DIVESTMENT AND NET ZERO: WHAT IT MEANS FOR YOUR FINANCIAL INSTITUTION

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The term Divestment is increasingly being used in the context of sustainable finance and climate risk management. The simple definition of divestment is the process of selling subsidiary assets, investments, or divisions of a company in order to maximize value. On the surface divestment may initially appear simple, but there is a vast range of approaches to divestment, with different methodologies, purposes, and trade-offs.

Fossil fuel divestment has become one of the main manifestations of activism against climate change,[1] and one of the most contentious. For this reason, divestment in the context of the fossil fuel sector will be the primary focus of this paper. Furthermore, varying approaches to fossil fuel divestment are complex. The efficacy, outcomes, and impact of divestment vary by holding type (e.g., direct vs indirect), asset class and strategy; this paper will cover direct equity investments.

The push for fossil fuel divestment stems from a desire to limit climate change, accelerate the transition to a low-carbon energy system, and mitigate climate-related financial risks. This paper addresses how divestment can be used as a component of prudent climate risk management and provides a discussion around how climate-related risks can be mitigated without an external fossil fuel investment exclusion policy. This is of particular importance as many Canadian institutional investors have chosen to forgo fossil fuel investment exclusion policies in favour of escalatory engagement[i], at this point.

There is a need to critically evaluate fossil fuel divestment strategies to examine methodologies and alignment with investor fiduciary duty. Examples throughout the paper will highlight varied approaches to divestment and discuss potential motivations and efficacy of the strategy. Fossil fuel divestment is not black and white; rather, it is immensely nuanced and characterized by shades of grey.

DIVESTMENT AS A BUSINESS STRATEGY

In most cases of active portfolio management or corporate business strategy, divestment, divestiture or exiting an equity or ownership position is not contentious. In fact, “firms continuously pursue divestments to adjust to changing market conditions and shareholder requirements.”[2] These activities are considered good business practices, and by doing so as part of an effective strategy, businesses maintain resilience and optimize shareholder value.

However, divestment related to the energy sector (fossil fuels) and other carbon-intensive sectors is not currently recognized by the market as part of an ongoing effective portfolio management strategy. This circumstance may in part be due to the gradual change (over the past number

Public commitments to divest are facilitated by any investment exclusion policy. **An exclusion policy is adopted by an investor that specifies exclusions of “specific investments or classes of investment from the investible universe** such as companies, sectors, or countries. This approach systematically excludes companies, sectors, or countries from the permissible investment universe if involved in certain activities based on specific criteria.” If a security is excluded based on the criteria set by an investor, it is removed from consideration in the investment process.

Fossil fuel divestment can also occur without an external public investment exclusion policy, which will be discussed in more detail in the section covering fossil fuel divestment strategies.

i See Appendix for Definition

of years) to the role this sector fundamentally plays within a balanced portfolio. This notion is emphasized by the following insight "in the current global economy, the business environment is always changing. Some changes are so dramatic that everybody notices them, but others may slowly creep up over the years until they can no longer be ignored."[3]

The dispute around fossil fuel divestment stems from misunderstanding of motivations underlying divesting of carbon-intensive assets, the nature of climate-related financial risks facing financial institutions, and the impact divesting of these assets can have in mitigating climate change.

Part of this misunderstanding stems from the lack of data, research and methodologies currently available to reliably project and estimate the potential financial impact of climate change on investment portfolios, businesses and other assets.

HISTORY OF DIVESTMENT AND THE USE OF INVESTMENT EXCLUSIONS

Divestment campaigns have been employed as a strategy for decades. The first major campaign to push for divestment, and one of the largest to date, was first advocated in the 1960s in protest of South Africa's Apartheid system. The movement reached critical mass in the mid-1980s when student activists across America organized protests and called for universities and financial institutions to divest from companies doing business in South Africa.[4] There have also been long-running divestment campaigns for tobacco, alcohol and arms since the 1970s and 1980s.

Over the last decade, fossil fuel divestment has gained significant momentum. Fossil fuel divestment entails reducing or eliminating exposure to specific fossil fuel-intensive companies or sectors, which can involve a variety of positions along the fossil fuel supply chain by publicly adopting investment exclusion policies. The movement originated with a small number of US college campuses in 2011.

DIVESTMENT AND FIDUCIARY DUTY

Asset managers are responsible for addressing all material risk factors that have the potential to affect long-term investment performance.[5] As such, it is an asset manager's fiduciary duty to consider all risk factors impacting long-term investment performance, including physical, transition, and other climate and broader ESG risk factors within their due diligence process. As such, it follows that divestment related to climate risk, based on appropriate due diligence, is consistent with fiduciary duty. Fossil fuel divestment actions by hundreds of funds worldwide have passed the prudence tests required of fiduciaries.[6] The legal and business case for investing sustainably is arguably settled, with sustainable investing proving to be consistent with fiduciary duty.

It is important to recognize that **divestment is one potential tool available to be utilized to mitigate climate-related financial risks.** It can be used to create an investment exclusion policy or used alongside corporate engagement and integration. Regardless of the approach taken, fiduciaries need to demonstrate they have identified and evaluated climate change risks in their investment portfolios, assessed how these risks might impact investment returns in the short and long term and developed a robust strategy to manage the risks effectively.

THE EMERGENCE OF DIVESTMENT AS AN INVESTMENT AND RISK MANAGEMENT STRATEGY

As mainstream investment managers have increasingly included divestment (internally or externally) as a component of managing climate-related financial risk, the primary motivation has shifted from one centred on values/morals to one centred around **financial value preservation** and **risk management.**

Divestment strategies vary significantly between investment management institutions. Fiduciary investors must develop a framework to evaluate the risk and return trade-offs between "hold versus divest"[7] to support their chosen strategy. It is critical that investors determine their risk tolerance and investment strategy as these factors will determine the preferred divestment approach, risk/return profile and scope of exclusions (if any). Considerations could include, for example, minimizing short-term financial risk and deviation from standard market returns or mitigating long-term climate and financial risk posed by potentially stranded assets.[8]

Even without an externally communicated divestment strategy, climate-related financial risks are increasingly being taken into consideration. There are heightened considerations of longer-term downside risks and loss of valuation related to carbon-intensive assets and firms,[9] which has led to many investors quietly rebalancing their portfolios.[10]

Divestment to Support Financial Value Preservation

Increasing volumes of research point to the potential and significance of climate related damage on company valuations, stemming from the manifestation of physical and transition risk. The World Economic Forum estimates that between now and 2100, the potential financial losses arising from climate change could range from $4.2 trillion to as much as $43 trillion, versus a total global stock of manageable assets worth $143 trillion. From a more optimistic perspective, climate-change adaptation and mitigation efforts are predicted to generate investment opportunities worth up to $26 trillion between now and 2030. At the company level, actively addressing climate change risks and opportunities through operating, investment and financing decisions has the potential to lead to positive impacts on cash flow, financing costs, terminal values and exit values, ultimately leading to the creation of shareholder value. These valuation related considerations can influence and drive divestment strategies of investment managers.

Divestment to Support Risk Management

While we note that an investment exclusion policy or divestment strategy does not necessarily equate to active climate risk management, they are interdependent.

As a simple example of a divestment application within risk management, stranded asset risk can stem from regulation changes, shifts in social norms and the falling costs of clean energy and other tech solutions that can replace emission-heavy technologies. Divesting from fossil fuels could reduce potential exposure to stranded assets, thereby protecting asset values and organizational reputation. Such a risk-mitigation strategy has practical limitations that must also be considered. For example, an investment manager must assess the degree to which investors are willing to deviate from a broader market portfolio.[11] Meanwhile, institutional private equity investors must consider competing priorities such as reputational risks, stakeholder relations and alternative investment opportunities.

DIVESTMENT METHODOLOGIES AND INVESTOR STRATEGIES

While there has been widespread growth globally in fossil fuel investment exclusions and divestment commitments, it can be challenging in practice to determine the actual extent of fossil fuel firms subject to these restrictions, as the scope and scale of assets excluded vary significantly. On a practical level, divestment may seem superficially simple. However, a closer look at the nuances involved in divestment strategies – particularly for energy companies – reveals that “divestment” entails a broad and wide range of heterogenous tangible strategies. The most common techniques are listed in Chart 1, ranked from most to least restrictive/aggressive:

Chart 1 Divestment Strategies (non-mutually exclusive)

Fossil Fuel Divestment Strategy	Explanation	Public Investment Exclusion Policy	Types of Investors Who Utilize the Strategy
A. Full or partial divestment of fossil fuel	Strategy uses a negative screen to identify specific securities based on specific criteria (e.g. sector, sub-industry, often using GICs to identify specific areas for divestment) Full divestment – May include the entire energy sector (in addition to fossil fuels) and other carbon-intensive sectors such as utilities Partial divestment – Limited to specific fossil fuel segment(s) (e.g. coal, oil sands)	Yes	Various Canadian banks and pension plans use a partial divestment strategy.
B. Climate aligned	Strategy uses research and judgment to determine the status of individual firms (could employ a negative screen once the initial list is determined). This strategy utilizes a discretionary approach, which entails bespoke analysis of a company/industry. Assessment of viable transition pathways is integral to this analysis and the ultimate determination of whether a company/industry remains an attractive investment.	No – Divestment occurs as part of an escalatory engagement strategy where a company is divested from following numerous failed attempts to evidence achievement of desired progress/ outcomes with respect to climate.	Select Canadian pension plans use a climate aligned strategy.

From a technical perspective, investment exclusion policies (full and partial fossil fuel divestment) utilizing negative screens are by far the most popular. They are comparatively easier to implement/execute than a Climate Aligned strategy.

A. Full and Partial Divestment Strategies – Taking a Closer Look

Negative or exclusionary screening involves applying filters to a universe of securities, issuers, investments, sectors or other financial instruments to rule them out based on pre-specified criteria. This may include ruling out particular products, services, regions, countries or business practices.[12]

Fossil fuel divestment commitments (investment exclusions) range from "coal only" to "completely fossil free." (Figure 1). Fossil fuel negative or exclusionary screening conducted by investors and asset managers can be quite diverse owing to the wide variety of perspectives on the energy sector and variations in investment theses.

Screening Techniques – Taking a Closer Look

At the broadest level, investors can screen companies using the energy Global Industry Classification Standards (GICS) classification or any involvement by a company in the business. This comprehensive definition usually excludes oil & gas service companies and other indirect fossil fuel market participants. More sophisticated strategies may

Figure 1

The spectrum of fossil fuel divestment

Fossil fuel free	Full divestment	Partial divestment	Coal and oil sands	Coal only
No investments* in fossil fuel companies** *and* committed to **avoid** any fossil fuel **investments in the future****	A binding **commitment to divest*** from any fossil fuel company**	A binding **commitment to divest *across asset classes*** from **some** fossil fuel companies** *or* to divest from **all fossil fuel** companies**, but ***only in specific asset classes*** (e.g. direct investments, domestic equity)	A binding commitment to divest* from any coal and oil sands companies	A binding commitment to divest* from any coal companies

Notes:

* Direct ownership, shares, commingled mutual funds containing shares, corporate bonds or any other asset classes

** Fossil fuel companies (coal, oil, natural gas) and especially those in The Carbon Underground 200, the world's top 200 public companies ranked by the carbon content of their proven fossil fuel reserves

Source: *Schroders* https://prod.schroders.com/en/sysglobalassets/staticfiles/schroders/sites/australia/pdf/schrodersau_divestment_final.pdf

entail screening aimed at capturing only those companies producing substantial quantities of fossil fuels as defined, for instance, by a revenue threshold of 20-50% or using a negative screening that focuses solely on companies with reserves. Alternative strategies may entail applying screens to exclude specific categories of fossil fuels such as coal or oil sands. (Figure 2) As one considers the wide variety of divestment approaches and techniques that can be taken, it becomes increasingly clear that the term divestment, specifically as it relates to the energy sector, is more complex than it may seem at first glance.

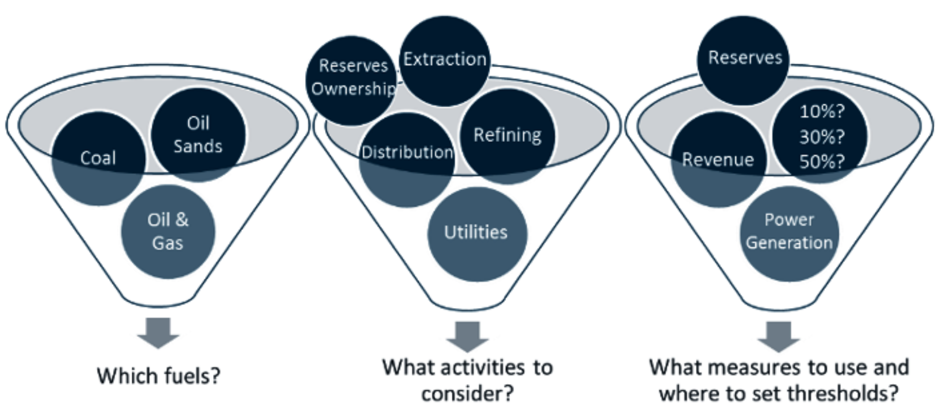
The narrowest approaches focus only on thermal coal (metallurgical coal[i] is not subject to most investment exclusions) and set a high threshold for revenue or power generation in determining exclusions. For reference, in Chart 2 are some of the most frequently used criteria for coal investment exclusions.

B. Climate Aligned Divestment Strategies

Climate aligned divestment strategies are designed to identify firms that – as determined by the investor/investment manager - lack sufficient ability and/or willingness to transition to a net zero world. These firms

i See Appendix for Definition

Figure 2 **Considerations in Establishing a Fossil Fuel Divestment Strategy**



Source: *MSCI Inc* https://www.msci.com/documents/10199/759575ba-929f-4d7b-b9f3-fa7cfec7e9d2

Chart 2 Example Exclusion Thresholds for Coal Divestment

	Financing of coal mines, plants and infrastructure projects	Development of new coal plant	Coal share of revenue or power production (%)	Annual thermal coal[i] production (MT) or total coal-based installed capacity (MW)
Exclusion thresholds	No project finance	Ban if adding >300 MW to the grid	Ban if >20%	Ban if production >10MT or installed capacity: >10GW

Source: *MSCI Inc* https://www.msci.com/documents/1296102/26195050/MSCI-Net-Zero-Tracker-Mar2022.pdf

i See Appendix for Definition

often involve carbon-intensive assets, owned by firms that have demonstrated insufficient action to realign their business model, leading to an unacceptable level of climate risk. This divestment strategy can be used as the final step of an escalatory engagement strategy. The strategy can also be used pre-emptively by investors to analyze and evaluate the potential for investor influence over companies, along with identifying realistic pathways for decarbonization prior to allocating capital.

A notable example of an investor who had adopted a climate aligned divestment model is the New York State Common Retirement Fund (NYSCRF), a pension fund with Assets Under Management (AUM) of US$272.1 billion (March 31, 2022) on behalf of more than one million New York State and local government employees and retirees. The fund is known for its public approach to putting forward climate-related shareholder resolutions, evaluating fossil fuel investments for their transition readiness, and listing fossil fuel companies it has chosen to divest from due to their lack of transition readiness."[13] In applying its climate aligned strategy, NYSCRF reviews fossil fuel investments to determine, for example, "if they are prepared for the transition to a low-carbon economy"; as of August 2022, these reviews have resulted in NYSCRF publicly divesting from 55 shale oil and gas, oil sands and coal companies.[14] NYSCRF uses divestment as a strategy when it is determined to be consistent with their fiduciary duty, and where the specific risk posed by a company's **failure to develop any meaningful climate transition plan** is viewed to be extreme.

When using a climate aligned fossil fuel divestment strategy, investors need to reach a conclusion based on their assessment of risk and opportunities, while being prepared to defend their position. Furthermore, different investors will reach different conclusions.[15] The investment organization must determine the appropriate elements of divestment and/or exclusion within their investment policies, which align with their risk management framework and strategic objectives.

INVESTOR MOTIVATIONS AND CONSIDERATIONS - PUBLIC STATEMENTS ON FOSSIL FUEL DIVESTMENT

Canadian investors agree on the importance of climate-related financial risks, but to mitigate these risks, firms have implemented a range of external and internal strategies. There is a wide range of motivations for investors when choosing to publicly pursue a fossil fuel divestment strategy, adopt fossil fuel investment exclusions, or address risks internally without explicit public disclosure. These include internal and external factors, along with previously discussed considerations, such as risk tolerance and investment approaches. Investor considerations and motivations include:

A. Strategically Changing Perceptions

Public fossil fuel divestment announcements and investment exclusion policies by a firm are a comparatively easy action to send a clear signal to the market, peers, and energy (and other carbon-intensive) companies. Although nuanced to determine, divestment commitments are relatively simple to communicate (more so than transition finance.) Public statements still act as a signalling mechanism even if the impact of the action is negligible (e.g., divestment policies for market segments that are becoming or are already uneconomical, such as thermal coal and arctic drilling.)

Public declarations can be used to signal that a firm is striving to be a market leader in this area but can also be used in an attempt to change a firm's reputation. Fossil fuel divestment announcements that are excessively vague or an investment exclusion policy crafted to have unusually narrow coverage may lead to reputational risk as these actions could be viewed as greenwashing. Such approaches could also be perceived as attempts to respond to (or stall) additional regulation by demonstrating that voluntary action is sufficient.

B. Attempting to Avoid Attention

Some investors may develop an internal fossil fuel divestment strategy and keep it private to avoid drawing attention to the firm. Motivations for minimizing attention could include a desire to appear neutral as the issue of fossil fuel divestment has become increasingly contentious. Other reasons could include minimizing the risk of potential greenwashing claims.

C. Managing Stakeholder Expectations

Hesitancy to publish externally could be related to managing stakeholder expectations and concerns related to being held accountable for a publicly stated position. Avoiding external declarations may help investors avert accusations of greenwashing if actions are not aligned with public statements (despite actions being taken internally.) On the other hand, choosing not to communicate a divestment strategy externally could conversely result in the organization being viewed as a laggard on climate risk and becoming a target of climate activism.

THE CANADIAN INVESTMENT MANAGEMENT DIVESTMENT LANDSCAPE AND TRENDS

Most Canadian investors have an investment exclusion policy (e.g., controversial weapons), but few large investors have adopted fossil fuel investment exclusion policies or have a formalized fossil fuel divestment strategy.

Most large Canadian financial institutions have chosen to make ESG integration[i] and active ownership/engagement the cornerstones of their ESG strategies. **Engagement is an essential component of a climate risk management strategy. Engagement is the carrot; divestment is the stick.** In the Canadian landscape, rather than adopting specific policies related to the divestment of fossil fuel assets, managers and investors will act in accordance with climate risk management policies, including evaluating the long-term viability and potential of the underlying business. This approach aligns with recommendations from the Independent High-Level Expert Group on Climate Finance, which states, "In aligning portfolios with net zero, asset owners should carefully balance their options across strategies ranging from divestments to active ownership and shareholder engagement, and direct investments in sustainable assets."[16] **Exiting non-viable carbon-intensive positions will likely become more common as climate-related financial risks are more accurately calculated and more investors who have committed to achieving net-zero emissions in their portfolio by 2050 meaningfully explore potential decarbonization pathways and transition readiness.** This aligns with investor fiduciary duty, as capital should not be allocated to companies that fail to align with stated climate and risk mitigation objectives.

i See Appendix for Definition

ACTIONS THAT CAN BE TAKEN TO MITIGATE STAKEHOLDER CRITICISM OF FOSSIL FUEL DIVESTMENT

Most Canadians support climate action and mitigation of climate-related risks, even if they do not explicitly support fossil fuel divestment or investment exclusions. **Steps those in the financial service industry can take to mitigate criticism of fossil fuel divestment by stakeholders include:**

- Develop and publish an engagement escalation plan: Develop and communicate what actions will be taken if climate expectations are not met on the agreed timeline (i.e. shareholder resolutions, voting against directors, divestment).[17] This will provide clear guidance to inform decisions when engagement fails.

- Set clear expectations: being transparent with stakeholders about processes to exit fossil fuel or other carbon-intensive positions, along with the rationale. Divestment decisions must not be viewed as ideological but as the natural last step of an escalatory and timebound engagement program. This can also be applied to climate-related expectations for all held companies (i.e. companies must adopt credible net-zero commitments and create pathways for achieving them).

- Disclose fiduciary and risk management rationale: Specifying the financial justification for divestment and clarifying the divestment strategy in sufficient detail is an increasingly important component of risk-mitigation strategies to prevent economic, reputational, and legal risks.

- Clear transparent communication: ensuring communication on ESG topics is clear, concise, credible.

- Building trust: addressing greenwashing and misleading statements builds trust with stakeholders and increases the credibility of other actions.

- Proactively develop messaging: being prepared to defend actions taken and to explain trade-offs in managing risk and opportunities as no two perspectives on divestment will be the same.

CONCLUSION

Identification of clear objectives regarding the role of fossil fuel divestment in prudent climate risk management along with adherence to fiduciary duty is required. This discussion within firms should entail considering divestment within a broad range of strategies and identifying the rationale for their usage in specific circumstances. When forming any divestment strategy, firms should consider the risks weighed against the potential benefits.

The Canadian financial services industry has demonstrated a range of motivations for current approaches to fossil fuel divestment. Opportunities exist to use fossil fuel divestment strategically to mitigate climate-related risks to their portfolios while maintaining Canada's credibility and positive momentum around sustainable investing. It is important to recognize that a one size fits all approach does not exist. Divestiture should be considered within a broader discussion and organizational plans to address a net zero future.

Appendix: Definitions

Engagement: Ongoing interactions and dialogue conducted between an investor or their service provider and a current or potential investee (e.g. a company), or a non-issuer stakeholder (e.g. an external investment manager or policy maker) to improve practice on an ESG factor, make progress on sustainability outcomes, or improve public disclosure. In private markets, engagement also refers to investors' direct control over and dialogue with management teams and/or Board of portfolio companies and/or real assets.

Escalation: Escalation in the context of stewardship is the approach an investor takes if initial stewardship approaches are unsuccessful at achieving its objectives over a given time period. Escalation differs by asset class and investor type but generally involves the use of increasingly assertive stewardship tools and activities.

ESG integration: Including ESG factors in investment analysis and decisions to better manage risks and improve returns.

Metallurgical coal: Coal used to produce steel and other industrial products. The carbon released from burning metallurgical coal renders steelmaking emissions-intensive.

Stewardship: The use of influence by institutional investors to maximize overall long-term value, including the value of common economic, social and environmental assets, on which returns and client and beneficiary interests depend

Thermal coal: Coal used to generate electric power. Burning thermal coal to produce steam that turns electricity plant turbines is among the leading sources of greenhouse gas emissions.

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