What is Stopping the Finance Sector?

by
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SUMMARY

Focus

The purpose of this panel session is to review the potential impacts of climate change upon the insurance and finance sector, and explore some of the possible responses. This short paper aims to provide some context by describing attitudes towards climate change among institutional investors, and obstacles to an effective response[1]. If these aspects are addressed, measures to counter global warming will be much enhanced.

Current status

Notable positive initiatives on climate change in the finance sector (i.e. institutional investors) include the Carbon Disclosure Project CDP), Institutional Investors Group on Climate Change (IIG CC), Investors Network on Climate Risk (INCR), and UNEP Finance Initiative's Climate Change Working Group (CCWG). However, apart from CCWG, these are all very new. Also, while they have some weighty adherents, they cannot be said to represent mainstream attitudes, or even to have much foothold outside northern Europe. This means that the sector has played little part in the policy-making and corporate-world debate on climate change. This is despite the fact that potentially it has the power to direct corporate industrial strategies either through the terms on which finance is provided, or through engagement with corporate boards. The barriers to active involvement on climate change flow from two sources: firstly, the general way that the sector operates, and secondly from factors peculiar to the issue of climate change.

Modus operandi of institutional investors

In general, the investment market adopts a short-term (up to three years ahead) filter to events, on the (questionable) basis that it is difficult for companies to maintain a competitive edge beyond that, and that beyond that horizon unpredictable events become critical. "Green issues" like climate change are not associated with monetary values inside the horizon, or with reliable economic valuations at any future date, and so are ignored in asset management calculations. This is compounded by a tendency to monitor and reward "progress" excessively frequently. Innovative thinkers are beginning to challenge these assumptions[2], but the autonomous pace of change is slow.

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[1] It is based primarily on research projects carried out by the author for the UNEP Finance Initiative, The Tyndall Centre for Climate Change Research, and the Association of British Insurers in 2002-2004.

[2] World Resources Institute have explored the technique of scenario evaluation for long-term/ uncertain events in the oil and auto sectors. Universities Superannuation Schemes have recently commissioned long-term asset managers following a public competition to encourage new thinking.

The manner in which big investors like pension funds formulate strategies is cumbersome: the lay trustees appoint consultants, who recommend asset managers, who commission research from brokers. This means that the long-term implications for beneficiaries can be overlooked, while short-term, quantifiable objectives are prioritised by the investment professionals. Traditionally also, such "arms-length" funds have adopted the policy that "management knows best" and have not intervened directly in the business strategies of their investees. Recent corporate scandals and misjudgements have shown the danger of a loose rein, but there is still too great a reliance on part-time lay trustees to ensure that proper direction is given to long-term concerns.

The division of responsibilities on bonds and equity investment described above, also occurs for property assets, where the division of roles between financier/owner/occupier/manager creates the same inertia in respect of long-term issues.

It is important to remember also that investment markets go through cycles. Currently markets are in a trough, with major concerns about funding adequacies for statutory liabilities. This means that long-term issues necessarily take second place.

Climate change-related issues

Investors find it particularly hard to deal with climate change, because there is so much uncertainty:-

1. On science, where climate models cannot yet provide consistent projections on key variables like precipitation patterns, ocean currents and storms.
2. On policy, where governments seem only lukewarm towards emissions controls.
3. On technology, where it is unclear how governments intend to achieve the economic transformation that will be necessary to move away from fossil fuels.

The consequence is that investors are unable to evaluate how climate change might impact their assets in different sectors, either directly through extreme events/sea-level rise, or indirectly through regulatory actions to mitigate global warming, and therefore adopt a "wait-and-see" approach. The approach of the EU's Emissions Trading Scheme and Energy Performance of Buildings Directives, and the eventual ratification of the Kyoto Protocol are all reassuring signals, but the lack of clarity for the longer term is more significant. Governments need to invest more in climate science, make rapid progress on the post-Kyoto framework, and adopt adequate and coherent mitigation policies and measures.
The lack of corporate data on climate change (e.g. greenhouse gas emissions, product carbon intensity) makes it difficult for asset valuation research to identify winners and losers at company level. This would be ameliorated if market regulators promulgated standards for disclosure in this area.

Conclusion
Institutional investors are starting to wake up to the issue of climate change, but the sector does not view it as a critical issue. To change this will require major changes in the way that

governments themselves are addressing climate change and also in how market regulators frame their expectations on the way the sector tackles long-term, "soft" issues.

Andrew F Dlugolecki: After graduating in 1973, Andrew worked for 27 years in Aviva (formerly General Accident), the global financial services group, and retired from the position of Director of General Insurance Development in the group world HQ in December 2000. During his career, he became known internationally for his research on climate change and financial services. He was the lead author of that chapter in the Second IPCC (Intergovernmental Panel on Climate Change) Assessment Report in 1995, and the review editor in the Third Assessment Report (2001). He performed similar duties for the official UK reviews of climate change, and chaired two studies of climate change by the Chartered Insurance Institute (1994 and 2001). Recently, he has turned his attention to the implications of climate change for investment markets, and this is a feature of his new study " A Changing Climate for Insurance", published by the Association of British Insurers (June 2004). He is now a Research Fellow at the Climate Research Unit, University of East Anglia, and a director of the Tyndall Centre on Climate Change Research, and the Carbon Disclosure Project, and advisor on climate change to UNEP Finance Initiative. He also consults privately from his home in Perth, Scotland, contactable at:
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