

A sustainable future for financial services

Climate change is beginning to reshape the world's economy, and financial services companies are racing to position themselves for success. What are the risks—and opportunities—for financial services firms in this new economy?

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The climate is changing. Is your business?

Climate change has moved from theoretical possibility to reality. Scientists overwhelmingly agree on why it is happening.¹ They also agree that we must act aggressively to reduce the amount of greenhouse gases entering the earth's atmosphere if we are to avoid serious disruption of the earth's natural systems.

But there's less certainty among businesses about how to address the coming changes to the world's economic systems. Companies will need to offset the greater likelihood of damage to assets, operations and markets. They will need to comply with new regulations governing the release and disclosure of greenhouse gas emissions. And if they contribute to climate risks, they will face damage to their reputations, competitive disadvantages and potential liability.

While it's not clear how companies will adapt to these new realities, it is evident that new risks will confront all businesses and affect all classes of investing. This means financial service providers will need to scrutinize their investments in new ways as well as assess their own contributions to climate change if they are to reduce their exposure to risk.

Faced with this sobering future, financial services companies have a choice. They can regard the costs associated with adapting to climate change as a drag on profitability and try to stave them off as long as possible. This seems to be the prevailing view in the mutual fund industry, for instance, which in 2007 voted against 65 percent of all climate-related shareholder resolutions.²

Or, they can seize the opportunities flowing from the need to manage a world of new and heightened risks. The financial services industry, with nearly \$6 trillion in market capitalization, specializes in managing investment risks, and this strength positions it to lead the way toward a more sustainable—and wealth-generating—economy. To capitalize on this position, the financial services industry must sharpen its focus on the fundamental driver of climate-related risk—carbon.³

1 *Fourth Assessment Report* of the UN's Intergovernmental Panel on Climate Change: <http://ipcc-wg1.ucar.edu/wg1/wg1-report.html>

2 *Mutual Funds and Climate Change: Opposition Begins to Thaw*, Ceres, April 2008

3 Broad scientific consensus, exemplified in *Fourth Assessment Report* of the UN's Intergovernmental Panel on Climate Change and in the *Stern Review on the Economics of Climate Change*, identifies the single most significant cause of climate change as carbon dioxide emissions produced by human activity, along with a handful of other greenhouse gases, also resulting from human activities, including methane, nitrous oxide and ozone.

The cost of carbon

The twentieth-century economy was built on the assumption that fossil fuels would always be cheap and plentiful. Increased oil use was a sign of economic health; it meant more commerce was happening, more wealth was being created. The cost to our environment of burning fossil fuels remained invisible. Carbon, in other words, was assumed to be free.

But that assumption is rapidly crumbling. It already has in Europe, where carbon trading reached US\$62 billion in 2007—up 80 percent from the year before.⁴ And while Europe, thanks to its participation in the Kyoto Protocol, has a head start in carbon trading, the United States will soon follow; both presidential candidates support some version of a cap-and-trade system that limits the amount of greenhouse gas emissions allowable under the law.

Such regulations make the ability to emit greenhouse gases a limited and valuable commodity, creating incentives for businesses to reduce their carbon footprint. The research firm New Energy Finance estimates that the United States carbon-trading market could reach US\$1 trillion by 2020, and that number could be much higher once derivatives are factored in.⁵

The cost of carbon will affect not just businesses that directly emit greenhouse gases but also investors and companies that serve investors. There is growing pressure—from the U.S. Senate Appropriations Committee and from numerous state treasurers, pension fund managers and institutional investors—for regulations that would require publicly traded companies to disclose their financial risks related to climate change.⁶

Many experts believe that failure to recognize and mitigate climate risks may lead to serious market repercussions. For instance, Sir Nicholas Stern, former World Bank chief economist and head of the United Kingdom's Government Economic Service, has called climate change “the greatest and widest-ranging market failure ever seen” in a 2006 report. The assumptions driving the carbon-intensive economy, in other words, have prevented markets from effectively addressing climate risks. Stern's calculations predict that if we continue business as usual, climate change could cut global gross domestic product by 20 percent.⁷

4 “The Greening of Wall Street,” *The Economist*, March 13, 2008

5 Ibid.

6 “SEC Urged to Act on Climate-Change Rules,” MarketWatch.com, July 24, 2008

7 *Stern Review on the Economics of Climate Change*, HM Treasury (UK), October 30, 2006

A new era of fiduciary responsibility

In this era of new costs, obligations and liabilities, the financial services industry will need to factor carbon-related climate hazards into its fiduciary obligations to clients. Increasingly, investors are beginning to scrub their portfolios for climate risks, just as they have for sub-prime risks in the wake of the sub-prime lending crisis.

As former Vice President Al Gore told investors convened at the United Nations 2008 Investor Summit on Climate Risk: “[M]any of you will find [your portfolios] chock-full of sub-prime carbon assets. Now that the world is moving to recognize the true scope and magnitude of the historic challenge we’re confronting, the time is drawing nigh when you, like some colleagues in the mortgage business, will be personally held accountable for what you didn’t see that you should have seen.”⁸

While this pronouncement may seem ominous, it’s really just an acknowledgement that new standards for due diligence are quickly developing. As Senator Jack Reed of the U.S. Senate Appropriations Committee stated recently, “Climate change has broad implications for the marketplace that could significantly impact companies’ future earnings and, if not accurately disclosed, could impair investors’ ability to make sound decisions.”⁹ Companies, of course, already have a duty to inform investors of potential risks. The coming requirements to disclose climate-related risks simply acknowledge the fact that climate change is now recognized as a significant, if hitherto ignored, risk. Henri de Castries, CEO of AXA, agrees: “Climate change and the impact that it will have is as important as interest rate risk and exchange risk.”¹⁰

Factoring climate risks into basic investment decisions will reshape the long-term investment strategies of banks, institutional investors and investment advisors. For instance, any decision to buy a stake in a utility that depends on an indefinite supply of glacial runoff to generate hydroelectric power ought to take into account the possible disappearance of glaciers due to global warming. Similarly, carbon taxes will exert new competitive pressures on traditionally lucrative industries such as oil extraction, and that may make them less attractive investments than they have been in the past.

8 2008 Investor Summit on Climate Risk: Final Report, Ceres, April 2008

9 “SEC Urged to Act on Climate-Change Rules,” MarketWatch.com, July 24, 2008

10 “Profiting from Sustainability,” Green Order, June 2008

Size of the clean energy opportunity³⁰

\$500 billion	Value of low-carbon energy markets by 2050 (Stern)
\$100 billion	Demand for projects generating GHG emissions credits by 2030 (UN)
\$100 billion	Worldwide investment in clean energy by 2009 (New Energy Finance)
\$18.6–\$23 billion	Estimated solar industry revenues by 2010 (Solar Buzz)
\$15 billion	Global fuel cell and distributed hydrogen market by 2015 (The Climate Group)
\$84 billion	Cumulative net savings from energy-efficient products in U.S. by 2012 (The Climate Group)

Source: Deutsche Bank

In other words, accounting for climate change requires clear-eyed business decisions, not simply do-gooder aspirations. “Environmental risk management is not corporate philanthropy,” observes Chris Bray, head of environment risk at Barclays in London. “It is not about the bank wanting to be seen to be an eco bank. It is about understanding the extent to which environmental issues represent a risk, cost or liability to the organization.”¹¹ As the magnitude of these risks, costs and liabilities becomes ever more apparent, the drive for regulatory oversight may increase.

But it’s not merely the promise of governmental regulation spurring companies to include environmental costs in their business. Customers and shareholders are pressuring companies to help combat climate change, affecting both revenues and brand equity. “We are now confronting the limits of our ecological system, and at the same time societal expectations of business are widening. ... We’ve reached a point where civil society is now demanding a response from business,” says former CEO of Goldman Sachs Asset Management and current managing partner of Generation Investment Management, David Blood.¹²

Beyond risk: Opportunity

How should businesses—and financial service providers in particular—respond to climate change? At first glance, a defensive posture might seem to make sense; corporate managers might seek to contain climate risks by mounting green PR campaigns or concentrating on basic compliance with regulations.

But David Blood of Generation Investment Management states that “the leading CEOs are the ones who explicitly recognize that sustainability factors drive business strategy.” In other words, a successful sustainability strategy won’t consist of token gestures; it will change the way a company does business. Blood adds: “[W]e see this changing context for business as an opportunity for companies to establish competitive positioning, grow revenues and drive profitability. In the end, that’s the holy grail of sustainability investing—to seize the opportunities, not just avoid the risks.”¹³

In this view, the real risk is to remain on the sidelines as the economy begins to integrate the challenges of climate change. Sir Nicholas Stern, who

11 “How Banking Became Green,” Greenbiz.com, August 11, 2008

12 “Investing in Sustainability: An Interview with Al Gore and David Blood,” *The McKinsey Quarterly*, May 2007

13 Ibid.

predicts massive losses if climate change is ignored, echoes this thought: “Tackling climate change is the pro-growth strategy; ignoring it will ultimately undermine economic growth.”¹⁴

Sustainable strategies

Financial services companies are beginning to factor sustainability into their businesses in several ways, from lending capital for the development of clean energy to creating green investment products. Financial services firms are also incorporating sustainability into their own operations by establishing governance practices and working to reduce their corporate carbon footprints. Here are some representative examples:

Lending practices—Citigroup has pledged \$50 billion to finance green initiatives over ten years, including \$31 billion for clean technologies, and Bank of America has pledged \$20 billion to support sustainable business activities that address climate change. Some banks, including Royal Bank of Canada and Wells Fargo, have begun figuring carbon risk into their loan portfolios. Bank of America stands apart for setting a specific goal of reducing greenhouse gas emissions associated with its utilities loan portfolio by 7 percent by 2009, making it the only bank so far to have established such a target.¹⁵

Financial products—There are about 256 climate-related mutual funds, comprising \$66 billion in assets, and investments increase every year. Only 10 percent of these assets are domiciled in the United States, suggesting that American fund companies have room to grow.¹⁶ In addition, several banks, such as Bank of America and Wells Fargo, offer discounted “green” mortgages for sustainable building projects, as well as credit cards that earn carbon-offset credits. Several indexes, such as the 20 Dow Jones Sustainability Index and the KLD Global Sustainability Index, have emerged to track sustainable investments.

Governance—Several banks have charged their board of directors with addressing climate change as part of their fiduciary duty to shareholders. European banks, including HSBC and Deutsche Bank, currently lead the way in this area. Goldman Sachs publishes an annual environmental report—rare among financial services firms—that details its environmental investments and initiatives.

14 *Mutual Funds and Climate Change: Opposition Begins to Thaw*, Ceres, April 2008

15 *Corporate Governance and Climate Change: The Banking Sector*, Ceres, January 2008

16 *2008 Investor Summit on Climate Risk: Final Report*, Ceres, April 2008

Greenhouse gas management—An increasing number of financial services firms are purchasing renewable energy and adopting energy-saving measures, such as “green” data centers and buildings and paperless statements. Wells Fargo, for example, claims to be the largest purchaser of renewable energy in the United States, buying 550 million kW hours per year to power its operations.¹⁷

Making sustainable strategies work: Transparent communications

As sustainability strategies take hold, financial services companies will continue to innovate new ways to invest and create value. But that’s not the whole story. The success of any business strategy depends on how well it is communicated to customers, stakeholders and employees. And when it comes to sustainability, transparency in communications is crucial. Investors and customers generally regard corporate sustainability claims with skepticism, suspecting “greenwashing” rather than real accomplishments. A study by AccountAbility, a sustainable development advocacy group, finds that only 10 percent of consumers in the United States and the United Kingdom believe corporate claims about sustainability.¹⁸

Still, consumers are looking to businesses to lead the way on climate change, according to a 2008 Lippincott survey, because they feel companies bear more responsibility for finding solutions than individuals.¹⁹ Another study finds that 53 percent of U.S. consumers factor a company’s social and environmental activities into their purchase decisions and that 57 percent are likely to trust a company once they find it is environmentally friendly.²⁰ This desire for trustworthy guidance on environmental solutions is pronounced in the investment services area, where 73 percent of investors said they need help from a financial advisor to select environmental investments.²¹ Notably, 83 percent said their advisors had yet to recommend an environment-related investment opportunity.²²

These findings suggest that financial services firms have a significant opportunity to promote sustainable investment opportunities to their clients.

17 “Wells Fargo & Company: Building Today for a Green Tomorrow,” Wells Fargo & Company, June 3, 2008

18 “What Assures Consumers on Climate Change?” AccountAbility, June 2007

19 *Consumers, Brands and Climate Change*, Lippincott, 2008

20 “Over Half of Consumers Factor Green Record in Buying Decisions,” *Environmental Leader*, August 6, 2008

21 Survey conducted by GfK Roper Public Affairs & Media, released by Allianz Global Investors, January 2008

22 Ibid.

And beyond such specific selling opportunities, financial services firms stand to bolster their reputations with consumers and investors by touting their green accomplishments.

But those accomplishments must be genuine. To ensure transparency in their environmental activities, companies are increasingly communicating their accomplishments in sustainability through formal corporate sustainability reporting. As of July 2008, 86 percent of companies on the Standard and Poor's 100 Index had corporate sustainability websites—up from 58 percent in 2005—and about half of those companies produced a full sustainability report, also an increase from 2005.²³ Many companies adhere to reporting standards, such as those developed through the Global Reporting Initiative, to strengthen the credibility of their disclosures.

A recent study by KPMG Sustainability showed that following such reporting standards helped build a sense of trust in 90 percent of sustainability report readers. Moreover, 85 percent of readers had a more positive view of a company after reading its sustainability report.²⁴ And while it's important that companies report genuine environmental accomplishments, transparency of communication is perhaps even more important for engaging with stakeholders. When companies incorporated their stakeholders' critiques into their reports, 60 percent of sustainability report readers felt it demonstrated a firm's commitment to sustainability.²⁵ In an age of heightened climate risk, investors will increasingly factor a company's verifiable commitment to sustainability into investment decisions.

But companies have more at stake in communicating their sustainability agenda than reassuring investors. Sustainability is becoming an essential motivator for employees. Financial services firms that depend on hiring the best and brightest will need to demonstrate a coherent commitment to sustainability to compete for top talent. A 2008 Stanford University survey of graduating MBAs from 11 top business schools found that nearly all (97 percent) of new MBAs would be willing to sacrifice up to 14 percent of their expected salary to work at a company that demonstrated high standards of corporate social and environmental responsibility.²⁶ Another study discovered that 79 percent of new college graduates would accept a job at an eco-friendly company over one with a conventional firm.²⁷

23 "More S&P 100 Companies Reporting CSR Progress: Study," *GreenBiz.com*, July 22, 2008

24 "Survey: Sustainability Report Readers Single Minded," *www.thecro.com*, 2008

25 *Ibid.*

26 "Challenging Work and Corporate Responsibility Will Lure MBA Grads," *Stanford GSB News*, June 2008

27 "Green Allure for College Grads," *GreenBiz.com*, August 6, 2008

The challenge isn't just in recruiting talent, but in retaining it as well. A Towers Perrin study finds that a company's commitment to corporate social responsibility is the third most important driver of employee engagement, just behind support from senior management and company reputation in the community.²⁸ Employees want to work for a company that shares their values, which include a commitment to sustainability. But a recent survey suggests that companies have a long way to go in communicating their stance on sustainability to employees—54 percent of employees feel confused about how environmental impacts are being addressed at their company, and one out of two feel their company communicates environmental concerns poorly to key stakeholders.²⁹

To ensure their employees remain motivated, financial services companies need to communicate their sustainability vision clearly and consistently across the organization. When employees see themselves in the company story, they buy in. And with a galvanized workforce, financial services firms can focus on seizing the opportunities of the post-carbon economy.

Investing in a sustainable future

The writing is on the wall: the carbon economy will eventually be replaced. Businesses that position themselves to hasten the transition to a non-carbon economy stand to prosper—not just because they will have a stake in the enormous new revenue flows that will facilitate this transition, but because they will have earned the loyalty of customers and stakeholders who want to conquer climate change. The transition has already begun. Are you ready?

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28 "Corporate Social Responsibility: It's No Longer an Option," Towers Perrin, June 2008

29 *Corporate Sustainability: Employees Want the Change*, Fresh Marketing, May 2008

30 *Corporate Governance and Climate Change: The Banking Sector*, Ceres, January 2008