Talking Climate and Sustainability – Episode 8: Changing investment for Net Zero

LUBA NIKULINA: We think that climate risk has reached the stage where it is a financial risk and a financial opportunity for our clients. And we do want to help our clients to stay ahead of the curve on this journey of how we, as investors, can both help this system transition, but also earn some money for our stakeholders in the process.

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SPEAKER: You're listening to Talking Climate and Sustainability, a podcast series from Willis Towers Watson where we explore why climate change and building a sustainable future is a responsibility we all share. From the complexity of shaping an effective ESG strategy to achieving an orderly transition to a sustainable, low carbon, climate resilient economy, organizations across the public and private sectors are grappling with the challenges of climate change and creating a more sustainable future for communities and society.

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LYDIA MESSLING: Hello and welcome to our *Climate and Sustainability* podcast. Now this time, we've got something a little bit different for you. In these next few episodes, we thought we'd chat some more about the themes that emerged at our Climate Risk and Financial Stewardship Summit back in May 2021, where we heard from industry-leading experts on the changes and challenges in stewarding the transition to a climate-resilient economy. There's so much more to explore. And so we hope you enjoy the perspectives and insights from Willis Towers Watson's thought leaders as they further unpack climate risk, resilience, and sustainability and what organizations need to be thinking about.

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Hello and welcome to our *Talking Climate and Sustainability* podcast. I'm Lydia Messling, your podcast host. And I'm delighted to be joined this time by Luba Nikulina. Luba, hello.

LUBA NIKULINA: Hello, Lydia. Thank you for having me at your podcast.

LYDIA MESSLING: Thanks so much for joining us, Luba. And so, Luba, one of the questions I like to ask people is, in your role as an investment researcher, was there a particular moment where you became aware of the sheer size of climate change as a challenge?

LUBA NIKULINA: Well, it's difficult to think about a particular moment because I have been doing investment research for the last 25 years, a bit more now. And to be honest with you, environment, environmental risks, they have always been very high in the priorities when we do research. And maybe just quickly for the context what my team and I do. We look at the universe of different investment managers, we find the best ones, and then we help our clients build portfolios out of these investment opportunities.

So environmental risks have always been very high in our due diligence, but it's, literally, in the last four or five years that they have really become very significant. And then in the last 16 to 18 months since the start of the pandemic, they really took the front stage. There is an element there of the increased regulation across different countries, but particularly here where we are based in the UK, hence client demand is increasing. But there is also an element that it was more just a non-financial operational risk in the past. But now it is increasingly becoming a financial risk and indeed a financial opportunity for clients, and hence it is so significant in what we do.

LYDIA MESSLING: And so when you talk about opportunities, what things are you researching and looking at.

LUBA NIKULINA: Yeah, so we think about climate now in every financial decision that we make because when we think about the impact that climate change has, it has impact on all of our lives and indeed on all of our businesses. So we have the Paris Climate Agreement that more than a hundred countries have signed up to. And many of them are bringing it to become the law, including here in the UK, which means that the government will be bringing increasing regulation and just changing business models for many companies. And this does create an opportunity for investors to differentiate between those who are likely to be losers, on the losing side of this change, compared to those who are likely to become winners.

And then there is also an element that our society and our economy need some climate solutions. So just thinking about the way we produce energy, the share of the renewable energy has increased so significantly, but it's still nowhere near where it has to be. So that's a massive opportunity for clients.

And then there are a number of other things. We call them climate solutions that we are looking for our clients to invest into. For example, electrification of transport, creating these charging points for electric vehicles, a massive ramp-up, and it does require capital. So that's another opportunity example there.

LYDIA MESSLING: And so, Luba, a few of the things that you mentioned there, I know probably tie in to actions related to-- I'm going to say a phrase that we hear used a lot at the moment, net zero. Net zero commitments, net zero targets. But when I was speaking to you previously, I realized that investors have a very specific way in which they talk about net zero, and it's quite different to being carbon neutral. So how is it you define those two terms?

LUBA NIKULINA: That's a good point that you are picking up here, Lydia, that there is some confusion in terms. And different entities will be defining different terms differently. It's the sign of the journey we're in, so I'm sure that the definitions will become tighter. And you can see that the net zero definition is becoming more entrenched in the investor language with all the net zero commitments that we see various investors making.

And the way the best practice in net zero financial commitments seems to be narrowing towards is actually ensuring that when we talk about net zero, we talk about the reduction of emissions, and not only carbon, as in carbon neutrality, but also all greenhouse gases and the absolute reduction in those greenhouse gas emissions. We don't use offsets, so-called "carbon offsets" that are often used in carbon neutrality.

When you think that if I am a very heavy emitter as a business, then instead of thinking how to reduce the amount of emissions, I will just go and find a way to buy some carbon offsets, and then I will be carbon neutral. When we talk about net zero, we think that carbon offsets should be treated separately. So we talk about the absolute reduction of emissions and bringing them to zero.

LYDIA MESSLING: OK, so for you, net zero is about the bringing down of the emissions full stop, not trying to cancel them out or sort of buy them in some other way, whether it's through negative emissions technologies, those sorts of things. So OK, here's the challenge, then, for you, Luba. What are the three reasons why you should take this sort of net zero approach over just trying to go carbon neutral with offsets and things like that. What are your top three reasons for going net zero?

LUBA NIKULINA: Yeah, well, the first one is probably all the uncertainty about various technologies that ultimately can generate offsets. So some of them, as land reforestation, planting trees, are relatively easy. But it's really difficult to do in scale.

So there are some innovations there about carbon capture and storage, so-called CCS technologies. So it's good that there is a lot of thinking and also some capital going into this space. But it's not guaranteed that they will be successful. So that's the first reason.

The second reason, I was just giving an example of the heavy carbon emitter who can go and buy some offsets instead of thinking about their transition plans. I think there is an issue there because it sort of shifts your incentives. The availability of those carbon offsets may actually delay the transition of the economy to the level of low carbon emissions. So that's the second.

And then you asked me about three reasons. The third reason that I would probably cite here is the fact that this market of bringing those who can produce carbon offsets versus those who need to buy them, it's really not developed. It's very fragmented. There are so-called "carbon offset credits," but the market is tiny and it's very inefficient.

The infrastructure for trading of those credits is underdeveloped. So this needs to emerge. And then there will be a more efficient way to allocate those offsets. And it doesn't exist right now. So here you go, Lydia-- three pretty significant reasons, I would say.

LYDIA MESSLING: Pretty significant reasons, indeed. And so Willis Towers Watson announced recently our net zero commitment. And there's some pretty robust reasoning behind that, as well. Could you tell us a little bit more about what we saw as the investment case for that?

LUBA NIKULINA: Yes, absolutely. And I am very proud of all the work that had been invested into this commitment. So that's, I think, really significant for our business. We announced two commitments simultaneously.

The first one is about our own operational emissions, the commitment to bring them to net zero in the way that I described, without relying on carbon offsets. So this is the first commitment. But then the second one-- and for me as an investor, it is more significant in scale-- is actually ensuring that our delegated portfolios, the capital that we manage on behalf of our clients, is aligned to this transition to net zero. And we have done it across $168 billion of assets that we have under management, under our care.

We have done it globally. And we have done it because we think that climate risk has reached the stage where it is a financial risk and a financial opportunity for our clients. And we do want to help our clients to stay ahead of the curve on this journey of how we, as investors, can both help the system transition, but also earn some money for our stakeholders in the process, and protect their capital from potential devaluation because of this risk.

LYDIA MESSLING: That's really great. And it is quite exciting to see that commitment come out. And we're seeing others make similar commitments, too.

But I don't really know much about how we can actually measure the progress towards net zero through these sorts of commitments. How do you know that you're making progress in these sorts of investment shifts?

LUBA NIKULINA: Yeah thank you, Lydia. That's a somewhat multifaceted question. I would probably say the first thing is that it's really important to work collectively on this topic.

So not only we have made the net zero commitment ourselves, we have also joined the Net Zero Asset Manager Alliance to ensure that when we think about how we measure, how we report, but also what sorts of data we require from underlying businesses, underlying asset managers, what data we give to our clients, that we gradually try to create some standards there and help the whole value chain within investments talk the same language and measure in the same way.

And there has been a lot that's been happening in this area. So we were talking about carbon emissions. That is one thing that the investment community have found as something that we can easily measure and ask companies to report on, which on the one hand, it's a step forward.

Finally, we have something to measure. That's good. We are all measuring it right now. There are still issues, even with carbon emissions, because how you measure them across the chain is a challenge.

But then, it has also started demonstrating that you cannot get away with just one measure. So there are situations where you have heavy emitters, as they stand right now, who have excellent transition plans to the low-carbon economy. So you would want to be invested in these businesses because they are on the trajectory to be those winners in the future.

But then there are businesses who will have a similar carbon load right now, or maybe even lower, but with no transition plan. And these are the businesses that you wouldn't want to be investing at the moment. How do you differentiate between the two-- with transition plan or without transition plan? And this is where carbon emissions, if they are taken on a standalone basis, could potentially be misleading for investors. And we are increasingly looking into such metrics as climate value are at risk, which attempts to measure the future of the transition for underlying businesses.

LYDIA MESSLING: So Luba, I think it's really interesting what you were saying, particularly around the climate value at risk stuff. Can you tell us a little bit more about how that is done, and how you think that can really influence investors' decisions?

LUBA NIKULINA: Yeah, well, I think it's very important to look on those forward-looking metrics which I just described. Unfortunately, it's not easy to do. So the way we do it, we have this business unit, Climate and Resilience Hub, that has been focusing on this area for a long time. And it's really not your usual analytics that you can get straight from a company's report. You really need to do some analysis there, including future planning scenarios.

And the impact that it will have on the business model of every business that we look at, how it will be affected by the climate change. Do they have a proper transition plan in place? And how these plans will be affecting their cash flow and P&L?

And then when you bring all this analytics up, it gives you the potential value at risk of climate change. And we are actually working on creating a smart beta solution for our investors that would allow us to calibrate exposure in passive investing to this climate value at risk, forward-looking metrics. I guess we are just fortunate to have this group of analysts providing us with these measures.

LYDIA MESSLING: Yes, I mean, it's great. Every time I see them present their new tools or a new way of doing something, it just blows my mind again, just the advancement that they're getting there. It's great.

OK, so clearly, we know that achieving net zero is something we really need to do, and urgently. And we definitely need to make sure that we get there. So what do you think may emerge as significant barriers for us reaching net zero? And do you have any suggestions on what it is we can do to overcome them-- a bit of a big question there, Luba.

LUBA NIKULINA: Yeah, it is a massive question. And unfortunately, at the moment, I see more barriers than I would love to hear in the ideal world. For now, we are moving on the trajectory of the temperature increase that is scary.

And to be honest with you, no matter where you are in the world right now, we have started feeling and seeing this climate change on the way weather patterns are emerging. So this definitely creates some shift in the mindset of society, of investors.

But it's a really difficult problem, and hence the list of barriers is, at the moment, very, very long.

So we can talk-- we already spoke about how difficult it is to collect and analyze data. So that's the first thing. The second thing is, how do we ensure that if there is innovation happening, that there is the right amount of capital supporting this innovation?

And private capital is hugely important in this space. And we have been, as I mentioned, directing our capital in certain climate solutions, in businesses that are preparing for transition. But private capital cannot do everything.

So private capital needs a certain return for their stakeholders, for their investors, for average [? will-be ?] savers, pensioners who need this return. So the role of public capital, governments' actions, regulations, is incredibly important. And again, at the moment, it's-- well, I wouldn't call it a barrier, but it's definitely something that needs to evolve and become better.

I can carry on about the barriers, but I think what I would focus on is actually that I have been working very actively in this area for the last year and a half. And I see a lot of like-minded people, a lot of passion in wanting to make the change and actually overcome these barriers. And this is what gives me hope.

LYDIA MESSLING: And it's always good to end on a little bit of hope. We could all do with more of that. Thanks so much, Luba. Well, thank you again for joining us on the *Talking Climate and Sustainability* podcast.

LUBA NIKULINA: It's been a pleasure. Thank you so much, Lydia.

LYDIA MESSLING: Thank you. And thank you all for listening, and we hope to see you again soon. Bye for now.

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