Investor leadership on climate change
An analysis of the investment community’s role on climate change, and snapshot of recent investor activity.
Foreword

Caring for Climate (C4C) was introduced by United Nations Secretary-General Ban Ki-moon in July 2007. The Secretary-General challenged Global Compact participants to exercise leadership on climate issues by:

- making climate change a leadership issue for strategy and operations;
- setting emission reduction targets and exploring low-carbon technologies;
- supporting public policy efforts aimed at achieving low carbon economies;
- sharing experiences and publicly disclosing progress made on an annual basis.

Less than two years on, Caring for Climate has emerged as the world’s largest and most diversified business engagement platform on climate, with more than 350 corporate signatories in over 60 countries.

Less than seven months before the crucial UN Climate Change Conference in Copenhagen, we are releasing several new research studies and reports, the Caring for Climate Series, to offer a range of perspectives on the role of business and investors in tackling climate change. It is our hope that the findings of the C4C Series will inspire more businesses to make climate change a priority issue, so that policy makers will feel more confident that business is ready to be part of the solution.

The good news is that businesses from all regions and sectors have already started their journey towards energy efficiency, innovation and GHG emission reductions. Indeed, in many instances businesses have embraced climate action as an opportunity to drive efficiency and to gain competitive advantages, even where Governments have not yet taken action.

Caring for Climate participants recognize that climate change is not only an environmental issue. Around the world, businesses are beginning to feel the economic impacts as well. Consequently, some have made the connection between mitigation and adaptation, putting in place long-term measures to address not only emissions, but also food and water concerns and related natural resource issues. In fact, this drive towards energy efficiency and carbon reductions, combined with a proactive management of systemic climate risks, is defining a new level of environmental stewardship. Long-term investors, asset managers and analysts are also beginning to integrate these considerations into investment analysis and decision-making.

The bad news is that, despite encouraging and inspiring leadership, the number of businesses that are actively addressing climate change is far too small. Too many are still sitting on the fence waiting for others to act first.

What is needed now is Government leadership to produce a clear incentive structure that favors good performance and a global deal on climate change that creates certainty. Governments should be confident that change is possible. If Caring for Climate is any indication, business and investors certainly have the capacity and understand the compelling case for taking action. We therefore hope that the C4C Series will give policy makers and negotiators the confidence and inspiration to bring the Copenhagen Climate Conference to a successful conclusion.

Georg Kell
Executive Director
United Nations Global Compact

Claude Fussler
Programme Director
Caring for Climate
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Preface

For many institutional investors, including many large pension funds and asset managers, climate change is rapidly becoming as relevant a factor in an investment decision as more traditional financial elements such as liquidity or competition.

As this report shows, there are a number of powerful drivers underpinning this change, and its extent is not restricted to purely long-term investors. Across the world, asset owners, investment managers, researchers and other participants in the global investment community are increasingly aware they must take climate change into account as part of a holistic approach to fiduciary duty. This report explores how investors are putting that awareness into practice in their daily business.

While much is being done, the clear message of this report is that more efforts are needed. Despite the tough economic conditions, investors urgently need to act on climate change if they are to protect their investments over the long term and capitalize on the opportunities created.

There are four clear challenges for investors:

- To increase capital flows into projects that help mitigate and adapt to climate change;
- To improve the way investment processes incorporate climate change;
- To use their influence as shareholders to improve the carbon performance of the companies in which they invest;
- To engage with public policy frameworks to ensure they catalyse the transition to a low-carbon economy.

In short, investors must, to borrow Warren Buffett’s memorable phrase, “build the ark” and ensure that mainstream capital markets produce a sustained and successful response to climate change.

Donald MacDonald
Chair of the Principles for Responsible Investment Initiative and Trustee, BT Pension Scheme

Glossary

- ACSI Australian Council of Superannuation Investors
- BINGOs Business and Industry NGOs
- CDM Clean Development Mechanism
- CDP Carbon Disclosure Project
- CMIA Carbon Markets & Investors Association
- COP Conference of Parties to the UNFCCC
- EAI Enhanced Analytics Initiative
- ESG Environmental, social and governance
- EU ETS EU Emissions Trading Scheme
- GHG Greenhouse gases
- IEA International Energy Agency
- IFSA Investment and Financial Services Association
- IGCC Investor Group on Climate Change
- IIGCC Institutional Investors Group on Climate Change
- INCR Investor Network on Climate Risk
- IPCC Intergovernmental Panel on Climate Change
- J1 Joint Implementation
- ppm Parts per million atmospheric concentration of CO2 equivalent
- PRI Principles for Responsible Investment
- UNEP FI United Nations Environment Programme Finance Initiative
- UNFCCC United Nations Framework Convention on Climate Change
Introduction

Climate change is a major source of opportunity and risk for investors. The International Energy Agency (IEA) estimates that around US$10 trillion must be invested by 2030 in low-carbon technologies if we are to achieve the 450ppm CO2 stabilization level accepted as moderately safe. That is only one estimate, many other such estimates can be found in other parts of the Caring for Climate series of reports, but it is clear the amount of capital needed to achieve a low-carbon economy is colossal, and many argue the lion’s share must come from private funding sources. The good news is that even such large sums of money are within the long-term capacity of the financial sector, as long as the appropriate public policy incentives are in place. Indeed, the transition to a low-carbon economy will be a huge opportunity for investors.

On the other hand, climate change presents risks to investors. In the short term, carbon pricing will change the cost structure for many companies and the relative competitiveness of carbon-intensive business sectors. Over the long term, if unchecked, the changing climate could do severe damage to the economy, undermining the ability of pension funds and other long-term investors to finance their liabilities.

A growing number of large institutional investors accept these realities and are acting on them. The widespread adoption of the UN-backed Principles for Responsible Investment reflects the perception that climate change and other ESG issues must be addressed by investors.

It is becoming increasingly clear that the world will be effective at mitigating and adapting to climate change only if the investment community is actively engaged in the process. As this report argues, this is not just a matter of business as usual; leadership is needed within the investment community.

The first chapter of this report looks at the ESG movement in the context of climate change and explores the reasons behind it. The following chapters set out distinct leadership roles for investors arising from the climate challenge.

This report aims to take a snapshot of some of the activities already going on in these areas and highlight best practice where possible. It should be read in conjunction with its sister publications that make up the Caring for Climate series, published by the United Nations Global Compact.

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**UNFCCC (2008), Investment and Financial Flows to Address Climate Change, Geneva, Switzerland.
1. Beyond business as usual

An investment opportunity
As climate change has steadily risen up the public agenda in recent years, so has the call for investors to provide capital in the service of climate change mitigation and adaptation. Providing capital comes naturally to investors — it is their vocation — and as long as the risk-adjusted returns are available, investors will be ready to provide capital for this purpose. This has certainly been the case over recent years. In 2007 alone, an estimated US$204 billion of finance was made available for investment in renewable energy projects of various kinds.*

There is now a huge array of low-carbon investment opportunities. These include: renewable energy technologies that use solar, wind, tidal, wave or geothermal power; microgeneration and smart grids; carbon-efficient buildings; low-carbon transport technologies and systems; and sustainable forestry and land use changes. Successfully exploiting these varied opportunities requires a range of different investment approaches, from venture capital and private equity to infrastructure finance and property investment, as well as the large-scale investment activity taking place in the listed bond and equity markets.

Such a diverse field of opportunity cannot be fully captured by this short report. Our focus is on equity investment, though we also provide case studies illustrating many of these other areas. Other aspects are covered in more detail by other reports in the Caring for Climate series.

The long-term investment case
For long-term investors such as pension funds, climate change is a major source of systemic risk that could undermine their ability to meet their liabilities. For these investors, the fiduciary case for action on climate change is compelling.

Pension funds have to meet liabilities far into the future. A 20-year-old employee enrolled in a defined benefit pension scheme is likely to be receiving pension payments in 60 years time. Over these time horizons, climate change has significant potential to affect the global economy. The Stern Review, probably the most influential report on the long-term economic implications of climate change to date, concludes that some of the scenarios included in the UN’s third Intergovernmental Panel on Climate Change (IPCC) have the potential to trigger a depression-level economic collapse, wiping 20% permanently from global GDP by 2100.** The fourth IPCC report concludes that outcomes could be even worse than previously thought.*** While these conclusions could be seen as highlighting pessimistic scenarios within a range of possibilities, they are widely considered a fair indication of the scale of potential risks facing long-term investors.

These risks are systemic. In other words, they will have impacts across the entire economy. This will make them difficult to hedge or avoid. As we have recently been reminded, depression-type economic events affect all asset classes, including supposedly safe havens and diversification plays. While there are some sectors of the economy that might benefit from catastrophically low climate change, most would not. Pension funds, particularly large pension funds, are universal investors**** and, so they are large, that they tend to have long-term investment exposure to the whole economy. This makes it difficult for them to avoid systemic risks of the kind that unmitigated climate change will impose on them. As a result, prudent pension funds have good reason to pursue cost-effective strategies to support climate change mitigation and adaptation. Arguably, this may even be part of their fiduciary duty.*****

The problem with business as usual
Investors might be tempted to think they need not make any special efforts on climate change. That they can simply wait for policymakers to create incentives for investment in low-carbon opportunities and then exploit them by repricing risks and reallocating capital accordingly. However, there are a number of problems with this business-as-usual approach:

- It assumes equity investors are not merely providers of capital — they are shareholders of companies. As we explore in detail in chapter 4, they have a unique position of leverage over the entities that, in one way or another, are accountable for most of our carbon emissions.

Some of the actions described here will not deliver immediate outperformance for investment portfolios. The returns they deliver tend to be long-term and dispersed. Nevertheless, they are critical to the ability of pension funds and other long-term investors to meet their liabilities.

Leadership role for investors
If investors want to play a role in mitigating climate change risk — for their clients, their beneficiaries and for society — it is clear from the case studies and findings in this report that they must go beyond their business-as-usual roles. Doing so will be necessary if they are to fulfill their fiduciary duty over the long term.

Leading investors are focusing on four broad areas beyond business-as-usual:

- Increased allocation of assets to climate change mitigation and adaptation projects (explored in chapter 2).
- Leadership in building climate change into investment processes and pricing climate risk (explored in chapter 3).
- Shareholder leadership of corporate climate change activity (explored in chapter 4).
- Leadership in the climate change policy process and institution building (explored in chapter 5).

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* See chart on p.12
** Nicholas Stern, The Economics of Climate Change: The Stern Review. 2007
*** International Panel on Climate Change, Fourth Assessment Report 2007
**** Shareholders are collection shareholders who have a significant market capitalization.
***** See, for example, arguments in Freshfields 2005 and Mackenzie 2006.
2. Allocating capital to low-carbon opportunities

The flow of new investment into areas such as clean tech and renewable energy infrastructure projects is vital to meeting the challenge of climate change. Perhaps the most obvious role for investors is to put new money into projects that both help prevent climate change and exploit attractive growth opportunities.

The IEA estimates that around US$45 trillion will be needed to develop and deploy new, clean technologies between now and 2050.* Many billions of dollars are already flowing into this low-carbon industrial revolution. In 2007, an estimated US$204 billion was made available for investment in renewable energy projects (see chart).

Pension funds play an important role in providing this capital. The green fund detailed in the box below, set up by the largest public pension fund in the US, is a good example.

To an extent, this kind of investment can be seen as a business-as-usual investment as it allocates capital into projects with market returns. Low-carbon technologies, particularly when supported with carbon pricing or subsidies, can deliver the kind of risk-adjusted returns that make them attractive to investors. As a result, investors might think that no special leadership is required of them. However, many investors are yet to explore these opportunities. As with any other new asset class, investors are needed to be able to convert the potential to action.

Responding to the financial crisis

It is too early to assess the full effects of the 2008 financial crisis on capital allocations to climate change mitigation and adaptation, but it is already clear that it will have major consequences. In particular, the crisis is reducing the availability of capital for low-carbon investment projects, and enhancing the role of governments in this market.

The crisis in the banking sector also means that credit for asset finance projects such as wind farms is much more restricted. A decline in funding for some kinds of renewables projects is evident in data for 2008. (see chart, right)

Ordinarily, a temporary reversal of this kind might be considered disruptive but perhaps not of long-term concern. However, in order to successfully mitigate the risks of climate change, a trajectory of very rapid growth in investment in low-carbon energy supply is required – reaching US$50 billion a year by 2020.** Without this growth in investment, it is extremely unlikely that the necessary GHG stabilization levels will be achieved. We cannot afford a fall in levels of investment in this sector.

The current financial crisis, therefore, makes investor leadership even more vital than before. If the banking sector is unable to provide capital, other sources of capital need to step forward.

New kinds of credit finance instruments such as climate bonds may provide a vehicle for this (see box on p.15). There also appears to be an appetite among institutional investors for stepping up their investment in renewables, in spite of the global recession. A recent survey conducted by DB Climate Change Advisors and New Energy Finance of 100 institutional investors for stepping up their investment in renewables, in spite of the global recession. A recent survey conducted by DB Climate Change Advisors and New Energy Finance of 100 institutional managers and asset owners, together representing more than US$1 trillion of invested assets, found that 49% expect to increase their exposure to the renewables sector, with most of the rest maintaining current exposure.

Governments as investors

The other major implication of the financial crisis for climate change investment relates to the role of governments. One aspect of this is the emphasis given to low-carbon investment projects by the government stimulus packages. For example, around 10% of the US stimulus package unveiled by President Obama in March 2009 is being allocated to low-carbon investment, including US$33 billion to “green the country’s electricity supply”.

The increased prevalence of public money in the markets has also provided an incentive for governments and investors to interact on a much greater scale. Investors can provide

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*IEA Energy Technology Perspectives 2008

**New Energy Finance, Global Futures 2009

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New build asset finance investment

Q1 2004 - Q4 2008

Note: Includes asset finance of new build large scale renewable energy projects (does not cover acquisitions and refinancing). Grossed-up and buffered values are based on disclosed deals.

PENSION FUND COLLABORATION TO INVEST IN CLIMATE CHANGE MITIGATION

In October 2007, ABP and Pensioenfonds Zorg en Welzijn became cornerstone investors in the Ampère Equity Fund, committing themselves to invest up to €0.5 billion in the development, construction and operation of sustainable energy projects.

Evelop, the sustainable project developer of Eecom, will realize most of the projects, which include wind parks on land and at sea and biomass power stations in various Western European countries. The first project financed by the Ampère Fund was the Koegorspolder wind farm. With a capacity of 44 megawatts, this is the largest operational onshore wind farm in the Netherlands.

All projects financed by the fund are expected to generate both a long-term predictable cash flow and an attractive yield on investment. In comparison with conventional power stations, these sustainable power stations reduce CO2 emissions by 1,500,000 per year.

The Ampère Equity Fund was developed out of the need for a suitable source of finance for the existing Evelop project portfolio. Evelop has worked with ABP and Pensioenfonds Zorg en Welzijn for more than a year to create a cost-effective project finance and legal construction for the fund. The investment criteria are set out in a mandate. If the fund meets the conditions, the fund will invest in it in the form of an equity stock.

The independent management of the Ampère Fund has been delegated to Triodos Bank because of its longstanding expertise in sustainable energy financing.

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CalPERS: INVESTING IN CLEAN TECHNOLOGY PRODUCTS.

CalPERS is the largest public pension fund in the US. Through its ADM program, it has committed US$1.1 billion to building a best of breed, diversified portfolio of clean technology-focused investments.

The fund has made investments in areas such as alternative and renewable energy, water technologies, advanced materials, and air purification technologies.

This allocation of capital has helped support the creation of a number of innovative products that are helping tackle climate change. For example, through its partner NGEN venture capital, CalPERS has holdings in Konarka Technologies, the creator of Power Plastic®. This is an inexpensive, lightweight and flexible substance that can be embedded in devices and buildings and converts light to energy.

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*New Energy Finance, Global Futures 2008

**New Energy Finance, Global Futures 2009
VC and PE invested in companies and projects, Q1 2004 - Q4 2008

The Danish public sector pension fund ATP is one of Europe’s biggest pension funds, with US$644 billion in assets. It recently announced US$400 million of investment in a global renewable energy fund run by Hudson Clean Energy Partners. The fund will focus on solar, wind, hydro, biofuels and biomass in Europe and the US. ATP has made clear that this decision is based on expectations of good risk-adjusted returned. But as ATP’s Chief Executive Officer Lars Rohde has said, the investment will also “give us direct access to brand-new knowledge about climate-related technologies – unique knowledge that will be useful in our future investments.”

Alongside this large renewables investment, ATP is also channelling an additional US$400 million into a programme of sustainable forestry purchases. The fund’s first investment was a purchase of 38,000 hectares of forest in New York State. The fund will only hold directly-owned forests that are certified by the Forest Stewardship Council. This will mean that the fund will focus investment in forests in developed economies for stewardship purposes. It recently announced US$400 million of investment in low-carbon solutions. If carbon prices rise to the US$180/CO2e that the Intergovernmental Panel on Climate Change estimates will be required by 2030 to achieve a safe 450ppm stabilization level,*** low-carbon investment opportunities will clearly become attractive to investors.

In advance of this, it makes sense for investors to prepare themselves for exploiting these opportunities. There may be particular rewards for those who develop knowledge of these new asset classes and investment opportunities at this early stage. In practice, this means that asset owners should seek to make pilot investments in new asset areas in order to gather experience and intelligence about the technological, physical and regulatory risks involved. This also means that, if a new wave of national and global climate policy instruments come into force, investors will be able to scale up their investments ahead of the pack confidently and safely.

What more could investors be doing?

If the global climate policy process appears successful, we can expect rapid growth in incentives for investment in low-carbon solutions. If carbon prices rise to the US$180/CO2e that the Intergovernmental Panel on Climate Change estimates will be required by 2030 to achieve a safe 450ppm stabilization level,*** low-carbon investment opportunities will clearly become attractive to investors.

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Confidence and safety are important. If climate policy negotiations proceed more slowly than anticipated, or if (as with the EU ETS) there are problems with policy design, or if currently promising renewables technologies fail in the marketplace, then investors may not see the returns they were hoping for. For fiduciary investors such as pension funds, investment in low-carbon opportunities must be accompanied by a proper evaluation of these risks. Leadership in investing in new low-carbon initiatives must therefore be tempered with appropriate caution.

Note: Includes total invested by VC and PE players in the clean energy and clean technology industry (in US $0.5 bn

US $1.3 bn

US $0.9 bn

ATP: INVESTING US$800 MILLION IN CLEAN TECH, RENEWABLES AND FORESTRY

ATP believes that forestry is a promising asset class offering relatively high returns and diversification opportunities.*

* www.responsible-investor.com
3. Building climate into investment processes

The recent financial crisis has thrown a spotlight on how investors make decisions. Risk management processes, research and reporting have all been widely discussed in the public arena. This chapter explores how climate change is being built into day-to-day business by organisations throughout the investment chain.

As we have seen, in order to mitigate climate change, it is vital that investors allocate large amounts of capital to low-carbon technologies rapidly and efficiently – US$10 trillion by 2030, US$45 trillion by 2050, on IEA estimates. This requires them to price the comparative risks and returns of investment opportunities accurately, and respond quickly to changes in public policies, scientific understanding, and technological advances. To the extent that investors fail to do this, capital will be misallocated, with the effect that climate policy will be blunted, and companies will receive unhelpful signals about where to focus their activities.

It is possible that the capital markets are not as ready as they might be to price climate change risks efficiently. Part of the problem is that the risks associated with climate change are complicated and subject to uncertainty of three main kinds:

- **Scientific uncertainty.** How fast will the climate change? Where will the most severe effects be felt?
- **Technological uncertainty.** Which technologies will emerge as the most cost-effective at reducing emissions?
- **Policy uncertainty.** What shape will climate policy eventually take? How effective will it be?

The need for leadership from the top of the value chain

The burden of reducing the three areas of uncertainty described above does not lie primarily with investors, but with scientists, high tech entrepreneurs, and policy-makers respectively. However, investors have a role to play in ensuring they themselves are well briefed on the implications of the latest climate science, technology and policy, and that they can analyse those investment implications effectively. This is mainly a challenge...
for financial analysts, as well as sell-side
brokerages and the buy-side asset manage-
ment houses that employ them. But it is also
a challenge for the investment value chain as
a whole.

The investment industry can be seen as
a value chain, with asset owners (such as
pension funds, insurance companies, mutual
fund companies and sovereign wealth funds)
sitting at the top, and with investment
consultants, asset managers, stock brokers
and other intermediaries spread throughout
the chain. Ultimately, it is asset owners
who determine how their capital is allocated and
their asset managers and service provid-
ers respond accordingly. It is asset owners,
therefore, that hold a particular responsibility
to act on this issue. They need to make sure
their agents (investment consultants and asset
managers) can and are taking the necessary
steps to incorporate climate change risks into
the investment process — and if not, to con-
sider taking their business elsewhere.

Of course, responsibility for investment
action on climate change does not lie with
asset owners alone. Many owners outsource
day-to-day investment management to asset
management companies. In these cases, it
is these companies that must decide how to
take account of climate change risks in their
investment decision-making. Many asset man-
agers, in turn, outsource much of the financial
analysis to the sell-side research houses
associated with the stock broking op-
erations of investment banks. Asset managers
should, in turn, ensure the research houses
they use have the necessary capabilities to
analyse climate risks.

There are various ways that asset owners
can and are incentivising managers and other
agents to undertake the often costly addi-
tional research on climate change risks. These
include:

• Assess the capability of an asset manager
to analyse climate change risks during
the manager selection process.
• Give asset managers a longer-term mandate
with a clear request to evaluate and incor-
porate climate change risks in investment
decision making.
• Evaluate asset manager performance in
this area as part of the annual cycle of asset
manager reviews.

Work with managers to ensure that the
broker commissions and the fees asset manage-
ment houses charge are aligned with their
share trades is allocated in a way that
rewards high-quality stock broker research
in this area.

If the investment industry value chain does
not lay the foundations now for analysing the
consequences of climate change, the chances
of capital misallocation will be all the higher
in the years to come.

Pressing for disclosure
In addition to sending signals down the invest-
ment value chain, there are a number of prac-
tical steps investors can take to improve their
ability to price climate change risk. The basis
for any sound investment decision is good in-
formation. Many financial analysts, when as-
sessing companies, will now look at data such
as the level of carbon emissions produced by
that entity. However, the market often fails to
provide the necessary data on these poten-
tially material environmental issues.

Therefore, investors have an important role
to play in using their influence to ask com-
panies to disclose across a wide range of ESG
issues, including on climate performance. This
is an undertaking consistent with Principle 3
of the PRI and there are many examples of PRI
signatories acting with their peers to encour-
age better climate disclosure from
companies and other entities in which they
invest. Two outstanding examples include the
Carbon Disclosure Project and Global Climate
Disclosure Framework for Electric Utilities,
detailed in the box on p. 21.

Improving research
Once investors have the appropriate informa-
tion from companies and other entities, they
need to ensure this information is analysed
effectively. The engine rooms for financial
analysis, at least in the equity markets, are
the investment analyst divisions of the major
brokerages. This sell-side research is provided
to buy-side asset managers in order to attract
brokerage commissions. Many asset managers
allocate commission to their brokers explic-
itly on the basis of such research. In order to
ensure that sell-side analysts produce high-
quality research on climate change risks
and opportunities, it is important that asset
managers recognize and reward good research
in this process.
In 2007, the Institutional Investors Group on Climate Change (IIGCC) in Europe, Ceres in the US, which manages the Investor Network on Climate Risk (INCR), and the Investor Group on Climate Change (IGCC) Australia/New Zealand, collaborated with sell-side and industry experts on a series of sector-based climate disclosure guidelines.

The frameworks, which have currently been produced for the electric utilities and auto sectors, contain guidelines for effective corporate disclosure of GHG emissions, and provide a format to present both quantitative and qualitative issues in a clear and consistent way.

For investors, these guidelines make it easier to assess and compare the investment risks and opportunities posed by climate change and climate policy to individual companies. For companies, the frameworks provide them with a better understanding of how they are positioned in their sector, and where new opportunities and risks may exist.

The disclosure frameworks encourage companies to disclose this information using their existing communication channels, including GRI reporting, Carbon Disclosure Project responses, financial reports, sustainability reports, analyst briefings, and mandatory reports to securities regulators such as the US Securities and Exchange Commission.

The Carbon Disclosure Project (CDP) began in 2000 as an investor-backed initiative to encourage companies to disclose information on carbon emissions and business risks. Its mission is to collect and distribute high quality information that motivates investors, corporations and governments to take action to prevent dangerous climate change.

CDP now has the backing of 475 institutional investors with combined assets of over US$55 trillion. Each year, CDP writes to the largest listed companies around the world to gain information on company GHG emissions data, and the business risks and opportunities presented by climate change. In 2009, CDP wrote to over 3,700 companies on behalf of investors.

In 2008, 1,500 companies filed data, making the CDP website the largest database of corporate greenhouse gas (GHG) emissions data in the world. The site also includes information on companies’ perceptions of climate risks and opportunities and details of the actions they are taking to address these.

The large-scale, collective backing of so many financial investors, openly asking for this information, has meant corporations have increased their focus on the issue. In addition, CDP is now working with large purchasing organisations to send the CDP questions to their suppliers, further enhancing the relevance and importance of the CDP process for corporations.

The data is collected annually and published online for open viewing.

The CDP also now requests that companies submit five year projections for their GHG emissions. These new measures will help make investment decisions and company comparisons easier.

By partnering with some of its supporting organisations, the CDP has also started encouraging electricity companies to base their reporting on the Global Climate Disclosure Framework for Electric Utilities developed by the IIGCC.
What more could investors be doing?

Individual investment institutions have made great strides in recent years in building climate risks and opportunities into investment processes. Markets now appear to be pricing in some aspects of climate change, which is a sign this work is having tangible results. Another problem is the lack of accurate and comparable data from companies. While initiatives such as the CDP have done an impressive job of driving voluntary reporting by companies, the quality and comparability of this data is often inadequate. Investors have good reason to continue to engage with companies on disclosure, but also where appropriate to call for mandatory reporting requirements for carbon emissions and related information, backed by robust accounting and auditing standards. Several governments are beginning to move in this direction, and the World Economic Forum, Ceres, CDP and others have joined together to establish the Climate Disclosure Standards Board to develop thinking on reporting standards.

In the longer term, it is important that the next generation of financial analysts are trained on climate change risk. Work to embed climate change risk analysis in the syllabus of the Chartered Financial Analyst qualification and similar training programmes might be a valuable starting point for this.
4. Shareholder Leadership

Investors are not merely providers of capital. As shareholders, equity investors are also owners of companies. This gives them significant power, influence and responsibilities.

Shareholder leadership is relevant because the companies that shareholders own are, collectively, the world’s largest source of greenhouse gas emissions. Companies in the electric power, cement, steel, chemicals, mining, energy, air travel, and shipping sectors account for over half of global emissions.

Many companies also market products that produce emissions when used by their customers (such as cars, washing machines and air conditioners). Their choices about energy efficiency in product design have significant second-order impacts on global emissions. Similarly, companies’ decisions about product specification and choice of suppliers, influence carbon emissions upstream in the supply chain.

There will be no solution to climate change without leadership from companies. Successful climate change mitigation depends on their ability to innovate and invest in new technologies, to design and provide low-carbon products and services, and to remove carbon from their supply chains. Collaboration

tions such as the UN Global Compact have an important role in helping improve company performance in this area.

Companies, like pension funds, are fiduciary institutions with duties to their beneficiaries: the shareholders. They cannot easily take actions that they know to be to the material detriment of their shareholders. While in line with their own fiduciary duties, shareholders can reasonably demand that companies do all they can to measure and reduce emissions. This includes asking them to:

- Disclose information about their carbon emissions and associated risks and strategies.
- Adopt effective strategies to respond to likely climate risks.
- Exploit opportunities to reduce operational costs through energy efficiency.
- Ensure that they do not illegitimately intervene in the political process to block sensible climate change policies.

The following sections explain the practical basis for these activities and illustrate them with case studies.

Shareholder governance power

The role of shareholders in the ownership and governance of companies is collectively reflected in company law around the world. The specific powers and responsibilities of shareholders vary from country to country. In some markets more power is given to other stakeholders; in others, less. But shareholders can have a significant role anywhere. Company law is commonly founded on the principle that they should play this role actively and diligently.

Shareholder power is perhaps most visible in shareholders’ right to vote on and propose resolutions at meetings of the company. But voting is just the tip of the iceberg. Large institutional shareholders have extensive formal and informal power to influence the behaviour of their managers. There is considerable potential for this power to be used to drive carbon efficiency across the economy.

Shareholder activism on environmental issues has been taking place since the early 1970s. In Europe, a small number of large investors have teams of ESG specialists that engage with hundreds of companies a year on various issues, using a variety of informal and typically non-confrontational methods to encourage improvements. Investors such as those signed up to the PRI can between them point to hundreds of examples where companies appear to have contributed to a significant change in their requests for improvements to the management of social and environmental risks.

In the US, where shareholder activism tends to be carried out primarily via proxy resolution, over 360 resolutions are filed each year on a wide range of issues. Of these, 20% now relate to climate change, nearly half of which appear to contribute to significant change in company behaviour. At first glance, this shareholder resolution activity may appear ineffective because investors rarely achieve majority votes at shareholder meetings (though investors are getting ever closer to this goal). However, shareholder resolutions can be very effective despite falling short of a majority.

The act of filing a resolution provides a platform for discussion between the company and concerned shareholders, and companies will go to some length to avoid these issues going to a vote. Many shareholder resolutions are withdrawn as a result of companies agreeing to take steps to respond to shareholder concerns during discussion.

Further influence

It is not just through voting and shareholder governance that investors can help improve the behaviour of listed companies. Large institutional investors often own a substantial proportion of the shares in listed companies. Their investment decisions can have a significant impact on company share prices.

This soft influence also has important implications, especially in business sectors where climate change raises genuinely strategic challenges for business. Here, shareholders have leverage to demand an effective strategic response, and can plausibly threaten to reduce their shareholding in the company if it fails to produce a credible strategy.

Investors do not have to follow through on this threat in order to influence companies. What matters is that companies believe the absence of an effective climate change strategy is likely to adversely affect shareholders’ perceptions of the company’s prospects, and therefore may be detrimental to share prices. It is not a case of investors making aggressive demands and backing them with credible threats (although, in extreme cases, this may happen). It is a more subtle matter of perceptions and expectations.

Investor power in this area is strong in the cases where climate change poses material risks for the company over the short and medium term. Their power wanes when the risks are non-material (risks that are too small...
to be considered by financial analysts), and when the risks are so long-term that they are ignored by analysts for discounting reasons. This means that shareholders will not be able to use their power as investment decision-makers to influence all companies or to address all aspects of climate change.

In practice there are various ways investors can seek to deploy their influence as investment decision-makers. Different techniques can have different responses.

- The most straightforward technique is for investors to raise the question of climate change strategy in routine meetings or communications with company executives or investor relations professionals. Agenda time at such meetings is a precious commodity — climate change is not the only issue investors will want to discuss with the company CEO. But if time can be made for this discussion, it can make a big impression. The better prepared investors are for such meetings the better. A vague question about climate change risk is likely to give rise to a vague answer. However, if investors are prepared with specific and financially-relevant questions about plausible climate change risks facing the company, the company will have a strong motive to ensure it has good answers.

- Many institutional investors also write letters to CEOs asking about climate change strategy. This is likely to be most effective when the content of the letter is relevant to the risks faced by the company concerned.

Investors are more likely to have influence when they engage companies on a collaborative basis. Using forums such as the PRI Clearinghouse or the INCR, investors can join forces around climate change issues and have a bigger impact.

Energy efficiency measures

One particular area in which shareholders have a large influence on companies is around energy efficiency measures. In its 450ppm scenario, the IEA projects that around half of carbon emissions avoided by 2030 should come from energy efficiency. This is a massive challenge, partly because

**It is worth mentioning that materiality and time horizons are relative to the practices of financial analysts, which are themselves not necessarily optimal, as discussed in the previous chapter.**

***IEA World Energy Outlook 2008.***
it is dispersed across thousands of companies (unlike in the case of decarbonising the power sector, for example). As the Stern Review**** pointed out, there is evidence that companies do not exploit all profitable opportunities to improve their energy efficiency and minimise carbon emissions.

This is reflected in typical global carbon emissions abatement cost curves, which forecast that as much as 20% of projected business-as-usual carbon emissions could be prevented with a positive investment return. Energy inefficiency costs shareholders money, as well as contributing needlessly to climate change.

But if profitable energy efficiency opportunities exist, why do profit-seeking companies not exploit them? There seems to be a variety of barriers. Investments in energy efficiency tend to be fragmented across lots of small improvement projects. Facilities managers who can deliver energy efficiency often do not have access to sufficient capital expenditure budgets necessary to implement their projects. And energy efficiency is rarely seen as a strategic issue, so it receives little attention from senior managers.**** As a result, energy efficiency projects are not implemented, even when they offer a competitive return on investment.

Shareholders are well placed to help companies overcome these barriers. If institutional shareholders challenge senior company managers to explain their approach to energy efficiency and encourage them to deliver improvements, they will help ensure that these projects are given the necessary priority.

Given the importance of energy efficiency in delivering climate change mitigation, and given it will take a few years for any post-Copenhagen climate deal to become effective, early voluntary action to deliver profitable energy efficiency action by companies could be particularly powerful. If shareholders can support and encourage the world’s many thousands of listed companies in their efforts to improve operational carbon efficiency, they can play a very useful role in the process of carbon mitigation. This will require a comprehensive process of benchmarking companies’ energy efficiency performance to identify those whose energy management is below good practice for their sector.

Some early initiatives have started to be undertaken. For example Insight Investment has completed a benchmark of large UK companies (see case study), and various research agencies provide information services for investors in this area.

What more could investors be doing?

Shareholders have considerable power to influence companies. They already routinely exercise this influence on a range of mainstream strategic issues, and on questions of corporate governance. As illustrated, they are starting to use this power effectively on climate change. On some aspects of climate change management, they have already been very effective in mobilising corporate activity; most notably on carbon disclosure. However, investors have considerably greater potential to use their influence to encourage progress on climate change.

The world needs the business sector to respond positively, energetically and creatively to the challenges of climate change and to react quickly to new climate change policy. Earlier and more persistent investor support for proactive company action on climate change strategy could be useful in encouraging this attitude across the corporate sector. Equally, shareholders should work with companies that may be acting defensively or obstructively.

There are also very substantial opportunities for companies to address operational energy efficiency, product design and specification, and low-carbon procurement, which would lead to reductions in carbon intensity and increase in corporate profitability. Shareholders could have a decisive role to play in catalysing more corporate activity in this area.

As the success of the Carbon Disclosure Project indicates, a large scale, coordinated programme of action to benchmark and engage with bottom quartile companies could deliver double benefits of large, voluntary, short-term emissions reductions and improved long-term profits.

Platforms such as the INCR and the PRI’s Engagement Clearinghouse provide a useful forum for investors to work together to share ideas and collaborate on shareholder engagement with companies on climate change issues.

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* See discussion in Chapter 13 of the Stern Review

5. Investor engagement with public policy

Climate change is a systemic problem, requiring a systemic public policy response. If investors accept the long-term investment arguments for caring about climate change, then they should also help to ensure that the policy response to climate change is systemic, timely and adequate to the task.

**Engagement with international policy**

Investor collaboration around public policy is a relatively new development. It is perhaps easiest to understand how this has emerged by highlighting some examples. Perhaps the first major cooperative effort at financial sector engagement with international climate change policy was catalysed by UNEP and a group of commercial banks including Deutsche Bank, HSBC, Natwest, Royal Bank of Canada, and Westpac. This group came together to launch the UNEP Finance Initiative in 1991. In May 1992, as the United Nations Framework Convention on Climate Change (UNFCCC) was being negotiated, the first UNEP Statement by banks on environment and sustainable development was issued in New York. A similar Statement of Environmental Commitment by the insurance industry was issued by UNEP and a group of leading insurance and re-insurance companies and pension funds in 1995. These statements constituted an important expression of support for a number of principles incorporated into the UNFCCC and Kyoto Protocol, such as the precautionary principle and the principle of intergenerational equity. However, they were general statements, and only the one issued by the insurance industry mentioned climate change explicitly.

Institutional investors were not directly engaged in the public policy process until more recently. The Institutional Investors Group on Climate Change (IIGCC) was established by a group of European pension funds and other institutional investors in 2001. By mid-2008 the group had over 50 members, representing over €4 trillion of assets. It has also taken a leading role in bringing together the investment community so it can speak with one voice on climate change issues. The IIGCC’s objectives include advocacy of “public policy and market solutions that ensure that an orderly and efficient transition to a secure climate system which is consistent with long-term investment objectives.” To this end, the IIGCC submitted an open letter to the December 2007 Conference of Parties in Bali (see box below).

**IIGCC OPEN LETTER TO NEGOTIATORS AT THE BALI CLIMATE CHANGE CONFERENCE, 2007**

The IIGCC open letter, submitted to the politicians and negotiators participating in this major conference, set out the elements relevant to investors that should shape a post-2012 framework. The group emphasized that, from an investment perspective, the global deal needs to set ambitious GHG emission reduction targets in the medium and long-term, and that these targets should be informed by the best available scientific evidence based on the stabilization levels required to avoid dangerous climate change. They also highlighted the importance of an expanded global carbon market and greater use of a credible and more efficient CDM, as well as the need for more support for energy efficiency programmes, renewable energy, measures to reduce emissions from deforestation and for adaptation.

Strong policy signals are necessary to encourage investors to integrate climate change considerations into their investment decisions and to re-allocate capital towards a low carbon economy. A timely agreement on a post-2012 global climate deal is a crucial element in underpinning business and investor confidence in this area and the IIGCC will continue to engage with government on this. The IIGCC is working with partners on an updated letter that will inform the upcoming COP15 negotiations.
Engagement with regional and national policy

The largest carbon market in the world at present is not driven directly by the Kyoto Protocol, but rather by national legislation. This is the EU Emissions Trading Scheme (EU ETS), where transactions reached an estimated US$94 billion in 2008. While it is unlikely that the EU ETS would have been implemented to the same extent in the absence of the international policy framework set up by the Kyoto Protocol, it is notable that the legislation establishing the scheme preceded the entry into force of the Kyoto Protocol itself by nearly two years. The original legislation also commits to continuation of the scheme beyond the Kyoto Protocol commitment period of 2008-2012, thus providing a crucial lifeline for investments with a post-2012 payback period. The EU recently agreed on the detailed arrangements for Phase III of the scheme, running from 2013 to 2020.

Other regional and national carbon trading schemes have emerged in the USA, Japan, Australia and elsewhere. The climate change policy framework in North America is currently fragmented, due to the lack (to date) of a comprehensive national policy in both the USA and Canada. Three major regional initiatives (the Regional Greenhouse Gas Initiative, the Midwest Multi-State Greenhouse Gas Reduction Accord and the Western Climate Initiative) are in various stages of development, and a major challenge for both the USA and Canada will be to integrate these schemes in such a way as to provide a coherent, long-term, consistent pricing signal to investors.

Another challenge facing these schemes is the creation of an economy-wide market that is equitable for all participants. Currently these schemes cover a select group of industries (such as the power sector and large industrial plants). This means that they are bound by the rules and caps set by these schemes, while other industries can go along with business as usual.

There are many examples of groupings of national investment institutions making clear their support for an ambitious policy regime to their national governments.

Institution building

The policy frameworks described above create rules and incentives for overseeing organisations, but often leave the task of creating organisations to implement the frameworks to the market and the private sector. This is deliberate, and based on the assumption that market and private sector actors are better suited to entrepreneurial risk-taking than intergovernmental agencies or national governments. This choice requires the private sector to respond quickly and effectively to the frameworks and incentives established by policy-makers.

This quick response is not always reliable. Even with well-designed policy instruments, it may take time for entrepreneurs to assemble the expertise and capital necessary to establish organisations to enable tangible progress towards policy goals. With the global response to climate change, time is of the essence. There is a need to move very rapidly from entrepreneurial start-ups to large-scale international organisations.

This suggests another possible dimension for investor leadership. Some investors, particularly those with venture capital and private equity experience, have in-depth knowledge of the requirements for the rapid scale-up and growth of new businesses, whereas policy-makers, in general, do not. Investor input could help design mechanisms that are more amenable to these particular demands. At the very least, investors need to ensure they understand the policy frameworks that emerge from international, regional, national and local processes, in order to evaluate the associated risks and opportunities and respond with investment in new businesses and projects.
What more could investors be doing?
At the international climate change policy level, the principles and objectives already set out in the IECC/ENCR/IIGCC 2008 Investor Statement to the Poznan climate change conference (p.32) need to be translated into concrete suggestions at the COP15 negotiations. The investment community cannot afford to assume that international negotiations have the capacity, even if they have the willingness, to do so without assistance.

The need for investor leadership on climate change policy is particularly acute at the international level, due to the global, systemic nature of the problem and the urgent need for a timely response.

The Copenhagen COP 15 negotiations, and subsequent meetings which will be required to elaborate any deal achieved in Copenhagen, will have unique importance for investors worldwide. This is due to the long-term nature of the policy framework being negotiated, its economic impact on investments across the board, and the knowledge that this time, the framework needs to be capable of mobilising not hundreds of millions of dollars of new investment, but hundreds of billions per year.

While general principles and objectives are still a necessary first step, the new policy framework will also build on the existing principles and objectives of the UNFCCC and Kyoto Protocol, as well as the body of knowledge that has developed in recent years about the operation of carbon markets, funds and other frameworks for investment. It will therefore be more detailed and prescriptive in terms of the actual design and regulation of instruments and measures, such as carbon markets and mechanisms for technology development and transfer. The more detailed the framework becomes, the greater the risk that government negotiators (typically drawn from environment departments) may not fully understand the consequences for investment and financing of the text that they negotiate.

This suggests two key areas on which investors could focus:

First, whenever possible, the investment community must speak with a single voice at the negotiations.

The various bodies already representing investors (UNEP FI, IGCC, INCR, IIGCC) should cooperate even more closely. The fact that they are likely to join forces to produce a combined statement for Copenhagen is helpful. But given the nature of the UNFCCC process, it would be useful if they could seek to broaden their representation, in particular to developing country investors. In addition, investors are currently loosely represented by the business and industry constituency of observers to the climate change negotiations (known as the Business and Industry NGOs group, or BINGOs). Investors should ask themselves whether their interests are adequately represented as part of this diverse group, and whether a more specialised INGOs (Investment NGOs) group would provide a better means of highlighting investor concerns to the negotiating parties. If so, a request for recognition of an INGOs group could be made in Copenhagen, and this request in itself could raise the profile of the investment community at the summit.

Second, investors should seek appropriate engagement with the broadest possible range of negotiators directly involved in the process. Investors should seek to ensure that they allocate resources to enable their representatives to contribute effectively to the negotiations. This includes providing capacity building to governmental negotiators (especially from under-resourced developing countries), so they understand the potential impact on future investment decisions of the regulatory framework to which they are signing up. A Copenhagen deal is achievable only by consensus between all of the 190+ parties involved.

The relatively more mature European carbon market has seen the emergence of a specialised Carbon Markets & Investors Association to represent investor interests and engage in market development at this more detailed level (see box on previous page). Similar new investor forums may be required to fulfil a similar role in the major developing country markets around the world.

In the wake of the crisis in conventional financial markets, governments will expect increased oversight and regulation of carbon markets. This may not be a bad thing. Increasing the transparency of carbon financial instruments and preventing excess volatility in carbon prices may also help to reduce risk premiums that in turn constrict investment flows into climate change mitigation and adaptation projects, such as government-backed climate bonds.

CARBON MARKETS & INVESTORS ASSOCIATION
The Carbon Markets & Investors Association (CMA) was formed in August 2008 by the merger of the Carbon Markets Association (CMA) and International Carbon Investors and Services (INCIIS). The association represents around 50 companies involved in the carbon markets, including financial institutions, carbon funds, project developers, lawyers, accountants, verifiers, emissions brokers and IT firms.
As well as acting as a representative body for these investment and services companies, the association provides support for the development of market enabling factors such as improved global trading rules and arbitration facilities, training and standardization. A key area of the CMA’s policy engagement is focussed on the reform of post-2012 carbon market institutions, such as the CDI Executive Board.
6. Conclusions

Stabilising carbon emissions at a level that will successfully mitigate the risk of catastrophic climate change is a huge challenge. Investors have a vital role to play in enabling us to meet it.

In the next 20 years, their most basic role will be to provide much of the capital needed to finance the development and deployment of low-carbon technologies and solutions.

Investors will not be able to do this unless policy-makers ensure that such investments are financially rewarding. This will not happen by itself. Leading investors around the world must work constructively with national governments to ensure public-policy frameworks drive this forward rather than holding it back.

Even if policy-makers deliver the necessary frameworks, creating the organisations and markets large enough to channel trillions of dollars of finance to appropriate investment opportunities in the short time necessary will be challenging. Leadership will be required from investors to ensure they are ready to develop and scale up institutional responses as soon as governments establish policy frameworks.

It is also vital that this capital is allocated efficiently in the face of ongoing uncertainties about climate science, technology and policy. Investors that over-emphasize the short-term profits arising from carbon intensive businesses and under-emphasize long-term carbon price risks will impede the transition to a sustainable low-carbon economy, and, in the end, fail to serve the interests of their clients.

Tackling this requires clear incentives within the investment value chain to reward excellence in this area, and this ultimately depends on strong signals from the asset owners at the top of the value chain. It is also important that there are improvements to research on climate change risks, better training of financial analysts, and a continued push for greater disclosure of material climate change information from companies and other investee entities.

As well as providing capital, investors are also shareholders. As owners of the world’s biggest carbon emitting companies, they have a direct opportunity to drive carbon efficiencies across the economy, while also improving their investment returns. Leading investors are starting to demonstrate that they can play this role effectively.

The challenge of climate change is so great that all sectors of the economy must play their part if we are to meet it. Along with investors, governments, voters, companies, and consumers all have important roles to play.

The fourth report of the IPCC shows that if the world fails to stabilise emissions somewhere near 450ppm, we run a substantial risk of an extremely dangerous outcome; one that may undermine the ability of long-term investors to deliver the returns they (and their beneficiaries) have been counting on. It is firmly in the interests of investors that they help avoid this outcome, and devote the resources necessary to rise to the challenge of leadership.

Methodology
This report draws on the authors’ extensive experience working in the field of investment and climate change.

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Francisco Asciu has worked in climate change policy and carbon markets for the past 10 years, in government and as an independent consultant. He is the lead author of UNEP’s Guidebook to Financing CDM Projects and a registered CDM and JI expert for the UNFCCC. He lectures in business and climate change at the University of Edinburgh Business School.

The authors conducted a survey of recent literature, reports, and web materials relating to investment and climate change. They also interviewed individuals in a number of PRI signatory organisations and, assisted by the PRI Secretariat, conducted a consultation of the PRI signatories. Extensive comments and helpful advice were provided by a large number of other stakeholders and a special note of thanks must go to David Russell of USS, Rob Lake of APG, Marcel Jeucken of PGGM, Butch Bacani and the UNEP FI team, PRI Secretariat and PRI Board.
Bibliography


SIX PRINCIPLES OF THE PRI

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.
The Ten Principles of the United Nations Global Compact

HUMAN RIGHTS

Principle 1 Businesses should support and respect the protection of internationally proclaimed human rights; and
Principle 2 make sure that they are not complicit in human rights abuses.

LABOUR

Principle 3 Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4 the elimination of all forms of forced and compulsory labour;
Principle 5 the effective abolition of child labour; and
Principle 6 the elimination of discrimination in respect of employment and occupation.

ENVIRONMENT

Principle 7 Businesses are asked to support a precautionary approach to environmental challenges;
Principle 8 undertake initiatives to promote greater environmental responsibility; and
Principle 9 encourage the development and diffusion of environmentally friendly technologies.

ANTI-CORRUPTION

Principle 10 Businesses should work against corruption in all its forms, including extortion and bribery.