Carbon Bubble & Divestment

A Report on Fossil Investments in the Austrian Fund Market

Summary

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When the new UN climate deal (“Paris Agreement”) entered into force on 4 November 2016, the international community committed itself, inter alia, to the common goal of keeping global warming to “well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C“. Implementing the climate agreement not only has an impact on the profound transformation of the energy system, but also on many other economic sectors such as the financial markets. Article 2, para 1(c) of the Paris agreement explicitly defines the goal of designing financial flows according to the necessary reduction of greenhouse gas emissions: **“Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.”** An analysis of the various risks showed that the financial industry ought to benefit from an organized transition to a climate-friendly economy, for an **abrupt structural change in the energy sector would also carry significant risk for the financial markets.** The Paris climate agreement assumes that the peak in climate-damaging emissions, and thus the imminent reduction of greenhouse gas emissions, should be achieved as quickly as possible. The later the greenhouse gas emissions decrease, the more abrupt the reduction or volume of the so-called negative emissions is needed to achieve greenhouse gas neutrality. For the use of fossil energies and the relevant market developments this means that an **increase in demand, which is the key assumption for explorations and the development of fossil energy reserves, will no longer be possible in many markets.** In addition to the **physical and the liability risks, this represents one of the key transformation risks** for the financial market.

This analysis provides an overview of the current international developments in the **“Carbon Bubble”** discussion about the risks and climate-friendliness of financial products whilst offering an assessment of the domestic **carbon exposure with the help of an analysis of the mutual funds of Austrian investment companies.** The Carbon Bubble describes how companies are overvalued due to their oil, gas or coal reserves which cannot be economically exploited under the Paris climate agreement conditions. The basis applied is the **“Carbon Budget“**, the maximum volume of CO_2 emissions still available if global warming is to be limited to max 2°C, or to stay under 1.5°C.

The “**divestment movement**” addresses this risk and tries to encourage players in the financial markets – in particular asset owners – **to phase-out investment in fossil energy for ethical reasons,** and to “Divest-Invest“ by investing in promising, climate-friendly areas. According to the latest study by Arabella Advisors, as of December 2016 **already 688 institutional and tens of thousands of private investors, representing a total of at least USD 5 trillion,** have committed to withdrawing from fossil energy investments and not making any profits any more at the cost of the climate. Meanwhile, the list of institutions around the world which have decided in favour of divestment measures has grown long. The **high number of universities, prominently headed by the US University of Stanford** in 2014 with the exiting coal, was joined by the renowned British universities Imperial College London, London School of Economics and the Oxford University fund, followed among others with total divestment by the University of Glasgow and the universities of Stockholm and Copenhagen. In terms of ethical investments and phasing-out fossil fuel, **church organizations are among the most active groups internationally**. Even the Vatican has put divestment on its agenda following the Pope’s **Laudato Si’ Encyclical.** The **Church of England** is among the most prominent examples, phasing out its capital investments in energy generation from oil sands and coal; the Church of Scotland has done the same. The synod of the **protestant churches in Germany** have also agreed on the decision to divest. **Charitable trusts** hold a large share of the assets of those institutions which have committed themselves to divestment to date. Among the best known is the **Rockefeller Family Funds** which divested its shares in coal and oil sands as well as selling its investments in oil company **ExxonMobil**. Other examples include the **Sainsbury Family Charity Trusts (UK)**, Danish KR Foundation, and the LeoDiCaprio Foundation. The **Government Pension Fund of Norway**, the biggest state pension fund in the world, approved a coal divestment strategy and deleted a number of mainly coal and tar sand companies from its portfolio in 2015. A **large number of cities (Paris, Oslo, Stockholm, San Francisco Copenhagen, Berlin and many more**) and now **even a country – Ireland** – have set initiatives towards divestment.

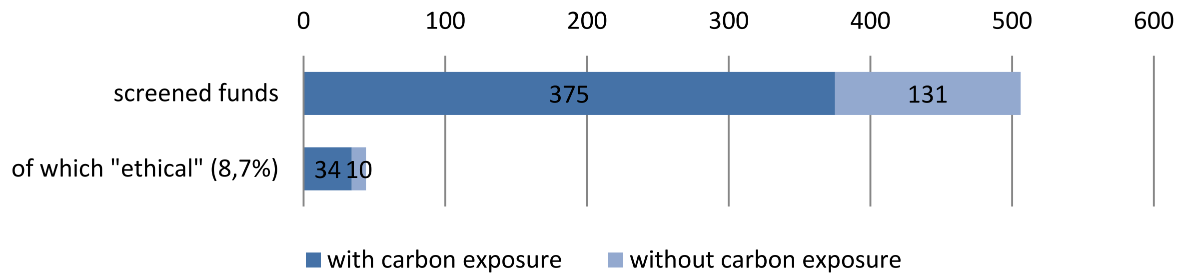
At international level the awareness of risks for investors due to climate change and transformation risks is increasing. A large number of initiatives and players are engaging themselves in this issue. One of the key events triggering this was the speech given by **Mark Carney,** the **Governor of the Bank of England and the Chairman of the Financial Stability Board,** on 29 September 2015. Carney explicitly referred to the dangers of the "Carbon Bubble". In addition to the **"Climate Disclosure Task Force"** which was later established, he proposed stricter **disclosure requirements for companies**, introducing CO_2 prices and performing climate stress tests. For the financial sector the process introduced in 2015 led to **an intense analysis of the risks as well as decarbonization strategies** which includes adequate disclosure and calculation methods to foster transparency, and enables climate-friendly portfolio design. Divestment is only one aspect of this debate. In comparison to other countries such as Switzerland or Germany, an intensive debate on the climate topic arrived rather late in the Austrian financial market. The Swiss study by South Pole and CPSS calculated, for example 2015 **a total of 4.6% of the shares assessed in the study were directly invested in coal, oil and gas companies of the Carbon Underground 200**™. If those reserves stayed in the ground due to climate protection reasons, significant losses in value must be expected. Due to the **importance of the Swiss financial market, the study concluded that action is needed.** For **Germany, as of February 2017,** the first preliminary results of a South Pole Group and partner organization study are now available. Transferring the economic costs of climate change to the financial markets would result in **severe investment losses, especially in oil, gas and coal-intensive industries**. This risk lies particularly in the abrupt adjustment of CO_2 costs. Combined with other risks, this could potentially lead to a destabilization of the financial market. According to the French treasury report "Assessing climate change-related risks in the banking sector", **up to 15% of the capital investments of French banks are exposed to climate-related risks.** In December 2016 the European Commission appointed a **high-level expert group on sustainable finance.** The group comprises 20 policy leaders from civil society, the finance sector and academia. By the end of 2017 it aims to provide recommendations for a comprehensive EU strategy on sustainable finance as part of the Capital Markets Union.

This development is accompanied by several **regulatory initiatives on disclosure obligations and climate protection strategies** at national (e.g. France, Sweden) and EU Level for pension funds, as well as a **multitude of voluntary initiatives** such as the UN Principles for Responsible Investment (PRI), the Institutional Investors Network on Climate Risk (INCR), Carbon Disclosure Project (CDP), Institutional Investors Group on Climate Change (IIGCC), Global Investor Coalition on Climate Change (GIC), Asset Owners Disclosure Project (AODP) and the Climate Policy Initiative (CPI).

In Austria**,** as of 2016, **21 asset managers are offering slightly over 2,000** funds managing EUR 167.1 billion. Of these 1,183 are public funds, and 837 with a discretionary mandate. The mixed funds of which there are 1,100 constitute the largest group, followed by the group of 500 bond funds and approximately 350 equity funds. While the equity funds with a share of approximately 40 percent are internationally the largest group, they have a significantly lower share with 17 percent in Austria.

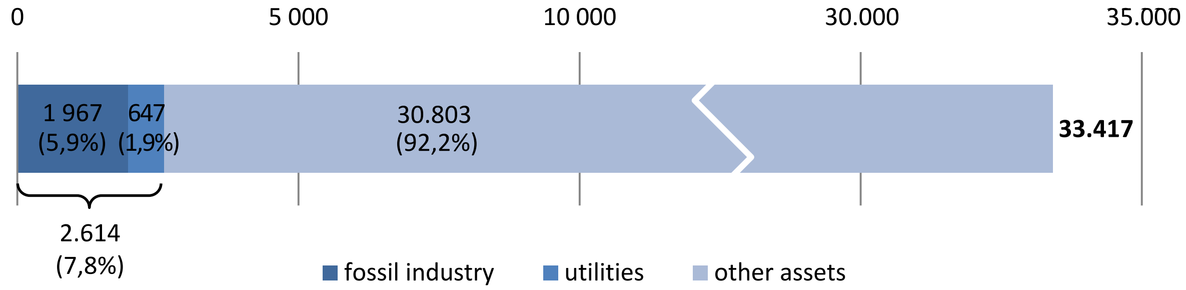
Concerning sustainable investments, the Sustainable Investment Market Report published by the Forum Nachhaltige Geldanlagen (FNG) offers a good overview. According to this report, the **total volume of Sustainable and Responsible Investment (SRI) in Austria reached EUR 10.2 billion in 2015.** At EUR 5.8 billion, public funds account for the largest part of the total volume; EUR 4.4 billion are within "closed" (non-public) mandates. However, at this point it is necessary to understand that a broad range of possible **sustainability criteria is being applied, though hardly any of the funds consider excluding investments in companies with fossil reserves.** Comparing the preferred sustainable investment strategies shows that exclusion criteria are in general clearly favoured: exclusion criteria are applied to EUR 10.2 billion, amounting to almost **100 percent of sustainable funds and mandates.** The **Best-in-Class approach (BIC) and norm-based screening** are used to a slightly lesser extent, although still frequently, at EUR 8.2 billion and EUR 7.9 billion respectively. According to the FNG Market Report, **environmental damage is not among the top ten exclusion criteria in Austria,** in contrast to Germany and Switzerland. In January 2016 the first players from Austria, the Erste Asset Management (EAM) and the VBV – Vorsorgekasse AG, announced to divest within their sustainable funds from companies which make at least five percent of their annual revenues from coal mining. Since 2015 the Austrian subsidiary of Allianz Group completely excludes coal mining in its proprietary investments.

This analysis of the Austrian fund market concerning risky fossil investment and the related financed long-term CO_2 emission effect has focused entirely on the perspective of public funds which are relevant for consumers. **By screening 500 equity, bond and mixed funds** of different sizes and orientation, **approximately one quarter of all investment funds managed by Austrian asset managers and about 40% of the total market volume** were covered. In total, the Assets under Management (AUM) of this sample reached EUR 64.4 billion. The most recent (half) yearly reports of the funds served as the basis for this and other evaluations (valuation as of: 27/6/2015-31/8/2016, with only 23 of the 506 reports referring to valuation dates before 31/12/2015). Forty-four of the selected 506 funds (8.7%) bore names including "responsible", "sustainable", "ethical", "eco" and the like and were therefore identified as "ethical investment funds".



At the time of this analysis around **three quarters of all screened funds were invested in the fossil sector and/or adjunctive industries** and must therefore be considered as "at risk" in terms of the necessary transformation towards a decarbonized economy. Of those 375 investment funds with a "carbon exposure" 248 funds representing AUM of EUR 33.4 billion were analysed in greater detail (funds-of-funds are not included due to complexity reasons): On average, **5.9 percent of these assets were directly invested in coal, oil or gas sector companies, and another 1.9 percent in the suppliers and energy utilities dependent upon them.** Some fund investment products focused on the areas of Emerging Markets, Energy or Commodities had invested up to 100% of their assets in the fossil fuel sector.

In the sample the emissions potential from only the fossil reserves of those companies thus financed adds up to around 128 million tonnes of CO_2 – the equivalent of Austria's current greenhouse gas emissions for a period of 20 months.



The funds which have the largest shares of capital at carbon risk are those which specialize in investments in the energy sector (energy commodities and generation) or in the emerging markets which are heavily represented in those markets (e.g. Russia/Eastern Europe, Turkey, China, India, Brazil etc.). Among the top 30 riskiest funds analysed, 19 had this particular focus.

Of the 44 analysed ethical investment funds 34 demonstrated a carbon exposure as defined above. 33 funds were analysed in detail: Of the total volume of the funds' Assets under Management of almost EUR 3.14 billion, the climate-related risk capital reached around EUR 150 million, or **4.8 percent,** at the time of investigation. Although this keeps the **share of investments in fossil fuel companies (3.4%) or utilities (1.4%)** under the total average for the analysed funds, some sustainable funds, in particular the "ESPA Responsible Bond EM Corp" focused on Emerging Markets with a carbon exposure of almost 18 percent, turned out to be significantly higher. **At the time of investigation only one of the 33 funds had no fossil shares,** 31 were investing in oil reserves, 30 were financing natural gas, and 6 funds were holding coal investments. In total the CO_2 emissions thus financed reached 2.3 megatonnes (compared to 128 Mt for the total analysed fund assets). It is noteworthy that some sustainable or ethical **funds** also held positions in companies including **Lukoil, Oil India, BHP Billiton, Schlumberger, Rio Tinto, Anglo American, Shell, Eni etc.**

This overview and evaluation allow us to arrive at several political recommendations which will be discussed in this paper, including:

- **Creating a database: Carbon risks of the Austrian capital market**

In contrast to Switzerland and Germany, the Austrian government has not yet commissioned a detailed analysis of the Austrian fund market. The goal of such a study is to provide a detailed assessment of the carbon risks in the Austrian capital market, to analyse the role of the state in its own investment strategies, and to heighten awareness of the related transformation risks.

- **Stronger integration of climate targets into sustainability criteria**

The exclusion criteria approach applied by many capital market companies should increasingly focus on climate-relevant criteria such as mining and the generation of fossil-based energy. Excluding the use of coal should be only a first step; in terms of sustainability, the turnover limits for companies active in mining (occasionally 30 %) represent an insufficient measure in particular in the sustainable sector. The much promoted Best-In-Class approach is insufficient where investments into fossil fuel companies continue. The Austrian eco-label ("Umweltzeichen") should serve as a model and decide on a stricter application. (Currently a 5 percent tolerance for coal mining and no explicit exclusion of electricity generation based on coal and thermal power is part of the criteria.)

- **Setting up a fiscal Paris strategy for Austria**

In addition to budgetary and fiscal effects (costs of inaction as well as costs resulting from the transformation itself, e.g. fuel tax), impacts on global financial market developments must also be taken into account. The political level must accompany, drive and help direct the process of incorporating climate-relevant aspects into investment decisions. The target is to achieve a climate-friendly financial system, as defined by the Paris climate agreement: "*Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*."

- **Create transparency – encourage dialogue**

Transparency is an important goal, designed to help investors take trendsetting decisions. While the key role lies with the capital market itself, politics has the task of encouraging stakeholder awareness of climate-relevant aspects and actively contributing to the development of international and national regulations as well as climate transparency initiatives.

- **Design regulations fit for the future**

Based on international initiatives, regulatory measures should be used to increasingly take into account external climate costs. The goal is for capital market players to disclose their climate-relevant data and corresponding strategies. The pension fund directive recently approved by the European Parliament, which demands reporting on climate risks, should give important directions to this effect. The Financial Stability Board's (FSB) proposals must also be taken into account.