An Audience with Michael Sheren

Senior Adviser to the Bank of England

At the recent United Nations Climate Action Summit, Mark Carney, Governor of the Bank of England, was explicit on the need for better risk management and disclosure on climate change:

"To bring climate risks and resilience into the heart of financial decision making, climate disclosure must become comprehensive; climate risk management must be transformed, and sustainable investing must go mainstream".

Lazard Asset Management was privileged to have Michael Sheren, Senior Adviser to the Bank of England, share his insights on this topic. In this article, we summarise three key takeaways:

- The financial industry must prepare for more regulatory supervision on climate change
- The transition presents both risks and opportunities for investors
- Large asset owners could move the dial quite quickly through asset allocation decisions

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Climate change has the attention of financial regulators and supervisors

Mark Carney was one of the first central bankers to publicly acknowledge the impact of climate change on the stability of the financial system. The landmark speech that he gave four years ago has helped to engage a global network of central banks on tackling climate change through initiatives that include The Network for Greening the Financial System (NGFS) and the establishment of a new joint FCA-PRA Climate Risk Forum. These initiatives help consider climate-related financial risks, share best practice and provide intellectual leadership in this emerging field.

Michael suggests the risks identified by international organisations, such as the UNFCCC and G20, will lead to an accelerated development of a regulatory agenda on climate change for banks, insurers and large asset managers. The development of the regulatory agenda is well under way with much of the analytical work being driven by central banks and supervisors from 42 countries who make up the NGFS. It is probable that important regulatory measures will be introduced in the not-too-distant future. These potential regulatory actions could include:

1. Mandatory climate disclosures for banks and insurers. This will follow the recommendations and framework set out by the FSB's Task Force for Climate-Related Financial Disclosures
2. Stress testing for financial institutions, particularly for those systemically important banks with a view to understanding the risk of their balance sheets to stranded assets
3. Enforcing the use of green taxonomies: The EU's Technical expert group on sustainable finance has already attempted to shift the definition of Standard Industrial Classifications (SIC) which have been used by all government statistics departments for decades into Standard Carbon Classifications (SCC). Ultimately, this could see borrowing costs for 'brown' industries such as coal become more expensive, whilst reducing the cost of borrowing for low-carbon and sustainable investments. Natixis is the first bank to formally include carbon-style classifications into the risk-weighting of its lending activities and it has said that it plans to share its methodology with other signatories of the newly established Principles for Responsible Banking[1]

The transition presents both risks and opportunities for investors

Climate change presents far-reaching and unknown risks for investors. These risks could ultimately manifest in large capital expenditures and research and development costs to companies aiming to transition their business to a more sustainable model. Such transitions could have meaningful implications for companies' free cash flow however, the potential consequences for those that do not attempt to transition could be dire. Hence, asset managers must have an understanding of the size, impact and velocity of free riding negative environmental externalities embedded within business models and take a view on how mitigating or eliminating these free riding externalities might affect the price of bonds and equities connected to these business. This would involve stress testing at both the individual security and portfolio level to ensure valuations reflect the cost of mitigation. This work should ultimately inform engagement with companies as to how this influences capital spending and research and development.

At Lazard Asset Management we are building a proprietary framework that helps us systematically quantify negative externalities through integrated analysis of ESG factors across our research and investment platforms. Here are some examples of our research that assess the impact of changing environmental policy, labour and safety regulations on different industries, including mining, shipping and the gig economy.

There is a wide range of investment opportunities that will arise from the transition to a low-carbon economy. The OECD estimates that $100 trillion needs to be reallocated to sustainable infrastructure investments by 2035 in order to meet climate and development objectives. As one example, Michael suggested that there is $7-8 trillion of institutional demand for green bonds. For more information on Lazard's allocation to green bonds read here.

Asset owners could move the dial quickly if they act together

Michael recounted a scenario modelled in an important Cambridge University paper titled Unhedgeable Risk that assessed the impact on markets when asset owners altered their investment preferences away from climate intensive investments quickly. If asset owners were to make these moves, how would this impact the asset prices of 'brown' and 'green' assets? With the NGFS examining the risk characteristics associated with brown and green assets, this certainly is not a low probability event.

In conjunction, recently some of the world's largest asset owners announced the 'Net Zero Alliance' where members of the group commit to reducing the carbon emissions of their portfolio to net zero by 2050, with a view to limiting global warming to 1.5 degrees.

At Lazard Asset Management we expect an increasing number of asset owners to reallocate their capital away from the most carbon intensive sectors towards greener, more sustainable investments. As an active manager we believe we are well positioned to identify these opportunities for our clients' portfolios.

About the Author

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Jennifer Anderson is the Co-Head of Sustainable Investment and ESG. She began working in the investment field in 2006. Prior to joining Lazard in 2018, Jennifer was an Investment Manager for TPT Retirement Solutions and during this time she also served on the Board of the Directors of the Institutional Investors Group on Climate Change (IIGCC). Her previous role was as an Equity Research Analyst in Sustainable Investment at Citigroup Global Capital Markets and she started her career as an SRI Analyst at Jupiter Asset Management. Jennifer has a BA in Economics and Economic History from the University of Leicester and an MSc in Environment Technology from Imperial College London.

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Notes

1 The Principles of Responsible Banking has 130 founding signatories, representing 49 different countries and USD 47 trillion in assets.

Important Information

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