

Talking Climate and Resilience — Episode 5: CCRI and other climate change work in progress

CARLOS SANCHEZ: We've been only maturing more and more over the years to a point where you really can have discussions about climate risk at the board level with any top company in the world or institutional investor. And that was really not possible very few years ago.

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SPEAKER: You're listening to Talking Climate and Resilience, a podcast series from Willis Towers Watson where we explore why climate change is a responsibility we all share. The challenge of achieving an orderly transition to a low-carbon, climate-resilient economy is increasingly a part of mainstream financial decision making, as organizations across the public and private sectors respond to climate change and the wider implications for communities and society.

LYDIA MESSLING: Hello, and welcome to our Talking Climate and Resilience podcast. I'm Dr. Lydia Messling, your podcast host. And I'm delighted to be joined this time by Carlos Sanchez. So, Carlos, thank you so much for coming.

CARLOS SANCHEZ: Thank you, Lydia. It is my pleasure to be with you today. Thanks for the invitation.

LYDIA MESSLING: It's great to have you, Carlos. And I'm really looking forward to hearing what it is you have to say because I know that you've been up to lots of really interesting things recently.

But before we get stuck into that, Carlos, I like to ask people a little bit about how they got interested and captured by climate change. So was there a particular moment or situation for you when you first became aware of the seriousness and scale of climate change?

CARLOS SANCHEZ: Absolutely, Lydia. So I think that there are three key stages in my life where I acquired renewed interest and passion on this topic. I think from very early on in life I was very aware of the challenge of climate change. So it could be through media or through some events. But certainly I grew up with the realization of the challenge at the global level.

The next stage where I acquired a different level of interest was I spent some time in Africa in Angola. And I was working at the Spanish Embassy as a foreign direct investment advisor to Spanish companies. And in that role, I had the opportunity to interact with the Angolan government around the Clean Development Mechanism program, where, as you know, I was part of the former Kyoto Protocol around promoting investments in mitigation, as we characterize them today.

And at that time, I realized that, in a country like Angola, highly reliant on fossil fuels, this was a discussion that was becoming so, so critical and, also, the relevance of the topic to a government like Angola but also more globally, as I would interact with different international organizations. And then I think that there would be the third point in time, where I think that stage was more characterized by the inclusion of finance.

And then I think that with that I became absolutely passionate about the topic. It was, I believe, the Mark Carney speech in 2015, "The Tragedy of the Horizon." And that was an incredible change in the narrative. Up to that point, climate change had been only about policy, about science, about activism-- all critically important. But all this time, finance was in the room and finance was recognizing that this was an

important topic. And then, since then, of course we know everything that has happened and where we are.

But I think that that is a critical element to really recognize that climate change is about basically everything. It's about finance. It's about policy. It's about science. And I think that, both, in terms of motivation, it's a global citizenship duty. But also, in terms of how fascinating the topic is, that is where I would say my motivation comes from.

LYDIA MESSLING: That's great. And so motivation, then, to this current point is keeping you going. You've been working on something very exciting recently, the CCRI. Tell me more.

CARLOS SANCHEZ: Thank you. Yeah, so CCRI is the Coalition for Climate Resilient Investment. This is an initiative that was launched at the General Assembly of the UN in September 2018 in the context of the UN Climate Action Summit.

Our CEO, John Haley, and also chair of the Coalition, was there to announce this initiative that, at the time, represented 30 institutions, representing \$5 trillion in assets. And that was committed to a bunch of very practical solutions for a better integration or pricing of physical climate risks in investment decision making.

This was in very close partnership, and actually to this day, with the UK government, cabinet office-- they've been absolutely wonderful, wonderful partners-- the World Economic Forum, and the Global Commission on Adaptation. Actually since the launch, where, as I said, we were 30 institutions and \$5 trillion, now we are glad to report that we are now 93 institutions and \$15 trillion. But really, really exciting.

LYDIA MESSLING: That is really-- and I think one of the most interesting things is that it's focused on developing practical solutions to adequately pricing climate risk. What do you think has been the main thing that's been holding back the adequate pricing of climate risk? Is it technology? Or is it communication?

CARLOS SANCHEZ: Yeah, thank you. And we recognized early on that given the abundance of excellent initiatives in the climate space, we would only get the attention of key actors, institutions, and industry sectors if this was really laser focused on practical solutions, solutions upon which we could be tested and we could be accountable for.

So that was the decision to be very, very practical, of course because we need those solutions. In terms of what is the problem formulation, we believe that actually we are starting now to have the science and the risk modeling to allow for practical integration in decision making. And when we say decision making, we start with a very 10,000-foot definition of decision making.

So really encompassing public decision making, multilateral development decision making, and then corporate decision making. And within that, of course there is investment decision making. It is true that then we narrow it down to investment decision making. And then within that, on infrastructure decision making just because we think that it's a place to start with, let's call it the asset class that is very tangible and that, upon which, there's a lot of social and economic continuity around the world that it's reliant on. But to your question, up to this day we have struggled, and we still struggle, to have a consistent view of risk, a consistent view of risk that tells us what is certain exposure in year 0, so today, but then, most critically, in years 5, 10, 15 and 20. Beyond that, the challenge is to really speak between disciplines and between industries and sectors.

So it's from the science or the physics story to then have the financial story. And that is a challenge in itself. And there is very encouraging progress.

But of course, there is a lot to be achieved. And that is where CCRI comes with its humble call to really contribute to that overall discussion. And then from the financial story, that is basically understanding how those exposures in year 0, 5, 15, and 20 are going to affect your decision making or your expected financial outcomes and, let's call it cash-flow modelling.

Then we need to go to the third level of work that is about the incentive structures that we could oversimplify to call it regulation and credit quality, so how regulation and rating agencies enforce and reward that interpretation of physical climate risks in investment decision making. So to summarize, it is to get the physics story right, so the science, to get the financial story right-- the cash-flow modeling-- and to get the incentives story right-- regulation and cost of capital.

And that is the complexity of the topic, that in just those three steps, you can really bring in hundreds of institutions, some very distinctive areas of expertise and industries. And we are very excited that CCRI's contributed to this dialogue and to this genuine collaboration and hope to really support those key initiatives at the regulatory and credit level that are the ones that are really going to change the narrative on this story here.

LYDIA MESSLING: That's great. And so I think-- well, I can say this because my background as a scientist-- we're not always the best at communicating. [LAUGHS] And you're talking about those three different types of stories there, sometimes that even just the language or the way in which we use particular words are completely different.

So how is it the CCRI goes about practically building bridges across those different, almost, disciplines? How do you help these different stories speak to one another, because we're from very different backgrounds and use different language?

CARLOS SANCHEZ: Absolutely, Lydia. So the way we approach this is, again, being very practical and very, very specific in how we articulate this discussion. So of course we have had, let's say, roundtables, where the discussion at the theoretical level has been brought to the table. And it has been really exciting on the outcomes from those.

But what really brings a real collaboration and that kind of translation and exercise is the practical work. So CCRI has three working groups. And I'm going to just pick one. Maybe later you want to ask me more broadly. But let me narrow it down very quickly into one of the working groups. That is called the Asset Design and Structuring Working Group.

That working group is relying on real data from real infrastructure investments where we have the cash-flow models. We have the engineering studies. And then that data is circulated and processed by different groups and industries.

So we start with the climate risk analytics firms. Incredibly thankful to them because they are delivering pro bono segments of risk for each individual infrastructure investment.

But then that data is brought to the engineering module. And the engineering firms are interpreting that in terms of, OK, what does this mean in terms of the design, the CapEx, the OpEx, the depreciation of the assets?

OK, great. So that's where we are seeing a lot of translation. And also, as you say, the jargon and the terminology needs to find some kind of common ground for it to be an effective discussion.

But then we bring that discussion of CapEx, OpEx, to then the rating and the cost of capital, the banks in terms of default risk, in terms of cost of capital, in terms of cost of equity, cost of debt. So in that process, we are facilitating, let's call it a cross pollination across industries, where there's a tremendous level of

value, as it's told to us by the participants, in how they are learning from other industries and then developing this kind of harmonized language about climate resilience investment, if we can call it as such.

LYDIA MESSLING: So are you already able to sort of see the value in this multidisciplinary approach? Do you have evidence for how this has improved the pricing yet? Or is it still too early? [CHUCKLES]

CARLOS SANCHEZ: Well, it's still early. And we want to be very, very diligent and very, very rigorous on how we describe. But the same way that I say is I can say that preliminary findings are allowing us to be quite excited.

And those preliminary findings come in the form of really finding ways to adjust the initial design and structure and undervaluation of the asset and until we find ways to really adjust this thing here, this thing there. That does not mean that, as a result of this exercise, we will have a financially material result.

And what we mean with that is that even if you realize that you need to invest maybe one more percent or even if you realize that you need to do this action, it does maybe not necessarily affect the net present value of the investment. That is what we really want to see as a change.

We really want to come out of this and say, look, where you thought that this asset was valued 70, now this asset was actually valued at 60. But with this improvement and those adjustments, actually it may be worth 72.

That is a very, very tall order. And again, back to the initial point, we want to be very cautious and very diligent in how we go baby step by baby step. But the level of collaboration, the level of engagement, where we have more than three institutions that are bringing in six colleagues to each of the working sessions-- and we have had already 35 or more working sessions-- the excitement level is only growing. It's only because those preliminary findings are indicative of something down the road. So we have to wait. [LAUGHS] Nothing very specific to share but just the narrative that things are going well.

LYDIA MESSLING: I think that's so interesting and really great that you're already getting some early positive noises. Has there been anything, even in these early stages, that has surprised you, like pleasantly surprised you, about these new interactions?

CARLOS SANCHEZ: Well, yes. First of all, I'm positively surprised and sincerely thankful for all the support of the institutions because it's not just an initiative where institutions show up, and we take a picture, and then we go back home.

This is an initiative where institutions are bringing their expertise and their IP. And they're really sharing it. And they're sharing it because they recognize that out of this public good, which all deliverables off CCRI are going to be a public good, there is a long-term value proposition and commercial proposition.

And they recognize that right now we could almost characterize it as a market failure, the integration of physical climate risk in investment decision making, because we have imperfect or asymmetric information. We could really define it in many, many ways.

But we're not using the right information for that integration. And that is really a problem. So I'm very positively surprised about that level of engagement and passion in supporting CCRI.

I'm also surprised about that translation exercise. I didn't expect it to be so powerful in terms of different industries speaking to each other and really going back to definitions and then really recognizing the incredible value that they have in front of them, so, again, climate risk analytics versus engineering versus rating agencies.

But we could also go to insurance. And we could also go to econometrics firms that are also heavily involved. So we have a complete set of factors. And with that, I think it's that realization of the need for more dialogue and collaboration across industries.

LYDIA MESSLING: That's great. You mentioned the information. You can translate the information from different industries. But also the information that we're getting is constantly evolving and changing. And so with technological improvement, we're just going to get better and better information to make our decisions with.

If there were any bump in the road for you to come in stopping progress in adequately pricing climate risk, do you think it's going to be technological limitations and information limitation? Or is it going to be our decision-making infrastructure? What do you think is going to be the next hurdle you will need to jump?

CARLOS SANCHEZ: Well, the next hurdle is the one that we're experiencing. So it's more about how and when these hurdles are going to be addressed.

And I think that you're right. We know that as technology, or maybe let's do slash science/risk modeling as being one critical one. But then you're also, rightfully so, pointing out the relevance of other decision making and incentive structures to play a role.

And with that, I could go back to the real motivation of CCRI. That is really to protect lives, to protect assets, but also to allow institutional investors to position themselves ahead of what could be a correction of the market.

And I think that this is something that has been widely discussed as the notion of the valuation risk. And that notion says that, we recognize that today we are not properly pricing physical climate risk in investment decision making. We recognize that this is financially material, this risk.

But then we also recognize that, given that the pace that technology's advancing-- so there is modeling capabilities; and that is growing exponentially by the month-- combined with the really tremendous momentum of regulatory initiatives across the globe, we are seeing more and more how this is going to result into not only voluntary disclosure but potentially also mandatory disclosure and potentially also financial reporting.

And then if we combine that also with the role of rating agencies that are doing fantastic work in improving the integration of this risks, we could see a point in the future-- and of course nobody knows how and when-- where the practices integrating these risks are going to change. And associated to that, there is the risk that a given portfolio or a given balance sheet is corrected without necessarily experiencing a climatic event.

And this is a recognition that has driven a lot of the support to CCRI and, again, has the different ingredients, so you say, that is science, technology, and that is regulatory and broader decision making and incentives. So I would maybe leave it with that.

LYDIA MESSLING: Yeah. And so that relates to some other work that you're doing at the moment with the CFA, and so in terms of helping to educate people about climate risk. So tell me a little bit more about that, Carlos.

CARLOS SANCHEZ: Thank you, yes. And absolutely. So very thankful to CFA UK for having me in their panel for the advancement of the upcoming certification on climate and investing.

I have the honor to be the vice chair of the panel that is in charge of advancing the study materials and of course the exam questions. So that's really the ultimate signal of how the financial markets are really

embedding climate risk in their decision making and how there's a recognition of the need to advance the certification on such a topic.

This would have been just a wild dream, let's say, five, 10 years ago. And now we have it. So very thankful for the leadership of CFA UK. We are hoping to have our first exam by the end of the year. And I would really encourage everyone to learn more about it. But thank you for that question, Lydia.

LYDIA MESSLING: So go on then, Carlos. If you could put one question on that exam paper to trip them up, what would it be? [LAUGHS]

CARLOS SANCHEZ: Oh, that is [LAUGHS] a tough one because we are actually working on that. And there's some kind of NDA involved. And actually I learned that I'm not going to be able to take the exam in three years because of it. So that's kind of something I didn't know before. But still I'm absolutely delighted.

What I can say is that in framing the questions, we want to be very, very agnostic, if that is a term for this in terms of really getting to the facts. We want to exclude all more of the passionate considerations and more, let's say, opinion-driven aspects but really capture everything, capture mitigation and adaptation from the more traditional way of framing this but then, of course, capturing the evolution into more of TCFD, acute, chronic, and liability.

That in reality is more a subset of both acute and chronic. And I think that the questions are going to cover all that and then, of course, the financial implications, which I think that we are still evolving and defining what are those assumptions to interpret.

So it's going to be a wide range of questions. And they need to be, just given the reputation of the CFA and how we want this to become, a little bit of a gold standard for education on climate and investing.

LYDIA MESSLING: That's great. And so you say the questions would be agnostic. But, Carlos, I want to know what's giving you hope at the moment, [CHUCKLES] because we could all do with a little bit more of that, particularly in these times.

Has there been any encouraging change that you've seen recently, whether that be in policy or people's opinions or different approaches that you're seeing people take? Is there any positive change that you've seen recently that gives you hope that we will be able to have a climate resilient future?

CARLOS SANCHEZ: Absolutely. And, look, first of all, I think the science is evolving at a fascinating pace. And analytics, accordingly, are capturing that evolution. Second is the awareness. And I said that before.

I believe that Mark Carney's speech in 2015 was an absolutely pivotal time. And since then, nothing has been the same. And we've been only maturing more and more over the years to a point where you really can have discussions about climate risk at the board level with any top company in the world or institutional investor. And that was really not possible very few years ago.

And what you realize is that those conversations, apart from happening in a binary sense, that it's also the quality of them and it's also the substance about them. And it's simply incredible how there's a recognition that this is not about paying lip service to this. And it's about integrating effectively in decision making and adjusting whole business models to the reality of climate change.

So the awareness and the willingness is absolutely there. We just need to put in place the systems and the processes for that to be harmonized because, as we know now, there is still a challenge about the harmonization of the practice. So what do we mean with price or with pricing? How stress tests are going to work and how do we apply them?

So we are just learning. But we are learning very, very quickly. And I'm quite optimistic about how this is going. Of course, everything that I said today has been very much framed on the fiscal climate side of things. But on the transition risk side, it is also an incredible-- an incredible-- wave of commitment, of genuine commitment, for net zero, more recently, at Willis Towers Watson.

So I think that we have reasons to be very hopeful. But of course, we have no reasons to relax. So let's keep the ball. And I think that we are going to be successful.

LYDIA MESSLING: [LAUGHS] Well, thank you, Carlos, for sharing your hope. And speaking of cracking on with doing practical actions and getting them implemented, I won't take up any more of your time. But, Carlos, thank you so much for joining me today. And speak to you soon.

CARLOS SANCHEZ: It's been my pleasure. Lydia, thank you very much to you and to everyone listening. Bye, bye.

LYDIA MESSLING: Well, thank you again, Carlos. And thank you all for listening. And we look forward to welcoming you back to our next Talking Climate and Resilience podcast.

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