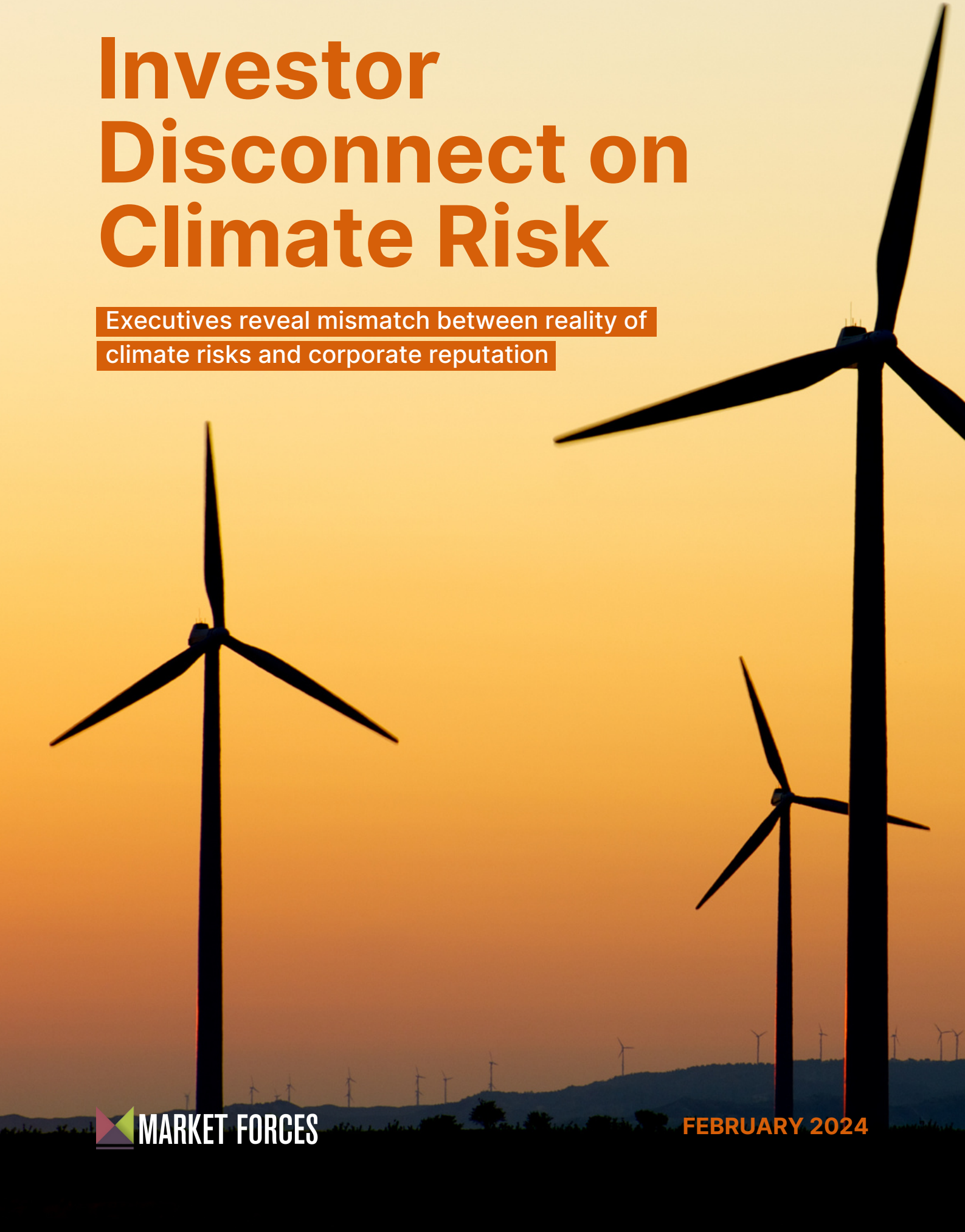
REPORT

Investor Disconnect on Climate Risk

Executives reveal mismatch between reality of climate risks and corporate reputation



MARKET FORCES

FEBRUARY 2024

Summary of key findings

1 Investors are more concerned about reputational risk to their company than the social and environmental impacts of the companies they invest in.

Respondents indicated that reputational risk to their company and client returns influenced their investment decision making the most, while environmental performance and climate change impacts of investee companies were amongst the least influential considerations.

2 Investors are overlooking scope 3 emissions as a key indicator of regulatory and reputational risk.

A large proportion of respondents indicated they largely disregard scope 3 emissions when evaluating investments and respondents were overall far more concerned about government regulation and reputational risk. Scope 3 emissions – those that a company is indirectly responsible for up and down its value chain – are a key indicator of material regulatory and reputational risks, especially for upstream fossil fuel companies. By overlooking scope 3 emissions, investors are failing to fully consider exposure to risks they are most concerned about.

3 The overwhelming majority of investors are personally concerned about climate change.

Overall, 84 per cent of respondents were moderately to extremely concerned, although significantly less so amongst US respondents.

4 Investors' personal views on climate change appear to influence their investment decision making.

Respondents with the lowest levels of personal concern about climate change were also the least likely to incorporate climate risk factors, beyond government regulation, in their evaluation of investments. This suggests some investors are allowing personal bias to dictate their investment decisions by ignoring what is objectively a profound risk to their investments.

5 Investors are overwhelmingly relying on internal modelling/analysis and investee disclosures when assessing climate risk.

By contrast, the International Energy Agency (IEA) and Intergovernmental Panel on Climate Change (IPCC) scenarios modelling and analysis are disregarded by most investors.

Summary of key findings

6 Of those relying on IEA scenarios, investors' base case forecasts were most likely to reflect the Sustainable Development Scenario.

This is consistent with a rapid energy transition that limits the global temperature rise to 1.65°C by 2100 at a 50 per cent probability.

7 Greenwashing and inadequate information from companies on their climate management plans are the main barriers to investors incorporating climate risk more effectively.

8 Investors are equally as willing to use engagement and divestment as tools for responding to climate risks.

About equal proportions of respondents would opt to engage with the investee and to reduce their investment if an investee was found to be facing a high level of climate risk.

Introduction

It is widely recognised that the world must swiftly cut fossil fuel use if it is to avert catastrophic climate change. Institutional investors play a crucial role in this transition due to their vast financial leverage and as the principal owners of some of the world's biggest fossil fuel companies.

Climate risks also have significant potential impacts on investments and portfolios, and the stability of economies. Recognising this, many big-name institutional investors have signed up to initiatives like Climate Action 100+, the Net Zero Asset Managers initiative (NZAM), Net Zero Asset Owner Alliance (NZAOA) and Principles for Responsible Investment (PRI).

However, the extent to which the frameworks developed by these groups are genuinely integrated into real-world investment processes remains unclear, with institutional investors frequently engaging in actions that appear to contradict them. Previous research[1] has found that while investors recognise the importance of climate risks, integrating them at a practical level across the industry is still in its infancy. Market Forces sought to build on this research to better understand how climate risk considerations are currently being applied by institutional investors in practice, and the key barriers to further integration.

In September to November 2023, Market Forces conducted an online survey of 150 investors at some of the world's biggest financial institutions across the UK, USA, Singapore, Japan, Australia, Hong Kong and Belgium, delivered in partnership with NewtonX. Participants were senior decision makers within their company, working at 'c-suite' level – chief executive officer (CEO), chief investment officer (CIO), etc. – through to investment analyst/strategist level (see *Methodology* for details). This report outlines the key findings from the research.

[1] Krueger et al. 2020; Christophers 2019.

> *"This is an important topic which seemed to be losing traction and media attention. The inflationary environment coupled with cost pressures have contributed to waning interest and discouraging investors, governments and public to tackle this important topic as a priority it deserves."*
>
> C-suite respondent, bank, UK

Explore the data
This report discusses the key findings from our research. Visit **www.marketforces.org.au/info/reports/investor-disconnect-climate-risk/** to view a breakdown of the results in this report by company type, job role, region and level of climate concern.

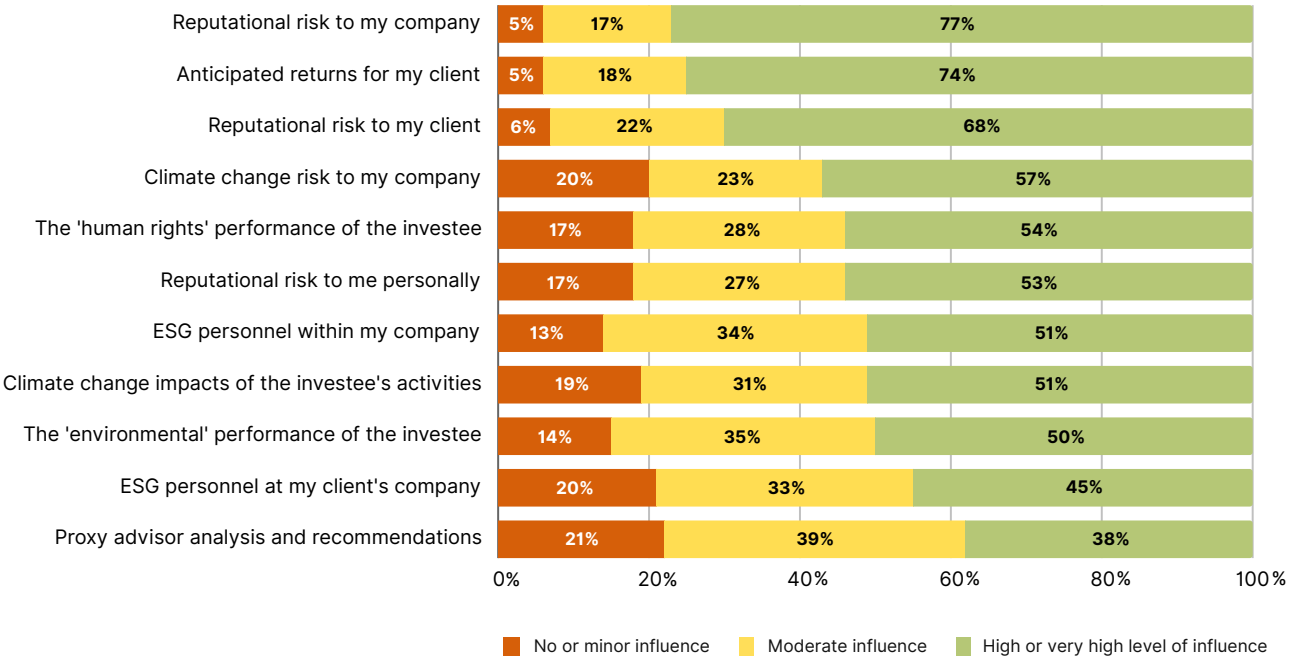
Key findings

1. Investors are more concerned about reputational risk to their company than the social and environmental impacts of the companies they invest in

Respondents were asked about the extent to which different factors, such as anticipated returns and ESG personnel, influence their investment decision making (Figure 1). The results clearly show that investors are generally attuned to climate change risk when evaluating investments, with three in five (57%) respondents indicating it had a 'high' or 'very high' influence on their decision making. However this only refers to climate risk to the investor's own company; the climate change impacts of the investee's activities (such as a coal miner or oil and gas producer) rank much lower as a concern, with just half of respondents viewing it as highly influential. Furthermore, reputational risks (to the investment company and its clients) and anticipated returns to clients still outweighed either of the climate-related factors by a significant margin.

> *Climate risks are largely irrelevant in the HF [hedge fund] investing process save for the opportunities and risks created by the legal, regulatory and political environment around these policies. Fund managers are less concerned about climate risks than they are political/activist pressure. This is almost entirely because climate risks have very little impact on asset performance.*
>
> Fund / portfolio manager, hedge fund, USA

Figure 1: Influences on investor decision making when evaluating investments



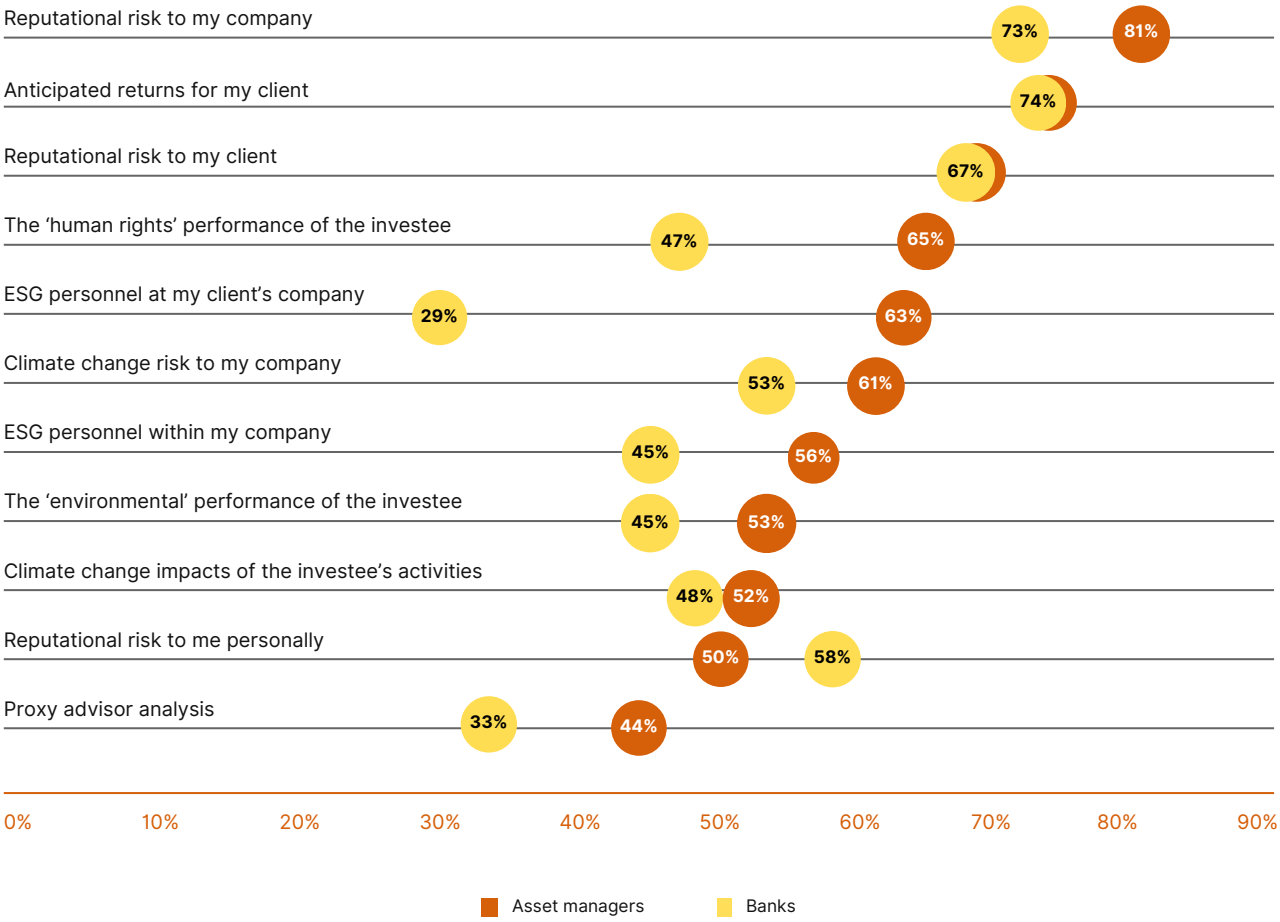
Asset management respondents were more likely than bank respondents to be influenced by climate risk, though the difference was marginal (Figure 2). By contrast, asset manager respondents were significantly more likely to be influenced by the investee's human rights performance, as well as by the ESG personnel at their client's company, compared to bank respondents.

2. Investors are overlooking scope 3 emissions as a key indicator of regulatory and reputational risk

> *Biggest challenge is tying work to financial performance. Shareholders' number one priority is returns.*
>
> Investment analyst / strategist, bank, USA

Results suggest a large proportion of investors are disregarding scope 3 emissions when evaluating investments – one quarter (25%) of respondents reported they 'never' or 'rarely' consider scope 3 emissions when evaluating an investment, while 37% said they only sometimes did this. Only 38% of investors said they consider scope 3 emissions 'often' or 'always'. Yet three quarters of respondents (75%) reported they frequently consider government regulation (Figure 3), indicating this is a major concern for investors, alongside reputational risk (as per Figure 2).

Figure 2: Factors with a 'high' or 'very high' level of influence on investor decision making – by company type



Similarly, when asked what factors indicate a high level of climate risk to an investment, 'insufficient plans to reduce scope 3 emissions' was reported by just 27% of respondents (Figure 4).

Scope 3 emissions – those that a company is indirectly responsible for up and down its value chain – are a key indicator of regulatory, market, reputational and thus material financial risk. Product end-users will be looking to minimise their emissions in response to government regulations and changing market trends as economies decarbonise. By overlooking scope 3 emissions, investors are failing to fully consider exposure to risks they are most concerned about.

> *Any organisation that adds ESG to audit and consulting touch points is considered valuable as they can take a holistic approach.*
>
> C-suite respondent, asset management, Australia

Figure 3: Climate risks considered by investors when evaluating an investment

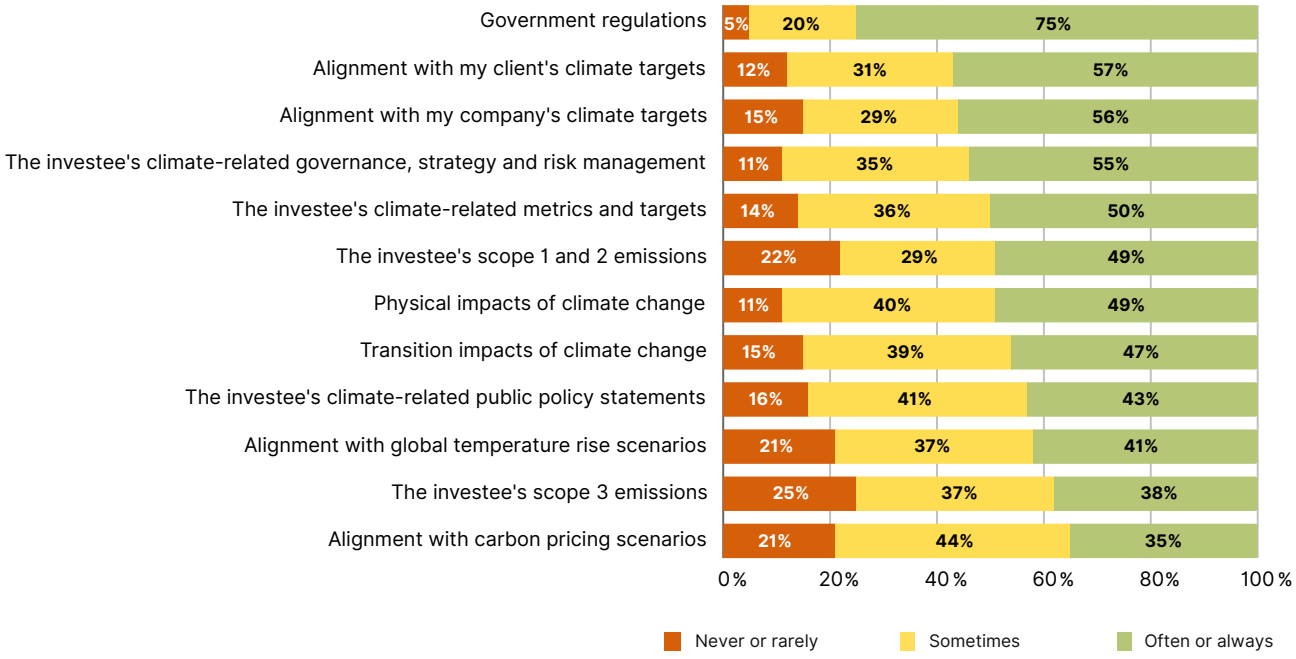
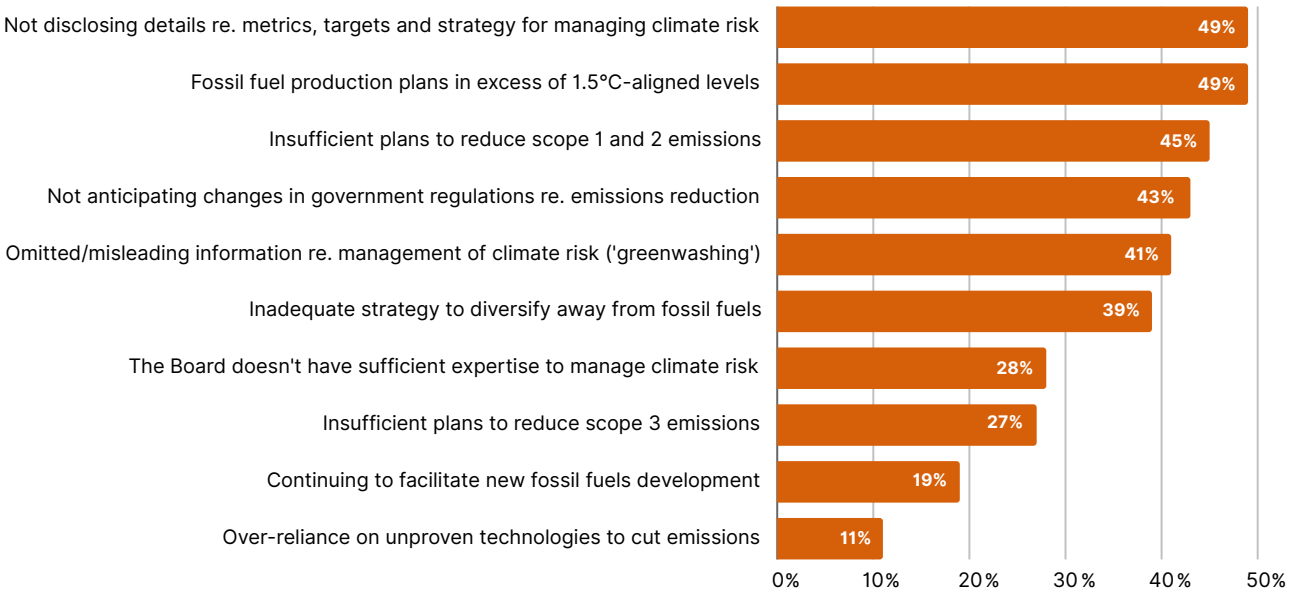


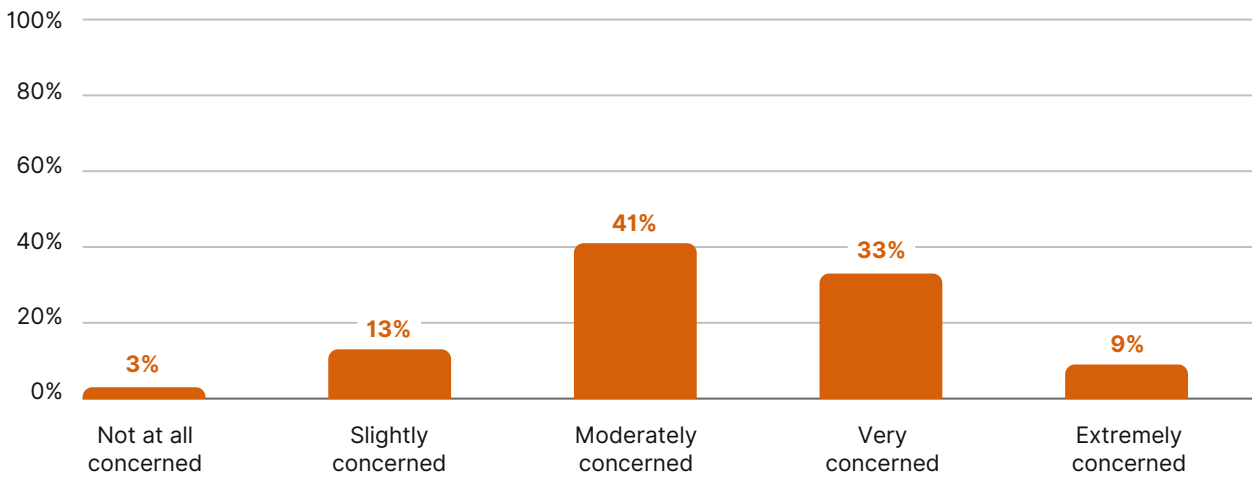
Figure 4: Factors that investors consider 'high climate risk' in an investment they are evaluating



3. The overwhelming majority of investors are personally concerned about climate change

Overall, 84% of respondents indicated they were moderately to extremely concerned. Just 3% of respondents were 'not at all concerned' about climate change (Figure 5).

Figure 5: Investors' personal concern about climate change



Levels of concern about climate change were considerably higher amongst respondents in the UK and Asia-Pacific (APAC), where at least half indicated they were 'very' or 'extremely' concerned compared with just one third (32%) of respondents in the USA (Figure 6).

Respondents from banks were more likely to indicate they were 'very' or 'extremely' concerned about climate change (49% of respondents), while those working in asset management firms were more likely to be concerned to a moderate degree (55%) (Figure 7).

Figure 6: Investors' personal concern about climate change – by region

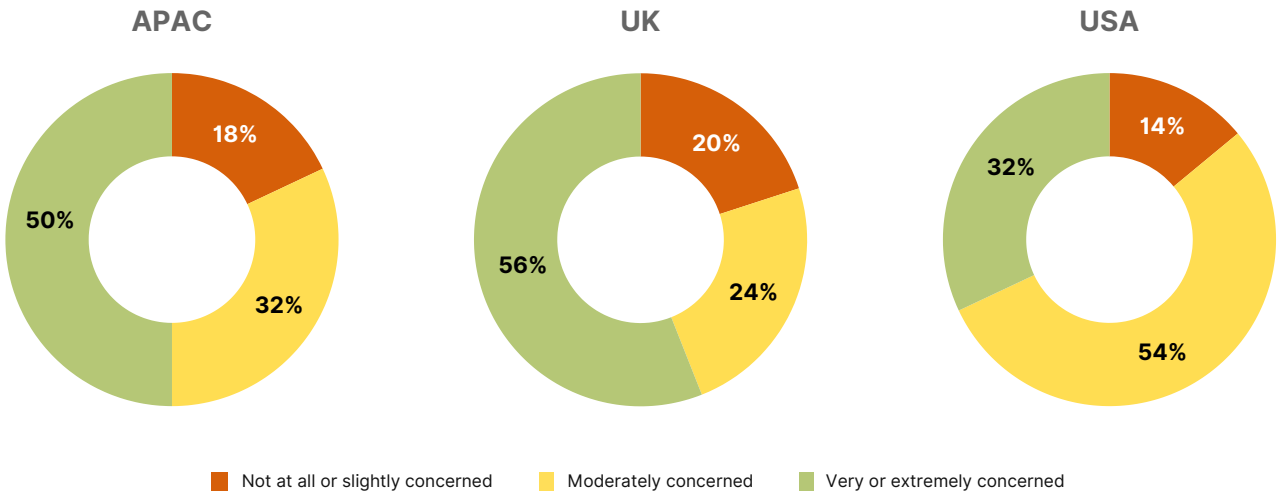
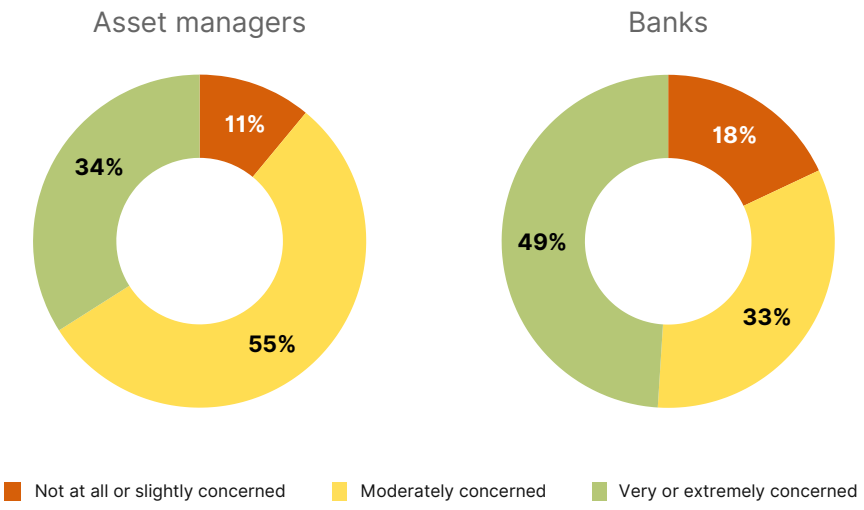


Figure 7: Investors' personal concern about climate change – by company type



4. Investors' personal views on climate change appear to influence their investment decision making

Respondents who indicated less personal concern about climate change also indicated climate risk had little influence on their investment decision making, and vice versa (Figure 8).

Similarly, those with the lowest levels of concern for the climate were also less likely to take into account the full range of climate risks as part of their evaluation of investments (Figure 9). This suggests some investors are allowing personal bias to dictate their investment decisions by ignoring what is objectively a profound risk to their investments.

'Government regulation' is a notable deviation from this trend, with even the least climate-concerned investors still clearly worried about the risk this poses to their investments.

Figure 8: Influence of climate risk on investor decision making – by extent of personal concern about climate change

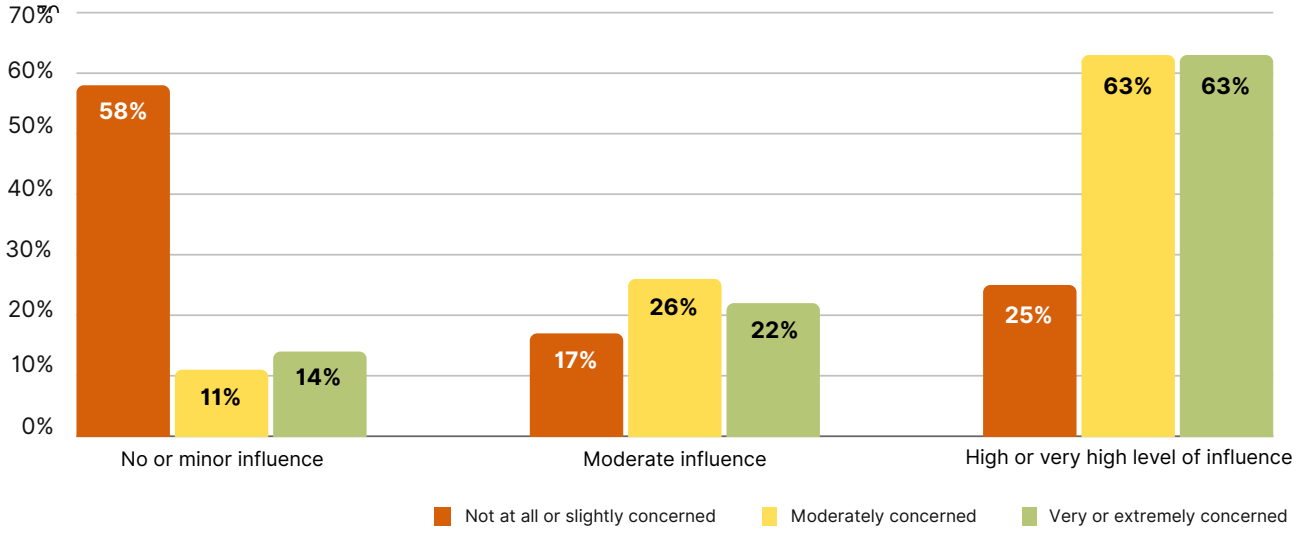
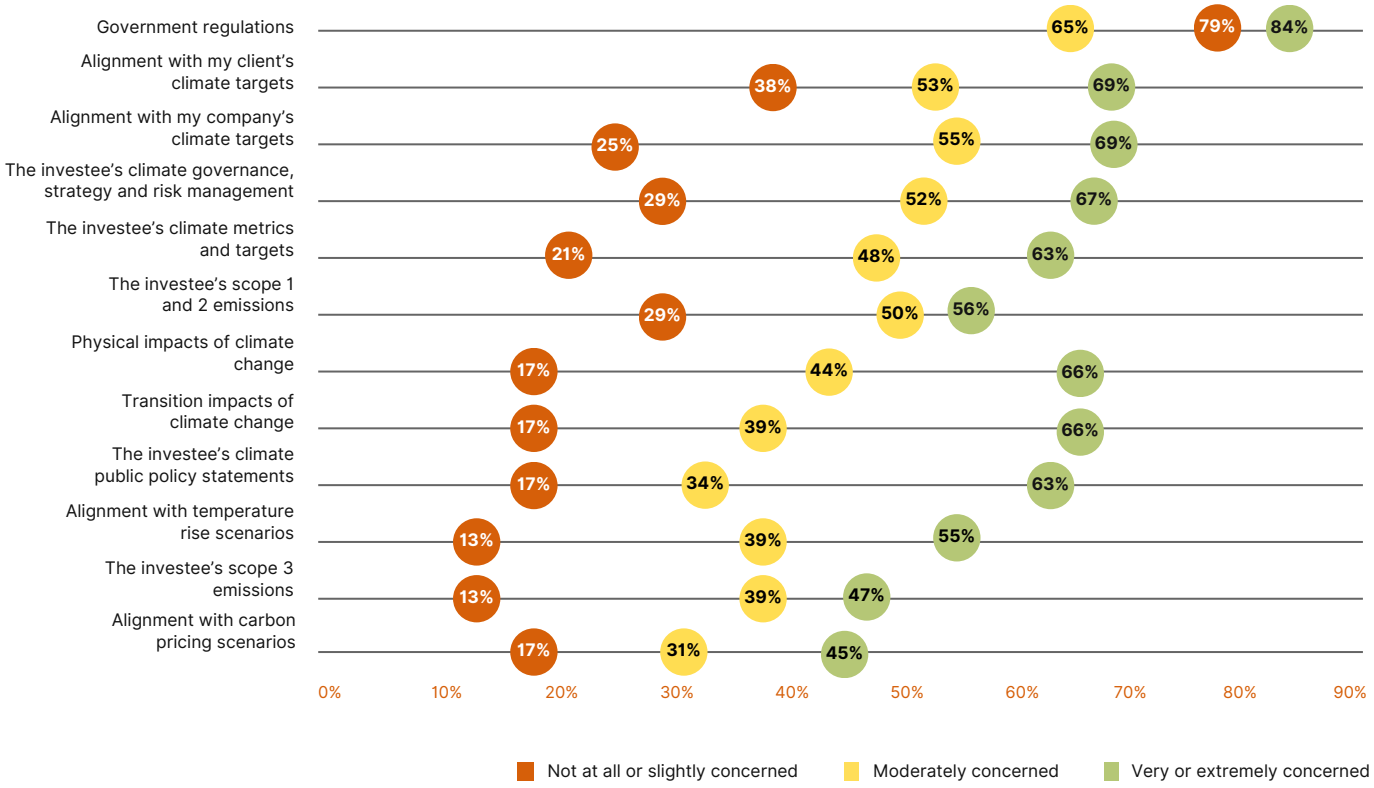


Figure 9: Climate risks 'often' or 'always' considered by investors when evaluating an investment – by extent of personal concern about climate change



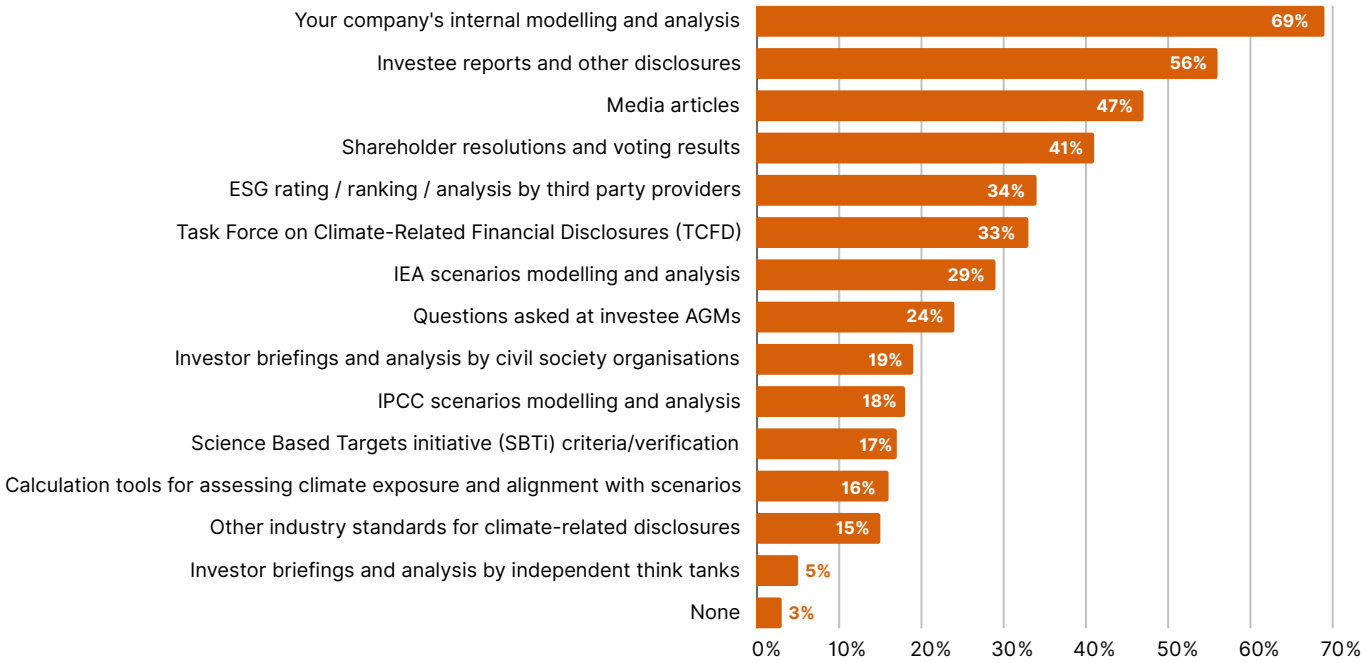
Whether an individual believes in it or not, climate change has an effect on the economy on a global scale. The amount of capital being funnelled into organizations that integrate solar, wind, and other alternative forms of energy is growing on a year-to-year basis. Not only are massive asset managers growing their ESG investing capabilities, but they are also being conscious of their own carbon footprints and taking measures that align with a greener future internally.

Investment analyst / strategist, private equity, USA

5. Investors are overwhelmingly relying on internal modelling/analysis and investee disclosures when assessing climate risk

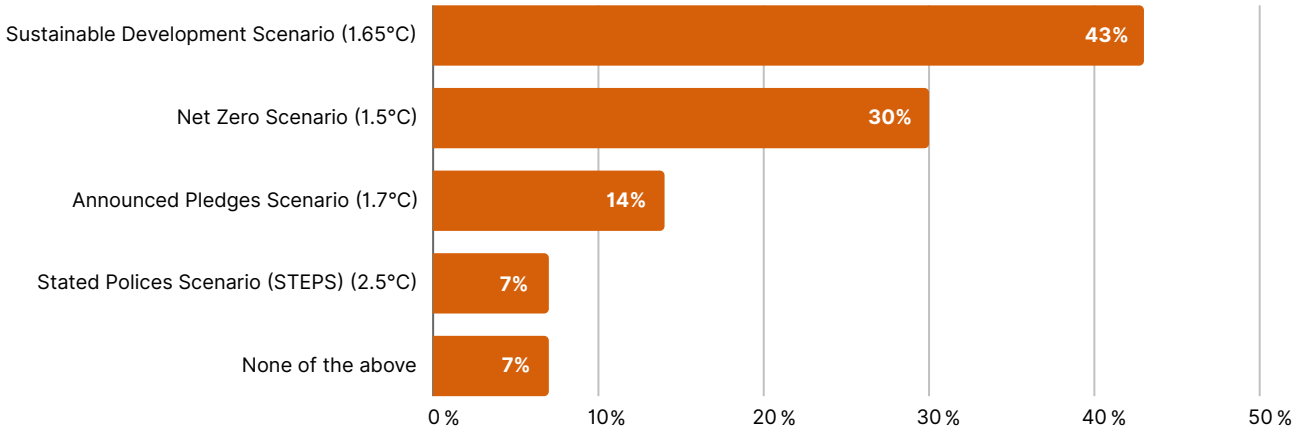
Respondents were most likely to rely on their company's internal modelling and analysis (69% of respondents) and investee disclosures (56%) to assess climate risks and opportunities (Figure 10). Relatively few respondents utilised IEA and IPCC scenarios modelling and analysis (29% and 17%, respectively). It is important to note, however, that some of these resources may be incorporated into the internal modelling and analysis used at respondents' companies.

Figure 10: Resources currently used by investors to assess climate risks and opportunities



> *Quantitative, issue specific, sector analysis from NGOs is most influential especially with regards to energy transition and climate policy/regulation risk assessment, or in areas (biodiversity) where data is generally unavailable.*
>
> ESG / responsible investment specialist, asset management, Japan

Figure 11: The IEA climate scenarios most in line with the base case forecast used by investor companies



Degree figures in parentheses are average global temperature rise by 2100 that could be achieved under the scenario at a 50% probability – IEA, World Energy Outlook 2021. Results are only for the 44 survey respondents who indicated they use IEA scenarios in their investment analysis.

6. Of the IEA's climate scenarios, investors' base case modelling is most likely to reflect the Sustainable Development Scenario

Almost one third of respondents indicated they use IEA scenario modelling and analysis when assessing climate risks and opportunities (Figure 9). Of these, nearly half said they consider the IEA's *Sustainable Development Scenario* to be most aligned with their own base case forecasts (Figure 11). This shows many investors are already 'pricing in' a rapid acceleration of the energy transition. The Sustainable Development Scenario is consistent with limiting the global temperature rise to 1.65°C by 2100 at a 50% probability. It is "based on a surge of clean energy policies and investment", whereby "all current net zero pledges are achieved in full and there are extensive efforts to realise near-term energy reductions" (IEA, *World Energy Outlook 2021*, p. 95).

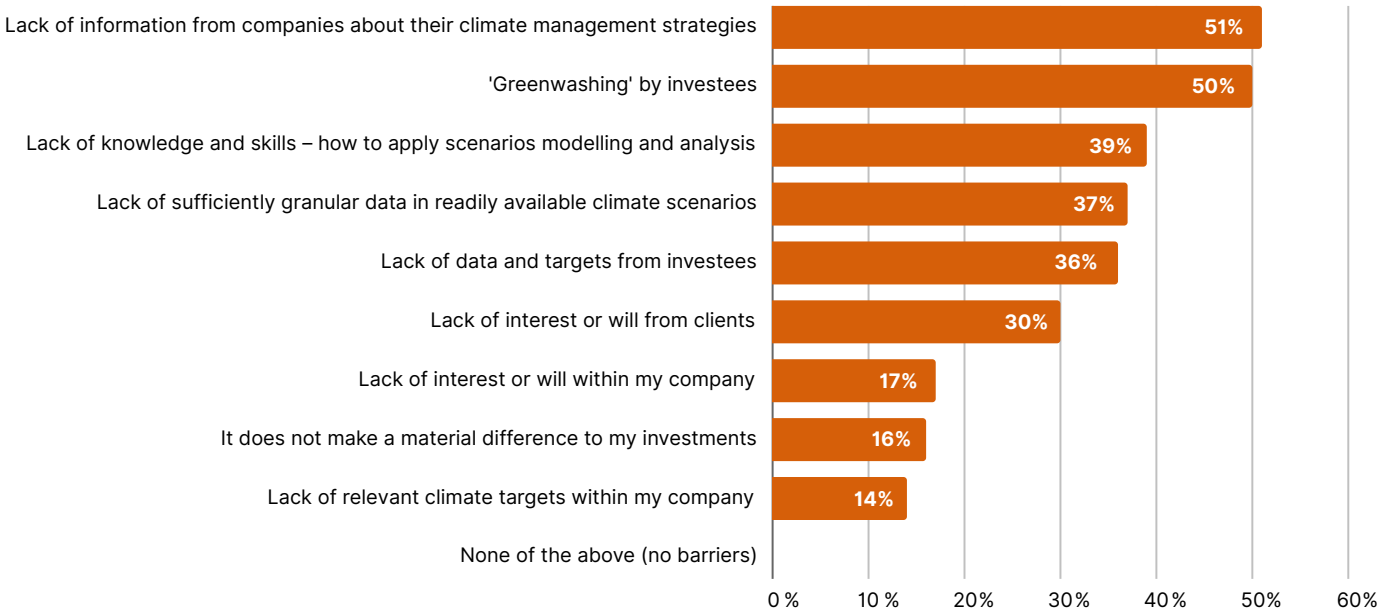
It should be noted that the IEA has stopped using the Sustainable Development Scenario in its World Energy Outlook analyses. The *Announced Pledges Scenario* is now the most similar scenario in terms of its assumptions and outcomes (IEA, *World Energy Outlook 2022*, p. 107).

7. Greenwashing and inadequate information from companies on their climate management plans are the main barriers to investors incorporating climate risk more effectively

According to respondents, the biggest barriers to investors effectively incorporating climate risk into their investment decision making are 1) a lack of information from companies about their climate management plans (51%) and 2) greenwashing by investees (50%) (Figure 12).

A lack of knowledge and skills around how to apply climate scenario modelling and analysis, alongside a lack of sufficiently granular data in the scenarios were the next most frequently reported barriers. This is a well-known problem – for instance, the IEA does not include regional pathways in its Net Zero Emissions by 2050 scenario, making it difficult to incorporate into most valuation models.

Figure 12: Key barriers to investors incorporating climate risk assessment into investment decision making

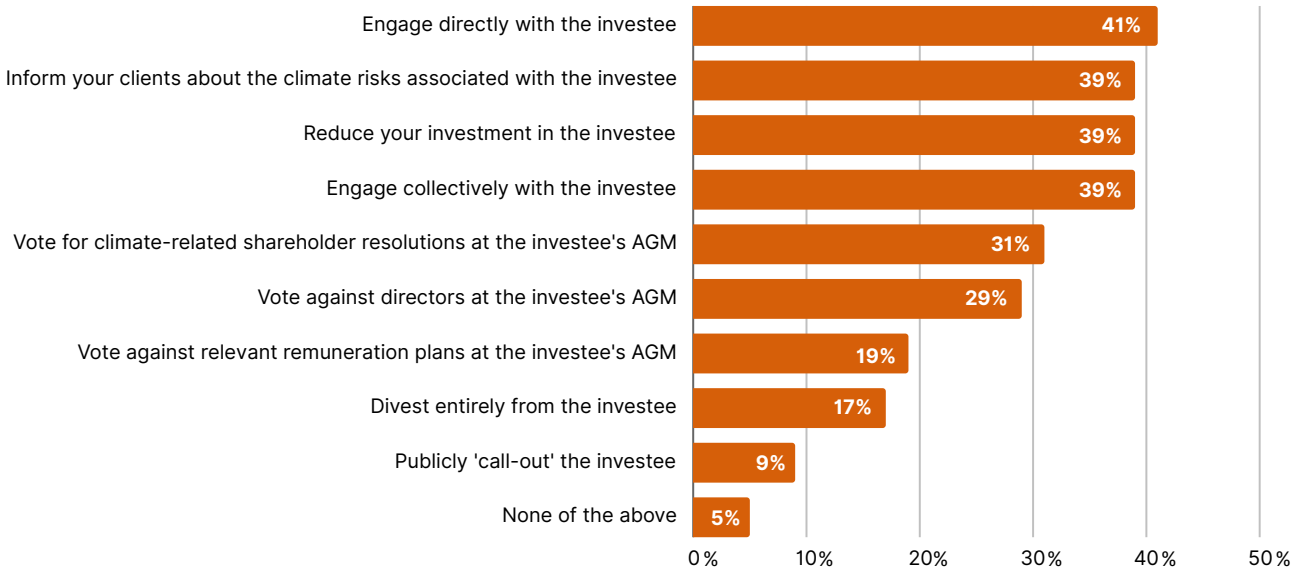


> *The industry can benefit from a consolidation of reliable, authoritative information sources and periodic vetting of its veracity.*
>
> Executive / Managing Director, bank, UK

8. Investors are equally as willing to use divestment and engagement with investees in response to climate risks

Remarkably, when it comes to managing any identified climate risks, investors are largely neutral on the respective benefits of engagement and divestment; about equal proportions (roughly 40%) would opt to engage with the investee (directly and/or collectively) and to reduce their investment (Figure 13). Nearly one-fifth are prepared to divest entirely, while just 5% of respondents indicated that they would not take any action if an investee faced a high level of climate risk. Guidance from major responsible investment initiatives commonly recommend investors address climate risk at investee companies by escalating active ownership interventions – such as direct engagement, filing shareholder proposals, or voting against directors – and considering divestment where a company fails to adequately respond.[2]

Figure 13: Actions investors would take if an investee company was found to be facing a high level of climate risk



[2] See, for example, the Institutional Investors Group on Climate Change's (IIGCC) *Net Zero Stewardship Toolkit*, PRI's *A practical guide to active ownership in listed equity*, the Paris Aligned Investment Initiative's *Net Zero Investment Framework Implementation Guide*, the Investor Agenda's *Investor Climate Action Plans (ICAPs) - Guidance on using the Expectations Ladder* and SBTi's *Financial Sector Science-Based Targets Guidance*.

What would help investors in high-risk companies engage more effectively?

Respondents were asked to describe what would help them to engage companies on climate risk more effectively. Better quality, more granular data and information stood out as a clear theme (42 comments), with investors wanting an authoritative, objective and standardised body of data they could draw on to quantify risks and impacts, and inform their arguments. This includes data that better quantifies reputational and regulatory impacts.

> *"A more prevalent and well informed, granular body of data that is recognised as authoritative, across the investment industry."*
>
> **– Executive / Managing Director, bank, UK**

> *"Climate risk is still not a widely adopted and standardized risk topic. Unfortunately there is a lack of consistent data across market caps and industries. As with any investment, there is a high [degree] of subjectivity, so until that risk can be pretty accurately (and universally agreed upon) quantified it will be difficult to get the industry to agree."*
>
> **– Executive / Managing Director, bank, UK**

> *"Better and more compelling data and information that climate risk reduction is good for the bottom line."*
>
> **– C-suite respondent, asset management, USA**

Other themes included:

- **Government support and regulation** (27 comments): More consistent regulation across jurisdictions, stricter regulation, clearer/more detailed regulations and more clarity from governments on likely future developments regarding regulation.

> *"If we had more defined frameworks and regulations it would be easier to hold them accountable because we would know the anticipated action for not managing this risk."*
>
> **– C-suite respondent, bank, USA**

- **Standards and standardisation** (21 comments): More/better industry standards around climate risk, a transparency standard, standard assessment and benchmarking tools, standardised disclosures/reporting from companies, standardised metrics.

> *"Clear standards such that greenwashing is called out and frowned upon whereas now the focus is often on virtue signalling."*
>
> **– Investment analyst / strategist, insurance company, Belgium**

> *"...verifiable and standard, transparent assessment and benchmarking tools vs peers, industries and geographic regions."*
>
> **– Executive / Managing Director, asset management, UK**

> *"Reporting and especially standardized measurement and metrics remain an area of significant improvement."*
>
> **– C-suite respondent, bank, UK**

- **Benchmarking** (17 comments): More benchmarking data and information (comparing across peers, industry and region), better ESG ratings/scoring.
- **Better communication and engagement with companies** (14 comments): Engaging companies on specific issues, collaborating with companies on target setting, offering support to companies, better access to and engagement with the C-Suite and Board.
- **Greater transparency / better information from companies** (13 comments): Greater transparency in company reporting, greater disclosure from companies on their ESG performance, greater use of independent assessments.
- **Collective engagement / collaboration** (10 comments): Collective engagement with other shareholders, collaboration with other stakeholders to engage companies, supportive networks, utilising regulator shareholders to exert pressure.

Methodology

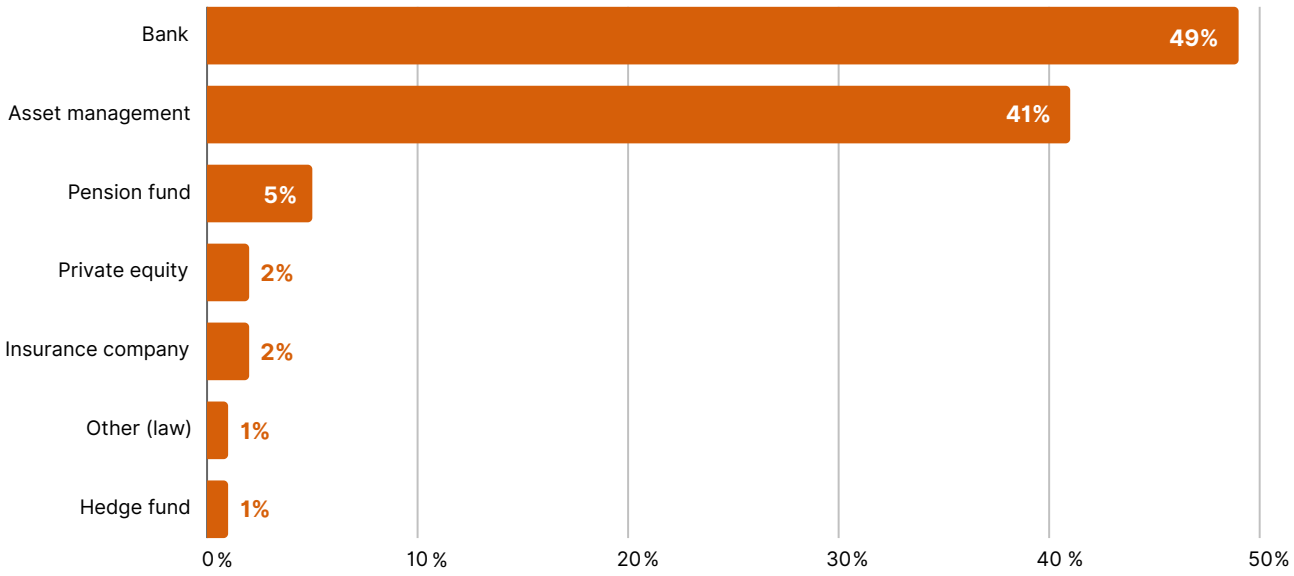
This research comprised an online survey of 150 institutional investors from more than 100 companies in the USA, UK, Singapore, Japan, Australia, Hong Kong and Belgium. The survey was designed by Market Forces and delivered by market research agency NewtonX during September to November 2023. Rather than using an existing B2B research panel, participants were recruited using NewtonX's 'AI-powered' recruiting process, whereby potential participants were targeted through existing networks, email campaigns, industry groups and digital advertising. A screening questionnaire was used to ensure participants met the needs of the research based on the following criteria:

- Company type
- Location
- Company assets under management (minimum of $20 billion)
- Role within the company
- Level of seniority
- Decision making authority.

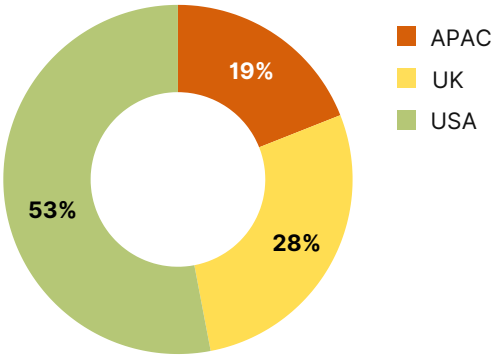
Soft quotas were applied to the latter three criteria to ensure a good spread of respondents across these groupings. For example, a quota of roughly 25% respondents was applied to the target role groupings (fund/portfolio manager, investment analyst/strategist, c-suite and executive/managing director combined with ESG/other respondents). Previous research on investor engagement with climate risk indicated a bias of survey respondents working in ESG/responsible investment, perhaps due to the nature of the topic and the recruitment methods used. For this reason, we applied an additional limit to respondents working in this field (a maximum of 30 respondents overall), though the survey achieved well under this number (eight respondents).

Respondent profile

Company type

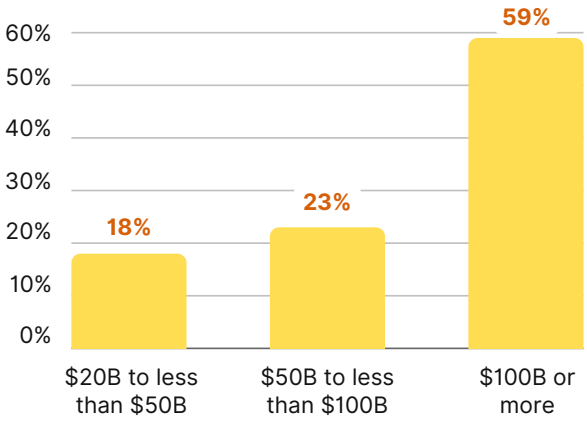


Respondent location

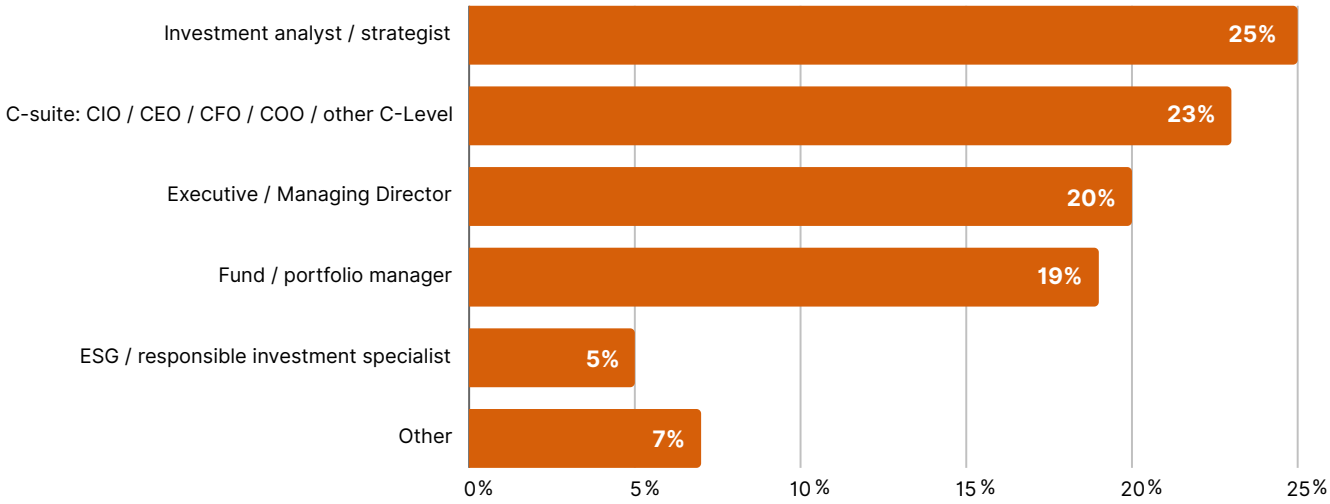


**Excludes 3 respondents from Belgium*

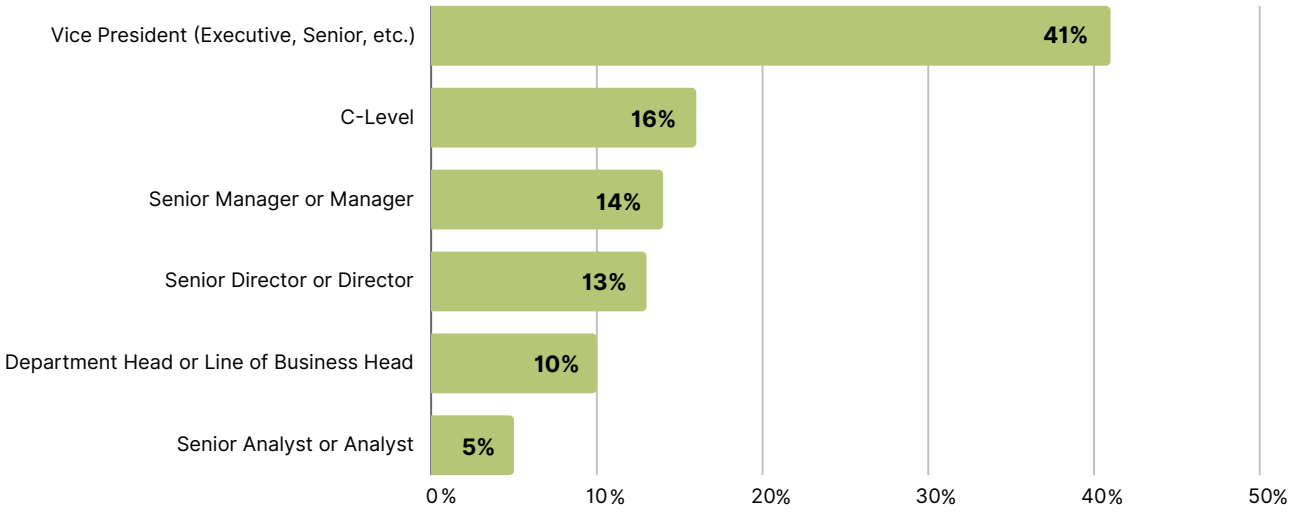
Company assets under management



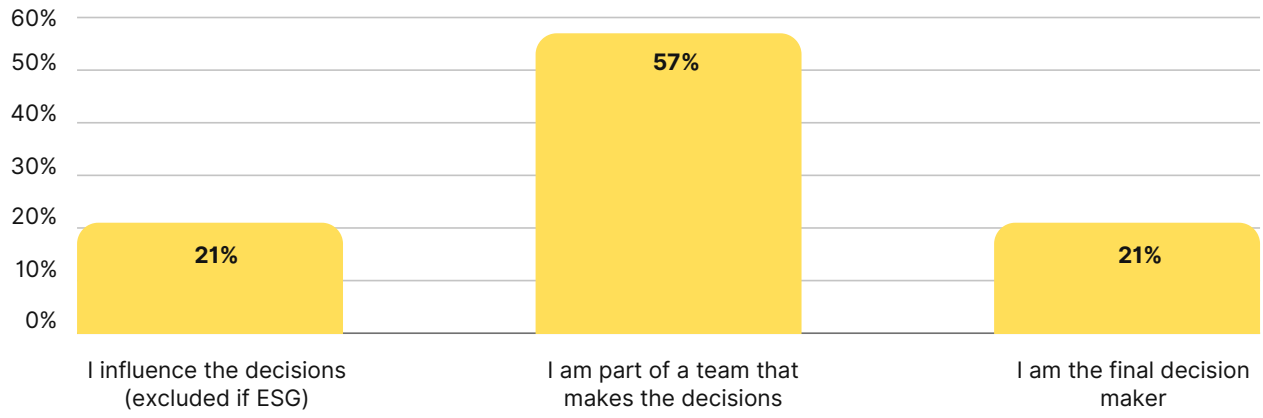
Role within company



Level of seniority



Decision-making authority



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