# From 'ethical crusade' to financial mainstream – is climate change reaching a tipping point for institutional investors?

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***Sarah Barker*** *(Special Counsel, Melbourne) and* ***Maged Girgis*** *(Partner, Sydney) report on international developments that are raising the bar on climate change investment risk management.*

## Fossil fuel exclusions and financial best interests

The issue of 'fossil fuel divestiture' continues to noisily occupy column space in the financial press. Confined by word limits, the debate on point is often simplistic and polar – presented as a binary choice between maximising financial returns, and the environmental ethics of investing in sectors with a significant carbon footprint (primarily through the combustion of fossil fuels).

Consistent with the binary positioning of the debate, the divestment or exclusion of fossil fuel-related assets by institutional investors has largely been explained by reference to 'moral' or 'ethical' grounds. For philanthropic foundations and private endowments (such as the high-profile Rockefeller Foundation), and faith-based or educational institutions (such as the Uniting Church in Australia, Stanford and Oxford Universities) – a decision whether to divest or otherwise can be relatively straightforward, as the interests of their stakeholders are more readily ascertainable. In contrast, open industry, retail and corporate funds and retail investment houses would have difficulty substantiating an 'ethically-based' divestment or exclusion in the absence of a clear mandate in the fund's governing rules or direction from the member corpus, as this may conflict with obligations to prioritise financial interests.

The potential conflict has been steadily eroded in recent times, with the recognition of the material financial risks (and opportunities) associated with climate change. Leading mainstream brokers and advisers such as Citi, Towers Watson, HSBC and Mercer have published reports recognising the risk of fossil fuel asset 'stranding' due to shifts in emissions regulation and renewables technologies. Industry funds including HESTA ($29 billion under management – see here) and Local Government Super ($7.4 billion under management – see here) have announced policies to negatively screen investments in thermal coal (and, for LGS, other 'high carbon sensitive' activities such as tar sands mining and coal-fired electricity generators) based on the best *financial* interests of members. However, no retail or sovereign wealth funds have followed suit. Until now.

Last week, the world's largest sovereign wealth fund, the US$902 billion Norwegian Government Pension Fund Global, announced that it would divest or exclude investments in companies '*who*

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*themselves or through other operations [that] they control base 30% or more of their activities on coal, and/or derive 30% of their revenues from coal*' (see here). Similarly, French insurance giant AXA announced that it would exclude *'mining companies deriving over 50% of their turnover from coal mining and electric utilities deriving over 50% of their energy from thermal coal plants*' (see here). These exclusions policies represent a significant inflection point in the 'fossil fuel divestiture' debate, with both funds making an express link between climate change and their *financial* risk/returns.

## Beyond 'divestiture' – new norms of engagement

The examples set by AXA and the Norwegians do not mean that, overnight, funds should adopt a herd mentality to divest or exclude assets in carbon-intensive industries. Any such knee-jerk reaction would itself be inconsistent with trustees' fiduciary duties. Such a complex issue demands diligent consideration of both portfolio impacts and treatments (from asset allocations to sectoral tilts, engagement, hedging and beyond). Many institutional investors have in fact determined, upon due deliberation, that it is *not* in their beneficiaries' best financial interests to divest from or exclude fossil fuel assets. Often, funds prefer to keep 'a seat at the table', and engage with investee companies on the relevant commercial risks and opportunities.

However, a decision to 'engage' cannot be seen as a passive strategy. The bar on 'active ownership' by mainstream investors is being raised, with leading funds have been increasing pressure on both investee companies and asset managers to proactively manage climate change risks. For example:

- In the current northern hemisphere reporting season, asset owners are engaging with portfolio companies on the topic of climate change at unprecedented rates. More and more, general corporate assurances around 'sustainability', and plans to incrementally reduce operational emissions, are failing to satisfy investor demands. A proactive, substantive approach to climate risk governance is increasingly required – with evidence that its implications for medium-long term strategy have been duly considered and meaningfully disclosed. It is important to remember that this is not just from 'ethical' shareholder activists, but also from mainstream institutional investors whose concerns remain squarely centred on risk and return. In April and May, special shareholder resolutions were passed at the AGMs of oil giants Shell, BP and Statoil requiring them to stress test their forward strategies against potential climate change futures endorsed by the International Energy Agency. Notably, these resolutions were passed with a resounding majority of 98.3, 99.8 and 99.9% of the shareholder vote, respectively. In each case, less than 3.5% of votes were withheld.
- In the United States, a letter co-signed by more than 60 large institutional investors (representing USD1.9 trillion in assets under management) has been sent to the Chair and Commissioners of the Securities & Exchange Commission (**SEC**) (see here). The letter expresses concern that '*oil and gas companies are not disclosing sufficient information*' about '*carbon asset risks*'[1] in their statutory filings with the SEC and requests the SEC to address these deficiencies in direct correspondence with the filing companies.
- In addition to the divestiture actions discussed above, in recent months two of the world's largest institutional investors, the Norwegian sovereign wealth fund and US$305 billion Californian pension fund CalPERS, have announced statements of expectation for portfolio companies

[1] These risks include, but are not limited to, the risk of capital expenditures on high cost 'unconventional' oil and gas projects, increasing global regulation of carbon emissions, and the possibility of reduced global demand for oil in the medium term.

(Norway) and external investment managers (CalPERS) on the integration of climate change issues into standard financial risk assessment processes.

## Conclusion

There is significant momentum behind the recognition of the financial risks and opportunities associated with climate change over current investment horizons.  This momentum is not driven only by 'ethical' shareholder groups but also by leading mainstream institutions who are proactively engaging with these associated valuation, risk management and disclosure issues.  Arguably, this represents a tipping point that trustees would be ill-advised to ignore.

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