Asset owner conversations

Date: 23 and 29 November 2021

Topic: Innovations in managing climate transition risk

Participants:

Mark Atkinson – Alliance Trust
Shweta Arya – OP Trust
Helen Jones – LifeSight
Tessa Calligeros – Queensland Investment Corporation (QIC)
Jeroen Rijk - PGB Pensioendienste
Brian Kilpatrick – HSBC Bank Pension Trust
Kim Farrant – HESTA
Helen Christie – Univest
Jas Chumber - Univest
Adrian Troller – TCorp
Stuart Smith – BT Pension Scheme Management (BTPS)
Craig Baker – Willis Towers Watson (WTW)
David Nelson – WTW
Roger Urwin – Thinking Ahead Institute (TAI)
Paul Deane-Williams - TAI
Marisa Hall – TAI
Ruth McDonald - TAI

Agenda:

- Roger Urwin: Discussion framing – Asset owners (AO) challenge to integrate climate thinking, TCFD top-down considerations and six key metrics for a climate dashboard
- Craig Baker: What is Climate Transition Value at Risk (CTVaR)?
- David Nelson: Innovations in climate metrics and CTVaR
- Freeform discussion and wrap-up

Discussion framing

- Roger started the conversation by outlining how climate change is impacting AOs, and what the portfolio opportunity looks like. Systemic risks (unhedgeable and undiversifiable) are increasingly a factor in our future. But policy responses are adapting slowly and climate data is maturing unevenly

Measurement

- Climate metrics are challenging. Factors include system transition (free rider opportunities), mandate changes, stewardship, climate solutions and de-risking
- Transition risk is a significant component because it represents a financial risk for AOs

CTVaR measures climate transition risk

- Decarbonisation metrics are only partially useful in relation to real-world outcomes. (e.g, they could prevent investment in carbon-intensive climate solutions). There is very little correlation between carbon footprint and financial risk
- CTVaR measures the value lost (or gained) during the transition to a low-carbon economy and is the methodology used behind the Climate Transition Index (CTI).

- **How CTI works:**
  - Uses data already available to portfolio managers and equity analysts (e.g. financial statements, asset level capex and operating costs, commodity and product supply curves, product margins, sector level competition models, and emissions levels including scope 3)
  - Measures what would happen to different commodities and companies under different climate-transition scenarios; then the difference between current market value and projected value under each scenario, based on the present value of free cash flows that underpin a company valuation
  - A simple, low-cost approach based on assets and strategies currently in place; not potential options in the future
- **Benefits:**
  - Allows governments, corporates, asset managers, investors and society to work together in a more consistent way
  - Goes beyond carbon footprint and expected change in carbon price
  - It assesses forward-looking company transition risk, rather than using historic carbon emissions data
  - CTI focuses on the wide range of changes needed at the systems level in order to drive down GHG emissions consistent with the goals of the Paris Agreement
- **Uses:**
  - Prices in transition risk
  - Challenges active managers
  - Helps companies plan for the climate transition

Round table discussion

- The challenge is to capture complex climate-change data and communicate it effectively
  - A sophisticated investor would work with a dashboard comprising multiple measures, including CTVaR. Retail investors like a single metric but is very challenging to achieve if to be meaningful
- Underlying assumptions when thinking about transition risk:
  - There are several models but currently the main one is based on a carbon budget of 67% remaining below 1.75˚C. Other assumptions include, e.g., dairy consumption reducing by 50% globally
  - Total cost of transitioning *globally* is negligible. More uncertainty on upside than downside of barbell but the transition brings very highly concentrated risks
  - As with any portfolio, all scenarios are balanced against the carbon budget. Not all will be correct but should be taken holistically
- This is one methodology, there are others, with the main aim of getting buy in to the idea of looking beyond carbon metrics
- This method has uses beyond equities, e.g. private equity & physical risk to real assets. But this is more manual and time-consuming
- Multiple metrics are needed, with different importance over time. (See TAI paper on the impact dashboard). Conversations with regulators and governments are ongoing.

Wrap up

- We must get better at measuring, and quickly. In the 1930s, improving reporting took ten years. We now have the same challenge but only 12-24 months to achieve it
- Better engagement is needed but measurement is hard to define. All models are wrong but some are useful
- CTVaR improves transparency and pricing. The challenge is communicating the benefits in a way investors can understand. To move on, we need more consensus around climate metrics.

Appendix

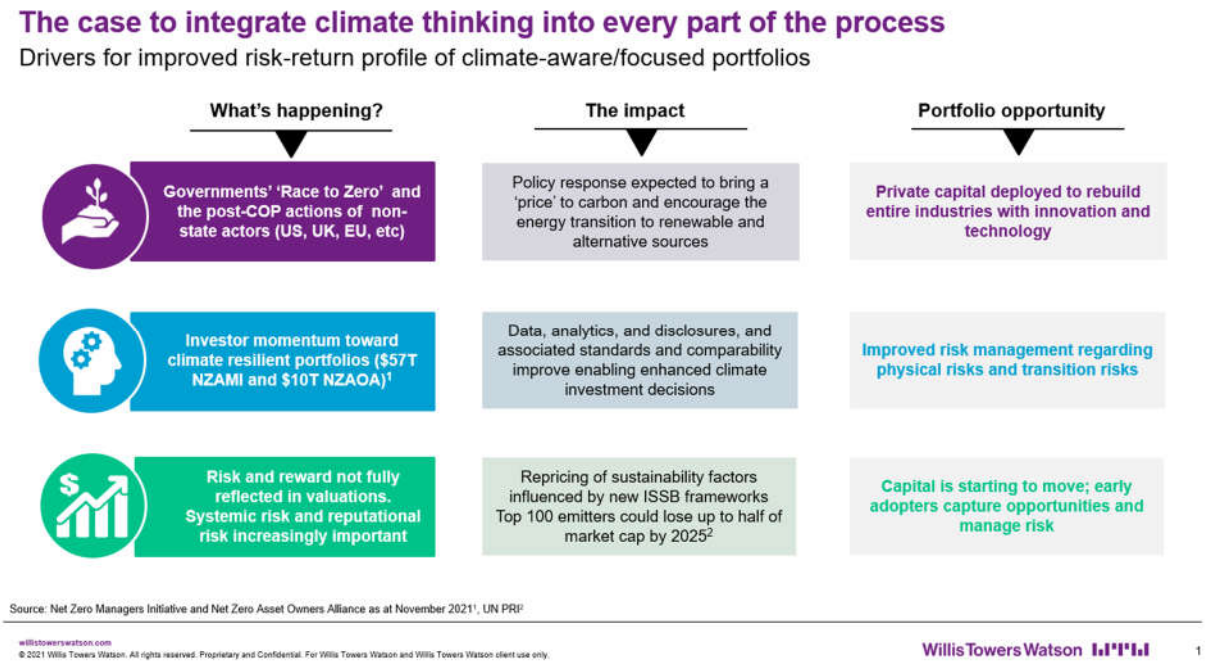
Polling results

1. The major issues that I am experiencing with climate metrics are... (select all that apply)

- Heavy weighting to carbon with limited climate dashboard – 67%
- **Weak standards and standardisation of metrics – 83%**
- **Problems with comparability of metrics across funds – 100%**
- Problems with double counting and non-additivity in metrics – 67%
- Challenge to deal with multiple stakeholders and use cases in metrics – 33%
- Other – 17%

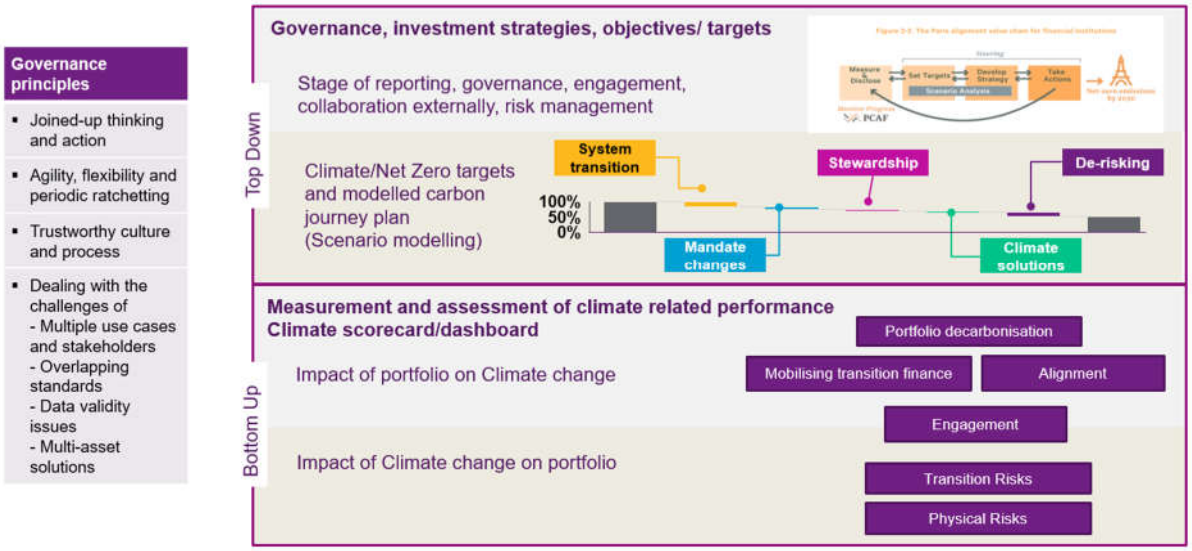
(6 responses)

Slides



How the reporting framework can develop

Example structure of a TCFD / net zero report, with key components

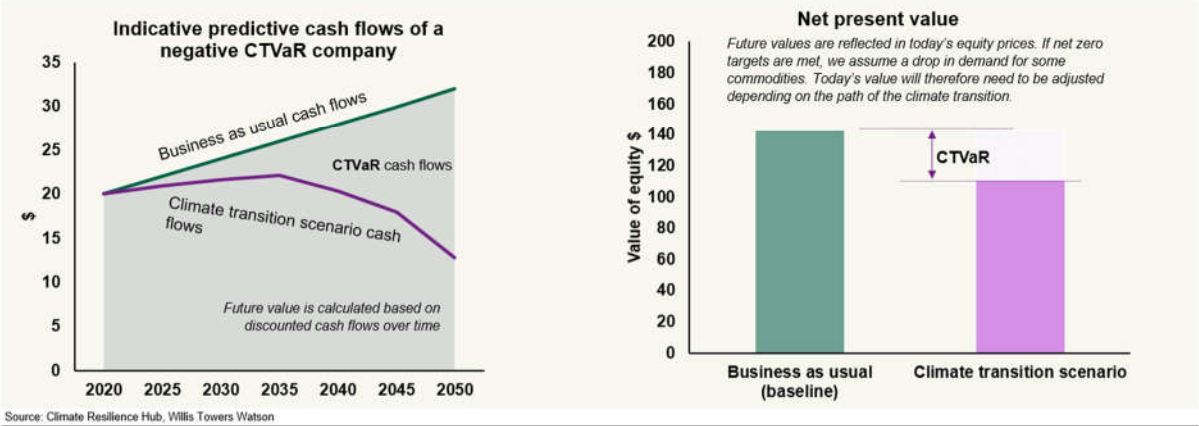


Climate Transition Value at Risk (CTVaR)

The measurement of the value lost (or gained) during the transition to a low-carbon economy

Ability to help:

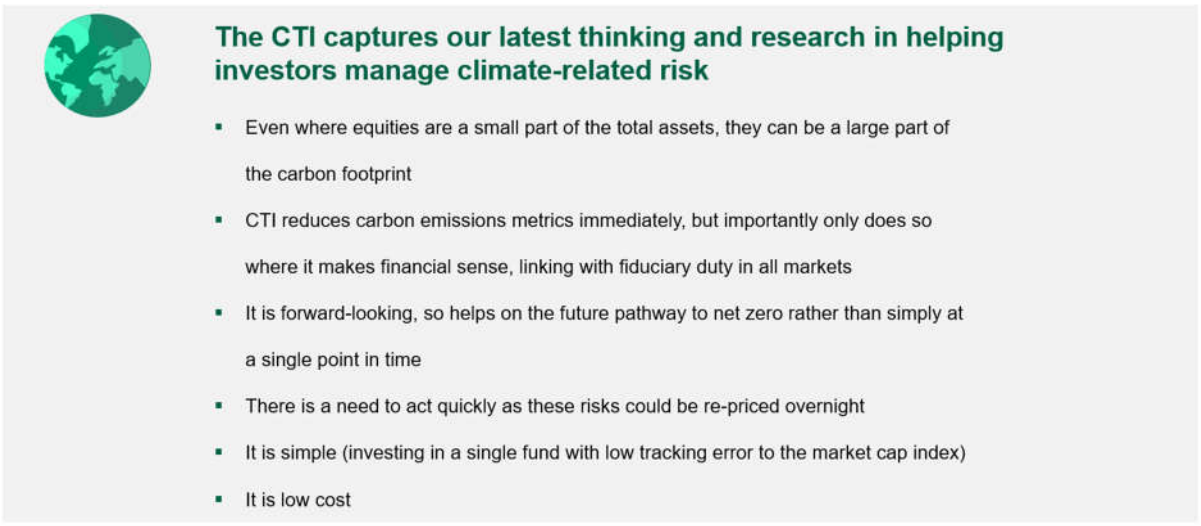
- **Governments** better assess where the climate transition risks are in their economy
- **Corporates** better understand and manage their own risks from the transition
- **Asset managers** better analyse the transition risks of each of their investments
- **Investors** reduce portfolio risks and capitalise on opportunities via the CTI
- **Society** benefit from all of the actions resulting from the above



Source: Climate Resilience Hub, Willis Towers Watson

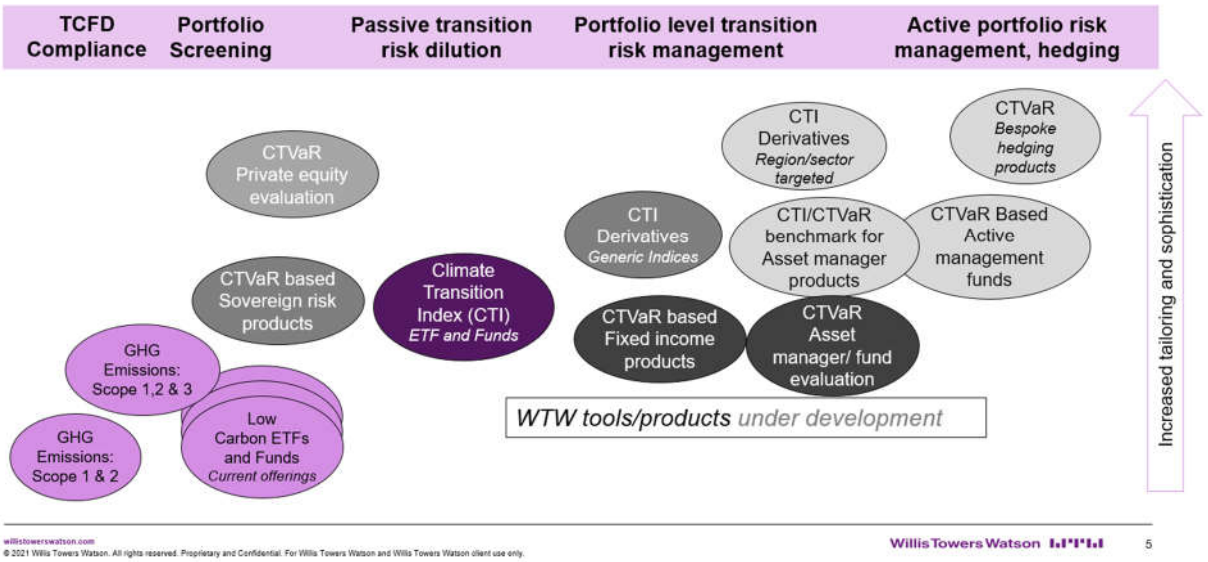
Climate Index (CTI)

How does the CTI help with a net zero commitment?



Innovations in managing climate transition risk

What is the objective?: Transition risk management application



About the Thinking Ahead Institute

The Thinking Ahead Institute is a global not-for-profit member organisation whose aim is to influence change in the investment world for the benefit of savers. The Institute's members comprise asset owners, investment managers and other groups that are motivated to influence the industry for the good of savers worldwide. It has over 50 members with combined responsibility for over US$12 trillion and is an outgrowth of Willis Towers Watson Investments' Thinking Ahead Group.