



UNEP **Finance Initiative**
Changing finance, financing change

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UNEP FI Investor Briefing

A document of the UNEP FI Climate Change Advisory Group and Investment Commission

PORTFOLIO CARBON

Measuring, disclosing and managing
the carbon intensity of investments and
investment portfolios

Why now is the time and how to get started



UNEP

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FOREWORD

The new reality that the concentration of carbon dioxide (CO₂) in the Earth's atmosphere has surpassed 400 parts per million for the first time in several million years underscores the urgency of a transition to a low-carbon economy. This transition will require the participation of the global financial sector and will also have tremendous implications for the sector itself. It is in the self-interest of financial intermediaries to start preparing to take action now, rather than later, to prepare for this transition.

Investor action to support the global effort to peak and gradually reduce greenhouse gas (GHG) emissions is needed on several fronts.

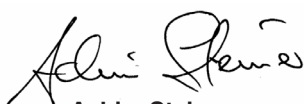
Institutional investment needs to be mobilised on a large scale to close the 'funding gap' for sustainable energy infrastructure, particularly in developing and emerging economies. Mobilising this investment is currently the primary objective of the international agenda as regards institutional investment and climate change, and it is indeed a crucial step on the path toward a sustainable future. The potential role that institutional investors can play in addressing climate change, however, goes far beyond the issue of 'infrastructure finance'. Institutional investors are more than infrastructure financiers: they are owners and creditors of large segments of the global economy.

With this in mind, we need to ask ourselves whether the owners and creditors of the global economy can and should play a driving role in decarbonising it, across all industry sectors, all regions, and all asset classes? And if they can and should, then how? One of the answers to this question is, in our view, to systematically measure, disclose and over time reduce the greenhouse gas (GHG) emissions embedded in global institutional investment portfolios. Ultimately, a decarbonised 'financial economy' will make the decarbonisation of the 'real economy' much more likely and easier to achieve.

Through this Investor Briefing, UNEP FI provides a clear and compelling case for why and how investors and their service providers should start measuring, disclosing and reducing the GHG emissions associated with their investments and investment portfolios. Not only can institutional investors play a catalytic role in the decarbonisation of the economy; increasingly, regulators, policy-makers, investee companies, pension beneficiaries and the public at large are expecting investors to fulfil precisely that responsibility.

The Investor Briefing document is organised as follows. The first two sections present current political, social and economic trends towards greater scrutiny and regulations of GHG emissions. The next two sections detail various ways in which investors can begin to measure and address the GHG emissions embedded in their portfolios, including advantages and obstacles associated with different methods. The document concludes with a short explanation of some of the future work that UNEP FI will undertake to assist investors and other financial intermediaries (FIs) in addressing their financed emissions, as well as a number of case studies on how leading FIs have already begun addressing theirs.

While the briefing is targeted primarily at investors themselves, it will also be of interest to other stakeholders, including policymakers, members of civil society and researchers. UNEP FI hopes that the briefing will serve to inform and to catalyse discussion and innovation on this important topic at various levels - within individual FIs, in the global financial sector and in the broader sustainable development community.



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EXECUTIVE SUMMARY

Why are corporate greenhouse gas (GHG) emissions important to you now more than ever?

- Despite the lack of a global agreement to price carbon, recent data shows that a global landscape of policies and regulation to cap and/or reduce GHG emissions continues to emerge at the national and sub-national levels. These GHG-relevant regulations will increasingly impact the profitability of businesses across various sectors, even when policy development at the global level stagnates.
- Furthermore, the current lack of policy ambition on climate change will likely lead to more sudden and radical policy interventions in the future. The public and political prioritisation of GHG emissions is expected to sharpen as the physical impacts of climate change continue to intensify with increasingly disruptive economic consequences.
- The growing mainstream perception among policymakers, political and economic leaders and civil society is that GHG emissions are among the most important global risk-drivers. Climate change related risks are accepted to have a high likelihood of materialising in the near future with a high economic impact; see, for example, the World Economic Forum's Global Risks 2013 report (World Economic Forum 2013). This conveys the level of priority and political focus that is likely to be put on reducing GHG emissions in the future.

Why should you start measuring and disclosing the GHG emissions associated with your investments?

- Mandatory reporting frameworks are emerging for both companies and investors. These include Grenelle II in France and mandatory carbon reporting for companies listed on the Main Market of the London Stock Exchange. Furthermore, these requirements might expand to the European Union as the European Commission considers requiring retail investment funds to report on their approach to Environmental, Social and Corporate Governance (ESG) issues.
- Civil society organisations are exerting more pressure on institutional investors to be more transparent about the ways in which they are addressing climate change challenges. For instance, following the success of the Carbon Disclosure Project (CDP), the Asset Owners Disclosure Project (AODP) is mobilising pension fund beneficiaries to request further transparency on how their investment agents are addressing climate change.
- Increasing pressure is also arising from companies that are becoming frustrated because they perceive their own carbon disclosure under investor-backed initiatives, such as the CDP, as not having the impact it should have. This perception stems from the fact that the extent to which investors are systematically integrating the data disclosed under such initiatives (to the degree justified by financial materiality) into their investment decisions remains unknown to disclosing companies.

How can you address the GHG emissions associated with your investments and portfolios?

Understanding and identifying costs and risks associated with GHG emissions

- Over the past few years, institutional investors have developed a sophisticated understanding of the implications of climate change and climate change policy for their investments.
- GHG emissions are relevant to investors particularly because they can be a source of two types of financial risk: **i)** regulatory risk, and **ii)** reputational risk. When analysed together, these two risk categories can be jointly referred to as ‘carbon risk’.
- To account for carbon risk, institutional investors need to understand their overall risk exposure through ownership of investee companies and be able to assess changing conditions (for instance: regulatory, physical, demand patterns, etc.) in order to identify sources of risk for companies, sectors and geographies.

Measuring carbon risk exposure and performance

- The carbon risk exposure of a company is a function of two sets of factors: internal (the relative GHG emissions of the activities and business model of the company viewed in a dynamic context over time and normalised to the size of the company and to the sector in which it operates, as well as its marginal carbon abatement costs) and external (primarily, GHG emissions-related policies, regulations, sanctions and incentives, and, secondarily, client sensitivity).
- Meaningful assessment of carbon risk requires that both internal and external factors be considered using qualitative and quantitative tools.
- Qualitative tools can help understand how external factors can increase liabilities for companies, as well as to gain a more comprehensive understanding of the internal characteristics of the company relative to the sector.
- Quantitative tools are necessary to assess company internal factors, such as carbon intensity relative to peers and competitors. They also track changes in carbon intensity over time and assess the contribution of internal factors to carbon risk exposure.
- Carbon footprint analysis is one of the quantitative tools that can be used to better understand how the internal factors of the company can contribute to carbon risk exposure. In GHG accounting terminology, the carbon footprint of a company is referred to as its ‘emissions inventory’ over any given period of time.
- The Greenhouse Gas Protocol, the most widely used international accounting tool for government and business leaders to assess GHG emissions, classifies a company’s direct and indirect GHG emissions into three ‘scopes’: Scope 1 (or ‘direct’) GHG emissions occur from sources that are owned or controlled by the company; Scope 2 GHG emissions occur from the generation of purchased electricity, steam, or heat, consumed by the company; Scope 3 GHG emissions are a consequence of the activities of the company, but occur from sources not owned or controlled by the company.
- For investors and their investment agents, the greatest proportion of GHG emissions by far will be those associated with their ‘investments’; therefore, an important fraction of investors’ GHG emissions will likely be Scope 3 emissions.

Carbon footprint analysis at the company and portfolio levels

- Carbon footprint analysis can be undertaken at two different levels: the individual investment position and the investment portfolio level.
- The approaches differ significantly from a cost/benefit perspective and may serve different but complementary purposes.
- To determine the carbon footprint of an investment portfolio, it is necessary to aggregate the carbon footprint of the individual positions.
- Assessing carbon risk exposure in a comprehensive and accurate way requires carbon footprinting analysis at the investment position level, as both the internal and external factors mentioned above must be considered in tandem for each position.
- However, calculating the portfolio carbon footprint can serve many complementary purposes, including but not limited to: **i)** reporting to clients and beneficiaries; **ii)** monitoring of asset managers by asset owners (some asset owners are already using portfolio carbon footprint analysis to monitor fund managers' integration of climate change considerations into portfolio management); **iii)** tracking carbon efficiency gains at portfolio level over time; **iv)** mandatory and voluntary public disclosure; **v)** carbon risk assessment and management (portfolio footprint analysis can be used to determine differences in risk exposure between similar investment funds).

Barriers to wider adoption of carbon risk assessment and carbon footprint analysis

- Lack of 'materiality' as a result of a lack, to date, of carbon pricing at the international level and uncertainty about its existence in the future.
- Issues around quality and availability of data, including difficulty in comparing GHG emissions data.
- Portfolio carbon footprint service providers seldom offer analysis and interpretation of data that could inform carbon risk assessment and management.
- The cost associated with hiring a service provider to undertake the carbon footprint analysis can be burdensome.

How can carbon footprint analysis be employed to understand carbon risk exposure?

- The carbon risk exposure of a portfolio can be interpreted as a weighted mean of the carbon risk exposures

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