

Climate Change Expectations

For investee companies



November 2020

Context

At the international business of Federated Hermes, we recognise the imperative for collective action to limit global average temperature increases to 1.5°C and to adapt to the changing climatic conditions that are already here and locked in by the current more than 1°C increase in average global temperatures.

The US's National Oceanic and Atmospheric Administration reports that 2019 was the second hottest year on record. The physical impacts of climate change are already becoming clear, with events including acute, disruptive impacts such as the devastating wildfires in Australia and California, heatwaves in the Arctic and increasingly frequent and devastating typhoons and hurricanes. There are also more gradual ongoing (chronic) impacts such as rising sea levels, an increase in vector-borne disease and reductions in agricultural yields, along with more floods, droughts and other extreme weather events. These physical changes along with the urgent action needed to reduce and, in time, eliminate new greenhouse gas (GHG) emissions will require significant structural transformation of the economy, both at a global level and locally. These changes will fundamentally affect our economies, our way of life and the value of investments we make on behalf of our clients.

We recognise that companies, regardless of sector, industry and a location they are in, need to understand and plan to manage the potential physical risks to their operations and supply chains that arise from a changing climate. Companies also need to undertake climate transition risk assessments. These are needed to understand what operational and business risks – and also opportunities – may arise from a progressively tightening climate policy environment capable of shifting global markets onto a sustainable footing that is aligned with what scientific experts in the Intergovernmental Panel on Climate Change say is needed to stay with the 1.5°C temperature limit.

The pathways ahead for investee companies are varied and uncertain, especially in the multiple regions where climate policies are absent or insufficient. However, we do know that a net zero carbon global economy needs to be in place by 2050 at the latest. Achieving this will require a far-reaching transformation of critical infrastructure, building, transportation, industry and land use. We also know this change will need to happen against a backdrop of adapting to the growing physical changes to the climate that are here and now.

We believe the threats from climate change are too serious to simply wait for governments to act. So we are setting out an expectation that our investee companies, alongside ourselves at the international business of Federated Hermes, now commit to understand their role and then become a proactive part of the solution. We urge those companies to challenge themselves to understand what more they can do to help accelerate the transition to sustainable and net zero economy and to prepare for the changes to our climate that we know are already locked in.

As a long-term investor with a mission to deliver holistic returns for our clients, we believe proactively facing the climate change challenge is a least regrets option to ensure investee companies can survive and indeed thrive, through ensuring their resilience and delivering long-term value for their stakeholders and, ultimately, our clients.

This briefing sets out a set of Expectations we have of our investee companies – and issues we ask them to consider – regardless of where they are on their climate change journey – to guide them and us as their investors to understand what more they can be doing and take action to deliver.

We believe the Expectations are relevant to all our investments regardless of asset class, or whether we are investing through public or private markets. This includes prospective corporate tenants within our Real Estate Portfolio.

Hermes climate change action expectations is the latest in a line of similar initiatives that includes Hermes EOS Environmental Principles and Hermes Remuneration Principles.

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Expectations

 **Expectation 1. Companies should use the Taskforce on Climate-Related Financial Disclosures (TCFD) as the best in class framework approach to understanding and setting out how it is responding to climate change.**

While ostensibly a disclosures regime, we believe the voluntary TCFD framework is the most universally appropriate framework for systematically working through climate change issues at a operational level and developing the appropriate governance, risk management and strategic responses to climate change. As such we expect companies to review this framework and either report against it or set out a compelling rationale for why they are not. Acceptable exceptions are likely to be where a company is very small in size. However even then, we could expect at least some minimal physical risk assessment to be undertaken.

 **Expectation 2. Companies should, in the first instance, prioritise putting the appropriate governance and internal capacity to act in place.**

Understanding and responding to the complexities of climate change risk and opportunity will not be straightforward. It will require dedicated capacity sufficient to understand and develop the appropriate risk management/strategic response. Acting on what is found will require Board and Senior Management engagement and oversight. We encourage companies to allocate sufficient capacity and senior level oversight on understanding its position regarding climate change risk and opportunity and report on the rationale for choices made.

 **Expectation 3. Companies should embrace the complexities of climate change and the transition to a low-carbon economy, seeking to model how it might impact the business financially under different physical and transition risk scenarios.**

The resilience of company sales and operations need to be considered under different climate change futures. To model these, scenarios could include an orderly transition, a fast and late disorderly transition and no transition at all. To be decision-

useful to investors, information should be shared on what assumptions and inputs are used and why – as well as the potential impact on forecast revenues over 5, 10 and 15 years and the mitigants that might be put in place to ensure the business remains viable without compromising the global shift to a resilient net zero carbon economy.

 **Expectation 4. To ensure resilience, companies should look beyond their own operations to consider supply chain risk.**

Companies should assess how physical risks might impact supply chains, identifying key factors and how they are working with suppliers to mitigate them where possible and seeks alternatives where they may not. Equally important are physical risks to distribution networks – which should be identified and mitigated.

 **Expectation 5. Where relevant, companies should use their influence positively with peers to build consensus on the need for collective climate policy success.**

Where the company is a part of industry trade associations, it should review such trade associations' approach and positions on climate change to ensure they reflect a constructive approach to acting on climate change and the role policy makers can play in ensuring a timely and orderly transition to 1.5°C. Similar considerations should be in mind when considering political donations.

 **Expectation 6. The priority is to commit to carbon neutrality by 2050 at the latest, backed up with metrics and targets to demonstrate progress made.**

We urge companies to commit to carbon neutrality by 2050 at the latest. Companies should provide information about short-, medium – and long-term science-based targets¹ – and milestones to reaching those targets as appropriate both in relation to climate change mitigation and adaptation. These should be both qualitative to demonstrate direction and intent and quantitative to show progress.

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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