help answer this question, we have two COP veterans with us, so to let's dive right in.

Simone Ruiz-Vergote (01:03):

My name is Simone Ruiz-Vergote. I'm based in the Frankfurt office of MSCI, and I follow anything related to ESG policy and engagement with major stakeholders.

Adam Bass (01:13):

And our other guest today.

Sylvain Vanston (01:15):

My name is Sylvain Vanston. I recently joined MSCI after a long career at the AXA Group, and I'm in charge of climate investment research as an executive director.

Simone Ruiz-Vergote (01:27):

So this was my eighth COP. And I think from a corporate perspective, what was new is sort of this sense of urgency. We might have seen it in Paris to a certain extent, but this time you really noticed that time is running out. And so the final text really recognizes this gap and it requires countries to upscale their ambition for emission reductions already next year. Normally it would've been five years from now. The text also says that greenhouse gas emissions need to fall by 45% compared to 2010 levels by 2030. And right now we are on track to increasing emissions by 13% over that period. So we have a real gap to close here. And we also know that the 1.5 degrees limit allows us only five years for action. So it's a very short timeframe we're having here. After that, we would enter what we call delayed action scenario.

Simone Ruiz-Vergote (02:25):

And I think probably a major headline that all corporates should look at closer is that the 1.5 target. So maintaining 1.5 degrees global warming target maximum inside was maintained in the final negotiation tax. And that means that some very serious policies will be implemented over the next couple of years to allow countries to contribute to this target. And actually in the end ultimately achieve it. That would also create societal resistance, but more from a corporate perspective again. The government's made it quite clear, there is no space for call in a net zero world with this face down formulation and a net zero world would really ask a full scale overhaul of the energy system as we know it today.

Adam Bass (03:15):

Sylvain concurred wholeheartedly that one of the main outcomes of COP26.

Sylvain Vanston (03:20):

Is that the global commitment to contain global warming under 1.5 degree by 2100 has been maintained. It's looking more and more challenging of course, but nonetheless, the final Glasgow pact does refer to that target.

Adam Bass (03:37):

Sylvain also found hope in the new found urgency around biodiversity. That's a subject that he feels has not really gotten its due. And he may have a point. As a point of reference the biodiversity cops, well, they're only up to number 15.

Sylvain Vanston (03:55):

Of course, the opinions on the outcomes of COP26 are mixed. For sure, it didn't satisfy everybody, but it's clear that it wasn't a failure either. Many interesting things happen. I think for example, the very important narrative space given to biodiversity nature-based solutions, the loss of nature-related services, this was an important piece of the conversation. And that is really new. I would've expected this to happen at COP15 in Kunming in China which was a parallel COP dedicated to biodiversity, but actually biodiversity was all over the place in Glasgow. That's really interesting.

Adam Bass (04:36):

I asked Sylvain why he thought biodiversity was getting more attention this year, why this newfound sense of urgency?

Sylvain Vanston (04:44):

I think it's due to the relatively sudden realization by corporates, investors and countries and heads of states that the biodiversity crisis is already on us. It's happening. It's fast. It runs deep. It is worrying because it is at the end of the day about sustaining life on earth, but also about obviously food production, pharmaceuticals. It's pretty significant. And while scientists have been warning about the erosion of biodiversity for many years actually, it's only since I would say 2018, 2019, maybe that this has started to become an investment community-related conversation. That is important because of course this is where financial flows can happen. We've had, for example, at the beginning of COP, a commitment to halt deforestation. 100 countries covering I think around 85% of forest that committed to end deforestation by 2030. We've had good commitments on public funding.

Adam Bass (05:47):

Like all matters, climate related, the trick is getting from commitments to action. And doing so takes guidelines, measurement, and a task force with an acronym. We now have the task force on nature-related financial disclosures. The TNFD. I think especially listeners to this program are getting somewhat familiar with the initials TCFD, but can you talk a little bit about the TNFD and through the lens of why should companies, corporates, why should they pay particular attention to this task force?

Sylvain Vanston (06:27):

Absolutely. So I'm quite close to the TNFD project. In my previous role, I have been part of the team's pushing for the creation of the TNFD and very much involved with the creation, the actual creation of the TNFD, so the task force on nature-related financial disclosures. It was launched last summer with a great team of leaders, a fantastic secretariat, good partners in this organization. And of course, as the name would imply, the ideas to emulate the success of the TCFD. But however, there's differences between the two projects. For starters, the TNFD doesn't have a mandate from the FSB. So it has to operate on a looser mandate given to it by the market generally, but also by the G7 in Q2 this year.

Adam Bass (07:14):

The FSB is the financial stability board. It's a recognized international body that works to promote global financial stability.

Sylvain Vanston (07:22):

And the other interesting thing is that from the outset, the TNFD has agreed to work on something called the dual materiality by this they mean to work both on the impacts and the risks related to biodiversity i.e. how are investors impacting biodiversity in the way they allocate assets, for example. And how is biodiversity laws going to impact their portfolios? That's something new. The TCFD strictly speaking is much more about risks than impact. Yeah, maybe I'll stop here.

Adam Bass (07:58):

That actually is a good place to stop because we should stick with this idea of different types of materiality. It's important for companies and for sure for their investors. So let's take a moment and get our terms straight.

Simone Ruiz-Vergote (08:12):

Financial materiality is anything that affects company value. And the double reality is broader. It looks also at how a company affects anything in terms of society or environment. So it's basically the company's impact on the world.

Adam Bass (08:30):

And when we're talking about biodiversity and the TNFD.

Sylvain Vanston (08:35):

It's the impact of investment policies, of investments on nature and the impact of biodiversity loss on those portfolios. So this dual materiality mindset is here from the outset in the TNFD project. Now it's interesting also because the TNFD has announced it will come up with guidance, first draft guidance for corporates to report on the impacts and risks related to nature loss by early 2022. I think it would be interesting for all corporates especially in some sensitive sectors such as mining, building materials, pharma, agriculture, food products. So look into these job guidelines and try and improve them because once those guidelines become final, if the success of the TCFD is to be replicated, then they will become market practice. Sometimes even they will be integrated into local regulations. So we will be stuck with it. So we might as well have a good reporting framework from the onset.

Adam Bass (09:44):

So essentially we're talking about getting your voice heard as we come up with how the structure will be for reporting. Standardization in other words, which obviously is a big topic, even on the carbon side, but when it comes to biodiversity, I've heard it said that while a ton of carbon is a ton of carbon, a tree is not a tree.

Sylvain Vanston (10:10):

Well, that is definitely true. A tree is not always a tree and the way you measure, for example, its ability to capture carbon or its ability to harbor by diverse life is quite different. People have to look into water eutrophication. Land use, land occupation, water pollution, air pollution, deforestation, drivers for deforestation et cetera. So we don't yet have a fully material set of KPIs to monitor risks and pressures on biodiversity. However, there are some areas where you can start working on. For example, are my investments contributing to deforestation? And here it's quite clear what are the main drivers of deforestation? It's industries like beef, timber, palm oil, soy that are the main drivers of deforestation and it's occurring in a handful of countries.

Sylvain Vanston (11:11):

So you can start by looking at your exposure to those sectors and those countries, and you start to have a good, at least whether or not you're contributing to deforestation. Deforestation, of course, is a key concern both from a climate perspective and biodiversity perspective. If you want to have a more thorough, comprehensive perspective on the issue, then this is where the TNFD guidelines come into place because it will look at every sector out there. And it will produce guidance for corporates to report on more sophisticated drivers that then companies such as MSCI, for example, can handle and turn into metrics that will be helpful for monitoring or strategic asset allocation. And so on.

Adam Bass (11:56):

Besides biodiversity finance also had its moment in the Senate COP, or was grilled under harsh light depending on your point of view. The main questions were around, of course, the $130 trillion commitment toward net zero efforts. The resulting announcements received a less than enthusiastic response from many. So I asked Simone what was behind that.

Simone Ruiz-Vergote (12:21):

I think because the number just seems to be so big and you don't see necessarily the financial market yet steering clear of fossil fuel assets for instance. And there seems to be a contradiction, but these 130 trillion come from the number of actors that have put their head in the basket and really they having basically said, "We will contribute to this. We want to contribute to achieving net zero." And in the end that's commitment that is far stretched. That comes the second point of critique because it's a net zero by 2050. But by committing to this Glasgow net zero financial alliance, the GFANZ, these institutions, they have actually said, "We will set short-term targets. So they will need to do something fairly soon."

Simone Ruiz-Vergote (13:12):

They also have said, "We will report every year on our targets." And they also have said that they will be ready to having these targets reviewed. And I think all of that will lead to some transparency around the net zero strategy that stands behind these 130 trillion. I think the major message is that there is a whole lot of capital that has been put up for net zero transition with significant commitments when you look at the details of this also called race to zero starting line criteria. There is a pledge, there is a plan. There is going to be publication. The scope is defined. It includes scope three that's very relevant for the financial sector.

Adam Bass (13:55):

And like other industries, this has an impact, not just on the investment companies themselves, but all of their vendors and their customers. So this could have quite a ripple effect, no?

Simone Ruiz-Vergote (14:08):

Yes, there is a whole ecosystem to that. And I think this is really relevant. So if the asset owner goes out there and tells his asset manager, even if that asset manager has not signed up to that alliance that will have that direct ripple-on effect. That also has ripple-on effect for the data providers like MSCI that have to deliver certain quick deliverables in a sense that they need to make sure that their clients can actually commit, sorry, deliver on these commitments. And now over 90 of the founding members have already delivered such short term targets and they have committed to reducing portfolio mission by 25 to 30%.

Simone Ruiz-Vergote (14:48):

And what is interesting maybe is that there are so many different approaches to how to get to net zero. And I think these alliances will play a role in finding a method that allows for the best approach and then sort of best practice approach that will then also lead to a better comparability of these different commitments. Because right now you see that there is so many different ones that it makes it sometimes hard to assess real progress or real success.

Sylvain Vanston (15:17):

I think those net zero commitments under GFANZ are hugely important.

Adam Bass (15:22):

GFANZ is the Glasgow Financial Alliance for Net Zero. The top dog of investment industry alliances Simone was referring to.

Sylvain Vanston (15:31):

And they're not some kind of remote commitment by a bunch of investors, banks, and asset managers and asset owners and insurers for that that will only impact the way they do business. I think it's pretty clear that within a pretty short timeframe, those commitments by the investment community will bite into the way they do business. For example, I've worked a lot on the net zero insurance alliance, at the end of the day, once it is fully launched through a quantitative set of targets for its members, this will change quite significantly. The underwriting terms in the commercial lines insurance industry. This means that if you're a carbon intensive client, the terms of an underwriting will be different than if you are maybe a more climate solutions provider or if you've committed to net zero and you can show how it's done.

Sylvain Vanston (16:28):

This is the same for banks. They will start to rebalance their portfolios. It's already happening for asset owners. When the asset owner alliance, which was, I believe the first net zero alliance was launched, shortly after it's launched, a few months later, it created its own target setting protocol that comes with so-called intermediate targets which means that all of the AOA members now have an intermediate target to reduce the carbon intensity of their portfolios. Usually corporate debt, corporate fixed income, equities and real estate. Sometimes it goes a bit larger than that. And this means that already today, I know for a fact that those asset owners have already started to rebalance their portfolios. So when I say it's going to bite into the way business is being done, it's already the case. It will change the shape of financial services for many years to come.

Simone Ruiz-Vergote (17:24):

The net zero asset owner alliance has been one of the first initiatives to set themselves a target setting protocol. And they also look at this new initiative to see how that can be aligned. And I think interesting here is that they have committed to really a 25% reduction for financial portfolios until 2025. That's in less than three years from now. So that's a very near term target and quite an ambitious one, more ambitious than most governments have committed to. And all of these initiatives also put a lot of emphasis on engaging with the companies in their portfolios. And what you can see is that there is this understanding that reducing finance emissions should not occur at the expense of the real economy. In the end, you need to finance this transition and the money needs to come from somewhere. And that's why just engaging with the companies in your financial portfolio is really important.

Simone Ruiz-Vergote (18:26):

And I've seen that it's difficult. I've seen that firsthand when I worked for an asset owner. But I've also seen that it's oftentimes actually more welcomed than you might expect. So some guidance is welcome. Some engagement is welcome. Some support from the investment community in implementing this agenda. The corporate side is welcome. There was a study by the University College of Dublin and the universities in Belfast and Edinburgh, and they analyzed the 46 members of the net zero asset owner alliance and they could show that only 13 out of these 46 did vote directly on climate related shareholder proposals. Also there were inconsistencies in voting on more ambitious resolutions that called for corporate action to align with the Paris agreement as the shell was actually having this year. And so the study closes by recommending that there is more alignment with the Paris agreement goals in the proper supporting of these asset owners.

Simone Ruiz-Vergote (19:32):

So I think there is room for improvement, but it stays to decide that these net zero initiatives all push and call for this engagement which I think can really make a larger difference.

Adam Bass (19:47):

And yet, Simone continues.

Simone Ruiz-Vergote (19:49):

The financial sector is a few years behind the corporate sector when it comes to sort of the emission inventories and target setting practices. Nevertheless, I think you can see that there is a real appetite in the financial sector to commit to these net zero targets and maybe the commitments don't always understand or fully understand what's really involved in these target setting commitments. So there's actually quite a gap between what's currently practiced and what's required when you enter such a commitment or alliance. And that's where institutions like the science-based targets initiatives come in that offer to develop a methodology to measure progress on such efforts based on scientific science-based emission reduction targets. So you set yourself a certain target and you make sure the target is in line with the latest signs on climate change.

Adam Bass (20:46):

The science based targets initiative is a partnership between a number of nonprofit organizations from the CDP disclosure insight action to the world wildlife fund as well as the UN's global compact. So a pretty impressive pedigree, but what were the actual recommendations?

Simone Ruiz-Vergote (21:07):

So they don't have yet a finite framework out there, but they're sort of consulting the market on the way forward. And they look at it. Basically, they offer three different approaches. For instance, you can look at how your portfolio aligns with net zero transition. You can also measure directly the emissions contained in your assets, so more on an asset level basis, but the ultimate aim should be to allow investors to measure their financial footprint on the mission basis, and then to decarbonize over time. And I think here, what you can see that they provide answers to questions like how should fossil fuels be addressed within such a target formulation. Then there is also a role for the more green assets, the climate solutions. How should that be approached or how should carbon credits come into the picture?

Simone Ruiz-Vergote (22:06):

And they're actually quite conservative here only allowing for carbon credits when you have already reached the zero objective. And then how should the near term target framework be updated? And then the next thing is, of course, you also need to understand how your finance emissions get measured. And for that corporate looks at the greenhouse gas protocol, but such thing, the greenhouse gas protocol has not handled the finance emission question. And for that, there is an industry build initiative, the portfolio carbon accounting framework, PCAF that does some very important groundwork looking at how different asset classes can treated for measuring finance emissions. So you have these two initiatives, basically a bottom up and a top down one.

Simone Ruiz-Vergote (22:56):

The bottom up telling you how to measure finance emissions. That's the PCAF and then the top down one is the SPTI that helps you answer any questions more related to the target setting. Both have consultations out there right now that might be worthwhile looking at because they will probably steer the way investors will handle these questions in the future.

Adam Bass (23:19):

You may have heard Simone mention there, the science based target initiatives view on carbon credits. The carbon markets, putting a price on carbon, along with the idea of carbon offsets. This was part of the Paris agreement in 2015 specifically the carbon market rule under article six of the Paris agreement for those of you keeping a score at home. Article six was adopted in Glasgow this year. After the carbon market had been pretty much dormant for 10 years, the effects of this article's adoption were felt very fast.

Simone Ruiz-Vergote (23:56):

Just after the COP closed, the EU emission trading scheme had its price going through the roof. So there was clearly an understanding in the carbon market that now we have new rules and that they mean tightening, which means we will see a more credible system emerge. So in a sense, governments can now link carbon markets in different countries, but also the private sector has a better access to carbon credits. And as a result of that, the cost of reducing emissions should go down and that allows them for deeper emission cuts. So you basically allow for higher ambition in the implementation phase. And these cost savings can, of course also be used to accelerate any transition measures and pay for some of the costs in the developing world. So I think here we see some real progress, maybe not as glossy and as front page as other announcements, but that can actually make a real difference in the implementation phase.

Adam Bass (25:03):

You mentioned how it brings the price down in terms of reducing emissions. Does that immediately affect individual companies and how they can go about reducing their footprint?

Simone Ruiz-Vergote (25:19):

Well, it does. So for instance, if a company is covered by a mandatory cap in trade, like in the EU, most of the energy intensive company, then you can use these offsets to reduce your own costs of reducing emissions, because you have to reduce a bit less. You use an offset from another country that maybe say 200 tons. That means you have to do less, by 200 tons less. And that reduces your cost depending on the price differential between the carbon you from abroad and the cost of your own emission scheme.

Simone Ruiz-Vergote (25:51):

So I think that's something, but also on the voluntary side, this is something that's an additional cost. So if a company buys voluntary offsets to reduce its own emissions like many of the financial sector industry participants do these days, then this is just an extra cost and they do it because they feel like it a good corporate policy to do it. So they support a mitigation policy somewhere else. So if you're part of a regulated market, it does reduce your cost to be able to use offsets. If you are not, then it's just an additional cost that you do for corporate responsibility purposes.

Adam Bass (26:27):

And in the midst of all this, where does the idea of a carbon border adjustment fit in?

Simone Ruiz-Vergote (26:34):

It's an additional complication. It's an interesting proposition because it was around for a very long time, and I never thought it would really make it, first, because of WTO concerns and compliance. But also because it's quite complicated as trade is complicated. You have exports of one good that comes back as another good, and that is needed again for export and all these processes, how can you possibly put a price on top at the border that is based on the carbon content of the product because that's what it is about? Now, the EU has done now, I think it's now 14 years of cap and trade. So there is a certain price that industries pay that others that are based outside the EU don't pay. So there's a competitive disadvantage of being in the EU and producing out of the EU.

Simone Ruiz-Vergote (27:28):

Now, the idea here is to equalize this price of carbon between the domestic products and imports. And so the EU wants to make sure that their production is not relocating because that is carbon leakage. What's the point? You regulate an industry here, it goes abroad it may emit even more. And so they have introduced this idea of a carbon border adjustment that would only apply as of 2026 in its current form and only for five industries, monad steel and aluminum.

Simone Ruiz-Vergote (27:58):

And I think the idea here is, or interesting maybe to know is that already in 2023, importers may have to report the emissions that are embedded in their goods. So without any financial adjustment, but still this reporting that is currently not and push the button and I have my emission report for all my goods in the value chain that is not there currently. So the first step is actually reporting and disclosure. And the second step would be to put the price on it. And in its current form, I think they've made very, very... We were very careful in formulating it so that it's WTO compliant and might actually really fly.

Adam Bass (28:37):

In the end, what can companies take away from COP26? There are the carbon markets, of course, where a lot of the focus will likely be. The bigger picture though, we have the reaffirmed commitment to limit warning to 1.5 degrees. And there are a number of initiatives like the TNFD for biodiversity or the science-based targets initiative for carbon emissions, both of which are working to set standards for measurement as well as reporting. And as we heard, both are still at the stage where they're looking for input. But in the end, I think Sylvain summed it up well with his message to every company out there.

Sylvain Vanston (29:21):

Well, my first thing would be to say in 2021, if you don't have a climate plan, you don't have a business plan. And by climate plan, I mean something that is aligned with the goals of the Paris agreement. Why is this? Because the Paris agreement is about containing global warming to safe levels. If we exceed the goals of the Paris agreement, then we enter the world of runaway climate change with irreversible damage and it will be a lot more costly and complicated to fix if it can ever be fixed. So my humble advice to anybody would be, be part of that net zero game. Do it seriously, be ready to make a pretty significant effort to do it seriously, but once you've done it, and once you've embarked into that journey, there's no turning back because you'll never regret having contributed to reducing carbon emissions.

Adam Bass (30:19):

That's all for this week. Our thanks to Sylvain, Simone and to all of you for listening. This is actually our last episode of 2021. Yep, Joe and I will be taking a few weeks off to recharge, spend some time with our families and okay, probably do some planning for next year. From everyone in Perspectives, we wish you and yours a very joyous holiday season and a very, very happy new year. Until then, I'm your host, Adam Bass and this is MSCI Perspectives. Stay safe everybody.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.
