INSTITUTIONAL INVESTORS AND CLIMATE RISK

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Introduction

Climate risk is one of the biggest challenges of our time, swiping through all industries and sectors as it impacts every facet of our world. The repercussions of climate change, manifested through extreme weather events and natural disasters, have resulted in ever increasing financial costs, reaching billions of dollars every year. In the face of escalating environmental threats, the role of institutional investors emerges as pivotal in navigating and mitigating these risks. The urgency is not only attributed to the immediate financial damages coming from natural disasters, but also because of a global shift towards a sustainable, eco-friendly economy.

In fact, climate risk materializes in both direct and indirect dimensions. Physical risk can materialize directly, through their exposures to corporations, households, and countries that experience climate-related disasters, or indirectly, through the effects of climate change on the wider economy through increased default risk of loan portfolios or lower values of assets, something much more complicated to quantify (IMF 2019). Take, for instance, insurance companies that need to revise their contracts due to increasing risks from natural disasters, especially in regions historically thought as low-risk but now facing unprecedented threats. The inclusion of climate risk factors is not only a strategic imperative for financial institutions themself, but also a pressing concern driven by investor demands. The changing perspective of investors, pushing for portfolios weighted towards sustainable investment, marks a shift away from short term strategies. This shift shows a forward looking investment approach aligned with a sustainable economic view. Consequently, financial institutions need to adapt to these evolving investor expectations, making them reconsider established business models, as investors are increasingly favoring enterprises committed to sustainability. Analogous to the choice between Blockbuster and Netflix in the early 2000s, the divergence between those embracing innovation and those resistant to change becomes the main focus. The unique challenges faced by institutional investors, including the need for long-term investment strategies, fiduciary duties, and the integration of environmental, social, and governance (ESG) factors, underscore their significance in the context of climate risk. Unlike individual investors, institutional actors are positioned to drive transformative change by influencing corporate behavior, capital flows, and regulatory landscapes.

Regulatory Landscape

In response to the growing significance of climate risk, regulatory bodies have implemented measures to ensure transparency and accountability within the financial sector, as they now recognize the potential systemic impact of climate change.

In the European Union, for example, the European Banking Authority provided a comprehensive set of reporting requirements being introduced on climate-related information. The reporting templates include qualitative disclosures on environment, social and governance (ESG) risks, and quantitative disclosures on climate-related transition and physical risks. Moreover, the European Central Bank is developing new metrics to measure climate risk in combination with financial risks in bank portfolios, which looks like a glimpse into the future nature of risk management to counter environmental challenges.

Other examples at a national level can be found in France, where the Autorité de Contrôle Prudentiel et de Résolution (ACPR) reports to monitor the climate commitments of French financial institutions, including banks, insurers and asset management companies. In this framework financial institutions have to provide insights on how they incorporate climate change considerations and how they undertake policies to mitigate their carbon footprint, which includes an examination of the climate-related requirements imposed on firms they invest in or engage with as counterparties. (Financial Stability Board, 2022).

What is interesting to see is that financial institutions' behavior is not only influenced by regulations on them directly, but it is also shaped indirectly by regulations inside the economy at a microeconomic level, with environmental requirements to firms, such as taxation on carbon footprint and subsidies on sustainable technologies. In fact we can see that banks behavior is correlated with the regulatory framework around climate risks. It can either be seen from a reallocation of credits toward firms that are negatively impacted by regulations, to help them in the transition, or from a push in lending to firms that can benefit from these environmental regulations (Mueller 2022).

A glimpse into Risk Management practices

While regulatory initiatives lay a robust foundation, the efficacy of risk management practices becomes the most important thing in safeguarding financial institutions from the challenges posed by climate risk. As the financial landscape, not only in terms of regulations, continues to evolve in response to climate-related imperatives, institutions have to adopt innovative risk management strategies to address both environmental concerns and financial stability.

In the face of climate uncertainty, financial institutions started increasingly incorporating environmental, social, and governance (ESG) factors into their risk evaluation frameworks. This broader perspective allows institutions to address not only direct financial impacts of climate-related events, but also the broader implications, also in social terms (image), against them. Several tools have been adapted, for example previous scenario analysis, now conducted to model the potential impacts of various climate-related damages scenarios on their portfolios. This method allows institutions to evaluate their vulnerability to diverse events, from extreme weather to shifts in regulatory landscapes.

Complementing scenario analysis there is stress testing, a cornerstone of risk management, which enables institutions to assess their resilience under drastic economic scenarios. Climate risk stress test aims at evaluating how well banks are set up to tackle climate-related risks in different scenarios that assess physical risks, as well as short and long-term risks coming from the transition to a greener economy (ECB Banking Supervision, 2022). It is important to note that these tests not only include physical risks, caused by extreme weather events, but also transition risk, including regulatory changes and shifts in investor sentiment towards sustainable practices.

As financial institutions navigate this dynamic landscape, diversification, or better, reallocation, strategies can also be an interesting tool for mitigating climate risk. Even though climate risk is likely systematic, so it cannot easily be diversified across investments because of the broad effects it has on companies all over the world, reallocation can still be used to include investments in sectors that are not negatively impacted by climate-related challenges. By identifying sectors susceptible to climate-related disruptions, financial institutions can allocate resources strategically, aiming to both improve portfolio resilience and contribute to broader sustainability goals. Moreover, supporting the transition of companies actively engaged in more sustainable business models, becomes another strategic tool for institutions committed to navigate climate risk. By directing investments toward businesses committed to environmentally responsible practices, institutions not only contribute to a greener and more sustainable global economy, but also potentially gain long-term financial benefits from the transition. This strategic focus on supporting sustainable transitions aligns with the growing trend of socially responsible investing, reflecting a broader commitment to environmental, social, and governance (ESG) principles.

Challenges and Opportunities

While institutions have made clear their recognition of the importance of climate and environmental risks, a comprehensive alignment with supervisory expectations remains a work in progress as it has been reported in the ECB Banking Supervision report of 2021. Although nearly all institutions have developed implementation plans, the pace of progress varies across the industry. Most institutions have laid the groundwork but face challenges in fully incorporating these risks. Incorporating C&E risks into the business environment is underway, with institutions integrating these risks into procedures and policies. However, challenges persist in quantifying the impact on the business environment and fully integrating them into the strategy-setting framework, these are areas where institutions have made limited progress (ECB Banking Supervision, 2021).

In response to the escalating importance of climate-related information disclosure, in 2015 the Financial Stability Board (FSB) established the Task Force on Climate-related Financial Disclosure (TCFD). This initiative came to life after the COP21 Paris Climate Change Conference, with the TCFD tasked with providing recommendations for consistent company disclosures to help financial market participants understand climate-related risks, which would provide consistent, reliable, and clear information about the financial impacts of climate change on businesses, making markets more efficient: “Access to high quality financial information will allow market participants and policymakers to understand and better manage those risks, which are likely to grow with time” (FSB, 2015). Before it fulfilled its remit the TCFD had more than 4000 supporters in more than 100 jurisdictions, all committed to disclosing TCFD-aligned information.

However, as we said previously, the main problem of climate risk is how to quantify it. Companies and institutions can align in how to disclose information to be more transparent, but quantifying climate-related risk is very complicated. Unlike other types of risks, such as financial market risks, climate change presents several complexities. The evolving nature of climate change, its long-term consequences, makes it challenging to rely on historical data and statistics for accurate quantification. Recent extreme weather and natural disasters have shown the impact that not considering climate change as a threat in the past 30 years is having in our economy. Financial institutions, particularly within the insurance sector, are very concerned about these effects. A recent report from S&P Global shows that half of the top 20 global reinsurers are either reducing their natural disaster exposures or decided to maintain them at the same level, despite the fact that the demand is soaring and the premiums keep rising in the sector. The elevated cost of reinsurance for property, attributed to increased losses from climate-induced catastrophes, underscore the financial implications of overlooking climate risks. As large-scale natural disasters grow more frequent because of climate change, the cost of assuming catastrophic risk has increased for large reinsurers companies (S&P Global, 2023).

Moreover, the interconnection of global financial markets exacerbates the challenge. The effects of climate change on economies, industries, and individual companies make it difficult for institutions to understand the full extent of their exposure.

Despite the challenges, institutions have to navigate and address climate risks to be able to unlock substantial opportunities. Integrating climate risk management into strategies improves resilience, those capable of identifying and mitigating climate-related risks are better positioned to survive market shocks and adapt to evolving regulatory landscapes. This would not only be good in terms of financial stability, but it would also improve their reputation among investors and stakeholders who prioritize sustainability and responsible investment practices. Most importantly, embracing climate risk management can confer competitive advantage. As the entire economy shifts towards sustainability, institutions that align their portfolios with environmentally responsible investment can attract a fast growing segment of investors that prioritize long-term strategies. This would not only contribute to positive environmental outcomes but also signals long-term financial sustainability. Institutions that incorporate climate risk considerations into their decision-making processes may find themselves better equipped to navigate a future where environmental sustainability is increasingly connected to financial success, and as we said in the introduction, it is like embracing innovation, reducing the risk of staying too attached to old practices that simply do not work anymore.

For instance, industries vulnerable to physical risks, such as agriculture or coastal real estate, may present challenges, but they also open opportunities for investments in innovative solutions and technologies. The OECD estimates that around $6.9 trillion a year would be required up to 2030 to meet climate and development objectives for energy, transports, buildings and water infrastructures (OECD, 2018). In essence, while climate risk may pose challenges to traditional models, it also presents opportunities for businesses and institutions to align their investments with sustainable practices and support the transition towards a more climate-resilient and environmentally conscious global economy. Financial institutions can play a pivotal role in both managing climate risk and fostering positive environmental change.

Climate action 100+

The capital markets have the capacity to be major agents of change by collectively allocating or restricting capital according to ESG or other related mandates, this assumes that market participants can be equipped with the right tools and incentives to actually exhort that influence. To address climate change, several initiatives have been taken inside the financial markets, led by investors. Climate Action 100+, launched in 2017, is an investor-led initiative to ensure that the world's largest corporate greenhouse gas emitters take necessary action on climate change. The idea is that, since the economy faces systemic risks from climate change, investors have to mitigate their exposure and secure sustainable returns. The primary objective is to ensure that these companies align their business strategies with the goals of the Paris Agreement and contribute to the global efforts to limit global warming. Climate Action 100+ represents a powerful alliance of investors, collectively managing trillions of dollars in assets. By leveraging their significant influence, these investors engage with companies to drive positive change in their climate-related practices. The initiative's approach is collaborative, emphasizing dialogue, engagement, and the establishment of measurable targets to hold companies accountable for their environmental impact. The impact of CA100+ has been substantial, driving companies to enhance their climate-related disclosures, set emission reduction targets, and transition towards more sustainable business models. This proactive engagement has not only influenced corporate behavior but has also fostered a broader cultural shift within the investment community towards prioritizing environmental sustainability (Climate Action 100+, 2024).

However, the landscape of institutional engagement in the initiative has witnessed recent shifts, as the initiative ventured into a new phase. Two of the world's biggest asset managers, JPMorgan Asset Management and State Street Global Advisors, confirmed they were leaving Climate Action 100+. The news comes after the world largest asset manager, BlackRock, decided to scale back its participation. All of this now means that "none of the world's five largest asset managers are fully behind the effort" (Financial Times, 2024). The loss of these big names may weaken the influence that the group has inside the polluting companies. Climate Action 100+ was initially established for a period of 5 years, but the pressing challenges of climate change required an extension, which was signed by investors to continue the work until 2030, the deadline to halve actual emissions to keep global warming under 1.5°C. This extension came with a tougher strategy, which is part of what they called “Phase 2”, to strengthen its members' engagement and accelerate the transformation, with a more active strategy, instead of being passive and mostly informative. The initiative will now focus on really implementing transition plans over mere disclosure, and it has unveiled new goals, mostly enhancements of previous ones, for example now asking companies to not only disclose but to implement robust transition plans and to take action. The heightened expectations also extend to lead investors, who are now required to publicly disclose their identity on the CA100+ website and publish details of their votes on the platform. This move towards transparency aims to improve accountability, especially given the historical lack of approval for shareholder climate resolutions in the previous phase, during which none of the flagged resolutions have ever been approved (Reclaim Finance, 2023).

While Phase 2 strategy signals a more proactive approach, there are still some gaps, the absence of sanctions for companies failing to meet fundamental goals. The initiative, despite its increased active position, refrains from implementing measures such as suspending investments or delisting companies from Climate Action 100+ when some criteria fail to be met. This would be the only way to really push these companies to meet their goals, if they do not want to incur in financial and reputational consequences. The absence of sanctions shows the delicate balance between collaboration and coercion in pushing companies towards a more sustainable future.

The initiative's not so toughened actions are the reason for top investment managers to quit or decrease their involvement in the coalition, which removes around $14 trillion in total assets from it. State Street cites the new phase moves as a “threat to its independence”, but none of the three cited investors have included politics among their motivations, even though there has been growing pressure from Republican politicians over the financial firms membership on these coalitions, as shared action could be a breach of antitrust law (Reuters, 2024). Even though these asset managers left, after the announcement of the new strategy, 60 new firms joined and the coalition now has over 700 investor signatories, together responsible for $68 trillion in assets (Climate Action 100+, 2023).

It is important to note that these big asset managers are probably responding to political pressure due to concerns about their independence, but they are not pulling out of their climate commitments altogether. In fact, according to a statement from JP Morgan Asset Management, the firm has been developing its internal engagement capabilities. JPMAM has also listed Climate Change as one of its six main investment stewardship priorities, which are the one that have the biggest risks and opportunities for investments (ESGtoday, 2024).

So even though it might seem that corporations are doing U-turns on ESG, they continue to consider climate change as one of their biggest threat and opportunity, but when considering the risk of the climate crisis we are living in, it is important that every single stakeholder works together to succeed in this challenge, from the individual investors, companies, institutional investors, regulatory bodies and governments.

Conclusion

The escalating impact of climate change on our world demands urgent and strategic responses, with institutional investors playing a pivotal role in shaping the trajectory of our future. The financial landscape is undergoing a profound shift, driven by the severely growing financial risks posed by climate-related events, and the transition towards a greener economy.

Regulatory bodies, both at national and supranational levels, are implementing measures to ensure transparency and accountability within the financial sectors. The European Union, for instance, as always in the forefront on these themes, has introduced comprehensive reporting requirements, for qualitative disclosures on ESG risks and quantitative disclosures on climate-related transition and physical risks. This regulatory landscape directly influences financial institutions and it is also interconnected with the broader environmental requirements also at a microeconomic level. Despite significant progress, challenges persist in fully incorporating climate and environmental risks into institutional strategies. Quantifying climate related risk remains a complex task, because of the dynamic nature of climate change, surprising us with new consequences and damages year after year. The interconnection of global financial markets further complicated the measurement of the exposure, as we have seen during the global financial crisis in 2008. To address the complexity of climate risk, physical and of transition, financial institutions are improving their risk management practices. Already known tools such as scenario analysis and stress testing are now being adapted to address the vulnerability to diverse climate-related events and regulatory changes.

Institutions now have to manage these risks while also unlocking new opportunities that come from the transition, aligning their portfolios with sustainable practices. An important strategy that is being used is the support in the transition of companies engaged in sustainable business models, as we have seen from the coalition initiative of Climate Action 100+. The problem is that we need much tougher decisions, we need to introduce sanctions and penalties to companies that are not doing enough in aligning with global sustainable goals, only like that we can better quantify the price of not considering climate risk.

In conclusion I want to underscore the importance of institutional investors as architects of capital allocation, they have a responsibility to lead the way in addressing climate risk. Their actions influence corporate behavior, and capital flows, they have to be able to lead the way. In the face of a rapidly changing climate, a collaborative effort involving everyone, from governments to individual investors is mandatory to overcome challenges and find opportunities presented by the climate crisis, as it is part of innovation, and we have always embraced it for centuries. The path forward requires collective commitment to innovation, transparency, and responsible investment practices, ensuring capital flows towards a sustainable future for generations to come.

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