UNIVERSITY OF CAMBRIDGE
INSTITUTE FOR
SUSTAINABILITY LEADERSHIP

Joint informal meeting of the EU Climate and Energy Ministers

Issues Briefing, Bratislava, 12 July 2016

Session III: 'Sustainable Financing and new governance with a view to achieving the EU's Climate and Energy Objectives'

Key questions to consider

To achieve the EU's climate and finance objectives, Ministers could consider the following questions during their discussions around sustainable financing and governance:

1. What can Member State governments do to facilitate increased long term investment by the financial sector?
2. What can Member States do to reduce climate related financial risk for industry?

Background

The dynamic between business, government and the finance system is of crucial importance. In an appropriately guided economy, business can be the engine for sustainable growth and development and effectively address global challenges such as employment, health and climate change.

Many business leaders are engaging with their peers, politicians and policymakers to turn sustainability and long-term thinking into practice. These leaders note that inequality is rising, ecosystems are being degraded, resources depleted and greenhouse gas levels are climbing. These trends are detrimental to environments, communities, businesses and long-term economic performance.

The Cambridge Institute of Sustainability Leadership (CISL) has created a framework called *Rewiring the Economy*, to lay foundations for a sustainable economy to be delivered by three key groups of leaders: business, government and finance.

Key points of relevance for your Ministerial discussions on 12 July are being set out below.

1. Ensure capital acts for the long term

Short-termism in financial markets has been widely identified as a cause of under-investment, economic inefficiency and poor decision-making by corporations, undermining long-term value creation. CISL's Investment Leaders Group (ILG) report *Taking the long view* sets out a definition for what a long-term investor is and maps out the characteristics of investment mandates that would lead to long-term, responsible investment strategies.

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Key findings:

- **General advantages of long-termism for investors?**
  - A general increase in economic output and efficiency across companies as a whole
  - Opportunity to enhance value creation (including through appropriate levels of capital expenditure) through engagement built on strong relationships with companies
- **Financial performance**
  - Recent research suggests that low portfolio turnover (portion of the securities bought and sold during the course of a year) is a significant determinant of outperformance by active fund managers
  - Research shows that investors hold a security, on average, for only 17 months – not enough to benefit to the full from longer term cash flows

Member State actions:

- Ensure that the Capital Markets Union, the Energy Union and the Circular Economy package promote long-term investment in illiquid assets such as infrastructure, but also in liquid assets such as public equity:
  - assess the opportunity for public pension funds and sovereign wealth funds, long-term investors by nature, to lead by example and implement responsible, long-term investment strategies
  - assess ways investors can monitor, and eventually report, on indicators regarding long-termism of their funds
  - assess the possibility of incentivizing, through fiscal means or otherwise, investments and funds that are sustainable and long-term
- As investing has consequences for society, the economy, and the environment, encourage, and eventually require, the assessment and disclosure of the social and environmental impact of investments and investment funds

2. Pricing capital according to the true cost of business activities

As a global consensus on climate change emerges, it is prudent for investors to consider the effect that carbon and energy regulation may have on company margins. The ILG has worked up two examples of how **scenario-based tools can be used to incorporate environmental risks into financial decision making**, **thereby encouraging more capital to be reallocated to a low carbon society**. *Feeling the heat* measures business risk from carbon and energy regulation and *Unhedgeable Risk* describes how climate change sentiment impacts investment.

Key findings:

Business risks from carbon and energy regulation

- Most investors now understand that their portfolios are exposed to climate risk and seek to understand how plausible carbon and energy regulations might affect the value of their assets
- Impact on sector average margins of plausible carbon regulation can have a significant impact on utility sectors across (three tested) countries and a €45 carbon price has a significant impact across two other energy-related sectors. Financial impact at a company level can differ significantly from sector averages due to technologies and current efficiencies in place. The financial impact can be highly reduced if mitigating action takes place

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Unhedgeable climate risks – how climate change sentiment impacts investment

- Short-term shifts in market sentiment induced by awareness of future climate risks could lead to economic shocks, causing substantial losses in financial portfolio value in the short-term
- Factors, including climate change policy, technological change, asset stranding, weather events and longer term physical impacts may lead to financial tipping points for which investors are not presently prepared
- Changing asset allocations among asset classes, regions and sectors, combined with investing in sectors exhibiting low climate risk, can offset half of the negative impacts on financial portfolios brought about by climate change. The other half can only be addressed by system-wide solutions (e.g. policy or addressing climate change itself)
- While the response to action aimed at limiting warming below 2°C is shown to be negative in its short-term economic and financial impacts, the benefits of early action lead to significantly higher economic growth rates and returns over the long run, especially when compared to a worst-case scenario of inaction

Member States:

- Assure that regulators and investors have a common understanding of climate risk to investment portfolios
  - Encourage the sharing of models and methodologies to incorporate climate risk in investment decision and eventually require the disclosure of climate-related stress testing to regulators
- Simulate the potential impacts of climate policies on company margins and stock prices to anticipate investor reaction, thus increasing the chances of capital flow reinforcing policy objectives (towards a low-carbon economy)
- Ensure that the EU's climate and energy policies reflect necessary technological changes and decarbonisation efforts towards a net zero emissions economy.
  - Take into account the potential (negative) effects of future asset stranding, weather events and longer term physical impacts
  - Enable business and investors to be sufficiently prepared to weather such changes and transitions

For further information please contact

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About The University of Cambridge Institute for Sustainability Leadership

The University of Cambridge Institute for Sustainability Leadership (CISL) brings together business, government and academia to find solutions to critical sustainability challenges. CISL provides the secretariat to the Prince of Wales's Corporate Leaders Group (CLG), the Investment Leaders Group (ILG) and the Green Growth Platform (GGP). Decisions of the CLG, ILG or GGP do not necessarily represent the policies or positions of CISL or of the wider University of Cambridge.

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The Green Growth Platform (GGP) brings together ministers from European governments, businesses and the European Parliament to discuss and debate the economic opportunities and challenges involved in the transition to a low carbon, resilient economy. This notable and influential platform is made up of climate, environment and energy ministers from 16 countries, 18 members of the European Parliament and some 40 major businesses.

The Investment Leaders Group (ILG) is a global network of pension funds, insurers and asset managers committed to advancing the practice of responsible investment. It is a voluntary initiative, driven by its members, facilitated by the Cambridge Institute for Sustainability Leadership (CISL), and supported by academics in the University of Cambridge.

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