DWS

Marketing Material

Climate change, the EU action plan and new requirements for investors

Climate change is one of the most well-known problems of our time. The increase in global extreme weather events has not only a perceived, but also a significant physical impact on quality of life, food production and the availability of drinking water. Hand in hand with this is the impact on assets – with financial consequences for the economy and investors. Politicians are addressing climate change and the financial industry is being called to account. Alexander Gerlach, DWS's expert for regulatory requirements and ESG, clarifies in an interview with Dennis Haensel the challenges facing investors and the new laws that will apply to them.

Q: Dennis: Alexander, 2019 was the second-warmest year on record since measurements began in 1880 and the temperature increase from pre-industrial times to today was about 1 percent, according to the Intergovernmental Panel on Climate Change (IPCC). These appear to be a clear sign that climate change is real.

ALEXANDER Climate change is real. It's not just our perception, it's getting warmer and it's provable. To make that a little more tangible: the five warmest years since records began in 1880 have all occurred since 2015. That means the last five years have been the five warmest in the last 140 years. And with that comes an increase in global extreme weather events. Let me give you three prominent examples: wildfires in California, bushfires in Australia, and Hurricane Harvey. Climate change is having a significant physical impact around the world, and the number and size of affected regions continues to increase.

We're not just talking about the impact on general livability, food production, or the availability of drinking water, we're also talking about the physical impact on assets – infrastructure and the economy – and therefore the impact on businesses and ultimately us as investors.

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Q: Dennis: That's one of the main reasons why ESG is no longer just a niche, but a central focus of investing. Can you elaborate on these economic consequences?

ALEXANDER Climate change has economic consequences. The global socio-economic impacts of climate change will most likely continue to increase, as a changing climate affects not only people but also physical and natural capital. The sad thing is countries and regions with a lower per capita income, i.e. developing countries in general, are more vulnerable. This also means that investors will have to analyze or quantify the economic consequences of climate change in the future.

> Climate change has not only an impact on general livability, it also has a physical impact on assets and therefore an impact on businesses and ultimately us as investors.

Q: Dennis: Can you elaborate on the nature of the risks?

ALEXANDER On the one hand, there are the physical risks, such as climate risks that have a financial impact on companies: for example, extreme weather that has a negative impact on delivery routes or even production processes. And then there are the so-called transition risks. These are risks that arise as a result of legislation or regulation in response to climate change. And there are prominent examples, such as the introduction of a carbon emission taxation or the ban of diesel vehicles in major cities. These developments might also have a negative impact on companies.

So there is a concrete need for action. The German Financial Services Regulator published a fact sheet in 2019 in which it outlined that these risks must be taken into account in the future. Important is on the one hand, the systematic consideration of sustainability risks in risk management tools – i.e., looking at these risks, checking whether we have any companies in our portfolios that will be more affected by these risks in future. The next step is to translate these risks into classic risk parameters. An example would be if a company experiences problems with supply routes or production due to extreme weather. This can then definitely have a negative impact on liquidity, supply or insurance. All these classic risk parameters must then be brought into line with sustainability risks. After all, the ultimate goal is to minimize risks.

Q: Dennis: When I listen to your explanations, I have to think about the 2015 Paris Climate Agreement. Could you explain the importance of this agreement?

ALEXANDER The Paris Agreement provides the political framework for fighting climate change. It's a binding contract that puts the fight against climate change into letters. It was adopted by all the parties to the United Nations Framework Convention on Climate Change – 196 countries at the time – and for the very first time it united all nations in one common cause. There are clearly defined goals. The most prominent goal is to limit global warming to well below 2 degrees better 1.5 degrees (compared to pre-industrial times). And there is the overarching goal of moving away from carbon-intensive industries. Another goal is that by 2050 the planet should be greenhouse gas neutral – meaning net zero new emissions. And that should significantly reduce the risks and impacts of climate change.

Q: Dennis: Is there a scientific basis for these targets?

ALEXANDER Yes, after the adoption of the Paris Agreement, the Intergovernmental Panel on Climate Change (IPCC) was asked to produce a special report to show the pathways to the climate targets. The report, which was issued in 2018, clearly warns of irreversible consequences due to climate change, such as extreme heat, heavy precipitation and droughts. That's why the World Climate Report also suggests aiming for a more ambitious temperature target to minimize these risks as much as possible. That was ultimately the scientific basis for the regulatory roadmap that followed.

Q: Dennis: Limiting global warming to well below 2 degrees seems very ambitious. How can we achieve this goal?

ALEXANDER In order to achieve that goal, greenhouse gases have to be reduced very quickly, and carbon dioxide has to be removed from the atmosphere on a large scale. That means a social and economic transformation is necessary. Furthermore people's lifestyles and consumption patterns have to change. And now the question is, how can we achieve that? Companies are responsible for a large part of carbon

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emissions and therefore it is important to create large economic incentives for them to reduce greenhouse gas emissions significantly. And meaningful investments in decarbonization strategies have to be done.

Q: Dennis: A certain temperature degree target can also be applied to investments. Can you explain how that works and the budget behind it?

ALEXANDER Basically, you put the climate target in relation to a carbon emission budget. To meet the 1.5 degree target, all future net carbon dioxide emissions since 2018 have to be limited to a total budget of 570 gigatonnes. If that's used up, we'll miss the 1.5 degree mark.

In contrast, all known fossil reserves which are still in the ground have potential CO2 emissions of 2,700 gigatonnes. That is almost five times as much as we are actually allowed to consume. This stock of fossil reserves, which may not be recovered due to possible new legislation, will have to be written off as a loss. The term "stranded assets" can be derived directly from this.

Q: Dennis: How long do we have if we continue on this path?

ALEXANDER The current situation is based on the fact that we currently have global emissions of about 40 gigatonnes of CO2 per year. For the 1.5 degree path, we would have to reduce the amount of CO2 to well below 20 gigatonnes by 2030. I.e. not less than 50%. And then to actually achieve net zero emissions by 2050, we would also need to push ahead with negative emission technologies in order to get CO2 out of the atmosphere within the 2030 to 2050 trajectory.

Q: Dennis: So what else is needed to stay on that path?

ALEXANDER People often talk about the energy sector having to play an essential role in fighting climate change, but it's not just the energy sector, it's all sectors of the economy. And the share of total greenhouse gas emissions makes that really clear. Industrial production accounts for 33% of CO2 emissions, agriculture and livestock 20%, energy 17%, transportation 10%, waste 8%, net deforestation 7%. You can see very clearly all sectors are affected, some of the risks are not yet priced and massive reductions in greenhouse gases are needed.

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Q: Dennis: We've talked about the fact that there are economic implications from risks and we clearly need to change our way of life. So how does the regulatory body now package these into a recommendation?

ALEXANDER The EU has already set clear signals in the past to fight climate change. At the end of 2019, Ursula von der Leyen, the president of the European Commission, presented the Green Deal, with a clear goal of achieving net zero emissions by 2050. Here we see a link to the Paris Agreement, which served as the basis. The question now is, how is this going to be implemented and who is going to finance this goal?

The economy is supposed to be fundamentally transformed and the financial industry is supposed to help playing a crucial role in re-directing capital. The EU has already set the course for the transformation of the financial industry in 2018. This highly complex regulatory project is called EU Action Plan on Financing Sustainable Growth and it is absolutely revolutionary. It will change the financial industry tremendously. The action plan is a broad-based package of instruments that will be turned step by step into European legislation.

Q: Dennis: What does this EU action plan look like?

ALEXANDER There are three overarching goals and ten measures.

The three goals are:

1 To reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
2. To manage financial risks stemming from climate change, environmental degradation, and social issues; and
3. To foster transparency and long-termism in financial and economic activity.

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Q: Dennis: And what are the direct implications that can be derived from this?

ALEXANDER The EU wants to be the first community of states to lay down very clear rules, which in particular make banks and institutional investors such as insurance companies and pension funds accountable. Now you've asked what measures are envisaged to achieve this. Four of the ten points in the EU action plan are already very concrete, or have partially already been incorporated into legislative proposals, so we can already see very clearly how the future might look like.

The first measure is the creation of an EU classification system, so called taxonomy, the definition of what is green or what sustainable economic activities are sustainable. The second is to consider sustainability in investment advice. In order to redirect capital in the long run investors will have to be asked in future whether they want to consider sustainability in their investment advice. If the customer or investor answers ‚yes', then the question is how to implement it. Here, the EU has created guidance as a third measure with the development of sustainable climate benchmarks. And last but not least, as already mentioned, it is also about transparency and disclosure. Here, the EU has developed a legislative proposal that aims to foster and provide transparency of sustainability criteria for financial products like investment funds.

> The affected investors will have to disclose, how they deal with sustainability risks in the investment decision or construction of the portfolio and they will also have to disclose what impact their investment decisions have on climate.

Q: Dennis: Will institutional investors be obliged to invest sustainably in the future?

ALEXANDER No. There will be no obligation. But, through the requirements of the Disclosure Regulation, institutional investors will be either directly or indirectly obliged to deal with the issue. They will not be able to avoid the topic of sustainability in the future.

Q: Dennis: When will the first measures come into force?

ALEXANDER One of these concrete measures has already come into force on March 10, 2021, for example, via the Disclosure Regulation. Asset managers, insurance companies, pension funds, and banks, among others, are directly affected. This means that all products issued by these participants just mentioned are directly affected as well.

The affected investors will have to disclose, as already mentioned, how they deal with sustainability risks in the investment decision or construction of the portfolio and they will also have to disclose what impact their investment decisions have on climate. A portfolio might have a carbon footprint or energy consumption that can be read and quantified.

Indirectly affected by this regulation, are all investors who invest in such vehicles through mandates, special funds and mutual funds. They will have to take indirect sustainability risks into account because the vehicles will have to take sustainability risks into account.

Q: Dennis: Why would you say it makes sense for our investors to look at these sustainability risks?

ALEXANDER Considering sustainability risks is not just about environmental protection – a lot of people are confused about that. It's about considering the serious financial and strategic implications for companies, and therefore the implications for investment decisions. And, as I described earlier, physical risks and also transition risks can have negative financial impacts on companies and portfolios.

Another aspect is, many investors are under pressure from both, the internal and external side to invest sustainably. Decarbonization of portfolios will play a bigger role in the future. Especially if we look at the fact that many German and international companies have made a very clear commitment to climate change and how they can contribute to fight climate change. And for this reason I assume that the importance of sustainable investments and sustainable solutions will continue growing in the future.

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Q: Dennis: Is there already a standard? Are there benchmarks that already take into account all these requirements?

ALEXANDER We hear this question very often from our customers: what approach can I take to invest sustainably? There are quite different approaches here. Banks and asset managers in Germany are currently working on a first draft of such minimum standards for mutual funds as part of the target market concept. These include, for example, minimum exclusions, i.e. certain sectors or companies that break certain sales thresholds are no longer included in the portfolio. These minimum standards are not currently applicable to special funds, but they clearly serve as a guidance.

And you just mentioned the issue of benchmarks. The EU has presented two different benchmarks which, in my opinion, serve as a good guide. The so-called Paris Alignment Benchmark and Climate Transition Benchmark, which should help to decarbonize portfolios in the future.

Q: Dennis: With our DWS ESG Engine we are able to show sustainability risks clearly and transparently. How can DWS further help investors implement this EU action plan in their portfolios?

ALEXANDER As a very first step, we can consider climate risks and transition risks in all active, passive and alternative investments, in special and mutual funds but also in mandates, so that the regulatory requirements are met. Additionally we can help to systematically align portfolios sustainably, which is something that many clients are now asking for. But one thing is also clear. The understanding of sustainability varies from investor to investor. The sustainability strategy varies from company to company and also from country to country. In France, nuclear power is perfectly fine; in Germany, nuclear power is controversial discussed. There is no homogeneous understanding here. So I'm very glad that we as DWS have the opportunity to individually implement the sustainability preferences and strategies of our institutional clients in their portfolios.

Dennis: Thank you, Alexander, for the overview and your insights on why it is important to consider climate change and also reflect it in portfolios.

In the German ESG Buzz podcast series, experts provide answers on the topic of sustainable investing. The moderator Dennis Haensel is Global Head of the ESG Investment Solutions & ESG Advisory Team.

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