What's new in ESG – November 2023

PRI in Person: Four important takeaways

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More than 5000 investors worldwide are now signatories to the Principles for Responsible Investment (PRI), as Alphinity has been since 2011. In October, I had the privilege of attending my first PRI conference which took place in Tokyo, Japan.

Under the resonating theme, "**Moving from Commitments to Action**", we covered a lot of ground in just two and a half days. Japan's commitment to net zero and renewed emphasis placed upon human capital, innovation and gender diversity served as a positive signal for Asia Pacific's ESG ambition. Complementing the main panels were side events that brought together 1400 delegates from more than 50 countries to explore the growing array of topics we must consider as responsible investors. Special academic break-out sessions invited scholars to present cutting-edge research that fostered debate and offered investors a chance to explore their studies and provide feedback. From physical climate risk and nature to intergenerational equity and human rights, there are many learnings to reflect on. This article outlines four important takeaways from PRI in Person 2023.

#1: Japan's ambition in sustainability and responsible investment

A conference highlight was the keynote delivered by the Japanese Prime Minister, Fumio Kishida. During his speech, he announced that seven national pension funds are preparing to become PRI signatories. This represents more than $US600 billion in assets and marks a significant stride towards responsible investment in the Japanese market.

The Japanese government has also emerged as an advocate for stronger ESG disclosures. In December 2022, TCFD disclosures were made compulsory for listed Japanese companies. Building on this, human capital and diversity reporting standards are expected to be implemented in 2024. This reflects the nation's push to improve workplace culture, to retain a new generation of talent in an aging population and stimulate innovation within a slowing economy. The government has also taken proactive measures to support 30% female participation to improve employment opportunities for women and narrow the productivity gap.

Local representation of Japanese companies impressed with their dedication to both ESG and sustainability. The president of Nippon Life Insurance said "*Managing ESG risks alone is no longer enough to fulfil our responsibilities*" and noted systemic problems such as climate change, nature and human rights requires coordinated action and the capital support of developed countries.

#2: Looking beyond energy in the climate change conversation, and into nature

The Intergovernmental Panel on Climate Change (IPCC) delivered a compelling speech highlighting two key strategies to mitigate climate change. First, the need to phase out the burning of fossil fuels. Second, and notably an emerging topic in the ESG space, was nature as a lever for net zero.

It felt like nature was being positioned as the next climate frontier. There was consistent emphasis on the roles of biodiversity, environmental health and sustainable agriculture as tools to achieve net zero by 2050. Nature, being the world's largest carbon sink, not only holds the potential to decrease emissions, but also supports food security and economic productivity. Sustainable agriculture too can improve soil sequestration, reduce dependency on fossil-based fertilisers such as nitrogen, and improve output from the land.

It's evident that companies are actively engaging in nature positive initiatives. This has been further supported by the Taskforce on Nature-Related Financial Disclosures (TNFD) sharing its recommendations earlier in September.

But the CEO of the PRI, David Atkin, pointed out that six of the nine planetary boundaries have already been crossed and noted that we as a society are only in the first stages of remediation (Stockholm Resilience Centre).

A powerful address from the WWF called for more urgent investor action on deforestation and urged that deforestation should by default be embedded within investor climate change strategies. While views on deforestation are fairly well-established, and are being enforced by new regulations in Europe and emerging collaborative groups like Nature Action 100+, a different idea proposed by WWF was to bring attention to reforestation. Rather than just minimising the risk, investors can integrate reforestation into their stewardship strategies to grow the opportunities in, and benefits from, the restoration of natural systems. This perspective, balancing risks and opportunities, resonates well with the TNFD framework.

Locating nature-related risks: Kirin's early research

Beverage company Kirin spoke to an early nature pilot in partnership with UNEP-FI (United Nations Environmental Programme – Finance Initiative) to explore risks related to deforestation and monocultures in Indonesian rubber plantations. These monocultures can generate substantial long-term impacts such as increased soil erosion, reduced carbon sequestration, biodiversity loss, and a deterioration in downstream services such as drinking water or pollination.

Because there was no data to provide a baseline for performance, Kirin worked with a local university to evaluate land use and determine where, and why, forest growth had materially changed. Importantly, Kirin was well placed to then explore the management practices needed to prevent risks to future production capacity. While data is still in its early days, this case study highlights the value in collaboration and early markers for success by using TNFD's LEAP (Locate, Evaluate, Assess, Prepare) framework.

#3: Physical climate risk to accelerate in the face of a slow transition

With global emissions still rising, the focus on adaptive capacity and proper planning for weather-related risks was a key theme across the conference. Physical climate risk was particularly relevant in light of the natural disasters in Japan, but was also reinforced by the recent NASA observation that found June to August 2023 to be the hottest months on record. Conversation on the energy transition and the state-of-play for fossil fuels did not receive as much attention.

An interesting aspect raised was that physical climate risk impacts are not confined to the borders of any single asset. While individual assets might be robust to climate events, due to investment in adaptive capacity and even the best insurance coverage, there are broader complications that arise with increasing severity and frequency of weather-related events. Factors such as insurance premiums or contract renewal disruptions, demand changes as a result of customer financial health, or lack of tourism or funding in regions highlight that the bounds of physical climate risk are nuanced and difficult to predict. While current TCFD disclosures recommend reporting the percentage of assets vulnerable to climate risk, one representative stated that this metric may evolve to become annual average loss estimates or climate value at risk (CVAR) in order to better reflect the degree of physical climate risks a company is exposed to.

Physical risk is particularly important as renewable energy grows. The profitability and success of these systems are highly dependent on, and exposed to, the climate. For example, a hydropower shortfall in China caused by drought caused an increase in fossil fuels such as coal. In Texas, a solar farm was in ruins after a severe hailstorm just earlier this year. Weather volatility could potentially be a significant income disruptor and this conversation certainly provided food for thought in terms of the resilience of our future energy systems.

#4: Challenges in Asia's net zero transition and ensuring interregional equity

Amongst the Tokyo backdrop there was plenty of discussion centred on emerging Asian markets and the role nations such as China and India play to meet global economic and supply chain needs. However, balancing these objectives with climate action, environmental preservation and improving human rights requires more than just country-level support. As the largest regional emitter of greenhouse gases globally, Asia demands urgent policy and innovation in order to achieve net zero, particularly within the energy and industrial sectors.

Steps taken by the Japanese government on the decarbonisation journey serves as a guide for the climate action that needs to take place across Asia. Japan's reliance on fossil fuels, particularly after the Fukushima nuclear disaster in 2011, has led to the country ranking as the 8th largest carbon emitter globally (Emissions Database for Global Atmospheric Research 2023). To address this, Japan has introduced the Green Transformation initiative, known as GX, to support the low carbon transition. This includes measures such as carbon pricing, a carbon tax on fossil fuel imports starting as early as 2028, and the issuance of ¥150 trillion of transition bonds over the next decade.

Conclusion

The PRI brought together a passionate network of financial, ESG and sustainability experts. Japan's ambition in sustainability and responsible investment was emphasised through the Prime Minister's address, along with the PRI sponsorship of many Japanese companies. Nature and reforestation were positioned as important pieces of the climate change puzzle and progress is being made to collect baseline data to underpin the management of nature-related risks. Physical climate risk came through as an issue requiring more focus, in turn emphasising the need to lifting the bar in decarbonisation before weather-related costs worsen. I look forward to attending many more PRI conferences and helping to bring the conversation back to Australia.

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