Virtual Seminar on Climate Economics

Organizing Committee:
Glenn Rudebusch (Brookings Institution)
Michael Bauer (Federal Reserve Bank of San Francisco)
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Òscar Jordà (UC Davis, Federal Reserve Bank of San Francisco)
Fernanda Nechio (Federal Reserve Bank of San Francisco)
Toan Phan (Federal Reserve Bank of Richmond)
Recent developments in finance research

Recent interest in understanding and managing the complex relationships between the economy and the health of our planet.

Climate Finance:
- How does climate change affect economic activity and asset values?
- What role can financial markets play to accelerate the "green transition"?
- Active literature (reviewed in Giglio, Kelly and Stroebel (2021))

Biodiversity Loss: Similarly important but understudied (Karolyi, Tobin-delaPuente 2023)

This Paper:
- Do people (in finance) worry about biodiversity risk?
- Measure biodiversity risks over time and across firms and industries.
- Is biodiversity risk priced in financial markets?
- Construct and release new data to facilitate research on biodiversity risks (www.biodiversityrisk.org)
What is Biodiversity Risk? Physical vs. Transition

**Biodiversity:** the sum total of genes, species, and ecosystems

- Losses of ecosystem services estimated to cause damages of $4\text{trn-}$20\text{trn} per year

**Physical Biodiversity Risks** from the loss of biodiversity and ecosystem services

- Deforestation or habitat loss → raw material and supply chain of paper product firms
- Species or genetic biodiversity loss → R&D of pharma and biotech sectors, food production
- Biodiversity loss → disruption of ecosystem, increased vulnerability to climate change

**Transition Biodiversity Risks** from responses to reduce biodiversity loss

- Regulation: land-use regulations, sustainable forestry requirements, or species protection laws
- Consumer preference: shifts away from palm oil due to its effect on deforestation
- Reputation: increased cost of causing ecological disasters such as oil spills
Overview

- Do people worry about biodiversity risk?
- Is biodiversity risk priced in equity markets?
  - Measuring aggregate biodiversity risk
  - Risk exposure by firms/sectors
  - Pricing in equity markets
Do People Worry About Biodiversity Risk?

Objective: How do researchers and market participants think about biodiversity risks?

A survey of the perceptions of biodiversity risks among finance academics, professionals, public sector regulators, and policy economists (668 responses).
Do People Worry About Biodiversity Risk?

Biodiversity risks for investors and firms are often divided into (i) physical risks coming from actual changes in biodiversity (e.g., reduced pollinators, freshwater scarcity) and (ii) transition risks coming from changes in the regulatory environment to combat biodiversity loss (e.g., the Clean Water Act). Please rate the financial materiality of these risks for corporations in the United States.

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Do People Worry About Biodiversity Risk?

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Physical Risk Importance (%)

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Transition Risk Importance (%)

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- Around 70% of respondents perceive physical and transition biodiversity risks to have at least moderate financial materiality for firms in the United States.
- Private sector respondents report highest perceived financial materiality of risks.
Do People Worry About Biodiversity Risk?

Over what time horizon, if any, do you expect these biodiversity risks to materialize?

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## Do People Worry About Biodiversity Risk?

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- About 20% of respondents believe that physical and transition biodiversity risks are already materializing today.
- Transition risks perceived as somewhat more important over the next five years.
Any particular ways in which biodiversity risks are important in professional life?

Physical Risk:
"I co-run an investment fund in farmland and timberland, which are directly affected by these risks"

Transition Risk:
"Regulatory risk related to biodiversity are a chief driver of long-term uncertainty in the energy markets in which I work"

Through the Economy:
"Biodiversity risks are a serious threat to financial stability and the resilience of financial companies"

Key: Biodiversity is a growing concern among ESG analysts, fund managers, VCs, and management consultants, especially those working with the energy, materials, and construction sectors, as well as among academics and public sector employees.
Overview

- Do people worry about biodiversity risk?
- Is biodiversity risk priced in equity markets?
  - Measuring aggregate biodiversity risk
  - Risk exposure by firms/sectors
  - Pricing in equity markets
Are Biodiversity Risks Priced in Equity Markets?

▶ **Traditional Approach:** Higher expected returns for long-short portfolios based on risk exposures (controlling for other risks)?
  - Proxy for expected returns with realized returns → Problematic over short horizons
  - Prices ↓ when risk first becomes prized → Realized returns lower

▶ **Our approach:** Do long-short portfolio returns co-move with news about future damages arising from the biodiversity risk?
  - Bad news about biodiversity → Price ↓ for exposed stocks
  - Good news about biodiversity → Price ↑ for exposed stocks
  → Easier to estimate covariances than means in short-ish time series
Are Biodiversity Risks Priced in Equity Markets?

- Do long-short portfolio returns co-move with news about future damages arising from the biodiversity risk?

- Need
  - Higher-frequency measure of news about future damages from biodiversity risk
  - Measures of exposure to biodiversity risk by firms / sectors to form portfolios
Overview

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Measuring Aggregate Biodiversity Risk

Need: Higher-frequency measures of news about future damages from biodiversity risk

NYT Biodiversity News Index:
- Use a dictionary-based approach to identify NYT articles that cover biodiversity risk (terms include “ecosystem”, “deforestation”, “habitat”, etc.)
- Article sentiment: Bidirectional Encoder Representations from Transformers (BERT)
- Index: Number of negative biodiversity articles minus the number of positive biodiversity articles.

Google Biodiversity Attention Index:
- Google search activity for terms like “biodiversity loss” and “species loss”
- The index is constructed as the sum of the search index series for each term

New Index: Based on ChatGPT
Note: Monthly NYT-Biodiversity News Index from 2000 to 2022, annotated with biodiversity-relevant news announcements. ESA: Endangered Species Act; IPBES: Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services; IPCC: Intergovernmental Panel on Climate Change.
Biodiversity-related events (e.g., Trump’s Announcement of changes in the ESA, Oil Spill in the Gulf Coast) did not result in spikes in the climate index.
Climate-related events (e.g., Bush’s withdrawal from the Kyoto Protocol, Delaware flood) did not result in spikes in the biodiversity news index.
Some common events (e.g., wildfires). Monthly correlation: 0.22
Overview

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Measures of Biodiversity Risk Exposures

- Different sectors vary in their dependence on natural capital (physical risk) and their effects on the environment (regulation risk).

- The absence of standardized disclosure frameworks for biodiversity risks makes quantifying these exposures hard.

- We propose several ways to measure firms’ and industries’ biodiversity exposures:
  - Firms’ 10-K statements: textual analysis
  - Expert Survey
  - Portfolio holdings of biodiversity funds
Firm-Level Measures of Biodiversity Risk Exposures

10K-Biodiversity-Count Score
- We identify biodiversity-related sentences in 10-K statements using a dictionary-based approach
- Firms that mention at least two sentences related to biodiversity are assigned a Score of “1”

10K-Biodiversity-Negative Score
- Separate mentions of biodiversity as both a risk and an opportunity for firms by .
- Classify the sentiment of each biodiversity-related sentence with the BERT model.
- The Score = # is constructed as # negative biodiversity sentences - minus # positive sentences.

10K-Biodiversity-Regulation Score
- Explicitly measure regulation biodiversity risks faced by firms
- We select biodiversity risk sentences that also contain at least one of the following terms: law(s), regulation, Act, ESA, discharge, or restriction.
- We assign a Score of “1” if the 10-K statement contains at least two biodiversity risk sentences and at least one of them is a biodiversity regulation risk sentence.
Industry-Level Measures of Biodiversity Risk Exposures

Survey-Based Measures of Biodiversity Risk Exposures
- Participants were asked to select the industries that they believe to be most negatively affected by (i) physical risks, and (ii) transition risks.
- An industry’s physical and transition biodiversity risk exposures are quantified as the share of survey respondents who select each industry as being particularly affected by the risk.

Holding-Based Measure of Biodiversity Risk Exposures
- Four biodiversity-related funds: HSBC ESG Biodiversity Screened Equity ETF, AXA Biodiversity Equity ETF, Ossiam Food for Biodiversity ETF, and Trillium ESG Global Equity Fund.
- The score of fund $f$ for industry $I$ is defined as:

$$HoldingScore_{t,I}^f = w_{I,t,M} - w_{I,t,f}$$

where $w_{I,t,M}$ is weight of industry $I$ in market portfolio, and $w_{I,t,f}$ is weight in fund’s portfolio.
Self-reported biodiversity risk exposures have been growing over time.
Biodiversity Risk Exposures Across Industries

- Sectors with the highest biodiversity risk exposures include energy, utilities, and real estate.
- Semiconductor, software, and communication services sectors have minimal exposures.
Biodiversity Risk Exposures Across Industries

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Variation Across Industries

Energy Sector

- Reputational and legal risks: drilling activities → oil spills & habitat destruction
- Regulatory risk: environmental regulations to prevent further biodiversity loss

“If one of our LNG terminals or pipelines may adversely affect a protected species or its habitat, we may be required to develop and follow a plan to avoid those impacts” (Cheniere Energy)

Utilities Sector

- Physical Risk: degradation of watersheds → water utility operations
- Regulatory Risk: regulations on species and habitat protection → limit utility firms’ operations
- Regulatory Risk: regulations on waste discharges → elevate utility firms’ costs

“The Company is also subject to laws regarding the protection of wildlife, including migratory birds, eagles, threatened and endangered species. Federal and state environmental laws have historically become more stringent over time, although this trend could change in the future” (Clearway Energy)
Variation Across Industries

Real Estate Sector

▶ Regulatory Risk: regulations to minimize habitat destruction → increased costs and delays to projects in areas with high biodiversity

“The sale or development of properties may also be restricted due to environmental concerns, the protection of endangered species, or the protection of wetlands” (St Joe Co.)

Materials Sector

▶ Physical Risk: availability and quality of raw materials → paper & forest products subsector
▶ Regulations and reputational risks: construction materials and metal mining subsectors

“Federal and state requirements to protect habitat for threatened and endangered species have imposed restrictions on timber harvest on some of our timberlands, and these protections may be expanded in ways that further affect our operations. These actions may increase our operating costs; further restrict timber harvests or reduce available acres; and adversely affect supply and demand more broadly across our markets” (Pope Resources Ltd Partnership)
Variation Across Industries

Pharma and Biotech. Sector

- Physical Risk: reduced potential pharmaceutical development options

“We focus on the use of biodiversity as a means of natural product drug discovery, while also using traditional chemical discovery and development techniques” (Cubist Pharmaceuticals Inc.)

Capital Goods Sector

- Building materials: the availability of wood and other raw material, shift of consumer preference
- Distributors: the use of chemical refrigerants
- Industrial and construction: environmental protection and waste disposal regulations

“As another example, many consumers demand certified sustainably harvested wood products as concerns about deforestation have become more prevalent” (Jeld-Wen Holding Inc.)
Variation Across Industries

Transportation Sector

- Regulations related to the protection of marine species → adjust the speed and route of vessels
- Regulations to reduce marine pollution → install new equipment and limit the type of fuels used by ships

“Protection of endangered and threatened species may include restrictions on the speed of vessels in certain ocean waters and may require the Company to change the routes of the Company’s vessels during particular periods. […] The reduced speed and special routing along the Atlantic Coast results in the use of additional fuel, which affects the Company’s results of operations.” (Seacor Holdings)
Climate Risk Exposures vs. Biodiversity Risk Exposures

Biodiversity risk exposures are distinct from climate risk exposures.

- An industry may be highly exposed to biodiversity risk because its operations are dependent on particular ecosystems or species that are not necessarily affected by climate change.
- From a regulatory perspective, some industries might have a more significant direct impact on ecosystems and habitats rather than contributing to climate change.

**Example:** Renewable Energy

- Windfarms and birds
- Hydropower and fish
- Land use requirements for solar
- Offshore winds and whale death
“In Atlantic City, N.J., groups have protested and sued to stop federal approval of as many as 98 turbines in close offshore waters. They cite hits to tourism and claim damage to whales, with no firm scientific evidence behind them” (The New York Times, 08/14/2023)
Overview

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Pricing of Biodiversity Risk in Equity Markets

- We form equity portfolios of industries sorted by their biodiversity risk exposures.
- The portfolios hold **long positions** in industries with **low biodiversity risk exposures** and short positions in industries with high biodiversity risk exposures.
- If biodiversity risk is priced, the return of these biodiversity-risk-sorted portfolios should covary with the aggregate biodiversity news.
  - Behave like a **hedging portfolio**.
- We compare the hedge performance of our biodiversity risk measures with that of hedge portfolios constructed using other firm characteristics.
Pricing of Biodiversity Risk in Equity Markets

- **Want**: Compare returns to news about biodiversity
- **Need**: Measure news in the NYT-Biodiversity News Index
- **Use**: Residuals from AR(1) model fitted to the NYT-Biodiversity News Index
Biodiversity Hedge Performance

Do biodiversity portfolios hedge biodiversity news?

- All the correlations are positive, with magnitudes from around 0.1-0.2.
- Observed correlations are comparable to those obtained by climate hedging portfolios when evaluated against aggregate climate news.
Biodiversity Hedge Performance of Portfolios Based on Other Characteristics

Is biodiversity exposure recasting exposure to other firm characteristics?

The portfolio built on the average biodiversity exposure measure has the highest correlation with innovations in the NYT-Biodiversity Risk Index.
Do biodiversity portfolios also hedge climate change?

Portfolios designed to hedge climate risks perform better than biodiversity hedge portfolios. Biodiversity hedge portfolio has, on average, zero correlation with climate news realizations.
Biodiversity risk exposures vary substantially across firms and industries

Variation is economically sensible

Long-short portfolios on this characteristic covary with aggregate realizations of biodiversity risk → Risks are being priced

Are they priced adequately?

Very hard to say, needs measure and model of “correct” pricing

Survey respondents on pricing in stock market

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Conclusion

- Biodiversity risks considered material by financial experts

- Introduce measures of aggregate biodiversity risk as well as measures of firms’/industries’ exposures to biodiversity risks

- Show the pricing of biodiversity risks in financial markets

- Release biodiversity risk exposure measures at www.biodiversityrisk.org to facilitate more research on this important topic.