

Should Ethical Investors Target Carbon-Neutrality?

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ABSTRACT

Carbon emissions play a major role in climate change. Current approaches to limiting global average temperature rises have focused on encouraging companies to report and reduce their carbon emissions. However, due to factors such as slow uptake of initiatives by governments, population growth and desirable economic growth in less-developed countries, reduction of carbon emissions is unlikely to prove sufficient to meet aims of limiting increases in global average temperatures to 1.5°C (or well below 2°C) above pre-industrial levels. To achieve this companies need to move towards zero net-carbon emissions (ZNCE), putting in place implementation strategies as a first step. In financial markets, ethical and sustainable investors are already familiar with carbon emission reductions as an environmental factor. However, now ethical investors need to appreciate the importance of zero net-carbon emissions as a factor in the selection of their investments, to stimulate companies to adopt strategies to achieve this. If such a development to ethical and sustainable investment is to become widely adopted it will require the involvement of underlying investors, wealth managers and fund providers.

INTRODUCTION

Unsustainable human activities have generated threats including climate change, (associated with rising sea levels, extreme weather and flooding for example) resulting in damage, loss of life, and disruption to food and fresh water supplies. As a result of these issues, proponents of responsible investment argue that behaving in an unsustainable manner will cease to be an option.

Carbon emissions play a major role in climate change, and current efforts have been based around encouraging companies to report and reduce their emissions. However, this may prove to be insufficient to meet the UN FCCC (United Nations Framework Convention on Climate Change) intended aims of holding the increase in global average temperatures to well below 2°C above pre-industrial levels while pursuing efforts to limit increases to 1.5°C above pre-industrial levels [1].

In themselves the UN FCCC aims already accept consequences from global warming, recognising that the risks and impacts of climate change would only be reduced, not eliminated. Thus, they may prove insufficient, particularly with slow uptake from international governments, and the potential for political pressures to delay or disrupt progress.

Progress is also likely inhibited by the ability of companies to externalise costs associated with carbon emissions. For example, a company's activities or products may release significant quantities of atmospheric CO₂. Although unsustainable, it is generally unlikely that the company responsible will be paying significantly towards atmospheric CO₂ reduction, or pricing the cost of CO₂ removal into the finished product. The costs of adapting

to climate change will fall to society as a whole, often with poorer countries suffering greater damage (and costs) than richer, industrialised countries, which have historically often benefitted from the industry that generated much of the carbon-emissions in the first place. This typifies externalised costs: the company responsible for the emissions has not paid for the consequences. Generally consumers buying that company's goods may not pay a price reflecting the true cost of dealing with the CO₂ involved in production, use or disposal. The company in question is left with little incentive to either reduce carbon emissions or to develop a strategy for achievement of carbon-neutrality [2], [3]. Although many companies will be responsible for lower levels of carbon emissions the same arguments still apply.

Sustainable investing, with carbon emissions in mind, is one way of encouraging companies to reduce carbon emissions. Awareness of ethical investment appears to be increasing rapidly, with £13.2 billion assets under management in the UK ethical funds sector in March 2017 according to the IMA (Investment Management Association) [4].

However, ethical investors need to be aware that while reporting and reduction of carbon emissions by companies is helpful, it is unlikely to be sufficient to meet the UN FCCC aims of limiting average global temperature increases to 1.5°C and well below 2°C at current rates. What is required is a clear movement by companies towards zero carbon emissions, or zero net-carbon emissions (ZNCE) to achieve carbon neutrality. At the current time companies appear to have been slow to accept the need for ZNCE.

To move this forward the ethical investment community (including underlying clients, wealth managers and fund providers) needs to start influencing companies to develop ZNCE strategies, and screening investments in companies based on their progress towards development and implementation of such strategies.

CARBON REDUCTION

Thus far current efforts have primarily been directed towards reduction in CO₂ emissions. Examples include the Carbon Disclosure Project [5] (which encourages companies to report their carbon emissions), or the UNPRI [6] which supports the adoption of ESG principles (environmental, social and governance principles) [7], [8]. These encourage their incorporation into decision making, policies and practices, disclosure, acceptance and implementation, and enhancing effectiveness in implementation and reporting.

In terms of accounting for carbon emissions, the Greenhouse Gas (GHG) Protocol has categorised emissions into three groups, or 'scopes' [9]. Scopes 1 and 2 cover direct emissions by companies (e.g. electricity used by companies and fuel used in company vehicles), while scope 3 emissions cover all indirect emissions arising due to company activities. Thus scope 3 emissions include those of suppliers and customers using their products (for more detail see [10]). For current purposes all three scopes of carbon emissions should be considered. Although many carbon emissions may take place when customers use products purchased, the companies are best-placed to make their products generate less carbon, and all CO₂ released, however generated, contributes to global warming.

Carbon reduction reporting and reduction initiatives are useful steps in the right direction – but given anticipated population growth and desirable economic development in less-developed countries, it is reasonable to question whether they are likely to be sufficient to meet the UN FCCC aims. Indeed, an expanding proportion of a growing world population will demand improved living standards as less developed countries modernise [3].

There is a danger of a Malthusian trap, in which any spare capacity gained by decreases in carbon emissions will be taken up by population growth or increases in economic activity. To quote Malthus "The power of population is indefinitely greater than the power in the earth to produce subsistence for man" [11]. The problem is that if carbon emissions are only reduced, the reduction is likely to be taken up by either increased global population, or else by increased emissions per capita, resulting from improved living standards in less well developed countries.

Alternatively, if there is continued exponential GDP growth in the carbon-based economy, anything less than an exponential reduction in carbon emissions will make no difference [12].

Apart from the need for dramatic reductions in carbon emissions, this highlights the need for companies to reach a stage where they rapidly become zero net-carbon emitters.

ETHICAL INVESTING AND CARBON SUSTAINABILITY

For current purposes, little distinction is made between ethical investment, socially responsible investing or sustainable investing. For brevity, the term 'ethical' investing will generally be used interchangeably with 'socially responsible investing', 'responsible investing' and 'sustainable investing' except in cases where a useful distinction can be drawn. Definitions of these terms are offered in [7]. Broadly, companies are encouraged to promote practices including environmental stewardship; consumer protection; human rights and to support the social good [7], [8].

Ethical investors are already familiar with sustainable investing with its focus on environmental, social justice and corporate governance (ESG) issues [7], [8]. In sustainable investing, funds are directed into companies with business practices capable of being continued indefinitely without causing harm to current or future generations, or exhausting natural resources (i.e. not 'unsustainable'). Sustainability is often defined as ensuring development meets the needs of the present without compromising the ability of future generations to meet their own needs [13].

ESG identifies three key aspects of sustainable investing:

Environmental, including CO₂ emissions, or carbon-intensity; forest and woodland degradation (important for absorption of atmospheric CO₂); airborne, water-borne or land-based pollution; usage of scarce resources, including water and living creatures as well as minerals, oil and natural gas; mining activities which generate toxic by-products; over-fishing, intensive agricultural methods and so on.

Social, including corporate social responsibility (CSR); child labour; modern-day slavery; payment of non-living wages; hazardous, exploitative and/or coercive working conditions; structures that reduce corporate taxation bills to levels incommensurate with the profits and activities taking place in those countries; anti-social working hours or conditions; displacement of indigenous peoples.

Governance; companies with weak internal controls may have management not following company policies, increasing risks of irresponsible behaviours, corruption and bribery. At board level, weak governance may mean that non-executive directors (NEDs) are unable to hold powerful executive directors in check, with possible damage to the company as well as the owners' (shareholders') interests, and increased risk of excessive executive remuneration.

Within sustainable investing, environmental factors include climate change and the need to avoid the worst effects of global warming caused by excessive build-up of CO₂ in the atmosphere. Thus the need for carbon emissions sustainability sits squarely within an ESG investment framework.

In environmental terms, climate change might be regarded as the 'grandfather' of all environmental issues. While other environmental issues are of undoubted importance (as well as other social and governance issues), few show the potential of climate change to pose an existential threat to human society, multiple species, and possibly even worse consequences for individual countries and cultures. For example, analysis of long-term temperature data suggests that global warming could be sufficient to significantly disrupt modern-day agriculture to an extent that would result in major food shortages [14].

CONCLUSION

Ethical investors need to start asking for investments in companies to be judged on the development and implementation of zero net-carbon emission (ZNCE) strategies, in addition to current ethical and sustainability criteria.

For this additional focus on ZNCE requirements to be effectively adopted by the financial sector, it will need to be taken up by underlying investors, wealth managers and fund providers. Fund providers will need to develop the capability to judge and screen companies on their development and implementation of ZNCE strategies. Interest from underlying clients will be needed to generate the demand for products incorporating this requirement, while wealth managers can facilitate direction of invested monies into the most suitable funds in this category. Ethical investors at all levels must work to raise the profile of this crucial aspect of sustainable environmental investment.

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