

IF CARBON FOOTPRINTING IS THE ANSWER, THEN WHAT IS THE QUESTION? ASSET OWNERS' REFLECTIONS ON CURRENT PRACTICE IN CARBON REPORTING

There are expectations on institutional investors (asset managers, asset owners, insurance companies) to report on the carbon footprint of their investment portfolios. These expectations have grown following the ratification of the Paris Agreement and the publication of the final recommendations from the FSB Task Force on Climate-Related Financial Disclosures (TCFD).

A group of European asset owners and their asset managers¹ have met and discussed their experiences with carbon footprinting. The majority of the participating organisations had conducted some form of carbon footprint of their investment portfolios, although in most cases this was been confined to listed equities. Some had also engaged with key stakeholders (beneficiaries, investment managers, governments) on the results of these footprinting exercises.

In this document, building on the experience of investment practitioners who have conducted carbon footprints, we discuss how investors might analyse the climate change and carbon-related characteristics of their portfolios and of specific asset classes. From this we offer a series of practical suggestions to other asset owners, asset managers and other stakeholders on the role that carbon footprinting might play in modern portfolio management.

The views and comments made in this paper reflect these practical experiences and present the common views of the organisations that participated in the discussions².

The participating organisations identified the following areas for future discussion and collaboration:

- Developing the methodologies to assess carbon footprinting across a range of asset classes
- Developing methodologies for dealing with unlisted debt in credit portfolios.
- Developing a footprinting methodology for investors with agricultural land holdings.
- Improving disclosures from private equity.
- Reaching consensus on whether to report emissions by unit of capital invested or unit of revenue generated by the investment, or both.
- Encouraging widespread adoption of the TCFD recommendations and improving corporate disclosures across markets and asset classes, including on Scope 3 emissions.
- Developing further scenario assessment tools and methodologies to help asset owners comply with requirements of the TCFD.

The central conclusions from the discussions were that, while carbon footprinting can offer insights to investors, (a) it requires development and more consensus on points of detail to be a useful tool to support investment decision-making, (b) it may not be the most appropriate tool for assessing carbon related risk in some asset classes, and (c) other KPIs need to be developed to capture the wider spectrum of climate-related risks and opportunities associated with investments.

¹ Those attending the meetings included: AP1, AP2, AP3, AP4, the Church Commissioners, the Church of England Pensions Board, EAPF / Brunel Pensions Partnership, MN, PGGM, RPMI RailPen, TPT Retirement Solutions, USS, and West Midlands Pension Fund.

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CONTEXT

Portfolio carbon footprinting (or carbon analysis) can provide a range of potential benefits to investors. These, depending on the details of the carbon footprint, can include: allowing investors and investment portfolios to be compared, allowing regulators and policymakers to identify systemic risks in investment portfolios, supporting investors' risk management processes, and providing investors with information they need to reduce the greenhouse gas emissions associated with their investments. Footprinting may also allow investors to be held accountable for their climate change performance

However, carbon footprinting also raises some practical issues and concerns: the data may not be current or reliable, current methodologies may not be relevant to all asset classes, the results may not link to recognised drivers of investment value, and the data may be misinterpreted or taken out of context. These concerns are most acutely felt in relation to public reporting given the increasing calls for institutional investors (asset managers, asset owners, and insurance companies) to report on the carbon footprint of their investment portfolios. These expectations have grown following the ratification of the Paris Agreement and the publication of the final recommendations from the TCFD.

This paper covers the following points:

- Why do investors conduct carbon footprinting?
- What are the general issues with carbon footprinting?
- What are the asset class-specific issues with carbon footprinting?
- How might investors work together to address these issues?

WHY DO INVESTORS PREPARE CARBON FOOTPRINTS?

There are three main reasons for investors to prepare carbon footprints:

- To support or inform their investment analysis and decision-making, including risk management, engagement/voting and identifying opportunities.
- To deliver on their responsibility commitments (e.g. as set out in investment beliefs and ESG policies).
- To communicate with stakeholders – including beneficiaries and regulators – about their practices and performance, with public reporting now an integral part of the climate change landscape.

Carbon footprinting can also provide other benefits. Among those identified in the discussions were: building knowledge on climate change (both within the organisation and across the investment system); understanding carbon exposure across an investment portfolio; providing a basis for discussions between asset managers and their clients about how climate change-related risks and opportunities are managed in investment portfolios; and encouraging better disclosures across the investment chain and from the underlying companies and other assets.

WHAT ARE THE GENERAL ISSUES WITH CARBON FOOTPRINTING?

Despite the potential benefits of carbon footprinting, the participants cautioned that carbon footprinting, certainly as currently practiced, has significant limitations as a tool for reporting, for investment decision-making or for company engagement. The following were identified as particular concerns (although participants noted that the significance of these depends on the specific methodology, data sources and data providers used, on the asset classes being assessed, and on the objectives of the assessment):

- Carbon footprints often rely on backward-looking and out of date data.
- Whilst there have been significant improvement in carbon data disclosure in recent years, even in relation to Scope 1 and Scope 2 emissions from listed companies (which have been the most studied and tend to have the best disclosures), significant gaps and uncertainties in the data remain. These gaps and uncertainties make it difficult to rely on these data for investment research and decision-making.
- Disclosure on Scope 3 emissions remains limited, and life-cycle emissions data are not of sufficient quality to allow full life-cycle assessments to be conducted.
- The idea of a “portfolio carbon footprint” suggests that emissions can be aggregated across an investment portfolio (i.e. across asset classes) and summarised in a single numerical measure of performance. This introduces requirements for these data to be comparable and consistent across asset classes. At the current time, this is not practicable nor is it necessarily a useful or appropriate way to characterise an investment portfolio.
- The ‘aggregated’ or ‘total’ portfolio carbon footprint is based on the footprints of individual asset classes, which themselves are based upon a number of estimations and assumptions. The consequence is that the aggregate number does not provide a meaningful measure of performance, and may be spuriously precise.
- Important methodological questions about the attribution of emissions and the relevance of carbon footprint-type metrics in different asset classes have yet to be resolved. For example, how should emissions be attributed between equity and debt (credit) in the same company? Similarly, with real estate, how should emissions be allocated between owners and tenants, and how should the asset class be benchmarked?
- Carbon footprinting only describes one set of attributes of a portfolio. For example, if investors want to assess portfolio exposures to stranded assets, conduct 2^o stress testing or scenario analysis, or assess the adequacy of corporate actions on climate change, they are likely to require additional and/or different tools and data. A similar comment applies to regulators who may be less interested in investors’ Scope 1 and 2 emissions, and more interested in issues such as stranded assets, investors’ management of climate-related risks and opportunities, and financial system resilience and stability.
- The lack of recognition among many stakeholders that carbon footprinting is not suitable for comparing **different** portfolios, although it can be used as a trend indicator for a **unique** or **specific** portfolio.

WHAT ARE THE ASSET CLASS-SPECIFIC ISSUES WITH CARBON FOOTPRINTING?

The group discussed carbon footprinting on an asset class by asset class basis. The aim was to identify the asset class-specific issues with carbon footprinting and to assess both the value of undertaking a footprint for specific asset classes and the value in aggregating or combining asset class-specific footprints into an overall portfolio footprint.

It should be noted that public equities – the asset class where carbon footprinting is most advanced – was not explicitly discussed by the group. However, participants often framed their comments with reference or comparison to the methodologies that have been developed for listed equities. The participants also acknowledged that the general issues with carbon footprinting noted previously are all relevant to listed equities.

Credit (corporate fixed income)

In principle, it should be possible to apply the same data and methods to corporate fixed income portfolios as to listed equities. However, corporate fixed income presents specific challenges:

- The data gaps are significantly greater than for listed equities, in particular in high yield and emerging market debt, and in those companies that are not publicly listed. The participants noted that the data gaps are not confined to carbon emissions and related data but also relate to revenues and to the sectors in which issuers are involved; these are important as they limit the ability to make estimates that would allow at least some of the data gaps to be filled.
- Using enterprise value (i.e. debt plus equity minus cash) as the denominator seems to be the preferred approach when assessing the carbon footprint of fixed income portfolios. There are ongoing questions on how best to attribute emissions across listed equity and fixed income (i.e. across the capital structure), and on whether these emissions are comparable.
- The approach to integrating ESG issues into fixed income investment decision-making is different than that for public equity; there is more focus on downside risk and less opportunity for engagement.
- There is limited information on the carbon footprints of the activities financed by the banking sector. Given that banking represents a large part of most corporate fixed income portfolios, this is a major omission.

Sovereign debt

Sovereign debt is one of the larger asset classes for many asset owners. There appears to be no consensus on how best to assess the carbon footprint of sovereign bonds or the carbon risks associated with sovereign bonds. In relation to the approaches that have been proposed:

- Emissions-based approaches: These raise question such as whether the focus should be on national greenhouse gas emissions (and therefore linked to GDP) or on emissions from government's own activities (offices, transport etc.). Furthermore, there are questions about how a country's emission performance might be assessed (e.g. against the country's NDC's, against a 2 degrees pathway, etc.).
- Risk-based approaches: For example, the assessment could assess the country's exposure to climate change-related risk (e.g. some measure of national resilience, climate vulnerability and readiness, the costs of climate change). However, there are many methodological uncertainties in this sort of analysis.
- Policy frameworks: For example, the focus could be on national policy and regulatory frameworks related to how governments are managing their risks and contributing to global risk reduction efforts.

It is also relevant to note that home bias is important as many funds will be investing in their home country debt given that this is what their liabilities will be measured against. Large parts of such portfolios will be in line with the benchmark (e.g. for a UK fund, the holdings will be UK gilts, and the benchmark will be UK gilts). In that context, whilst the carbon footprinting of sovereign debt may provide carbon data, it seems unlikely to provide much actionable insight into a pension fund's carbon exposure.

Direct assets

Large asset owners are increasingly investing in infrastructure assets such as airports and toll roads. For these assets, there are often relatively few investors and the asset owner may well have a position in the governance structure or on the Board.

While relatively little work has been done in this area, it is likely that it will be easier for asset owners to access climate-related data for such assets. However, carbon footprinting faces a number of practical challenges:

- Due to the limited number of comparators, it is often difficult to make a robust assessment of whether performance is good or not, i.e. benchmarking is difficult.

- There is no consensus on whether the focus should be on life-cycle emissions or on operational/current emissions. Most carbon footprints calculate operational emissions over a defined time period (e.g. the most recent financial or calendar year), although the most significant carbon-related impacts of infrastructure may be in the construction rather than the operational phase.

Real estate

Whether direct or via funds, real estate presents a series of practical challenges. The most significant in the context of reporting is the allocation of responsibilities for emissions between landlord and tenant, or between an owner and a mortgage (or debt) provider. This is a particular problem for the Full Repairing and Insuring leases (FRI), commonly used in the sector. In these leases, tenants have explicit and sole responsibility for energy usage and management, with building owners tending to have limited if any Scope 1 and 2 emissions. While this may be an accurate reflection of responsibilities, it may lack credibility with stakeholders who may not believe that the numbers reported for the landlord's or owner's emissions are a fair characterisation of their emissions. It may also not provide a good reflection of the carbon/climate related risk associated with owning a building. However, reporting on total building emissions does not account for tenants' responsibilities for their emissions (i.e. it introduces an element of double counting).

There is no obvious benchmark for carbon footprints of real estate portfolios. One suggestion was that GRESB could fulfil this role at a global level, and that national bodies (e.g. the Better Buildings Partnership or the Royal Institution of Chartered Surveyors in the UK) could provide country-specific data and benchmarks.

It was also suggested that a better measure of carbon performance may be to report on the energy ratings of buildings in the investment portfolio. This may also provide a (partial) measure of investment risk.

It is also important to acknowledge that other climate-related risks may be more significant for real estate. For example, investors may be more concerned about other risks such as flood risk and building energy efficiency.

Hedge funds

The term hedge fund covers a wide range of investment strategies. This is an asset class that has received relatively little carbon footprinting attention to date. The participants agreed that it would be possible to footprint hedge funds in cases where the underlying assets are long/short equities, although it is not clear how to handle short positions and whether or how any emissions should be attributed to them. Participants also agreed that a footprinting exercise would be more difficult if the fund was investing in other assets, for example, commodities or currencies.

Other issues with hedge funds include the practical issues of developing a carbon footprint or other measure of performance given the rapid turnover in these portfolios, the widespread use of derivatives, the fact that there may not be visibility on the assets in these funds, and the fact that hedge funds tend to be absolute return funds and so lack an obvious performance benchmark.

Participants were clear that any reporting of emissions should deal with longs and shorts separately. However, participants acknowledged that, for risk management purposes, a netted off figure may be more useful. Participants also commented that a wider strategy conversation around portfolio positioning might be more useful than a discussion about the carbon footprinting of the portfolio.

Private equity

The view of the group was that if carbon risk was relevant for public equities then it should also be relevant for assets held in private equity. Furthermore, the methods (carbon footprinting) used for listed equities and fixed income should be generally applicable to private equity.

However, data availability is a major issue. Many companies held in private equity portfolios are not subject to the same reporting requirements as public companies, and as a result do not have carbon data. In addition, private equity GPs have not historically requested that their portfolio companies collect or provide these data. Finally, few asset owners collect the data on portfolio companies required to enable the estimation of carbon footprints. As a result, with a few exceptions, the PE sector in general is not currently in a position to provide these data, let alone in the consistent, comparable way that would be required for a PE portfolio managed by multiple GPs or containing funds of funds or secondary funds with potentially thousands of underlying portfolio companies. The same challenges apply in private credit, an increasingly popular asset class.

MAKING PROGRESS

Investors are increasingly expected to report information on their carbon footprints. For example, the TCFD recommends that investors disclose (a) the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process, (b) Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks, and (c) (for asset owners and asset managers) the weighted average carbon intensity for each fund or investment strategy.

Those involved in the discussions acknowledged the potential benefits of carbon footprinting, but noted that:

- At present investors can only do carbon footprints for Scope 1 and 2 emissions and for certain asset classes (listed equity and debt, direct assets) with any confidence. Scope 3 emissions and other asset classes are a work in progress
- There are open questions about the relevance of carbon footprinting and carbon metrics to sovereigns, hedge funds or real estate.

The participants agreed that investors' decisions on how they manage and report on their carbon performance should be driven by their carbon and climate risk management-related aims and objectives. Within this they noted:

- Despite the data and methodology issues, carbon footprinting can be a valuable exercise that generates useful insights for investment decision-making and for engagement, as it helps identify areas where there may be carbon hotspots.
- Investors should explain why carbon footprinting is not the right tool for specific asset classes or for their investment portfolio.
- The carbon risk in an asset class tends to be specific to that asset class. It therefore makes sense to both benchmark and report on an asset class by asset class basis.
- The consolidation of an asset owner's asset class-specific carbon footprints into a single aggregate number has little meaning. Double counting is a particular issue especially if the aim is to report a number that represents the aggregate carbon emissions associated with the portfolio. Double counting is seen as less of an issue if the aim is to manage carbon-related risks (as some risks will crystallise across asset classes).
- The risks related to emissions are just one dimension of the wider risks presented by climate change to investment portfolios. Others include energy costs, the transition to a low carbon economy, adaptation and physical risk.

- As a general rule, Scope 1 and Scope 2, and Scope 3 emissions should be calculated and reported separately. Similarly, investors may report offsets or positive impacts but these numbers should be reported separately.

The participants identified the following areas for future discussion and collaboration:

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