A Commentary on *Embedding Environmental Risks in Finance: Current Methods and Ongoing Challenges*

Andrew W. Mitchell
Founder and Director, Global Canopy Programme

Material risks are growing for the financial sector, and, "Embedding Environmental Risks in Finance," makes a valuable contribution in reviewing and commenting on the range of methodologies available to investors for identifying and managing these risks. It is remarkable that so few financial institutions use the tools, many of which are actually supply-led rather than demand-led. For most financial institutions, the business case for investing in sustainability appears far weaker than the case for conducting business as usual. The reason for this is that the costs of using natural capital are not priced into the production of goods and services. Except in certain circumstances, regulatory frameworks remain too weak to make a material change in this position.

Change is coming, albeit slowly. The reputational risks of destroying natural capital with little regard for the impacts, whether they be on Earth's atmosphere, rainforests, or oceans, are increasingly measurable in share price falls, but these tend to be transitory and rarely result in wholesale bankruptcy. Big companies especially can take it on the chin, but neither their employees nor their customers wish to be associated with "bad" companies. Regulatory risk can have a significant impact, and commodities causing, for example, the illegal conversion of tropical forests may be increasingly excluded from mature markets (such as those of the United States and Europe) in the future.

Materiality, defined as the extent to which environmental risks can be financially quantified as having an impact on the future costs of goods and services and hence a company's performance, remains elusive. Because biodiversity and ecosystem services are treated as externalities and do not appear on balance sheets, it is hard for investors to assess positive or negative impacts on future share value. More research is needed here.

In addition to offering a comprehensive overview of the wide range of tools now available, the Hill et al. review provides investors with insights that can help them navigate this complex and evolving assessment process. Presented by UNEP Finance Initiative, with contributions by Citi and JP Morgan, the paper answers the question of how to apply each tool to the assessment of systemic environmental risk related to water, biodiversity, and ecosystem services within a portfolio. The discussion of key tools and frameworks includes an examination of barriers to implementation, and thus highlights as an opportunity the increasing need for data aggregation in the environmental sector.

There are some omissions, such as the Forest Footprint Disclosure Project, which for some reason is left off the list of tools and frameworks, though it is briefly mentioned later in the text. The paper could offer stronger advocation of nontraditional financial analysis as a means of capturing the potentially immense values associated with ecosystem services, such as has been promoted by the Economics of Ecosystems and Biodiversity (TEEB) review. TEEB hopes to increase investor consideration of the currently often-invisible role of natural capital in investor portfolios. The recent work by PricewaterhouseCoopers LLP and Trucost PLC with sport lifestyle company PUMA in delivering the first "corporate natural capital accounts" is an example of progress.

From the survey data, it would be interesting to know how many of the 48 investors have actually invested or disinvested on the basis of using the frameworks and tools currently on offer, and what questions investors would like to see answered that are not currently being answered.

A clear message is that investors are looking for simplicity—and the tools currently available generally offer complexity. This needs to be addressed. The role of credit rating in relation to natural capital use offers possibilities, as do standardization and some form of index that indicates comparative corporate performance. The mainstream finance industry must be clearer about its future needs in a potentially transformed fairer and greener 21st century economy.

Biography

Andrew W. Mitchell is a leading authority on forest canopies and related climate change issues. His extensive field experience in Asia, Africa, and Latin America combines with a thirty-year career spanning research, journalism, broadcasting, policy, and global project management. In 2001, he founded the Global Canopy Programme (GCP), an international network linking 38 leading scientific institutions in 19 countries engaged in research, conservation, and education for investigating the impact of climate change on biodiversity and ecosystem services in forest canopies. In his capacity as founder and director, Andrew has coordinated the growth of GCP into an influential alliance, using networks developed within the international science community to offer a global perspective on science, policy and finance for forests.

Andrew is a former Research Associate of the Zoology Department University of Oxford, and was the former Rufford Research Fellow in Environmental Understanding, at Green College. He is the author of seven books, including *The Enchanted Canopy*, and many articles for newspapers and magazines. His work has been translated into six languages.