Developing your climate risk management strategy

An introduction to net zero

Since the UK government declared a climate emergency and became the first major economy to commit to reducing emissions to net zero by 2050, sustainability has been rising on many agendas. We are seeing more and more net zero commitments from companies, cities, countries, organisations and investors.

Net zero

Your questions answered

Alongside net zero commitments, we are also starting to see more short-term targets being announced, actions being taken and policy changes taking place to achieve these long-term commitments. The scrutiny on commitments by external groups is also rising – and with it the reputational risk for those making empty promises.

At Barnett Waddingham, we have announced our net zero pledge, as we commit to doing the right thing for now, and over the longer term, to build a sustainable future.

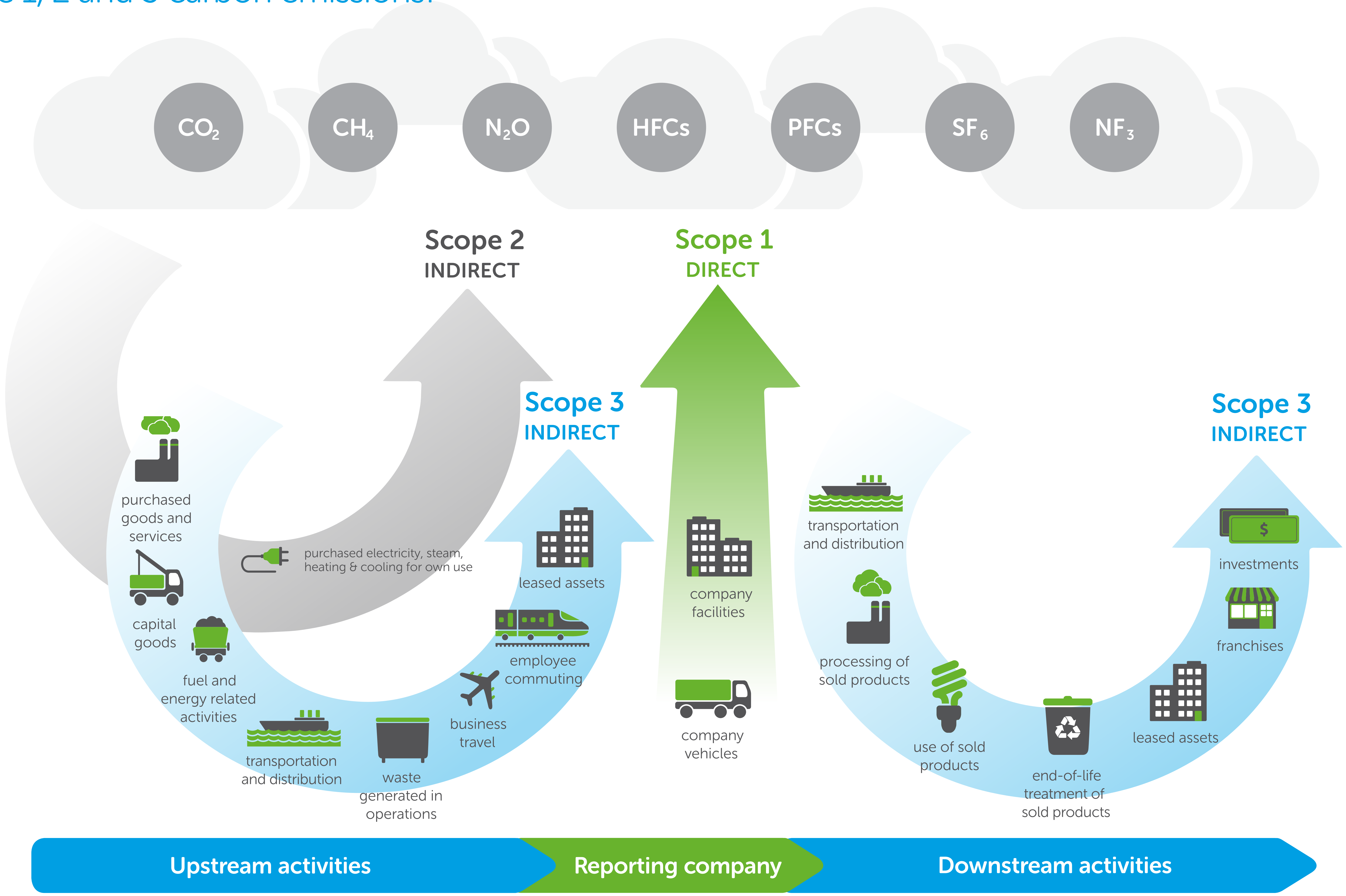
Set out in this document are the answers to some questions aimed at helping you better understand some of the terminology and thinking needed.

What does net zero mean?

Net zero is a target of completely negating the amount of greenhouse gases produced by human activity, to be achieved by reducing emissions and implementing methods of absorbing carbon dioxide and other greenhouse gases (usually expressed as their carbon dioxide equivalents) from the atmosphere.

From an investment portfolio perspective, it is having a position where the emissions (scope 1, 2 and ultimately 3 as well) that are created by the investments you hold (equities, bonds, property etc) are significantly reduced from their levels today, and any that can't be are offset using carbon offsetting.

What are scope 1, 2 and 3 carbon emissions?



Source: GHG Protocol – Technical Guidance for Calculating Scope 3 Emissions

What is the difference between being net zero and committing to net zero?

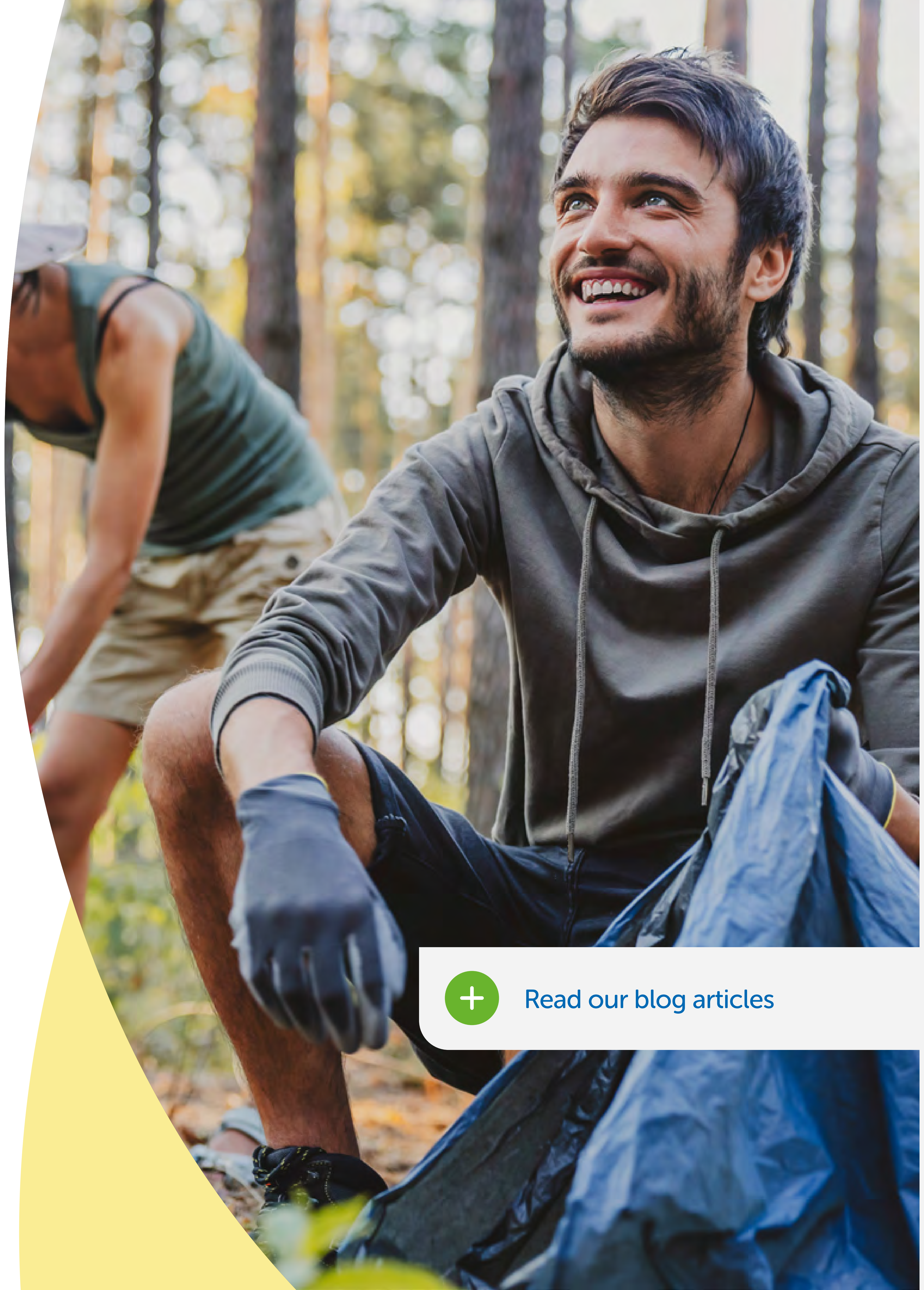
Being net zero means you have achieved the previous definition. Committing to net zero means that the investor will take steps to achieve net zero at some future point.

What date in future is usually used for net zero?

The Paris Agreement targets 2050 or earlier. Barnett Waddingham as a firm have set 2025 as our target. However, extreme care is needed when choosing a date as there are significant differences between what a firm can control, and what an investor can control. This is particularly true for those investors that use pooled funds.

A firm can control the emissions it generates and can control the emissions associated with its supply chain. A pooled fund investor is constrained by the activities of the companies that form the pooled fund.

The difficulty that arises is if an organisation says 'We want to be net zero by 2030', but use a pooled fund where the underlying companies have not made similar commitments, they may struggle to reach their goal. Opposite are links to two great blogs on this area and net zero.



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What are the consequences of making a net zero commitment at an 'early' date?

This is the interesting part. It may look like you are very planet aware and taking a very strong stance. However, it is almost universally recognised the transition to a low carbon economy will require substantial investment. If you do not make any investment to help fund the transition to a low carbon economy (i.e. introduce an impact element to your asset mix) and with it generate positive offsetting reductions in emissions, the consequences of making an early net zero commitment are that you have to make deep emissions reductions early.

From a practical standpoint, this means taking action to dump heavy emitting sectors. This could be seen as leaving it to others to deal with the challenge – typically not the message that is intended.

Is there more to making a net zero commitment today than just saying you are going to try and do it?

No. Not necessarily. But once a commitment has been made, current regulations covering many investors mean it is likely to end up in the public domain. You might expect to be challenged on what you are doing to achieve it.

How do you avoid the challenge that you are making an empty promise?

If this is a concern, then the next evolution of net zero commitments is to set a net zero commitment that is backed by a science-based target. This is a commitment that will see interim targets set, and a maximum residual emissions target in 2050 aimed at limiting the use of carbon offsetting.

SCIENCE-BASED TARGETS

There are two main investment frameworks to assist investors in setting their net zero aims and strategies. These are the:

- Paris Aligned Investment Initiative (PAII) Net Zero Investment Framework Implementation Guide (the "Framework")
- Target Setting Protocol of the United Nations-convened Net Zero Asset Owner Alliance (the "Protocol").

These frameworks set out desirable emissions reduction targets and pathways. However, they also recognise that capital allocation and engagement with the asset providers are also key tools in managing climate risk.

Broadly, they require net emissions to be reduced to around 50% of the level they were at prior to beginning to address climate change (2018-2020) by 2030, and then to reduce them further to see a 90%-95% reduction by 2050.

In this way the use of carbon offsets is minimised and should only relate to the net position that cannot be eliminated completely. This is a simplified description of a science-based target but the use of 'science' is more behind how the 50% and 90% reductions are arrived at, than in the actions needed. It is a strengthening and goal setting approach – and (arguably) will make you subject to more scrutiny in terms of the actions taken, in return for potentially less criticism that you have made an 'empty promise'

For more information, the Institutional Investors Group on Climate Change (IIGCC) Net Zero Investment Framework sets a common set of recommended actions, metrics and methodologies through which investors can maximise their contribution to achieving global net zero global emissions by 2050 or sooner - click here to download the guide.

What happens if I am investing in businesses that actually help reduce the emissions of others?

An example of this type of firm is an insulation manufacturer – it has high production emissions but saves far more through its use. However, you cannot take credit for the emissions avoided in future in your net zero commitment as it stands today.

Is that counter-intuitive, and doesn't it deter investment in some businesses that are addressing the problem? If it stops you investing, then yes. However, the reasoning behind this is to try and avoid double counting of emissions. Remember sustainable investment is about much more than the maths and actions to simply reduce emissions. What is your view on investment opportunities like these, and have you considered how they can be reflected in your investment strategy? What about the timing of making a net zero commitment (rather than the date you want to achieve it by)?

Our briefing note on investment megatrends gives some insight into our views on the opportunities.

Should we be holding off doing anything until the data quality and coverage gets better?

Let's separate the discussion around the measurement and the view of climate scientists in relation to change. There is a strong scientific consensus that the earth is warming and that this warming is mainly caused by human activities (supported by various scientists opinions and surveys). Crucially they also align with the statements made by scientific organisations such as the Intergovernmental Panel on Climate Change.

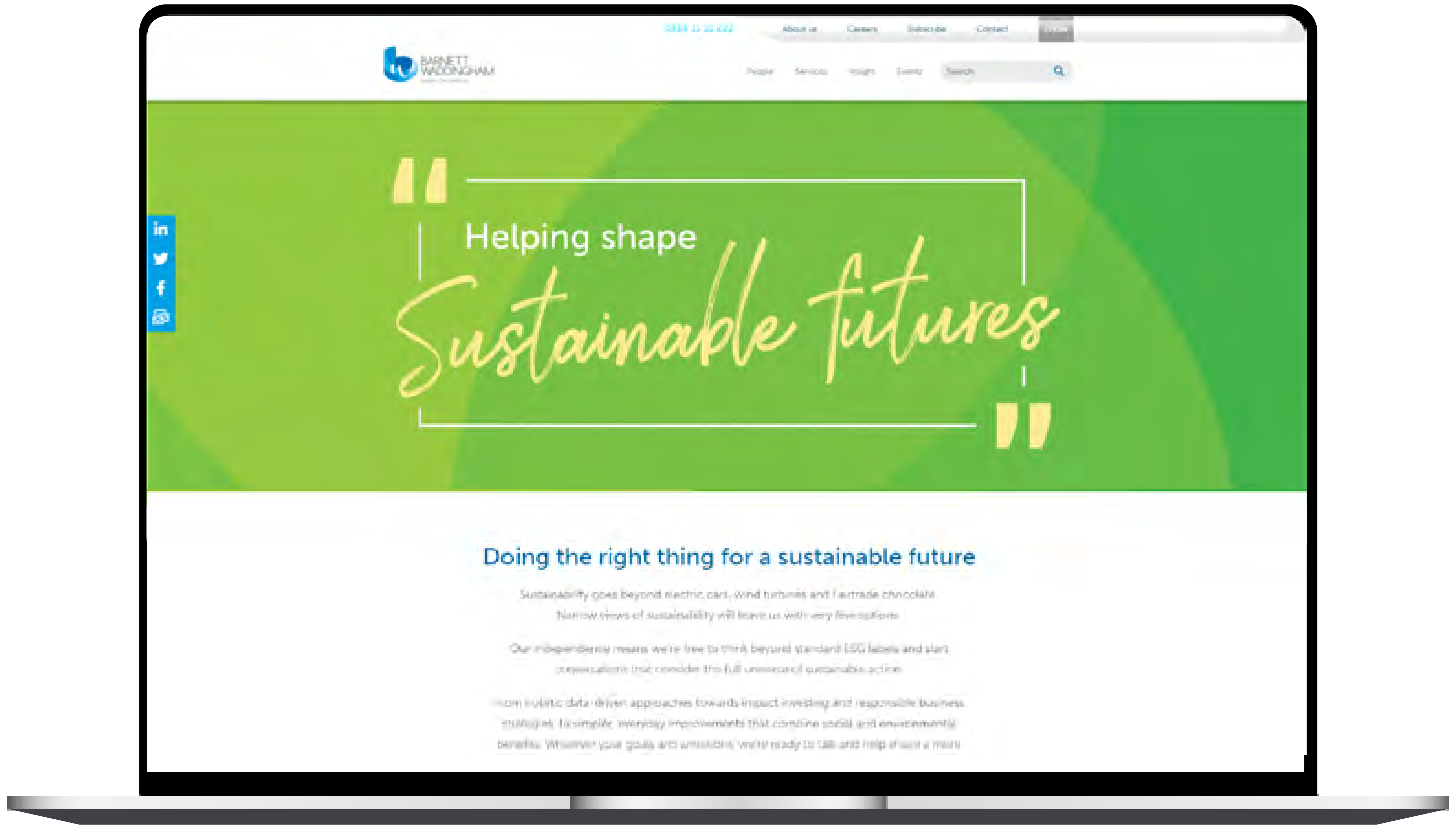
It used to be the case that 84% of climate scientists said they think human-induced warming evidence is taking place. The IIGCC now quote 97%. Is hanging an argument for inaction around a view that climate change hasn't been impacted by humans the equivalent of taking a selfie at the scene of a disaster rather than trying to help?

Yes data measurement does need to improve. But crucially, it is improving. From the discussions we have had with dozens of managers, there is a consensus that the next 3-5 years will see very substantial improvements.

Part of this will be driven by regulations and pressure from the accounting profession. The key is that we know which sectors are the heavy emitters. They will be the heavy emitters regardless of measurement refinement. Taking action to start reducing emissions using the funds available is unlikely to see radical change as measurement improves – although there will be some.

The question then becomes 'If we are not going to start today, when are we going to start?' Remember all those sponsoring employers that are making sustainability comments because they think they 'have to' – does the 'have to' sentiment come from a genuine place of concern for the planet, or because they believe it will be financially and reputationally detrimental if they don't make commitments?

Against that backdrop, what does prudence look like? Have a think – it's a good point for discussion.



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