Janus Henderson INVESTORS

FOLLOW THE MONEY: ADDRESSING FINANCED EMISSIONS TO REACH NET ZERO

When solving a problem – especially one that requires consensus from diverse stakeholders – it's helpful to have one simple and overarching goal. In the case of climate change, that 'big picture' goal is the reduction of carbon and other greenhouse gases (GHG) released into the atmosphere. Around 39 billion tonnes of GHG are released into the atmosphere each year[1], and this needs to be reduced if we are to meet the 1.5°C limit recommended in the Paris Agreement.

The human activities that release GHG span all parts of our society and economy. The building of factories, power stations, and homes; their functioning and the use of what they produce and in the case of homes, simply living in them. All aspects contribute their share to that single 39 billion tonnes that is being sent into the atmosphere.

All these emissions are enabled in some way by private or public capital, both debt and equity. That capital is provided to build plants and infrastructure, it flows through businesses to run them, and it is spent by consumers either to buy products or use services. This allocation and flow of money determines the volume of carbon we release, how it is released at each point along the production and consumption chain, and which parties are most responsible for enabling emissions.

As a significant allocator of capital, the investment management industry has a role to play in helping to reduce total carbon emissions. It is important, however, to remember that the industry wields material influence only over the specific use their capital is put to. We need to be cognisant of these "lines of influence" and understand that they vary depending on how capital is allocated. It is critical to map these lines of influence if we are to be effective in meeting our shared goal. On top of putting the industry at the centre of the net zero transition solution, this approach also makes fiduciary sense when it comes to investor capital: positioning portfolios towards investments that stand to address the net zero transition challenge should in turn lower risks stemming from the climate transition.

The purpose of this piece is to show that, whilst the increase in carbon data in recent years is essential to understanding how GHG are emitted into the atmosphere and arranging emissions into various "Scopes" can be helpful, all this needs to be understood within the context of who has influence over capital that enables emissions in each circumstance.

[1] Emissions Gap Report 2022 (unep.org)

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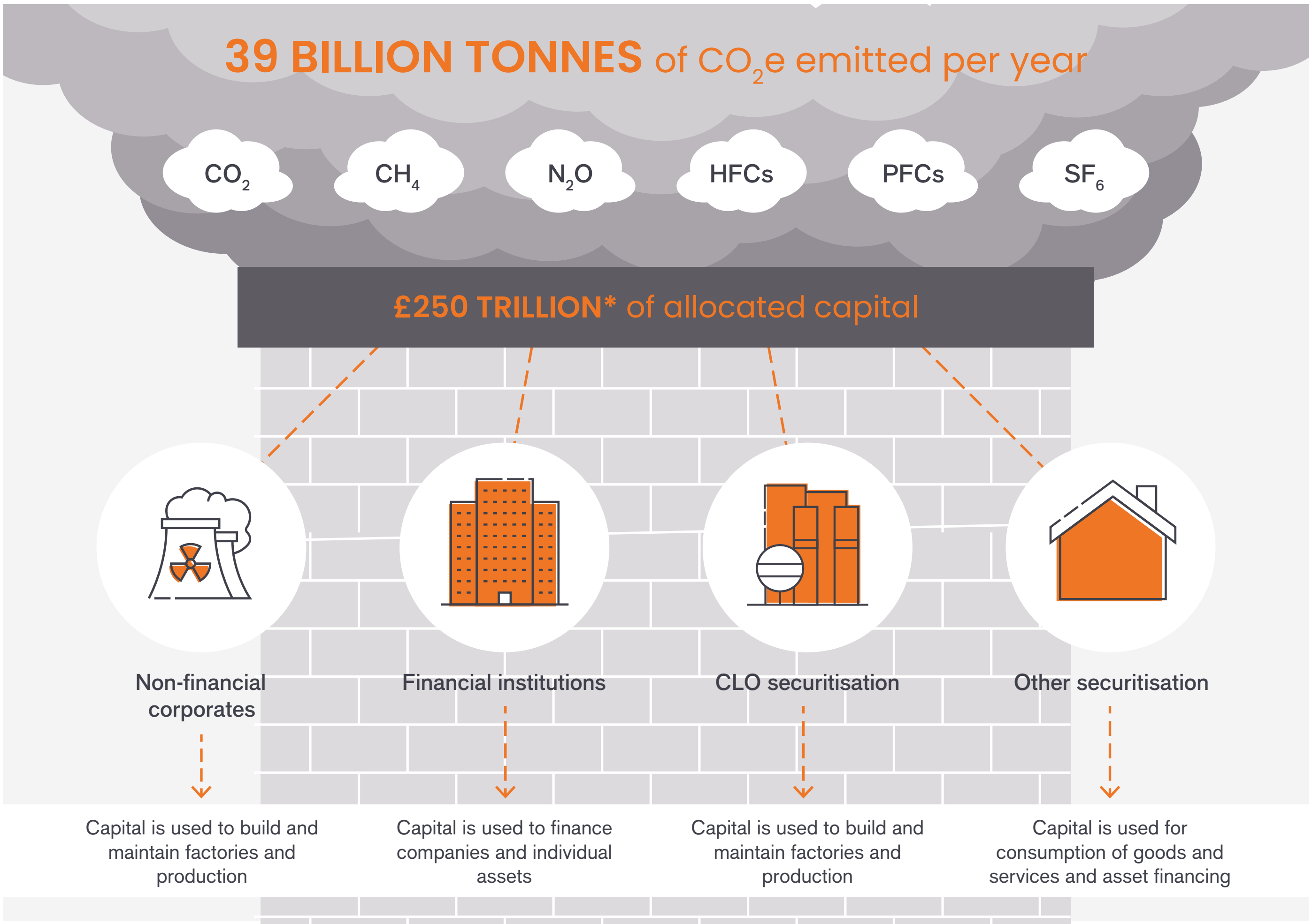


Source: Janus Henderson Investors. The above is illustrative rather than an exhaustive list of financing channels.

*Estimated information is based on SIFMA Capital Markets Factbook data as of 2021 and includes Global Fixed Income Market Outstanding (source: Bank of International Settlements "BIS") and Global Equity Market Capitalization (source: World Federation of Exchanges).

From cold cash to hot air

We need to begin by linking the capital allocated by asset managers to the activity that emits carbon emissions. The tools used by the investment industry that enable the economic activity of corporations and consumers can provide a roadmap for linking investments to carbon produced.

Applying a framework to assess what activity is *actually* financed allows us to focus on how private capital enables emissions:

- **Direct corporate funding through equity and bonds to non-financial companies** – (Equity, corporate bonds, secured loans, direct lending provides financing to corporates, specifically *non-financial companies*)

  Capital is provided to these corporations (like industrial and manufacturing companies) for building and operating physical assets, such as assembly lines, factories, fleet of boats and buildings. Direct emissions will form most of such companies' emissions given these carbon-intensive production lines, especially when compared to financial or technology businesses. Investors have much less control about indirect upstream and downstream emissions – assessing and quantifying these for non-financial institutions involves a host of considerations around materiality to overall emissions, influence over these emissions, and transparency and accountability for emissions.

- **Direct corporate funding through equity and bonds to financial institutions** – (Equities and corporate bonds funding financial institutions, primarily the financing of banks)

  This capital provides funding to support lending operations. The influence of this capital does not stop with the banks that receive it, as these banks then lend to non-financial institutions, such as the industrial and manufacturing companies mentioned previously; as well as consumers through mortgages, auto loans, and so on. How this capital is lent has significant potential to create emissions and investors should therefore account for these financed emissions when assessing the true carbon profile of their bank investments.

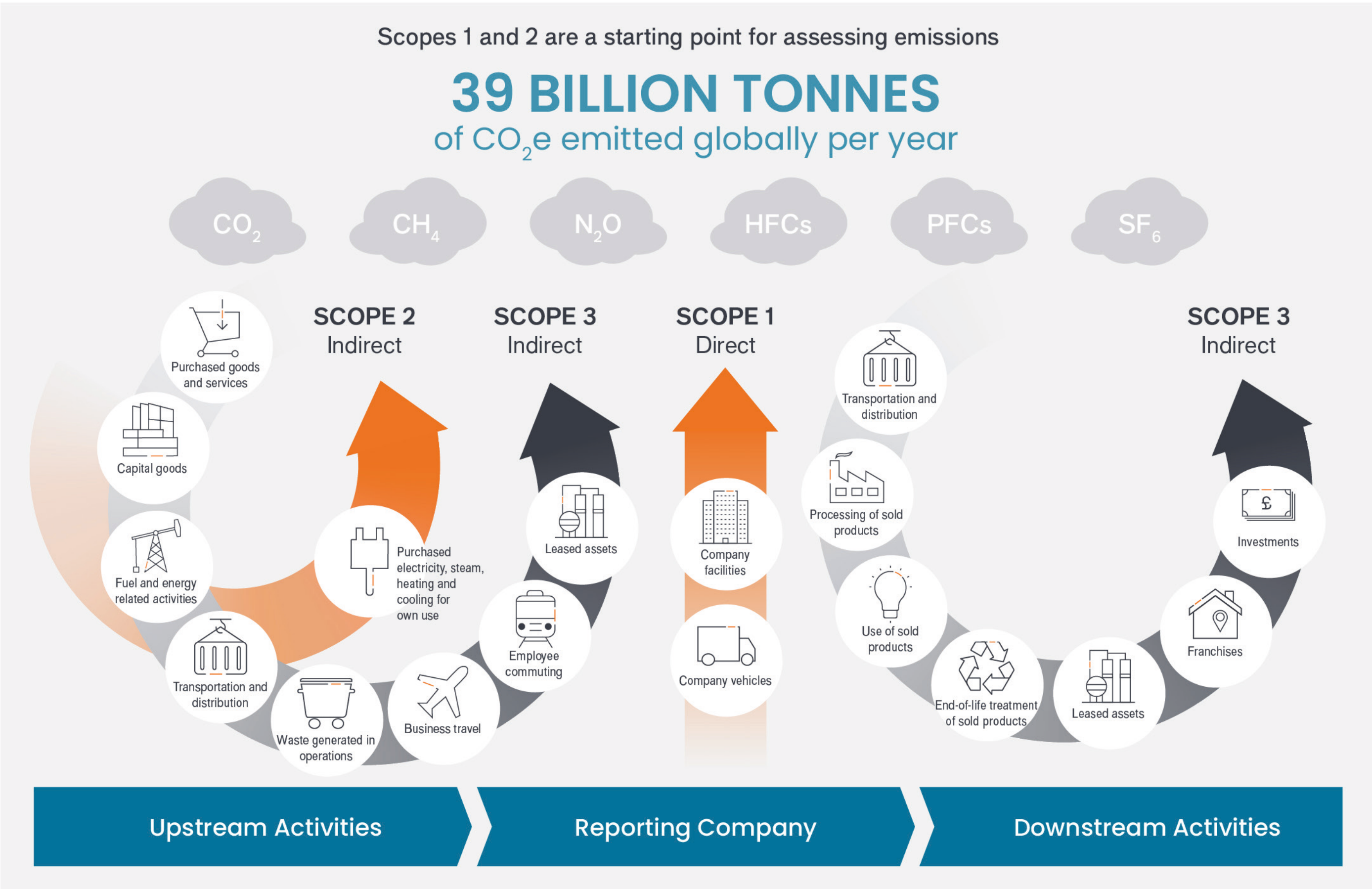
- **Indirect corporate funding through CLOs (collateralised loan obligations)** – where the underlying collateral of the securitisation consists primarily of sub-investment grade corporate loans.

  Capital allocated through this process ultimately goes to companies, though it first goes through a CLO vehicle. The direct emissions linked to this route are minimal since they only include the emissions of the asset manager that manages the loans in CLO portfolios. The material emissions that CLO investors need to quantify are therefore those involved when their capital is ultimately allocated to companies in the CLO collateral pool and the carbon tied to the building and operation of these physical assets, such as a car assembly line, factories, fleet of boats, buildings, and so on.

- **Indirect consumer funding through other securitisation** – this will often have consumer credit as underlying pooled collateral, including property mortgages, credit card receivables, and auto loans.

  Financial institutions originate consumer credit such as mortgages, auto loans, credit card receivables, and student loans, which are then segregated into specific securitisation transactions that are sold to end investors. As is the case with the CLOs above, 'direct emissions' from the asset they financed would be negligible and the largest part of the emissions linked to the securitisation funding are from use-phase emissions, such as residential homes and vehicles.

How are we approaching the Carbon Data challenge?



Source: Greenhouse Gas Protocol, December 2021

Through the various direct and indirect funding tools, the finance industry has a role to play in reducing carbon emissions by either engaging with primary emissions emitters, or alternatively, influencing spending patterns enabled by financing that it provides to end users to purchase cars, buildings and so on through securitised products.

Scope 3 is the magic number for securitised but challenges remain

If we look back through the "Scope" lens usually applied by investors when examining carbon emissions, we can see that Scope 1 and 2 figures are almost irrelevant for securitised assets as these comprise the negligible emissions of running a financial intermediaries' business. As such, investors who focus solely on the Scope 1 and 2 numbers of a securitised allocation and overlook Scope 3 have little insight into the true size of the emissions financed by their capital. In the same way that carbon emissions financed by a bank are measured as its Scope 3, so the emissions of CLO investments are best represented as the sum of Scope 1 and 2 of the businesses within the CLO. Meanwhile, the emissions linked to a residential mortgage backed security (RMBS) investment are best represented as the financed portion of Scope 1 and 2 of the properties within the RMBS.

Outside of securitised, Scope 3 emissions for non-financial companies – downstream activities use-phase emissions – can be significant. However, since these emissions aren't directly financed by our capital, our ability to influence them is diminished. Respondents to a recent industry survey[2] by the carbon-tracking body Science Based Targets Initiative agreed on the challenges faced in measuring these emissions, with 60% of respondents saying they had little influence on end-users that ultimately drive Scope 3 emissions. But the good news is that these Scope 3 emissions will be the Scope 1 and 2 emissions financed by someone else's capital, enabling them to have a more direct influence.

Points to consider

Capital gives its allocators leverage and the ability to influence the emissions linked to investments – even if that capital is deployed through an intermediary. As we have shown, securitised asset investors can still influence consumer behaviour since homes financed by mortgages go on to produce heat and cars purchased with auto loans end up producing emissions. The same can be said of bank investments that fund business and consumer loans. It therefore makes sense that asset owners wishing to participate in the net zero transition by 2050 track the emissions they enable to help them make best use of the influence they ultimately have over borrowers.

Beyond decarbonisation, having a full accounting of financed emissions makes for prudent risk management since linking capital to carbon emissions enabled by portfolio investments exposes potential transition risks such an increase in carbon costs. Any investment that doesn't consider financed emissions could therefore face risks by failing to correctly identify a source of emissions that could be subject to future carbon taxes.

But measuring the full range of emissions enabled by investments is challenging given that improving access to high-quality measured data and enabling value chain traceability isn't something that can be achieved by one actor alone. In the absence of a full ecosystem to enable effective primary data measurement and transmission throughout the value chain, we have chosen to plug the reporting gap with our own proprietary estimates of direct emissions related to our capital deployment across diverse portfolios of secured loans, corporate bonds and securitised products.

Taking a corporate accounting method and applying to portfolios while only using partial data can also distort the risks that trustees see and so impact the actions they take. As interest continues to increase in GHG reporting, we are likely to need enhancements to existing accounting standards. These could include increased sector-specific guidelines, greater standardisation of methodological choices and decisions, and the development of a supply chain traceability infrastructure to facilitate exchange of primary measured emissions data.

In the meantime, however, investors looking to maximise their role in the transition to net zero should follow the money.

[2] SBTi-The-Scope-3-challenge-survey-results.pdf (sciencebasedtargets.org)

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