JULY 2015 SUMMARY

In this issue:

- Will the latest EU reform deal inject new life into its carbon market?
- Accessing the risk and returns of Fossil Fuel Investing.
- Global event updates: Responsible Investor Europe and USSIF.

EU REFORM DEAL

Injecting new life in to the EU ETS

The EU's landmark reform deal aims to ease the glut of excess allowances in the carbon reserve market which are driving down the prices.

This year European Union (EU) is celebrating the 10th anniversary of its emission trading system, EU ETS. This is now the world's biggest scheme for trading greenhouse gas emission allowances, covering nearly 11,000 power stations and industrial plants in 30 countries, totalling 50% of Europe's total emissions[2]. The ETS System places a limit on the volume of carbon emissions a company can produce per year. Any firm that wishes to produce more than this set quota must buy these permits in the secondary market. The purpose of this cap-and-trade system is to gradually reduce the volume of permits given so as to slowly reduce the amount of volume of carbon emission released in the environment over time.

In the past decade, this cap-and-trade system has caught the attention of many major economies across the globe. Today there are 17 emissions trading systems (ETS) in force across four continents, covering 35 countries, 12 states or provinces, and seven cities. Together, these jurisdictions produce about 40% of global GDP[3]. Since 2011, China too has been experimenting with seven carbon market pilots across four cities and three provinces. In September 2014, it also announced the launch of a Chinese national system in 2016, which if successful, will propel China to the largest emissions trading scheme.[3] Further developments are expected in South Korea, California, Quebec, and Ontario who have announced their own carbon markets.

The EU needs to look for more long term reforms which not just cater to excess volume but also make it more resilient to supply shocks.

With the rest of the world moving fast, the EU too signed a landmark deal in May to ease the glut of around two billion allowances in the carbon reserves market created from the recession and lavish handouts to industry. This overflow of allowances drove down the carbon prices to €7 per ton, too low to encourage energy companies to switch from polluting fuels such as coal. Under this reform, an estimated two billion surplus allowances will be taken off the market and put into market reserve by 2019, two years ahead of the commission's original timeline. The move is just timely, given over two billion of additional surplus is likely to accrue by 2020 (as estimated by Sandbag, an environmental NGO), which may only add further pressure on the carbon prices.

In real terms, the current EU reform just touches the tip of issues facing the EU carbon market and comprehensive changes such as tightening of market's cap must follow to improve investor confidence.

The current action is just a temporary fix, and the prices may crash back, once the excess reserves are returned back to the market in 2019 and 2020. More long term reforms which not only cater to this excess volume but also make the market more resilient to supply shocks are needed. One such mechanism called 'Market Stability Reserve' (MSR) has been under discussion by European Commission. MSR is a type of carbon bank which will withhold and return supply to the market based on the number of allowances in circulation. This bank will work entirely on pre-defined rules with minimal discretion being granted to Commission or member states.

THE FOSSIL FUEL DEBATE

The risk and returns of fossil fuel investing

The 'Stranded Asset'' concept suggests a large portion of fossil fuel reserves will have to be written off to adhere to environmental regulations.

The debate around climate change, greenhouse emissions, and use of fossil fuels is not new. The issue has evolved overtime but today it is not only the regulators who are under pressure but also pension funds and endowments who are being urged to reduce their carbon exposure. This recent debate around fossil fuel divestment is based on 'stranded asset' argument. This argument revolves around the consensus of scientific research that the atmospheric CO_2 level needs to be kept under 450 parts per million. The world currently has carbon reserves up to five times higher than this limit which means that it will not be possible to economically exploit a large proportion of proven fossil fuel reserves if governments adhere to international agreements to constrain global warming below 2°C by 2050.

Given this, there exists a risk companiesthat are high greenhouse gas emitters. As the command and control method of regulation continues to become more stringent and economic incentives move towards higher carbon restraints, there is a possibility that these fossil fuel emitting reserves will become unburnable due to public policy restrictions. By rendering them unburnable the value of the assets will be reduced. Accounting estimates, show that $20 trillion in assets would potentially be written off due to increased regulation.[1] All eyes are now turned to the Paris UN Climate Change Summit this year in anticipation for further talks of regulation related to carbon and fossil fuel. In such a scenario, ESG policies can potentially serve as a hedging policy to help eliminate some of the risk that comes with investing in companies that heavily emit greenhouse gases. While some may preach complete divestment, this is highly unlikely. Investors should focus on reducing exposure to heavy emitters while also hedging their portfolios with strong ESG rated companies. [2]

Added challenge: Carbon risk and returns are particular hard to calculate

There is heavy uncertainty when understanding the effects of carbon emission and the timing and nature of potential future regulation surrounding the issue. Determining the price surrounding climate change and carbon emissions has proven to be an extremely difficult task with no real solution in sight. Prices need to be established to further understand the risk generated by trade-offs between consumption and negative externalities. An appropriate price would not only capture the current economic impact, but

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[1] * Bill McKibben, "Global Warming's Terrifying New Math," Rolling Stone, July 19, 2012
[2] http://www.pionline.com/article/20131125/PRINT/311259971/risk-of-stranded-assets-prompts-debate-over-engaging-or-divesting

would also calculate the risk related to plausible catastrophic outcomes that could be caused by emissions and anticipate risk reduction over time. The UK utilizes an economic impact strategy to charge companies every year on their carbon emission. In 2012, the European Environment Agency reported that environmental taxes resulted in 2.4% of GDP for the European Union.[3] By creating a tax-based incentive program, European countries have helped companies understand the "cost" both monetary and environmental, allowing for a full cost- benefit analysis.

As the market moves towards embracing an environmentally sustainable life, putting a price on carbon will incentivize producers to be cognizant of greenhouse gas emission, and could potentially be more effective than the command-and-control approach of policies today. All the stakeholders will play a key role in defining a global standard pricing mechanism for carbon pricing. A development to watch this year!

GLOBAL EVENT UPDATE

Responsible Investor Europe: London 2-3 June 2015

The eighth annual RI Europe 2015 was held in London from 2-3 June 2015. The conference was attended by over 500 delegates, representing 284 organizations and 26 countries. The 24 sessions over two days covered a wide range of ESG subjects offering practical tools for asset owners to consider ESG implementation. Mamadou Abou-Sarr, Northern Trust's global head of ESG investing, participated in an index workshop panel discussion alongside Christer Jonsson, Head of Global Equities at AMF. During his presentation he addressed the growing trend of ESG related passive solutions in asset management, the role of passive investors as active owners and the evolution of ESG indices with smart beta strategies. Over the past four years, passive investment has grown 25%. Moreover, 45% of investors now integrate responsible investing within their passive strategies including approaches such as norms-based exclusions, controversial weapons, or international norms or human rights. As ESG integration in passive investing is growing, so is the use of engagement as a tool to enable long-term dialogue with companies with a view to influencing company behaviour in relation to their social, ethical and environmental practices. Research, such as 'Active Ownership' by Dimson and Karakas[4], shows that successful engagements can lead to improvements in operating performance, profitability, efficiency and governance.

Among the other major trends affecting the ESG Industry, the integration of ESG factors with smart beta strategies is taking a greater place in investment decisions. New indices are being developed by index providers to merge ESG factors with compensated risk factors such as low volatility (FTSE4Good Global Minimum Variance Index).

Many others at the conference spoke about the growing implementation of low carbon strategies in Europe, particularly in Sweden, France and the Netherlands. The increasing need for green bonds was also a hot topic as investors are keen to have more fixed income solutions in the market.

3. http://greeneconet.eu/cut-income-tax-and-raise-environmental-taxes-develop-resource-efficient-economy-says-eea
4. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

USSIF: Chicago 4 May 2015

The 2015 US SIF was held in Chicago, IL and broadly focused on the various branches of socially responsible investing. Jordan Dekhayser, Northern Trust's senior quantitative researcher, presented on a panel discussingon governance as a risk factor. Northern Trust was one of the first companies to create a truly innovative governance screen on the Custom Northern Trust Emerging Market ESG Index fund. With more companies enhancing their proxy voting strategy and moving towards incorporating engagement, this represents the next step in governance for the market in the United States. There was a lot of discussion on what we may see from the UN Conference for Climate Change in December, whether that will be regulatory or establishment of climate change agreements.

The Sustainability Accounting Standard Board (SASB) was also a hot topic as many investors look at this as an alternate form of reporting that will give access to further disclosure and regulation. SASB is an independent 501(c)3 nonprofit that aims to develop sustainability standards for corporations to disclose relevant and material information to shareholders. While the US may be behind the UK in terms of implementation, the growth seen at the conference and the interest posed from asset owners and asset managers alike, is a great sign for the US ESG market.

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