ROUND TABLE ON SUSTAINABLE DEVELOPMENT

Integrating Climate Change-related Factors in Institutional Investment

Summary of the 36th Round Table on Sustainable Development[1]
8-9 February 2018, Château de la Muette, OECD Headquarters

Connie Hedegaard – Chair, Round Table on Sustainable Development

The OECD Round Table on Sustainable Development gathered a group of institutional investors, regulators and civil society to discuss emerging practices and challenges among institutional investors to integrate climate change risks and opportunities in their investment decisions, as well as the role of policy makers and regulators. The following reflects views heard at the meeting, which was held under Chatham House rule. The 36th Round Table on Sustainable Development was hosted by the OECD, with support from the European Climate Foundation. The background note for the discussion is available here. Round Table participants were invited to consider the following questions:

1. What are the next steps for institutional investors and investee corporations to overcome barriers to implementing the TCFD recommendations on climate-related financial disclosures and ensure they are effective? How can institutional investors adopt ambitious yet achievable climate-aligned investment strategies and how can organisations such as the OECD support progress?

2. Should regulators and institutional investors support mandatory climate disclosure schemes? If so, how can regulators work towards an international agreement on mandatory climate disclosure?

3. Beyond climate disclosure requirements, what other regulations and policies influence the integration of climate factors by institutional investors? How can regulators co-operate across policy areas, and with institutional investors, to address outstanding policy misalignments?

Main messages

- Despite progress and growing momentum, the integration of climate factors by institutional investors remains insufficient. This is linked to the short-termism of the financial system, capacity or knowledge gaps, data constraints and other practical implementation challenges.
- The recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), designed to encourage companies and investors – especially institutional investors – to integrate climate risks and opportunities, are quickly gaining traction. Their implementation is a strong priority. Better – not more – climate disclosure is needed from investors and corporations as a means for better climate risk management, strategy and governance. Institutional investors can play an important role in influencing the behaviours of investee corporations.
- Several investment strategies are available for institutional investors to adapt their portfolios to climate factors. Further analysis is needed to assess which investment strategies are most effective to achieve climate risk management, or climate impact investing in the real economy. Investors and policy makers need to identify investment opportunities not only in low-carbon energy but also in transport, food and adaptation, including in emerging economies and developing countries.
- Beyond important initiatives such as the European Union's High-Level Expert Group (HLEG) on Sustainable Finance, and targeted domestic policies, there is a clear role for the OECD to act as a standard setter, convener and clearing house for policy ideas. The OECD can help universalise the recommendations of TCFD and HLEG, address implementation challenges and assess policy implications arising from the integration of climate factors in institutional investment.

[1] This summary does not reflect the views of the OECD Secretariat or its member countries. It is prepared under the authority of the Chair of the Round Table on Sustainable Development (RTSD). The RTSD is grateful to the European Climate Foundation for its support.

- To become a useful policy tool, mandatory climate disclosure schemes must be simple and based on clear principles. An alternative approach is implementing voluntary schemes, with the "threat" of a mandatory approach in the future.
- Financial supervisors can play an important role in helping institutional investors to integrate climate factors. A coherent, system-wide approach bridging different policy communities is needed to integrate climate factors in policy frameworks, across policy areas relevant for institutional investors and corporations (e.g. prudential and financial regulations, corporate governance standards, accounting standards and policies for responsible business conduct).

Further points

A need for better – not more – climate disclosure

Participants stressed the need for better and more impactful climate disclosure over more disclosure and reporting. Disclosure was seen as means to an end, not an end in itself. A holistic approach is needed to encourage effective changes in investment strategies, business practices, governance and climate risk management of institutional investors and investee corporations. In particular, disclosure is required not just on performance, but also on strategy. Reporting in the financial sector is not just about providing climate-related information, but also increasing visibility of new behaviours, identifying emerging best practices, and creating incentives to change and act.

The TCFD recommendations were lauded as a good base for momentum. While serving as a framework for better climate disclosure, they are also useful as a business framework and a way for investors, companies, civil society and policy makers to agree on a common approach. Beyond the TCFD, there is a need to align other disclosure frameworks and reporting standards.

Adopting climate-aligned investment strategies and issues with portfolio construction

Different investment strategies are available for institutional investors to adapt their portfolios to climate-related risks and opportunities. Investors can **reduce exposure to carbon-intensive assets** through exclusionary screening and divestment, or **increase exposure to climate-aligned assets** through thematic investment in low-carbon, climate-resilient infrastructure. Several institutional investors have already divested from carbon-intensive assets such as coal. Divestment may not always be effective, however, as it can imply the sale of carbon-intensive assets by climate-conscious investors to investors who are unconcerned by the climate impacts of their portfolios. Alternatively, best-in-class investing in carbon-intensive sectors can avoid these disadvantages associated with divestment approaches, while providing incentives to investee corporations to improve their performance. Active ownership can be another useful investment strategy for institutional investors to engage with investee corporations. Investors and civil society can play a role in changing the behaviours of investee corporations, and accompanying companies in integrating climate factors.

Practical implementation challenges

Improving data, tools and indicators

Participants stressed the **need for enhanced and reliable data and tools** for climate risk analysis and effective strategies. In particular, efforts are needed to: improve the quality of climate-related data and tools across all asset classes, including non-listed asset classes; harmonise data and collect comparable data across sectors, funds and companies; harmonise classifications and taxonomies of green financial assets; develop real stress tests, not only sensitivity tests; and **develop scenario analysis at sectoral and country levels** as a way to explore companies' and investors' choices (including business models, investment strategies and technology options). Additional analysis is needed to further understand the underlying methodologies and assumptions associated with scenario analysis.

Several participants mentioned the **limitations of carbon footprint**, the most widely used metric so far. Additional disclosure indicators are needed to demonstrate that climate-aligned portfolios are less risky than other portfolios, and to compare their financial performance. This will help bridge the gap between long-term financial risk indicators and climate indicators, and to align interests of institutional investors, such as pension funds, and society. A global approach is needed to identify the material impacts of climate-related risks on institutional investors and companies.

Education and capacity building

Education and capacity building are needed not just for investee corporations, but also for smaller, less informed institutional investors. There are large discrepancies in terms of low-carbon investing strategies between large asset owners and other, smaller insurance companies and pension funds. Peer-level engagement of both investors and companies is needed, e.g. to inform asset owners and asset managers about what climate risk analysis and climate scenario analysis entail.

Educating pension fund beneficiaries and consumers of insurance products and services could help increase demand for climate integration by insurers and pension funds. Changing norms and public values, including through financial literacy and education programmes, can create incentives for investors to shift to more sustainable investment.

Leadership from boards and management can also be an important driver of change. Co-operation is needed between CEOs and chairmen to trigger change, as well as internal co-ordination across units within each asset owner and asset manager.

Long-term value creation and impacts on the real economy

Investment chains need to create long-term value. Increasingly, institutional investors want to demonstrate to beneficiaries and clients that their decisions have a positive impact on society and the economy. Yet even when improved climate data is available, investors often face challenges to define standards and impact indicators for low-carbon or sustainable investments, which are important for understanding and communicating the impacts of investments in the real economy. In addition, increasing value for investors requires addressing the real economy issues by pricing externalities associated with greenhouse gas emissions and climate impacts.

There is often **confusion between climate risk management** (i.e. changing portfolio allocation and reducing exposure to certain assets) **and climate impact investing** (i.e. investing to support the real economy's transition to low-carbon, climate-resilient pathways). The former does not necessarily imply the latter – changing portfolio allocation to manage risk does not necessarily reduce emissions in the real economy. The HLEG report makes important steps toward clarifying these two concepts, but additional effort is needed, including from the OECD.

Several participants stressed that beyond the need for improved climate risk management, institutional investors and corporations can contribute to the transition to a low-carbon, climate-resilient economy in ways that are measurable in the real economy. Investment can drive sectoral change, whether through direct investment or government bonds. Impact indicators are needed to track such progress. In the long term, the solution might be to reframe the global climate challenge as one of carbon disposal or carbon management by the global fossil-fuel industry. Participants also mentioned the need to consider the impact of stranded assets on local communities, and to promote job creation opportunities associated with climate change.

Role of policy makers

Policy makers can help institutional investors and other financial stakeholders integrate climate risks and unlock climate opportunities, including by aligning incentives and disincentives with climate goals.

Disclosure schemes

Governments can help inform investors' decisions by setting **climate disclosure schemes** – whether mandatory or voluntary. France's Article 173-VI for instance is designed as a flexible reporting tool to help institutional investors formulate their own climate disclosure approaches, to favour the emergence of good practices. Participants stressed that governments who wish to set up mandatory disclosure schemes should keep the process simple and based on clear principles to avoid the risk of failure.

Should climate disclosure schemes be mandatory or voluntary? On the one hand, it is important to avoid stifling the good will of institutional investors with too much pressure from policy makers and civil society. Mandatory schemes could lead to investors and companies becoming too cautious about what they disclose and treating risk reporting as a dull compliance exercise. What matters is long-term, reliable information on climate risks. For financial markets that are not ready yet for mandatory disclosure schemes, voluntary schemes similar to Switzerland's pilot project can be effective in raising awareness on climate risks, and shifting the burden away from investors to governments. The Swedish Investment Fund Association's new sustainability standard, which complies with Sweden's new legislation for sustainability reporting, is another example of consumer-oriented, self-regulation that can be effective in encouraging such reporting.

On the other hand, initial assessments of Article 173's reporting in 2017 suggest that it has already had significant positive impacts on the disclosure practices of institutional investors, despite outstanding gaps. Voluntary schemes will always be met with resistance from some investors or companies, so mandatory schemes can be useful to ensure reporting is widespread. Mandatory schemes can circumvent the tendency for company boards to not assess materiality when they are required to report what they deem to be material risks without being given further direction on how climate risks may be judged to be material.

Simply the “threat” of mandatory disclosure can also be an incentive. An option could be to implement a stepwise approach, by setting voluntary disclosure schemes as a first step, to gather data, good practices and experience, before implementing mandatory schemes as a second step. What matters ultimately is whether reported companies take responsibility for the reported information, not whether it is mandatory.

Other relevant standards, policies and regulations

The **EU High-Level Expert Group (HLEG) on Sustainable Finance** published its final report and recommendations at the end of January 2018. The HLEG’s ambition was to take a systematic approach and deliver the most comprehensive blueprint for integrating climate and other sustainability considerations into the EU’s financial policy framework.

Disclosure schemes such as France's Article 173 are not the only approach to encouraging climate disclosure. Standard setting, especially in accounting, can also help. **Credit rating agencies** can also contribute to setting standards, and to incorporating climate and ESG data in key performance indicators, despite challenges with inconsistent data. Corporate governance standards and stewardship codes can also support engagement from investee corporations.

Financial supervisors can play an important role in enhancing **scenario analysis** tools and demonstrating them for investors. An example is the Network for Greening the Financial System launched by central banks and financial supervisors during the One Planet Summit in December 2017. Commitments from financial supervisors can send a strong signal to institutional investors and intermediaries like banks.

Policy makers also need to review **prudential and financial regulations**, including to integrate climate risks, and to address possible unintended consequences of Basel III and Solvency II in constraining access to financing for capital-intensive low-carbon infrastructure projects, especially in emerging economies. Some participants argued that the EU's intention to lower capital requirements for banks' lending to green infrastructure would be a first step in the right direction; other options include raising capital requirements for carbon-intensive, "brown" assets.

Policy coherence and **capacity building** are needed to address policy misalignments, break silos across policy areas and bridge knowledge gaps between different policy communities. The HLEG process is contributing to these goals and could usefully be applied to other countries, while recognising specific national circumstances. Efforts are needed to bridge gaps between two sets of expertise – climate change and financial market – in order to integrate climate and sustainability expertise into the financial sector's investment practices and regulations. This is critical to address the clash between short-termism and the longer term perspective.

The HLEG however did not address priorities to align non-financial policies (such as fiscal policies) with climate goals. Though outside the scope of the discussion, participants also expressed the view that policy makers need to set stronger and more coherent climate policies, including by setting carbon prices and reforming fossil-fuel subsidies. This is critical to send coherent signals to investors and corporations, and to give investors the confidence to invest in low-carbon assets, including in emerging economies and developing countries. Policy makers need to address both the investment side, and the enabling conditions for low-carbon investment. Beyond the integration of climate risks, other priorities include setting a taxonomy of green assets and supporting the deployment of pipelines of low-carbon, climate-resilient infrastructure projects. Beyond the core role of the OECD, other international organisations such as the Financial Stability Board (FSB) can play a role, e.g. by incorporating sustainability in the FSB's mandate.

The Round Table Chair's suggestions for future OECD work in this area

Participants expressed strong confidence and trust in the OECD as the organisation best positioned to help institutional investors integrate climate change-related factors. Participants called on the OECD to engage on this issue in a number of ways:

- Act as a global **convener** by providing a neutral platform for dialogue between institutional investors, regulators and civil society, and engaging key stakeholders, including regulators and leaders of pension funds, insurers and asset management companies.
- Act as a **clearing house for policy ideas** and **support evidence-based knowledge sharing** in order to help investors address practical challenges to implementing the TCFD recommendations, identify emerging good practices and provide empirical evidence. The OECD can provide analysis and track progress on climate-related data comparability, scenario analysis and adoption of investment strategies consistent with climate-aligned roadmaps.
- Help to **universalise and contextualise the TCFD recommendation**s across specific countries, sectors or asset classes. The OECD could play a key role in gathering countries' support where the G20 has failed to do so. The OECD can help to harmonise other climate disclosure frameworks (e.g. from CDP, the Climate Disclosure Standards Board and Global Reporting Initiative) and align them with reporting standards, e.g. from the International Accounting Standards Board (IASB) and Sustainability Accounting Standards Board (SASB).
- Mainstream the TCFD recommendations on climate-related financial disclosures **in relevant OECD instruments and standards**, such as the *OECD Guidelines on Multinational Enterprises.*
- Foster capacity building and education among key global public and private stakeholders, including through consumer education and financial literacy programmes.
- Help to **universalise the HLEG process** by examining how to integrate climate factors into financial policy frameworks across policy areas and countries, while taking into account specific national circumstances.
- Clarify the confusion between climate risk management and climate impact investing, and provide analytical tools to assess key priorities and issues for institutional investors to develop each approach.
- Deepen the traditional OECD role of contributing to the "real sector" debate by engaging with policy makers to get price signals right and align investment incentives with climate goals, to rapidly deploy institutional investment in bankable real economy opportunities. The OECD could further identify priorities to transition to low-carbon, climate-resilient pathways across key sectors and countries, for instance by expanding on the integration of climate factors in its *Economic Surveys*.