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TRANSCRIPT

Carbon Footprinting Demystified

Transcript, 14 June, 2024

Mike Disabato (00:00):

What's up everyone? And welcome to the weekly edition of ESG now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Disabato, and this week we discuss the vital importance of calculating emissions for an investment portfolio, also called a portfolio carbon footprint. Thanks as always for joining us. Stay tuned.

(00:29):

Carbon accounting often centers around the burden of responsibility. Responsibility meaning not only what process emitted the carbon, but who owns that process and who would be impacted if that process were no longer viable in a climate change world. And assigning responsibility might seem easy, but think about it this way. Who is responsible for the emissions of a coal fired utility? Is it the utility itself that creates the energy from the coal or is it the coal mining company that sells the coal to the utility? Is it the consumer who buys the energy from that utility or is it the bank who made a loan to the utility or mining company thus providing a capital with which to broadly expand and develop? Now at times it can be all four, but what is important is those first three actors, the utility, the miner, the consumer, they are tangible actors.

(01:23):

The mining company sold the coal. The utility company used the coal to create electricity. The consumer used the electricity to power stuff with whatever they're doing. There's a carbon value to the tonnage of coal used, and there's a monetary value to the cost of the electricity. But what about the investor that didn't tangibly use any of that coal or its created energy, but they still were part of the equation in the way all those that profit off of production are? What are they responsible for and how would they be impacted if the utility that uses coal all of a sudden becomes unprofitable in both a literal and societal standpoint due to climate change? Well, to understand that piece of the equation, you have to calculate what is called a portfolio carbon footprint, something that is becoming more ubiquitous in the financial market, and that might seem really wonky, but you have to think about it this way.

(02:18):

Without a carbon footprint, a bank, an investor cannot know how exposed they are to pollutive processes at a broad portfolio level. They often have billions of dollars of assets at play and they're spread out in ways that are hard to calculate for a large investor. And what happens if, for example, the banking sector is continuously providing loans to an industry that is at risk of either monetary or physical collapse due to climate change? Must I remind everyone what happens when the banking sector is making bets on things they haven't calculated and so don't understand the risk of, and according to my guest and colleague Carrie Wang, who just finished writing a report called the Carbon Footprint 2 0 1, we did the 1 0 1 back in 2015. By the way, according to Carrie, the proliferation of the portfolio carbon footprint isn't due to just concerns of climate activists. It's from the fear of suited bureaucratic regulators,

Carrie Wang (03:15):

Regulators all over the world. They are requiring investors to measure and disclose their portfolio carbon footprint. And Europe is moving particularly fast on this front, and we have seen regulation schemes such as

the Sustainable Finance Disclosure Regulation, the SFDR and some others, and also APAC is catching up as well. But instead of creating their own set of rules, they tend to follow some common disclosure frameworks such as the TCFD or SSD,

Mike Disabato (03:50):

The T-C-F-D-R-I-S-S-B acronyms. Yes, but part of a very real international initiative to get more investors to set up carbon emissions accounting systems for their portfolios. And Carey is very right about the EU leading the charge. There are four globally recognized voluntary initiatives and three pervasive regulatory schemes for portfolio carbon footprint, which are all in the European Union and have been enforced as of April, 2024. And this is all because regulators are worried about what could happen to the financial sector due to climate change if it does not account for its exposure to carbon emissions. And regulators are not alone in that desire or concern. Of course, there's also a contingency of stakeholders and clients that are pushing banks, especially to better disclose on the carbon emissions associated with their loan book because up until relatively recently, banks that finance fossil fuel projects, let's say, haven't been reporting on those projects as part of their emissions profile.

(04:51):

Instead, they focus on the direct emissions that they are associated with, which obviously aren't much. You just have buildings with computers in them. For banks, this can paint an inaccurate picture when it comes to financial risk due to climate change. If your loan book is overexposed to pollutive projects in a region, seeing a decarbonization shift toward new technologies, let's say, or a regulatory push to lower emissions without proper carbon accounting in a bank's risk management system, and the disclosure of that carbon accounting, the bank or the asset manager, I want to include that as well in the investor profile is flying blind in a way, but with a calculated number. These investors can look at their portfolio and make a plan based on how exposed they are to carbon emissions.

Carrie Wang (05:37):

So whether they want to manage the risks of their portfolios, reducing exposure to carbon intensive assets, or they want to invest in some energy transition projects where they have some specific climate targets they want to reach. So they use the baseline to set targets as well.

Mike Disabato (06:00):

That is why this is important. Take the Hong Kong born multinational bank HSPC after it quantified its loan portfolio emissions, it was able to set a detailed climate target that aimed to reduce the absolute emissions for seven carbon intensive sectors that it made loans to. This includes oil and gas cement, metalworks, aviation, automotive, and the thermal coal mining industry. After HSBC identified these industries, it now plans to engage with the companies within these sectors to help them transition their operations or actively limit investments in the hard to abate pollutive sectors that they were invested in. It wouldn't know to do that and shareholders wouldn't be able to hold them accountable on those plans if it didn't conduct a transparent and comprehensive carbon footprint strategy. So all that, the need for our financial system to have a quantifiable disclosure for what can happen with climate change to their assets is why carbon footprint is important. Now, why is it so complicated? Why did we need to put out a guide on how to do that calculation? Well, because there is not yet a standardized way to calculate the baseline portfolio emissions number. As with all accounting, the devil is in the disclosures.

Carrie Wang (07:23):

It does matter in the process what calculation inputs investors are using for footprint and also what sort of adjustment they may make to ensure the results are meaningful. For example, a key set in calculating portfolio carbon footprint is to attribute a portion of the portfolio company's greenhouse gas emissions to the investor. And we need to know how that portion is determined and it is based on how much the investor owns of the company.

Mike Disabato (08:04):

Let's say a portfolio owns 3 billion US dollars worth of shell in stock and Shell's company value is 300 billion US dollars, then 1% of shell's emissions are counted toward the investor's carbon footprint. We do this calculation for the other assets in the portfolio and sum the results up to arrive at the portfolio carbon footprint. Okay, fine, but here's where I need to get wonky. Now, what is a company's value that isn't a set thing in the financial market now, is it?

Carrie Wang (08:32):

So early in the days when carbon footprint methodologies were focused on pure and equity portfolios, market capitalization was often used. But because more and more portfolios tend to be multi-asset nowadays the use of enterprise value, including cash, we call it eic, EIC has become more widespread. So EIC takes into account not only equity financing but also debt financing and cash balance sheet. So it's more like a whole picture of the total financing to the company

Mike Disabato (09:15):

EVic. It tells you the company's value and how much it would cost to buy the company. It is a number that shows a company's worth in essence. So you could just take the investor's position, as I said in the company and divide it by eVic and multiply it by the company's total greenhouse gas emissions. And there you go. You've got a portfolio carbon emissions number for that company that you've invested in. And there are other ways to do that calculation, but let's just keep it at that for the sake of the conversation because it can get complicated with timing issues of when eVic is reported versus the emissions. There's some details there that I'm going to just gloss over. Where this actually gets complicated and this is important is trying to understand the value of that portfolio carbon footprint number over time. That is the use of a carbon target to see how things move from one quarter to the next.

(10:06):

And there was a time a couple years ago where some investors were reporting their portfolio carbon footprint of huge swaths of the market and showing that it went down, but the overall absolute emissions of our society hadn't changed. In fact, they've been increasing. And what people realized was the only thing that was changing in these investors' calculations was the company value number, not the emissions number. Let me give you an example to make all that a bit more concrete. Let's say you have a portfolio that is heavily invested in nvidia, the tech company. The enterprise value of NVIDIA increased threefold in the past year. Even if NVIDIA's emissions didn't change or even increase 50%, the financed emissions intensity of your portfolio could appear to have decreased substantially because your denominator, which is the enterprise value of the company, increased by threefold while your numerator, the emissions did not change. This is a difference between what's called paper emissions and absolute emissions. If you have paper emissions, you have a company that just maybe increased in value and kept their emissions stable or just increased their emissions by a little bit. With absolute emissions reductions, you would actually see a lower absolute carbon emissions number regardless of the worth of the company. Now, regulators have gotten savvy to this problem of paper

emissions versus absolute emissions and have added requirements to remove the noise from the disclosed portfolio emissions that are reported out to the market.

Carrie Wang (11:37):

Some initiatives such as P cap, they also ask companies to report both the adjusted and unadjusted numbers to make sure the numbers are comparable as well. So as an investor, you do want to know what are so-called the real world emissions change of your portfolios companies, are they actually taking actions to improve their carbon profile, reducing their carbon footprint or their finance emissions intensity tends to decrease just because they have a better valuation where their stock price just increased so much. It's not like something the portfolios companies did to make the world cleaner.

Mike Disabato (12:31):

Understanding whether a bank, for example, helped lower the collective emissions of our society. It's an important metric for a more impact oriented investor that is all about trying to ensure their portfolio has the lowest absolute emissions possible. Now, an equally important complication that could arise without a proper counting of how the finance carbon footprint was lowered for a bank or for an asset manager would be for an investor that is trying to ensure it isn't exposed to companies that may run a file of regulations meant to increase the cost of carbon emissions, or an investor that wants to take advantage of portfolios that are pursuing low carbon tech, something that would be seen in its finance, carbon emissions numbers being lower. You have those two different types of investors that can be satisfied by this one disclosed portfolio carbon emissions number. What Carrie is hoping is with this report, investors will have a better toolkit for which to disclose their finance emissions and a better way to understand how different portfolio carbon footprints have been calculated that are starting to trickle out into the market. So in that regard, I asked her what she thinks all this will mean for the future of investing.

Carrie Wang (13:46):

So now we have the carbon footprint numbers and what this number will bring is transparency. Transparency for investors wanting to reduce exposures to companies that are at potential risk of credit or operational problems due to climate change or they increase their exposure and invest in companies that are likely to benefit in the transition to a low carbon economy. And where this number can go wrong is if investors just stop there and put the numbers out to show they're managing the risk of climate change, but they actually are not. It'll require a detailed portfolio attribution, as we mentioned, to provide further transparency and breakdown, and also shows how they're taking actions to change the portfolio emissions over time.

Mike Disabato (14:47):

Understanding climate targets requires transparency and consistency. If that isn't done, we are not actually sure whether or not emissions have been lowered and increased and where the assets are located with regards to risk or opportunity due to climate change. What Carrie is hoping with this guide is that she can make a more transparent financial market that sees climate change as an already present systemic risk that we all need to figure out how to address in numerous ways. Thanks as always for joining us. Thanks to my guest, Carrie Wang for discussing the news with an ESG twist. And if you like what you heard, don't forget to rate and review us. It always helps and subscribe wherever you get your podcast. Thanks again and talk to you next week.

Speaker 3 (15:50):

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