BERENBERG UK ESG REVIEW

Q3 2021 ESG UPDATE

The rapid social and political changes taking place have pushed environmental, social and governance (ESG) issues right to the heart of the investment analysis process. COVID-19 has brought 'social' factors into prominence alongside 'environmental' and 'governance' in that large elements of the population now want the companies they invest in to "do good". However, it is more than this. Companies with strong ESG credentials and policies are increasingly being recognised as being sustainable in a business sense. By this we mean, that they are able to retain the "licence to generate profits", as they positively contribute to meeting societies' wider goals.

ESG is a relatively new science – as a result there are no globally accepted standards. Hence, from an investor perspective, there can appear to be a bewildering array of rating systems, initiatives and, unfortunately, a lot of corporate green washing.

To help investors navigate their way through these issues, and to enable them to stay up to date with the latest advances and thinking, our ESG Equity Research team produce a weekly newsletter. From this we have extracted some interesting news stories and developments over the quarter.

IN A NUTSHELL

- US doubles climate finance commitment
- Three things you may have missed from the IPCC (Intergovernmental Panel on Climate Change) report plus what the scientists say we need to do about it
- Taxonomy should link ESG and executive pay, say EU advisors

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US doubles climate finance commitment (The Guardian)[1]

President Joe Biden announced that the US would double the financial aid provided to developing countries for climate investment to **more than $11bn by 2024.**

He also stated he is **confident wealthy countries will meet the pledge to provide $100bn p.a.** to help poorer countries deal with the climate crisis.

Berenberg view

The $100bn climate finance target has been a **key issue holding back progress in the lead up to COP26 (UN Conference of the Parties)** as developing countries have expressed the need for more support to be able to invest in climate change mitigation and adaptation. Analysis by Oxfam (2021)[2] suggests **Biden's announcement could take climate finance up to $100bn by the middle of this decade**, but with the funding supposed to be provided from 2020, **rich nations are set to fall $68bn short of the target over 2020-25**. So, while this is a decent step in the right direction, other developed countries may need to increase their financing commitments as well to bring developing countries fully on side.

Three things you may have missed from the IPCC report plus what the scientists say we need to do about it (The IPCC)[3]

1) The importance of methane

Methane has been a significant contributor to climate change, causing 0.5°C of global warming versus pre-industrial levels, while CO2 is responsible for 0.8°C of warming (some gases' negative effects, e.g. sulphur dioxide, lead to 1.1°C overall warming). Thus, methane mitigation, as well as net zero CO2 emissions by 2050, is crucial if warming is to be limited to 1.5°C. Implementation of the identified maximum mitigation potential could reduce human-caused methane emission by 50%, leading to 0.2°C less warming. Moreover, if methane emissions decline, it will help to improve air quality, through reducing near-surface ozone levels. (Note: Fossil fuels and livestock account for 60% of human-induced methane emissions.)

2) The reluctance to call out fossil fuels

While the willingness of the IPCC to confidently refer to human-induced/caused climate change is a step in the right direction in our view, it is concerning that there is no mention of fossil fuels in the report's 42-page summary for policymakers. Given the

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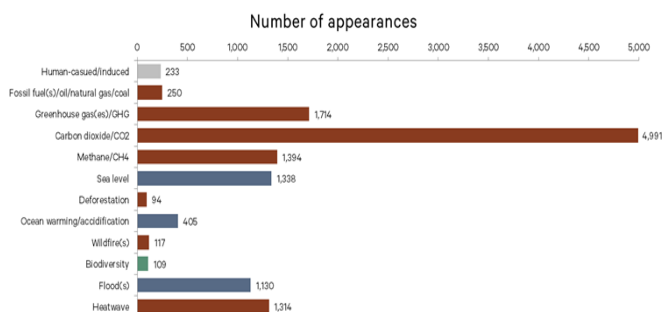
[1] The Guardian, https://www.theguardian.com/us-news/2021/sep/21/joe-biden-un-general-assembly-climate-aid-developing-countries
[2] Oxfam, https://www.oxfam.org.uk/media/press-releases/poorer-nations-expected-to-face-up-to-55-billion-shortfall-in-climate-finance/
[3] IPCC, https://www.ipcc.ch/report/ar6/wg1/

glaring omission, Berenberg's ESG Equity Research team decided to compare the number of references to key climate change related terms in the entire IPCC sixth assessment report (working group 1 contribution) and some of the results were very surprising. CO2 took the lead with nearly 5,000 appearances, being referred to almost 20 times more often than fossil fuels (or similar terms). With only 250 appearances, fossil fuels were mentioned far less frequently than the likes of ocean warming/acidification and methane.



Source: Berenberg

3) Sea level rise inevitable

Global sea levels are guaranteed to go up, with a rise of 0.28-0.55m by 2100 even if there are very low future Greenhouse gas (GHG) emissions. Dauntingly, at the other end of the spectrum, a sea level rise of 2m by 2100 and 5m by 2150 cannot be ruled out under a very high GHG emissions scenario due to uncertainty around ice sheets melting. Furthermore, even if net negative CO2 emissions were achieved and maintained, sea levels are set to rise for centuries to millennia due to deep ocean warming and ice sheets melting. As a result of higher sea levels, as well as an increase in rainfall intensity and tropical storms, coastal city flooding will become more common.

Bonus: What needs to be done (The Guardian)[4]

The third working group's contribution to the IPCC's sixth assessment report, looking at how humans can reduce their impact on the climate, is not scheduled to be released until early next year but it has been leaked by a group of scientists who are worried it will get watered down in the summary paper when released.

The key conclusions are:

1) Global GHG emissions must peak in the next 4 years to avoid "climate breakdown"
2) Coal and gas power plants must be shut within 10 years
3) Significant lifestyle changes regarding eating meat, driving SUVs and flying are required with rich countries overwhelmingly responsible and needing to change
4) Annual global investment required to shift to a low carbon-footing needs to be 5x the current spend (which is $550bn)
5) Echoes the International Energy Agency (IEA) findings that no new oil and gas developments can take place
6) Cutting methane would have a major positive impact

Taxonomy should link ESG and executive pay, say EU advisors
(The Responsible Investor)[5]

The Platform on Sustainable Finance – a group of 57 market participants, sustainability experts and public agencies set up last year to drive the evolution of the taxonomy – has published two new reports; one on the **extension options for the environmental taxonomy** and the other on a **potential social taxonomy**.

The report on extending the environmental taxonomy recommends **identifying business activities that cause significant harm** to the climate, waste, water, biodiversity or the circular economy, and **incorporating an intermediate performance category** that falls between the significant contribution and significant harm categories. The Platform **claims this is required as sustainable finance initiatives have not yet substantially increased transition finance**. It also suggests implementing this very swiftly, with the first reporting requirements by 2023.

The report on a potential social taxonomy argues the time is right to introduce this to help investors contribute to finance solutions around ensuring decent work, enabling inclusive communities and supporting affordable healthcare. It acknowledges, though, that **not all members of the Platform are convinced a social taxonomy is feasible or needed**.

Within the social recommendations, the Platform also suggests **the inclusion of ESG-linked executive pay would help**

[4] The Guardian, https://www.theguardian.com/environment/2021/aug/12/greenhouse-gas-emissions-must-peak-within-4-years-says-leaked-un-report?CMP=Share_AndroidApp_Other

[5] The Responsible Investor, https://www.responsible-investor.com/articles/taxonomy-should-include-links-between-esg-and-executive-pay-say-eu-advisors

increase the taxonomy's impact as it is an effective way to steer companies towards achieving their sustainability targets. However, it does note there are some concerns it could interfere with a company's culture and autonomy.

The reports were open for feedback until 27 August 2021 and the Platform will subsequently make its final recommendations in October, before turning its attention to the social safeguards requirements in the environmental taxonomy.

Berenberg view

With the launch of the European Commission's "Fit for 55" Green Deal proposals, these reports have understandably gone somewhat under the radar. However, they nevertheless present intriguing prospects for the continued development of the taxonomy.

The argument that the environmental taxonomy has not increased transition finance may be a bit premature given it has not yet started being reported on. However, th**e way the taxonomy is currently structured can create the perception of a binary choice** between sustainable (taxonomy aligned) and unsustainable investments. As such, this could unfairly affect finance for **activities that are not green but do no harm, while also not incentivising those doing significant harm to invest in transitioning** if that transition would not be sufficient to become green labelled. The recommendation to extend the taxonomy to identify significant harm has the potential to solve both of these challenges. In addition, it could provide a way around the current problems of classifying gas and nuclear energy. However, it would no doubt face opposition from those activities that could be classified as doing significant harm and the aim to introduce it by 2023 seems very ambitious.

Secondly, the **introduction of a social taxonomy would represent a significant step towards a holistic definition of sustainable activities** but could be tricky to agree upon given the difficulty of measuring some social factors.

Finally, Berenberg ESG Equity Research are very **supportive of including ESG targets in management remuneration,** so we see the consideration of adding it to the taxonomy as a positive. However, setting criteria for what constitutes a sufficiently sustainable incentive to be taxonomy aligned could be very complex. In addition, **as we found at our SDG (UN Sustainable Development Goals) conference, linking remuneration to ESG criteria may not universally popular**. As such, this may prove unfeasible to include.

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As of: October 2021