

Divestment – does it drive real change?

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Divestment has been a feature of the investment industry for decades. Attention has returned with the growth of the fossil fuel divestment campaign, among other recent environmental and social events. But what does divestment seek to achieve and does it work in practice? We carried out an objective assessment to find that it is not necessarily the most effective way to drive real change. We propose a new model for asset owners to drive change that centers on engagement and restricting the marginal supply of capital.

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Executive summary

Divestment is the imposition of a blanket policy to eliminate any investment in companies engaged in specific controversial activities. Divestment decisions reflect asset owners' desires to curtail exposure to contentious activities in line with their beliefs, avoid profiting from specific industries, or is often the simplest response to stakeholder and/or public pressure.

There is no escaping the conclusion that divestment is the only logical response to the second motive and often the easiest response to the third. However, if asset owners intend to use the power their capital provides to force change in companies' underlying activities, the picture is more complicated.

Divestment has raised public awareness and hurt company reputations...

Major divestment campaigns of the past include the 1960s campaign in protest of South Africa's Apartheid system, as well as those relating to tobacco, alcohol, arms, and more recently, fossil fuel divestment (which we focus on in particular in this paper, see page 8). Divestment has been important in raising public awareness and stigmatising companies, particularly for the South African campaign, but it was only one means of effecting change.

...but has limited effect on companies' operations

On the whole, we find that divestment has not been effective, particularly in restricting access to capital or influencing a company to cease an activity.

Focusing on divestment alone misses the bigger picture

Given this context, we do not believe that focusing on fossil fuel divestment in isolation will help limit global temperature rises to 2°C. The transition to a lower-carbon world is far more complex and, as we outline in our [Climate Progress Dashboard](#), significant changes are required across four key areas: public policy, business and finance, technology and the fossil fuel industry.

A new model for asset owners to drive real change

If divestment strategies have limited impact on effecting real change, what other options are available to asset owners? We propose a new model to drive change that encompasses the following key aspects:

Engage with companies

Investors should be holding companies to account by actively engaging with them to influence their behavior rather than washing their hands of the situation (which just means there are fewer investors to push companies to improve). However, this approach requires patience; it can take years for a company to transition its business model to one that is less carbon-intensive. Asset owners can have greater impact driving change by engaging with companies collectively.



Focus on the new supply of capital

Banks and bonds play a key role in allowing fossil fuel companies to continue their exploration and extraction activities. Their support for the industry dwarfs any new capital provided by shareholders. Investors can decline investment in bonds issued by these companies and challenge those that continue to supply capital to the industry in an effort to remove this much-needed financial support. More attention can be focused on insurers as well. Without insurance for mines, power plants and projects, fossil fuel companies will find it difficult to obtain funding and proceed with new and existing projects.



File shareholder resolutions and vote against management

The number of shareholder resolutions related to climate change has continued to rise as investors seek to push companies to align their businesses with a 2°C world. The scope of the resolutions vary, but include things like reporting annually on carbon emissions and adding a climate change expert to the board. While many of these resolutions are being supported, some of the largest asset owners in the world are voting against them. Having these asset owners on board could make a meaningful difference in getting companies to transition their business models sooner.



Put pressure on public policymakers to take action

More effective public policy is needed to drive the changes desired on the scale required so asset owners should engage with public policymakers as part of their strategy. To really change the status quo, we need to see higher carbon prices, incentives to reduce consumer demand for fossil fuels, a phasing out of the sale of petrol and diesel vehicles and an end to the significant subsidies and export finance for the industry as a whole. Phasing out these important sources of finance for the industry and redirecting the funds towards clean energy will help countries transition to a lower-carbon world.



What is divestment?

Divestment is the imposition of a blanket policy to eliminate any investment in companies engaged in specific controversial activities. Divestment decisions reflect asset owners' desires to curtail exposure to contentious activities in line with their beliefs, avoid profiting from specific industries, or is often the simplest response to stakeholder and/or public pressure.

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We separate divestment strategies from investment decisions based on poor financial performance; the latter are often used to justify the former, but in our view are separate considerations with different goals.

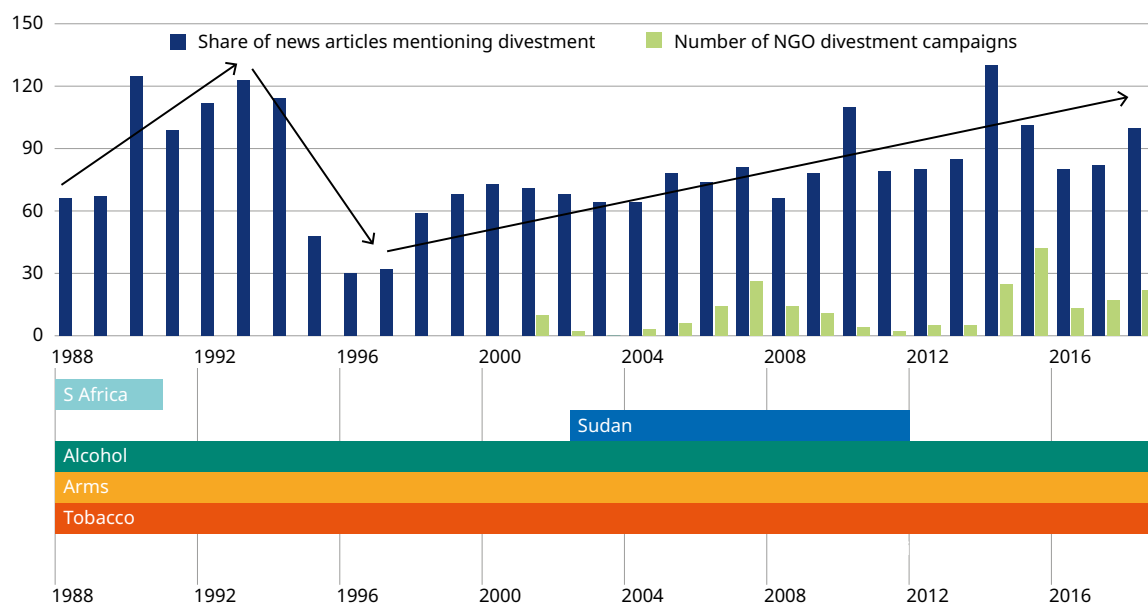
Tobacco divestment pressure can be traced back to the late 1970s with members of the American Medical Association (AMA) calling for its pension fund to sell all tobacco stocks, given the investment was at odds with the organization's efforts to get people to quit smoking. The campaign then spread to medical schools across the US, culminating in the creation of the Tobacco Divestment Project to coordinate efforts to end tobacco investments across universities and pension funds.

There have also been long-running divestment campaigns for alcohol and arms (see Figure 1). More recently, the fossil fuel divestment movement has captured the attention of campaigners globally. Asset owners around the world are facing mounting pressure to divest their fossil fuel investments, so we focus on this campaign in particular in this paper (page 8).

Divestment is not new, and is becoming more popular

The first major divestment campaign, 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.

Figure 1: Divestment campaigns and interest over time



News searches based on searches for the word "divestment" relative to the total number of articles in Highbeam's "Finance" category
Source: Highbeam, Schroders analysis

What does divestment seek to achieve?

At their core, divestment campaigns seek to exert pressure on companies deemed to be involved in objectionable activities, in order to bring about positive change. However, a closer examination of specific objectives shows different divestment campaigns can vary widely in terms of ambition and intended outcomes. Some campaigns focus on asking companies to change a part of their business, while others seek to change the entirety of companies' businesses. Perhaps unsurprisingly, those that focus on the former are likely to have more success.

Apartheid South Africa

In the case of South Africa, the divestment campaign sought to put an end to social injustices, and to bring about democracy and equality by ending the Apartheid system. The campaign sought to lower the value of targeted US companies and in doing so, put pressure on them to withdraw economic support from South Africa.

Tobacco

Originally, the tobacco divestment campaign was focused specifically on getting the AMA to stop investing its pension fund in tobacco stocks on behalf of members. It then morphed into the Tobacco Divestment Project which sought to coordinate efforts to end tobacco investments by universities and pension funds across the US.

Tobacco divestment campaigning efforts have since spread further afield. Tobacco Free Portfolios launched in 2012 with the aim of reducing and ultimately eliminating pension fund investment in tobacco across the globe.¹ In September 2018, the Tobacco-Free Finance Pledge was launched to address the financing of tobacco companies more broadly, across lending and insurance activities, as well as investment. Rather than concentrating on permanent sources of capital, this campaign is more focused on the marginal supply of capital.

¹ [Tobacco Free Portfolios website](#)



Is divestment an effective strategy?

More recent divestment campaigns have borrowed from history and all have a common intention to bring about change in corporate behaviour. However, they vary in the scope of change they aim to achieve (elimination of entire industries through to changes in practice) and the change agent they ultimately target (access to capital or wider social awareness). The effectiveness of a divestment strategy ultimately depends on its objectives and scope.

Apartheid

The South Africa divestment campaign was widely considered a success, with the political and public pressure credited for ending the repressive Apartheid system. But did the campaign hurt companies doing business with, or in, South Africa or the South African economy?

As the divestment movement continued to gather momentum across college campuses in the US and public pressure intensified, US Congress imposed sanctions on South Africa and passed the Comprehensive Anti-Apartheid Act of 1986. The Act banned new investment in South Africa and included specific trade restrictions. Several states introduced legislation forcing pension funds to divest from companies doing business in, or with, South Africa. A number also enforced selective purchasing policies, where preference was given to contract bidders with no ties to South Africa. By the late-1980s, more than 150 universities had divested from companies trading or operating in the country, along with 26 state governments, 22 counties and 90 cities. Between 1985 and 1990, 200 US companies had severed all ties with South Africa and it's estimated that US direct investment fell by \$1 billion².

However, many of the companies who divested allegedly continued to do their business indirectly via licensing, franchising and distribution agreements³. In terms of impact on company share prices, a study found that shareholder divestment from South Africa had very little impact on the valuations of banks and corporations doing business in South Africa, or on the South African financial market⁴.

Others point to the fact that the protest against the Apartheid system began well before the divestment campaign reached critical mass in the mid-1980s.

While opinion may be divided on whether the divestment movement alone was responsible for ending Apartheid, it's clear that the campaign played a huge part in significantly raising public awareness of the social injustices at the hands of South Africa's government.

Tobacco

Calls from pension holders for the AMA to sell off its tobacco stocks in 1978 were initially dismissed. However negative publicity surrounding the group's decision to reject the tobacco divestment proposal eventually led to the organization's sale of its \$1.4 million of tobacco stocks in 1981⁵. A number of medical schools and universities in the US followed suit in the ensuing years including Harvard University, which agreed to divest an estimated \$60 million invested in tobacco companies in 1990. However, of the 1,000+ universities and organizations holding tobacco investments, by 2013 only around 80 were estimated to have substantially divested from tobacco equity holdings, and even fewer from tobacco debt⁶.

While the number of institutions that actually divested their holdings can be debated, tobacco divestment campaigning efforts have undoubtedly helped to raise public awareness of the health impact of smoking and increased public scrutiny of tobacco companies. Governments around the world have increased taxes on cigarettes, imposed restrictions on advertising and introduced laws banning smoking in workplaces and public spaces.

Since 2012, the Tobacco Free Portfolio campaign has seen some success, with \$12 billion of tobacco assets divested globally⁷. A number of pension funds, insurers, sovereign wealth funds and banks have stopped investing in, or lending to, tobacco companies. These include AXA, Medibank, OP Trust, AP4, FRR, ABN Amro and Westpac. To put things in context, the total market capitalisation of global listed tobacco companies is approximately \$460 billion⁸. The amount divested from tobacco companies to date is less than 3% of this total.

The Tobacco-Free Finance Pledge launched in September 2018 with more than 90 founding signatories including banks, insurers and pension funds across 18 different countries, representing over \$6.5 trillion in total combined assets. The Pledge now has over 150 signatories with \$7.5 trillion in total combined assets, \$2 trillion in corporate loans and \$186 billion in gross insurance premiums⁹.

5 UPI, "[AMA drops tobacco stocks](#)", 29 September 1981.

6 Ansar, A., Caldecott, B. and Tilbury, J., "[Stranded assets and the fossil fuel divestment campaign: what does divestment mean for the valuation of fossil fuel assets?](#)", October 2013.

7 Tobacco Free Portfolios Toolkit – 12th Edition, February 2019.

8 Based on GICS sub-industry classifications. Data as at 28 June 2019.

9 UNEPFI, Tobacco-Free Finance, as at 17 July 2019

2 Knight, R., "[Sanctions, Disinvestment, and U.S. Corporations in South Africa](#)". Sanctioning Apartheid, 1990.

3 Ibid.

4 Teoh et al, "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott", The Journal of Business, 1999.

Spotlight: Fossil fuel divestment

Since its genesis on a handful of US college campuses in 2011, the fossil fuel divestment movement has continued to spread globally, and now includes pension funds, foundations, cities and municipalities. Research by Oxford University suggests that it has become the fastest growing divestment campaign in history. It is the area on which most of our divestment or exclusion discussions with clients focus, by a wide margin.

Growing support for the divestment campaign

Today, more than 1,000 institutions collectively responsible for almost \$9 trillion of assets under management are committed to divesting some, or all, of their fossil fuel exposure at some point¹⁰. This represents around 10% of all assets under management globally¹¹. Figure 2 charts the growth in the number of institutions joining the fossil fuel divestment movement and their collective assets. Interestingly, the campaign appears to have really gained momentum following the oil price collapse in 2014. This may have had a significant influence on the decision to divest for a number of institutions, particularly those concerned with the financial impact of divestment.

But divestment is not black and white – there is a spectrum

Divestment commitments range from coal only, coal and tar sands only to completely fossil fuel free (see Figure 3 on the following page)¹². Some asset owners have committed to “partial” divestment, meaning they are committed to divesting across asset classes from some fossil fuel companies (coal, oil, natural gas), or to divest from all fossil fuel companies but only in specific asset classes (e.g. direct investments, domestic equity).

Actual fossil fuel divestment commitments are a small fraction of the overall market value

While asset owners, collectively responsible for \$8 trillion, have committed to some degree of fossil fuel divestment, it is important to note that \$8 trillion is not the total that will be divested. The actual amount of fossil fuel investments held by these asset owners represents a small fraction of the headline figure widely quoted. In a paper published in May 2018, Hansen and Pollin point out that the largest divestment so far of \$9 billion, for coal only, by Norway’s Government Pension Fund Global (GPF), was around 1% of its total assets under management (AUM) at the time¹³. For AXA Investment Managers, the percentage was even smaller at approximately 0.03% of its total AUM. Analysing the asset owners committed to partial or full divestment, their total AUM and their fossil fuel assets, the truer fossil fuel divestment commitment is estimated to be around \$36 billion. While this is of course still a large number, it was a mere 0.7% of the estimated total market value of listed global fossil fuel companies for the period examined¹⁴.

10 [350 website](#), 17 July 2019

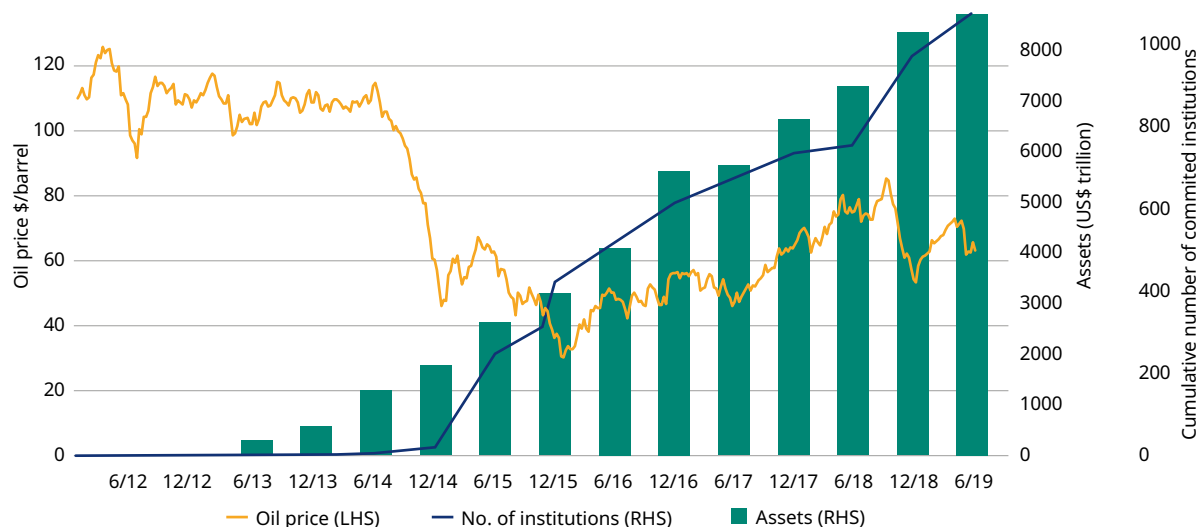
11 McKinsey “North American asset management in 2018: The New Great Game”, November 2018

12 [Fossil Free website](#)

13 Hansen, T. and Pollin, R., “Economics and Climate Justice Activism: Assessing the Fossil Fuel Divestment Movement”, PERI University of Massachusetts Amherst

14 As of August 2014

Figure 2: Growth of fossil fuel divestment commitments gathers pace after oil price collapse in 2014



Source: Bloomberg, Go Fossil Free, Arabella Advisors, 2019

Figure 3: The spectrum of fossil fuel divestment

Fossil fuel free	Full divestment	Partial divestment	Coal and Tar sands	Coal only
No investments* in fossil fuel companies** <i>and</i> 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** <i>or</i> 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 tar 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: [Fossil Free](#), Schroders, 2019.

Not all divestment commitments are binding

In their research, Hansen and Pollin found that while some city councils from certain municipalities have voted to divest from fossil fuel investments, the final decision to sell rests with the investment managers, not the council itself¹⁵.

Asset owners have committed to divest from fossil fuels over varying timeframes, but some have only agreed to do so subject to a review of the financial impact of doing so. As we have written about in our [Demystifying negative screens: the full implications of ESG exclusions](#), depending on an asset owner's mandate and objectives, excluding fossil fuels companies can have a real impact on strategy implementation and achieving financial objectives.

15 Hansen, T. and Pollin, R., "Economics and Climate Justice Activism: Assessing the Fossil Fuel Divestment Movement", PERI University of Massachusetts Amherst

Fossil fuel divestment still top of mind

Notwithstanding the above, the divestment campaign continues to grab media headlines around the world, ensuring the topic remains at the top of public consciousness.

In July last year, Ireland became the first country to commit to divesting from fossil fuels¹⁶ in its national investment fund after a bill was passed by parliament. In an effort for the country to meet its climate change commitments under the Paris Agreement, the fund will divest roughly €300 million from around 150 companies which derive 20% or more of their revenue from exploration, extraction or refinement of fossil fuels (coal, oil, natural gas and peat).

The Fossil Fuel Divestment Act 2018 was signed into law in December last year and Ireland's Strategic Investment Fund has already divested €68 million across 38 fossil fuel companies¹⁷. The fund will continue its planned divestment and increase investments in clean energy projects. However, the Act permits investment in so called "transition" companies if they are consistent with the achievement of Ireland's national low-carbon transition objective, climate change obligations and policy.

16 Carrington, D., "Ireland becomes world's first country to divest from fossil fuels", The Guardian, 12 July 2018

17 Taylor, C., "Republic withdraws public money from fossil fuel investments", The Irish Times, 4 January 2019

What is the fossil fuel divestment campaign trying to achieve?

The fossil fuel divestment campaign seeks to take away everything the fossil fuel industry needs to grow and survive: its social licence, its political license and its money, while also pressuring governments to limit emissions. Campaigners are demanding that public institutions sever ties with the fossil fuel industry to tarnish the industry's reputation and challenge its power. In doing so, the movement aims to starve companies of capital and remove the influence and infrastructure of the industry.

Has the campaign been successful so far?

While it is perhaps still too early to conclude definitively whether the fossil fuel divestment campaign is a success, we think it is worth examining whether it is having its intended impact so far. Given the breadth of objectives of the campaign, we look at each in turn.

Starving companies of capital and shutting off previously accessible sources of finance

One of the primary aims of the fossil fuel divestment campaign is to take money out of the companies that are heating up the planet and to cut the industry's financial ties¹⁸. Campaigners are putting increasing pressure on asset owners around the world to divest their fossil fuel holdings, based on the belief that this will have a significant financial impact on the share price of fossil fuel companies, which will in turn increase the cost of capital and make it more difficult to fund further projects.

¹⁸ [350 website](#), 10 October 2017



Equity markets

In the public equity market, divesting means selling shares in fossil fuel companies. The nature of the market means that when you divest, you sell your shares to a willing buyer. In this way, divestment doesn't actually impact the operations of fossil fuel companies, especially if there are profit-seeking investors who are willing to purchase those divested stocks.

Limited evidence that divestment alone has impacted share prices

A study published in 2016 suggested that divestment announcements have a statistically significant negative impact on the share price of fossil fuel companies¹⁹. The study looked at abnormal returns of companies in the Carbon Underground 200 on the day of a divestment announcement or event compared to the expected return of the market (MSCI ACWI)²⁰. Although the market returns were not affected by the announcements, the study concluded that there was a negative impact on fossil fuel companies for half of the events examined between 2012 and 2015, mainly for divestment events that occurred during 2014 (see Figure 4). The most significant impact was found to be less than 0.01%. With such a small impact on returns, it's difficult to conclude that the divestment announcements alone have had a material impact on the share prices of fossil fuel companies.

Falling oil price far more influential

While the study also suggests that the majority of the 24 divestment-related events weakened the share prices of fossil fuel companies in the period following the event, it found the most influential event on share prices was OPEC's announcement that it would keep oil production levels stable. Oil prices were already under pressure in 2014 due to slowing demand from the BRIC economies and increasing supply due to fracking in the US and oil sands extraction in Canada. When Saudi Arabia decided to maintain its production levels in order to retain its market share, this sent the oil price tumbling further. The market value of oil & gas companies followed the same trajectory (see Figure 5).

Since much of the focus of the event study was on divestment events occurring during a period where oil prices fell significantly and the sector underperformed, the bias towards underperformance in the event study is logically to be expected.

Figure 4: Returns for fossil fuel companies on the day of divestment announcements vs expected returns of the MSCI ACWI²¹

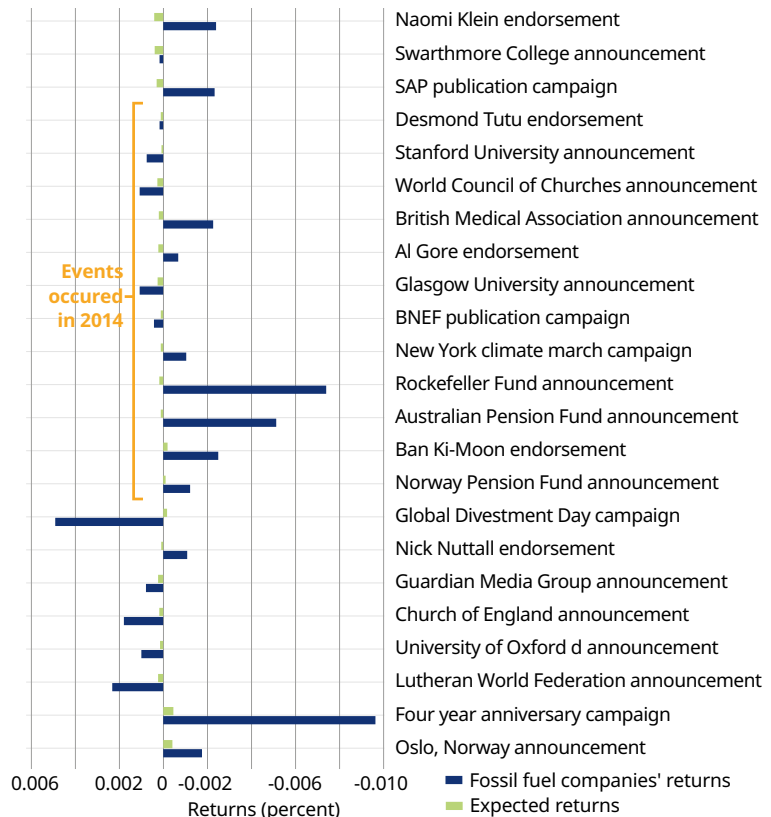
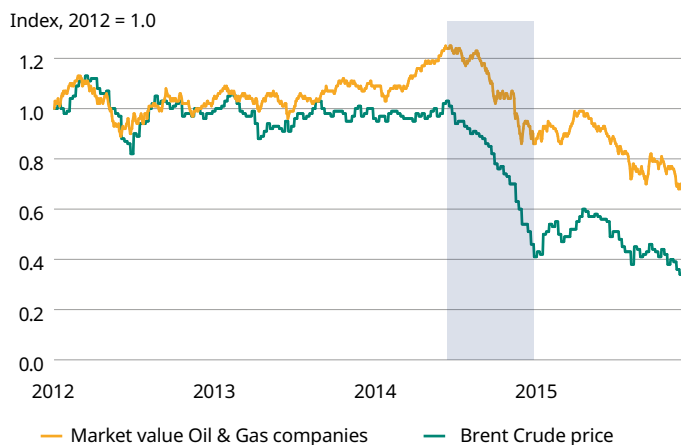


Figure 5: Market value of oil & gas companies fell as oil prices plunged more than 50% during 2014



Source: Bloomberg, Schroders Past performance is no guarantee of future results. Actual results would vary from those results shown above.

21 Weber, O., Dordi, T., and Saravade, V., "How divesting of fossil fuels could help save the planet", The Conversation, December 10, 20179

19 Truzaar, D., "An event study analysis of the fossil fuel divestment movement", August 2016

20 Expected returns were calculated using the Capital Asset Pricing Model, using the MSCI All Country World Index as the market return and the 1 year US Treasury price as the risk free rate.

The limited impact of divestment thus far is not too surprising if we consider the following:

- There is a large universe of oil and gas (close to 1,500) and coal (over 270) companies, yet the top 25 coal companies account for 77% of total market cap for the sector and the top 25 oil and gas firms are 61% of sector market cap²².
- Five of the top 25 investors in listed oil & gas companies are governments²³.
- The largest investor in listed coal companies is a government²⁴.

So even if thousands of investors with smaller holdings decide to divest, this will have little impact on share price or available capital for these large companies.

Publicly listed fossil fuel companies are only a small piece of the puzzle

It is also worth noting that publicly listed fossil fuel companies make up a small part of a much larger market. In 2015, 50 fossil fuel companies accounted for half of the operational and product greenhouse gas (GHG) emissions produced, and publicly owned companies accounted for 15% of these emissions (see Figure 6). If we look at the 224 fossil fuel extraction companies in CDP's data set (CDP was previously the Carbon Disclosure Project) which account for 72% of global industrial GHG emissions, 30% of emissions were from publicly owned companies, 11% from privately owned companies, and 59% from state-owned entities (SOEs)²⁵.

It is estimated that SOEs own approximately 80% of global oil reserves and 60% of global natural gas reserves, which account for 61% of global oil production and 52% of global gas production. In terms of coal, state ownership is significant (75%), particularly in emerging markets (66%)²⁶.

Investors have very limited scope to influence SOEs, where the federal, regional or local government has significant control.

22 Bullard, N., "Fossil fuel divestment: a \$5 trillion challenge", Bloomberg New Energy Finance, 25 August 2014

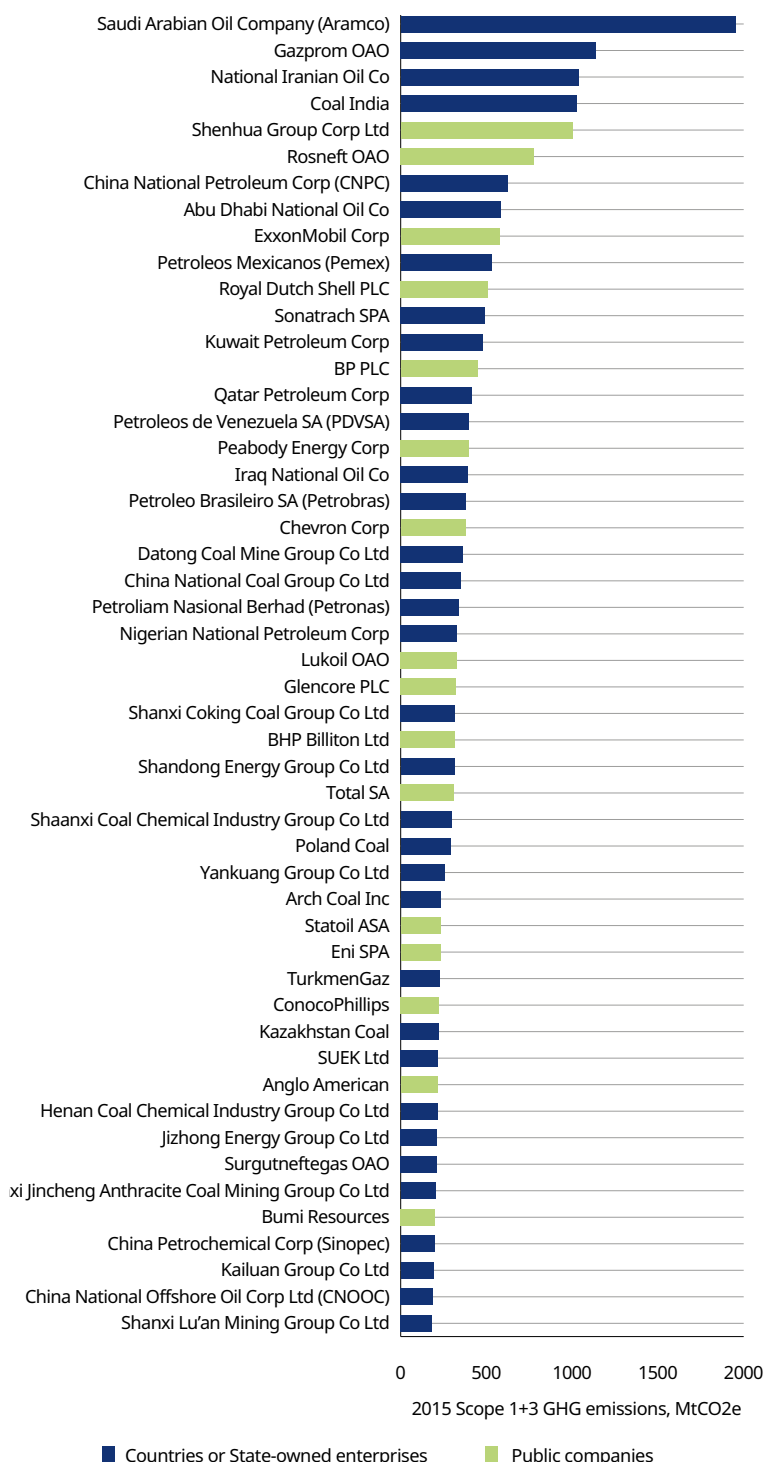
23 Ibid.

24 Ibid.

25 CDP Carbon Majors Report, July 2017

26 IEA, 'World Energy Investment Outlook', 2014, based on data from Wood Mackenzie

Figure 6: Top 50 fossil fuel companies in 2015 by Scope 1 and Scope 3 GHG emissions



Source: CDP Carbon Majors Report, July 2017

Debt markets

Unlike the equity markets, cutting direct sources of debt funding can have a real impact on a fossil fuel company's operations and profitability. Companies rely on bonds and bank loans to fund their exploration, development and production activities, or to refinance existing debt.

Without credit investors and financial institutions providing this funding, fossil fuel companies would need to source alternative, likely more expensive financing, or be unable to fund existing and future projects. This would directly hurt their profitability and potentially their viability.

Some small pockets of progress

Since the Paris Agreement in 2015, a number of banks have announced various lending restrictions, primarily related to coal. ABN Amro, BNP Paribas, Deutsche Bank, Natixis, Rabobank, Santander and Standard Chartered have all announced they would no longer provide finance for new thermal coal mining projects and new coal-fired power plants globally. Some banks have introduced variations of the same policy, with exemptions for poorer, developing countries. Meanwhile, other banks have announced lending restrictions based on the proportion of companies' revenue generated from specific fossil fuels. For example, the Royal Bank of Scotland said it would no longer lend to mining companies generating more than 40% of revenues from thermal coal or power companies generating more than 40% of their electricity from coal. This is in addition to ending finance for tar sands or Arctic oil projects, new coal-fired power stations, new thermal coal mines or unsustainable peatland clearance projects²⁷.

Elsewhere, ING announced it would phase out lending to individual coal-fired plants by the end of 2025 and would no longer finance clients in the utilities sector that have more than 5% of their energy mix in coal-fired power. The bank however, will continue to finance non-coal energy projects for these clients as they transition away from coal. Additionally, financing for new clients will only be supported where their reliance on coal is 10% or less and if they have a strategy in place to reduce their coal exposure to close to zero by 2025²⁸.

The World Bank has also stepped up its commitments. Having withdrawn funding for coal-fired power stations in 2010, it announced the end of financial support for oil and gas extraction beyond 2010²⁹ and has committed \$200 billion for projects focused on reducing emissions and climate change adaptation³⁰.

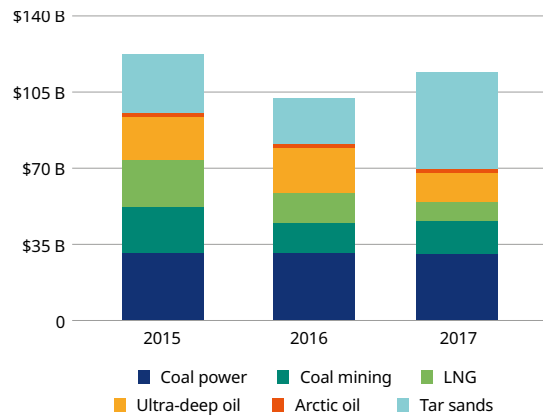
27 RBS, "RBS introduced new energy financing policies to support low carbon transition", 29 May 2018

28 ING, "ING further sharpens coal policy to support transition to low-carbon economy", 12 December 2017

29 The World Bank, "Q&A: The World Bank Group and Upstream Oil and Gas", 12 December 2017

30 Kyngje, J. and Hook, L., "Development bank halts coal financing to combat climate change", FT, 12 December 2018

Figure 7: Financing for the most polluting fossil fuels (2015 – 2017)



Source: 2018 Banking on Climate Change Fossil Fuel Finance Report Card

At the end of last year, the European Bank for Reconstruction and Development announced it would end financing for coal and cut funding for oil exploration and production³¹.

But limited overall impact so far

Overall funding for the most polluting fossil fuels (tar sands, Arctic and ultra-deepwater-oil, liquefied natural gas export, coal mining and coal-fired power) rose to \$115 billion in 2017, from \$104 billion in 2016 (see Figure 7)³². This increase was primarily driven by new loans and bonds for tar sands oil production and pipelines, and ongoing financing for coal.

Looking across the broader fossil fuel life cycle (exploration, extraction, transportation, storage and fossil fuel electricity generation), and adding financing for fracked oil and gas, the numbers are significantly larger. Since 2015, 33 major global banks have provided \$1.9 trillion of funding³³. It's clear that while some banks have ceased or have committed to cease financing for fossil fuel projects and companies, other banks have been more than willing to step in.

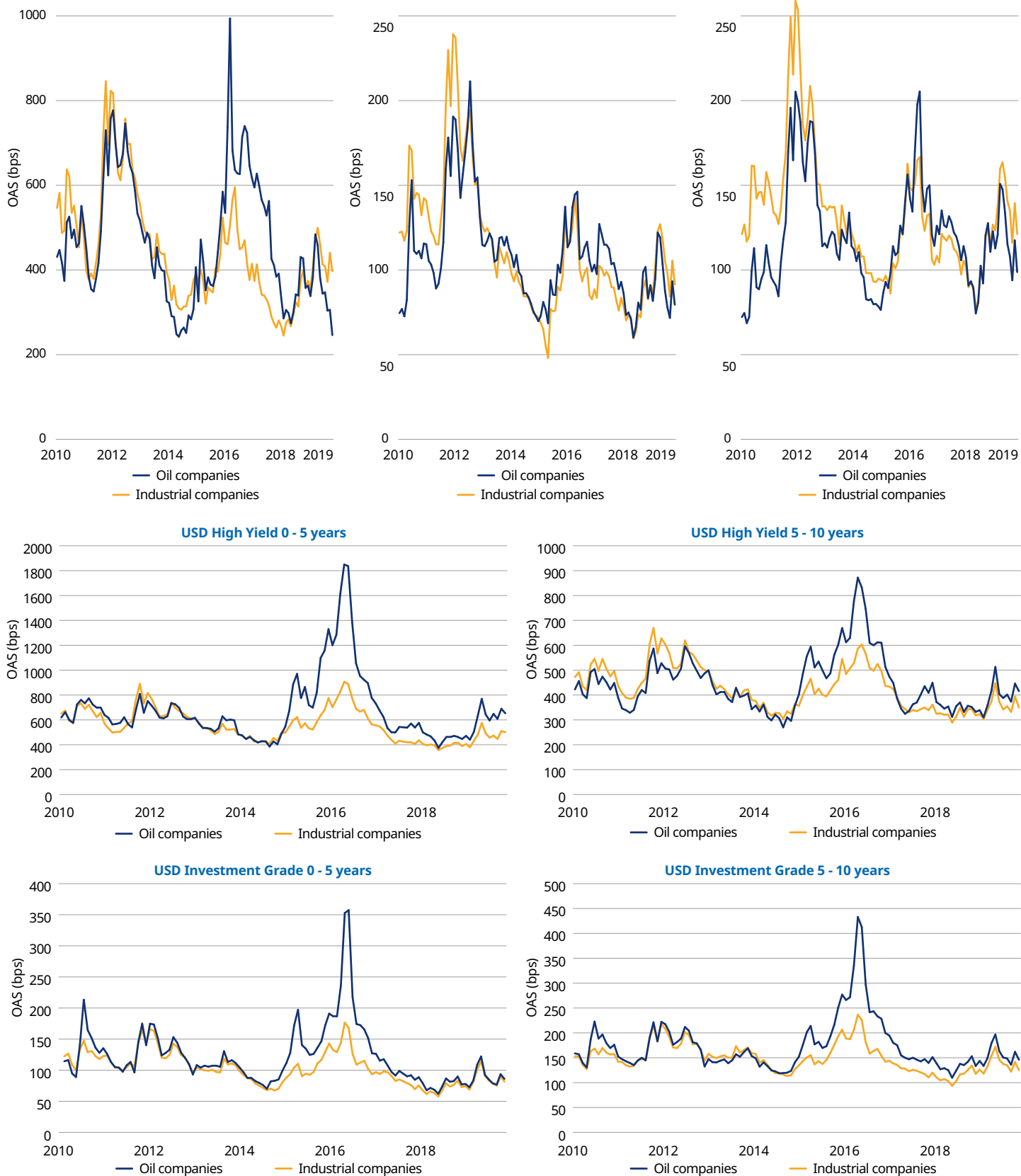
In terms of bonds, oil and gas companies have continued to successfully raise funding from investors. An analysis of credit spreads shows that the oil supermajors are not being forced to pay a premium over industrial counterparts, nor are high yield issuers (see Figure 8 on the following page). The result has been little to no impact on companies' cost of financing or operations.

31 Ibid.

32 BankTrack et al., "Banking on Climate Change 2018: Fossil fuel finance report card", 28 March 2018

33 BankTrack et al., "Banking on Climate Change: Fossil fuel finance report card 2019", 20 March 2019

Figure 8: Comparison of option-adjusted spreads (OAS) for EUR and USD denominated bonds issued by oil companies vs industrial companies



Source: Bloomberg, June 2019. Any performance shown reflects past performance of widely used, unmanaged proxies. Past performance offers no guarantee of future results.

As Figure 9 illustrates, corporate bonds and syndicated loans have provided the majority of funding for companies in the mining, oil and gas, and utility and energy sectors. In the case of the oil and gas sector, the amount of debt financing provided between 2010 and 2018 was 9.5 times the value of equity financing, and for the utility and energy sector, this multiple is even higher at 11.6 times. Over this period, US oil exploration and production companies alone raised \$313 billion in the bond market³⁴.

The financing aspect is absolutely critical. If the large, global banks restrict lending to these companies and push up the cost of capital, the impact could be significant. This is where campaigning and engagement efforts should focus.

Take away everything needed for the industry to grow and survive

Divesting shares has no direct impact on a company's operations, how much it costs to produce fossil fuels, nor its profitability. Importantly, it has no impact on consumer demand for fossil fuels. Fossil fuels are used in our everyday lives, from generating electricity, to heating our homes and fuelling our cars. Shutting down the fossil fuel industry completely would have significant economic consequences for many people, particularly those in developing countries.

As long as there is consumer demand for fossil fuels and companies are able to produce them profitably, they will continue to exist in the absence of tougher climate policies. Rather, a joined-up policy framework to promote alternative energy sources, handicap the fossil fuel industry's profitability in line with the damage it creates and to decarbonise consumption, along with all the infrastructure changes that requires, will be vital to lasting change. Moving the industry's ownership from concerned shareholders to others that are less concerned, in isolation, is unlikely to successfully address that challenge.

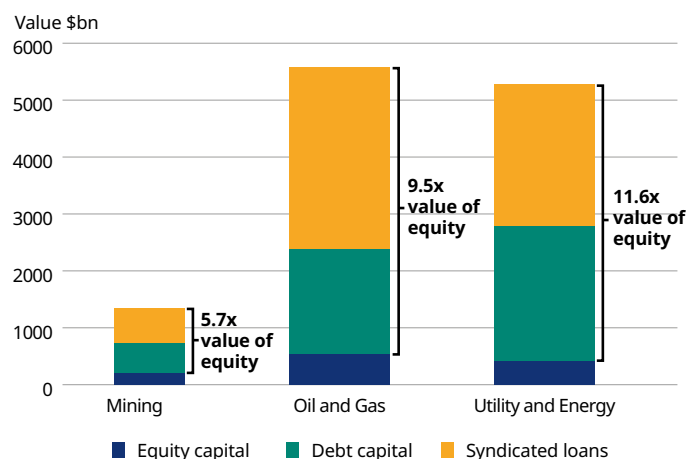
Interestingly, several European insurers have announced their shift away from coal. In 2017, AXA became the first insurer to announce it would no longer insure any new coal construction projects, or oil sands and the associated pipeline business. Since then, a number of other insurers have followed suit with various policies intended to make it more difficult for coal companies to purchase insurance cover. For example, Zurich Insurance announced it would stop providing insurance coverage for new coal mines, new clients deriving more than half of their revenue from thermal coal and utility companies where coal makes up more than half of their energy mix³⁵. Allianz said it would withdraw coverage for single coal-fired power plants and coal mines, and phase out all coal exposure by 2040³⁶. Elsewhere, Generali has committed to stop insuring new coal mines and power plants and taking on new coal company clients. The insurer has also said it would not provide insurance for any existing coal mines in Poland.

34 Egan, M., "Why oil companies have suddenly gone missing in the bond market", 5 February 2019

35 Kuchinski, R., "Insurers can facilitate the transition to a low-carbon future", Zurich Insurance Group, 13 November 2017

36 Ralph, O. and Storbeck, O., "Allianz to stop selling insurance to coal companies", FT, 4 May 2018

Figure 9: New debt and equity funding 2010 – 2018



Source: Dealogic, Schroders

Australian insurer, QBE, became the first non-European insurer to announce it would stop providing new direct insurance services for thermal coal mines, power plants and transport networks from July 1 this year. With increasing focus on insurers, others will likely follow suit.

While insurance premiums may not have increased significantly to date, as insurance becomes more difficult to obtain, premiums are likely to rise. This could impact the ability of companies to proceed with the construction of new coal plants and existing projects may need to be phased out.

Pressuring governments to limit emissions

In terms of influencing governments to reduce carbon emissions, there has been little impact from divestment to date. As we highlight in our [Q2 2019 Climate Progress Dashboard update](#), current fossil fuel production points to a 5.9 degree temperature rise, while oil and gas investment implies a 4.8 degree rise. Meanwhile, political action to date points to a 3.3 degree temperature rise, well off the 2 degree target.

Tarnish the industry's reputation

Arguably, this is where the campaign has been most successful. The fossil fuel divestment campaign has undoubtedly been effective in raising global awareness of the urgency of climate change and stigmatising targeted companies and the industry as a whole. Asset owners with fossil fuel investments are under increasing pressure as they find themselves the target of campaigners. Meanwhile, fossil fuel companies are under greater scrutiny than ever before and face mounting pressure to explain how they are aligning their business models with a 2-degree world. Some companies have consequently sold some of their assets, although this hasn't necessarily shut down fossil fuel production. For example, the Kestrel coal mine sold by Rio Tinto is still in operation under its new owners EMR Capital and PT Adaro Energy.

So how can investors drive real change?

Divestment is logical for investors looking to avoid exposure to a specific activity or as a simple response to public pressure. However, if asset owners are trying to effect real change in the world, we suggest incorporating the following approaches as a core part of their strategy

Engage with companies

Divestment is perhaps the final, and most drastic, option for an investor. Asset owners can actively engage with company management to influence behaviour before using the trump card of divestment.

It is important to hold companies to account

For example, looking at the tobacco industry, divestment advocates argue that engagement with tobacco companies is pointless given the only acceptable outcome is to cease their primary business. However this is too simplistic a view; there is more to the industry than the use of its products. Other important issues that need to be considered such as child labour in the supply chain, the health and safety of workers and the environmental impact.

As long as tobacco use and production remain legal, tobacco companies will continue to exist. Someone needs to question them about their social and environmental impact and hold them to account. Investors can, and should, use their influence to push tobacco companies to identify and address child labour and human rights abuses occurring in their supply chain, to monitor and audit their supply chains and to publish the audit results. Investors should also engage with companies to push for more responsible policies and robust marketing practices to ensure tobacco companies are not marketing their products to minors, either directly or indirectly (for example, by providing incentives for retailers to advertise smoking). More investors washing their hands of tobacco investments means there are fewer to push companies to improve in these vital areas.

Change is not impossible but it takes time

In terms of fossil fuels, there are a number of collaborative climate change initiatives, such as Aiming for A and the Climate Action 100+ initiative, where asset owners are joining forces to push companies for the changes needed for a lower carbon world. Divestment campaigners may again argue there is no point in engaging, but there is evidence that fossil fuel companies can transition their business models over time and be part of the solution.

Orsted, previously DONG (Danish Oil and Natural Gas) Energy, was once an upstream oil and gas business using coal-fired power plants. Now, the company has transformed itself into a global leader in renewable energy, with offshore wind farms powering 11.7 million people. Since 2006, the company has reduced its use of coal by more than 70% and cut its carbon emissions by more than half. In 2017, Orsted sold its upstream oil and gas business. By 2023, the company will be completely coal-free and have cut carbon emissions by 96% compared to 2006. This shows that a transition is possible, but it takes time.

Similarly, Norway's Equinor (formally Statoil) is building up its renewable energy business while lowering emissions from its oil and gas production. In 2017 the company published its 2030 climate roadmap which includes targets for carbon emissions reductions and improved carbon intensity, energy efficiency and plans to quadruple its investment in renewables and low carbon solutions.

Elsewhere, Spanish electric utility company Iberdrola is working towards a 50% reduction in its emissions intensity by 2030 (compared to 2007) and is committed to being carbon-neutral by 2050.

While global mining company Glencore has been slow to respond to investor concerns on climate change, there was a breakthrough earlier this year. Following ongoing engagement with investors signed up to the Climate Action 100+ initiative, the company announced it would cap its global coal production and rebalance its portfolio towards commodities that will help with the transition to a lower-carbon world.

With an increasing number of investors actively engaging with companies and pushing them to provide better climate risk analysis and disclosure, almost 7,000 of the world's largest companies, which account for over 50% of global market value, now report environmental data to CDP. This is 25% higher than the number that reported in 2015³⁷.

37 [CDP website](#)



File shareholder resolutions and vote against management

The number of shareholder resolutions related to climate change has continued to rise as investors seek to push companies to make their businesses more sustainable. The scope of the resolutions vary, but include things like reporting annually on carbon emissions, adopting specific emissions reduction targets, investments in low-carbon technologies and renewable energy, adding a climate change expert to the board and assessing the resilience of their business models under different climate scenarios.

Growing support for climate-related resolutions

While these type of resolutions had previously received little support, we have started to see a shift in recent years. For example, in 2015, the 'Aiming for A' coalition filed resolutions at BP and Shell asking for annual reporting on carbon emissions, the resilience of their business model under various low-carbon scenarios, investments in low-carbon technologies and their public policy position on climate change. The resolutions also called for alignment of executive pay with performance of low-carbon objectives. Both management and shareholders unanimously supported the resolutions.

In 2016, similar climate resolutions were filed at Glencore, Anglo American and Rio Tinto, and enjoyed resounding support. The following year, 62% of Exxon's shareholders voted for the company to report on the impacts of technological change and climate policy on its operations. Climate resolutions were also filed and supported at Occidental Petroleum and PPL.

Focus on the new supply of capital

Given bank loans form the bulk of funding for fossil fuel companies, banks can have a direct impact on the supply of capital and therefore companies' ongoing operations and their profitability. Greater attention should be focused on the banks that continue to support the expansion of fossil fuels in a way that's inconsistent with a 2 degree world.

Bonds are also a significant source of funding so reducing this supply of capital and making it more costly for fossil fuel companies to issue debt will have an impact on their existing operations and discourage new fossil fuel projects.

Furthermore, insurers have a key role to play. Without insurance for mines, power plants and projects, fossil fuel companies will find it difficult to get funding and proceed with new and existing projects.

Put pressure on public policymakers to take action

Even if asset owners continue to divest their holdings one by one, this will have little impact on companies' operations and their ability to survive. More effective public policy is crucial to drive the changes needed on the scale required.

According to International Energy Agency (IEA) estimates, global energy demand is estimated to grow 32% by 2040. Fossil fuels are expected to meet the majority of this demand. A low carbon transition is possible, but it will require far stronger action from policymakers around the world than we've seen to date.

Carbon prices need to rise significantly

We strongly believe that one of the most effective tools to incentivize widespread decarbonization is carbon pricing. While carbon pricing schemes are spreading across global industries, their economic impact has been limited. Carbon prices are still far too low to have a meaningful impact on most companies' strategic planning. If governments around the world are to have a chance at meeting their 2 degree commitments, carbon prices will need to rise significantly from where they are today.

As we have highlighted in our [previous research](#), we believe carbon prices need to rise to well over \$100/ton to incentivize the large-scale decarbonization that is necessary. Doing so would be far more impactful on fossil fuel companies' operations. Higher carbon prices would increase companies' costs in proportion to the total emissions they generate and prices are likely to rise to offset the increased costs. Demand should fall in line with the price elasticity of each market. We have written to G7 and G20 governments calling on them to implement carbon prices to drive the low carbon transition.

Incentives required to reduce consumer demand for fossil fuels

Campaigners target asset owners with fossil fuel investments in the hope that withdrawing investments will somehow bring an end to the fossil fuel industry and curb climate change. However, fossil fuel production, transport and refining only accounts for less than 20% of the greenhouse gas emissions related to fossil fuels. The remaining 80% comes from the burning of fossil fuels, through heating homes or in vehicle use. Divestment does nothing to help solve this crucial part of the puzzle.

Stronger policy action is needed around the world to reduce consumer demand for fossil fuels. Governments can help by providing incentives for renewable energy, energy efficiency, the development of innovative low-carbon technology and adoption of electric vehicles. For example, the Chinese government provides subsidies to electric car and bus manufacturers, as well as consumers purchasing electric vehicles. These measures have been key in making electric vehicles more affordable in China.

Reduce emissions by phasing out the sale of petrol and diesel vehicles

Tougher policy measures to phase out the sale of petrol and diesel vehicles would also directly help to reduce emissions. France and the UK were amongst the first to announce plans to ban the sale of new petrol and diesel cars in the country by 2040³⁸, while similar announcements have followed in India, Ireland, China and Denmark, amongst others.

End subsidies and export finance for the fossil fuel industry

Despite the commitments global leaders made in Paris in 2015, some of the largest and wealthiest nations continue to provide billions of pounds worth of subsidies to the fossil fuel industry each year, both directly and indirectly. The G7 nations (Canada, the US, France, Germany, the UK, Japan and Italy) collectively provide an estimated \$100 billion of subsidies each year³⁹. While the G7 governments committed to phasing out these subsidies in 2009, little progress has been made since then.

Export credit agencies (ECA) – government-backed institutions that provide guarantees, insurance, credits and loans to support the export of goods and services – are also a key source of funding for the industry. It is estimated that export credit agencies from G20 countries supplied over \$32 billion annually between 2013 to 2015 to back oil and gas projects and \$5.6 billion for coal (see Figure 10 on the following page)⁴⁰. Meanwhile, only around \$3 billion each year is directed towards clean energy projects.

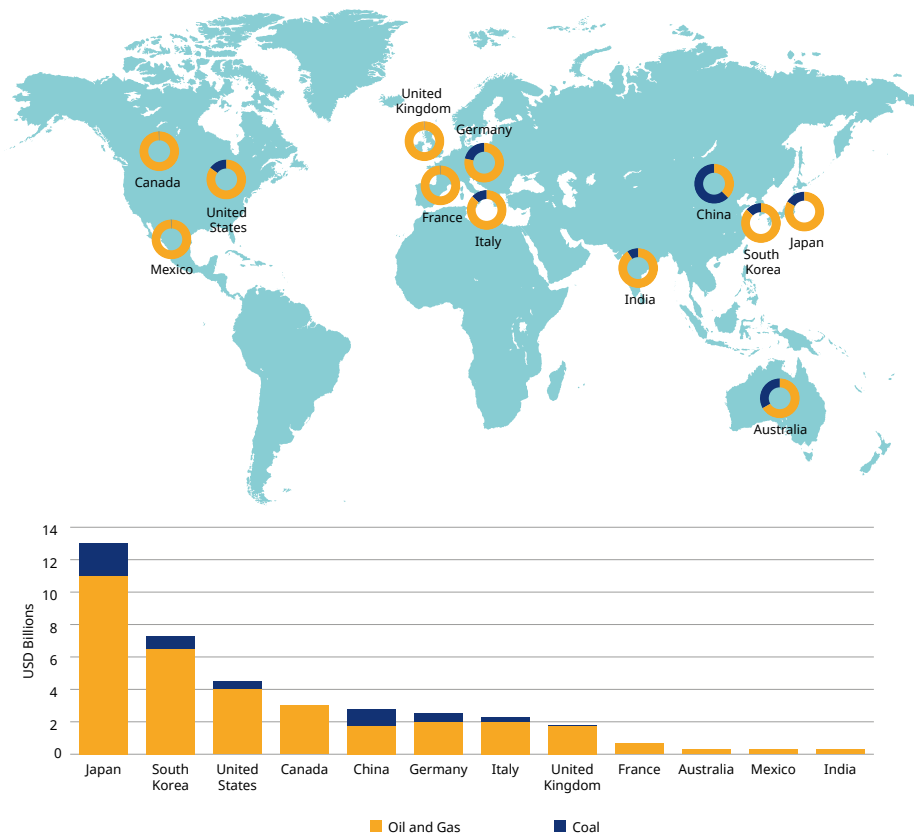
It is imperative that governments take actions that aren't directly at odds with their commitments under the Paris agreement. We have asked G7 and G20 governments to align their climate policies and phase out fossil fuel subsidies to help level the playing field and incentivise public and private sector flows to support the low carbon transition.

38 Pickard, J. and Campbell, P., "UK plans to ban sale of new petrol and diesel cars by 2020", FT, 26 July 2017

39 Overseas Development Institute, "G7 governments provide \$100 billion each year to support oil, coal and gas despite pledging to end fossil fuel subsidies", 4 June 2018

40 Oil Change International, Friends of the Earth U.S. and WWF European Policy Office, "Financing Climate Disaster: How export credit agencies are a boon for oil and gas", 16 October 2017

Figure 10: Largest ECA financiers of fossil fuels by country, annual average, 2013-2015



Source: Oil Change International Shift the Subsidies Database, based on most currently available data.

Conclusion

For asset owners looking for a simple response to stakeholder pressure or to manage potential reputational risk, divestment may be a logical approach, but it is not an effective way for asset owners to drive change in the real world. Divestment is not an investment strategy or a means to bankrupting companies or entire industries deemed to be involved in unacceptable activities. Even if more investors join the divestment movement, this will do little to impact an individual company's profitability, its ability to survive or change the underlying activity asset owners are concerned about. This is particularly true where campaigns are seeking to changing the entirety of a business, rather than just one aspect.

Rather than simply walking away from an entire industry, asset owners can actively engage with companies they are invested in, individually or collectively, to promote more sustainable

business practices and ensure management teams consider all stakeholders and their broader impact on society and the environment. They can also support or file resolutions and use their voting rights to push companies further. Ultimately, however, more effective public policy is critical to drive the changes needed on the scale required, on both the demand and supply side. Engaging with public policymakers should therefore be part of an asset owner's strategy.

To have greater impact on the nature of companies' activities and their ongoing operations, asset owners can focus their efforts on limiting the marginal supply of capital for the activities they want to change. This can be done both directly through declining investment in bonds issued by those companies, and indirectly through focusing on the banks who continue to provide funding for them and the insurers of those businesses.



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