



Op-Ed: Reducing exposure to physical climate risks may increase longer-term risks

New investment trends could increase systemic risks as combatting climate change is inhibited.



by **Willemijn Verdegaal** | April 30th, 2018

Climate risks, along with cyber-attacks, rank as the dangers most likely to occur in the next 10 years, and be the most impactful, according to the latest Global Risk Report of the World Economic Forum. The global response to climate change will be one of the defining issues of the 21st century. In its report to the Financial Stability Board, the Taskforce on Climate Related Financial Disclosure (TCFD) headed by Michael Bloomberg, called climate risk: “One of the most significant, and perhaps most misunderstood, risks that organizations face today”.

Climate change affects all asset classes, regions and sectors. For investors there are no ‘safe’ havens. Either portfolios will be impacted by the effects of a steep and deep decarbonisation or by the more severe effects of the physical consequences of global temperature rise beyond 2 degrees Celsius.

At the same time investment needs are high. The most vulnerable regions, in Africa, Asia and Latin America, are also the ones that need most investments in both adaptation (adjusting to the physical effects of climate change) and mitigation (reducing GHG emissions) given the population growth and urbanisation taking place there. The World Resources Institute (WRI) indicates that the annual costs for adaptation measures in developing countries could range from US\$28 – US\$300 billion annually. In 2014, the New Climate Economy report found that over the next 15 years an annual investment is needed of US\$6 trillion for high-carbon infrastructure for transport, energy, water and cities. Low-carbon infrastructure requires an increase in investment of US\$270 billion a year on top of the business as usual US\$6 trillion.

The mapping of climate-related risks and opportunities for investors is a rapidly developing area of expertise. Data for mapping ‘transition risks’ associated with transitioning to a low-carbon economy has been steadily improving for several years now and there is a selection of data and investment tools available on the market. Translating data on climate-related physical impacts

to financial risks has lagged behind somewhat, but this data is now coming on line as well. New investment products have appeared on the market that promise to reduce the exposure to the physical effects of climate change. Welcome as this development may be, it confronts investors with fresh and complex dilemmas. Whereas direct risks may be reduced in the short term, it is questionable whether this risk reduction also holds in the medium to long term. These products may actually increase the long-term risk. New climate conscious financial products like those recently launched by at least one prominent investment bank minimize physical risks by inter alia 'under weighting' (investing less) in assets located in or significantly exposed to physical risks in vulnerable areas. Under weighting assets from vulnerable areas will result in a higher cost of capital for companies and sovereigns located in these areas. This makes it more expensive for them to finance investments, both for building resilience to climate change as for mitigation. This could result in a downward spiral, increasing the risk perception of the market further and so forth.

These products may actually undermine financial risk management in the long run. They may even increase systemic risks as combatting climate change is inhibited, thus potentially fueling conflicts in regions that are often highly-populated and already face a host of economic, political and social challenges. For this reason, the US Department of Defense dubbed climate change a "risk multiplier". The risk of social instability, conflict and migration will increase. It is naïve to expect that global investors would be able to insulate themselves from such developments.

It is not only market forces that through increased cost of capital inhibit achieving the stated goals of Paris.

The products may undermine global support for the

Paris Agreement itself as the agreement relies on significant co-financing by the private sector of adaptation and mitigation measures in emerging and developing countries. Products that discourage capital flows to vulnerable areas may undermine trust in the whole agreement.

There is also an ethical dimension to this discussion. Increasingly investors are defining their purpose in a much broader sense than only financially. Pension fund savers indicate they want their savings to contribute to solutions for global challenges; think of the Sustainability Development Goals. Making it harder for vulnerable areas to adapt to climate change runs counter to these goals. Therefore these new products surely are not fit for purpose as a 'responsible' investment product – which is exactly what some of these products are calling themselves.

Finance has woken up to climate related risks and opportunities. Now it has to find a strategy to deal with them. Physical risks need to be managed. Keeping the world on a (well below) 2°C path is the best way to do just that. Of course, at the same time investments in climate resilience and adaptation are required to deal with the physical impacts of climate change that are unavoidable. Article 2c of the Paris agreement highlights the need for: 'Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development'. Regrettably, products that underweight investments in areas that are vulnerable to the physical impacts of climate change do not make a contribution to either of these goals and therefore do not belong in a portfolio that aims to invest in support of the Paris Climate Agreement, nor in that of any responsible investor.

This article was jointly written by Rens van Tilburg, Executive Secretary at Sustainable Finance Lab, Utrecht University, and Willemijn Verdegaal & Lisa Eichler, Strategic Climate Solutions, Ortec Finance