Net Zero Review: Call for evidence

Insight Investment response

October 2022

Insight INVESTMENT

BNY MELLON | INVESTMENT MANAGEMENT

Introduction

Insight Investment is one of the UK's largest investment managers, managing over £725bn in assets, primarily for UK defined benefit pension funds, as well as insurers, sovereign wealth funds and financial institutions[1]. The majority of Insight's assets under management are in risk management solutions and fixed income. Climate change is one of the greatest challenges of our time. Governments and businesses are grappling with the implications, and we believe responsible investors should seek to discern how climate change might affect investment risks and opportunities. Insight is a committed responsible investor and was a founding signatory to the Principles for Responsible Investment (PRI) in 2006.

[1] [1] As at 30 June 2022. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.

Overarching questions

1. How does net zero enable us to meet our economic growth target of 2.5% a year?

The evidence that climate change is already having an adverse impact on economic growth is increasingly strong; analysis by the Grantham Research Institute has pointed to negative impacts on growth of around 1.1% of GDP annually, with substantial regional variation. This is forecast to rise to 3.3% by 2050 and 7.4% by 2100.

Significantly, many economic risks of climate change are not endogenous to the UK; disruption to global trade and economic growth as a result of climate change is the major source of impact, given the open nature of the UK economy. This points to both avoided costs under a net zero trajectory (e.g. drought and flooding, lost agricultural production) and tangible opportunities for the export of goods and services to high-need emerging markets and advancing the priorities of the UK Industrial Strategy.

Given the growing importance of energy security in economic growth, low-carbon transition also allows the UK economy to reduce its exposure to overseas hydrocarbon imports over time, yielding economic benefits to the UK. Energy efficiency measures and switching to low-cost domestic sources of renewable energy will yield near-term benefits to growth given the UK economy's predominantly import/consumption focused structure. IEA research shows that demand-side energy management has particularly strong benefits for industrial productivity and employment growth.

Analysis by the UK Energy Research Council has shown that energy-efficiency-driven productivity gains have driven as much as a quarter of UK GDP growth since the 1970s. Similarly, renewable energy projects have been shown to yield strong local economic multipliers and employment gains – with cashable returns on investment £2.90 for every £1 of investment, according to historical analysis by APSE.

2. What challenges and obstacles have you identified to decarbonisation?

As an asset manager, the key barrier to decarbonisation observed by Insight is a lack of clarity on the domestic policy trajectory towards net zero and an increasing lack of policy stability, particularly in the energy sector. Insight has set targets to align its investments with net zero over the short, medium, and long-term, but meeting these targets is contingent on public policy evolving over time to meet the pledges made by governments under the Pairs Agreement and the investable universe of ‘green’ activities expanding over time. The only alternative for Insight to deliver these goals in the absence of government action is wide-ranging divestment, which does not deliver real-economy emissions reductions and may run counter to Insight’s fiduciary duty.

The UK’s ‘Ten-Point Plan’ for net zero, published in 2021, similarly needs to be followed by a more detailed breakdown of specific policy measures to be enacted in support of net zero and associated emissions reductions. This will provide investors with the necessary policy trajectory to channel capital to businesses and activities that advance net zero.

In this context, we note that multiple previous inquiries and analyses have been undertaken into the costs and benefits of net zero to the UK (for example, by the Committee on Climate Change). Posing such fundamental questions 14 years after the introduction of the Climate Change Act (2008) introduces further policy uncertainty for investors.

Delays to the Green Finance Strategy and Energy Security Strategy updates because of this report will be detrimental to the UK’s international competitiveness at a time when other major economies and international finance centres are moving rapidly to capture opportunities in this space.

Another important challenge that we face in decarbonisation relates to the lack of legal clarity on the influence of climate change on fiduciary duty for pension fund trustees. This is further explained in our response to question 14 below.

3. What opportunities are there for new/amended measures to stimulate or facilitate the transition to net zero in a way that is pro-growth and/or pro-business?

See our response to question 1 above. The transition to net zero presents strong opportunities to support economic growth and the priorities of the UK Industrial Strategy.

4. What more could government do to support businesses, consumers and other actors to decarbonise?

See Question 2 – policy and regulatory clarity on low carbon transition are key. In this context, we would hope that the UK government will follow up on its Net Zero Strategy document (October 2021) with a more detailed description of policy measures and associated emissions reductions to deliver the 2050 target.

5. Where and in what areas of policy focus could net zero be achieved in a more economically efficient manner?

A key example of this is in the UK built environment, where despite a range of policy targets (for example, tightening of residential energy performance certificate standards and aspirational targets for heat pump installation), there remains a lack of clarity on specific policy measures to be enacted in support of these goals.

Both residential and commercial property in the UK perform very poorly in international comparisons of energy efficiency, but policy coordination across these sectors in advance of decarbonisation has been notably lacking, particularly regarding details on funding measures to support the development and deployment of heat pump supply chains and improved home insulation. The consequence is higher household/business energy consumption, with negative implications for net household income or economic productivity in the context of high energy prices.

We believe the UK's long tradition of promoting alignment of international standards (e.g. BSI, BREEAM) should be leveraged to promote wider deployment of low-carbon built environment technologies and skills domestically and alignment of the international built environment value chain with net zero. We would also expect further detail on medium-term policy measures to complement the UK Heat, and Building Strategy published last year.

6. How should we balance our priorities to maintaining energy security with our commitments to delivering net zero by 2050?

Energy demand-side management has a key role to play in advancing the UK's net zero transition and enhancing energy security. Analysis by E3G has indicates up to 80% of current gas consumption from Russian imports could be reduced this year through measures to improve energy efficiency and cut primary energy demand, in particular home energy efficiency measures, with around 38% of UK gas demand linked to domestic heating.

Whilst domestic fossil fuel production will continue to play a key role in the energy mix, the timescale for development of significant new conventional or unconventional oil and gas resources will not meaningfully help alleviate short-to-medium term energy security concerns and would be detrimental to the UK's international commitments on climate change. As highlighted by the Committee on Climate Change, additional domestic oil and gas production will not significantly shift energy prices due to the international market structure. New projects coming online in the 2040s and 2050s face a high risk of asset stranding given forecast long-term demand destruction (for example, because of transport electrification).

Renewable energy has a key role to play in ensuring domestic energy security, particularly given the very high wind energy potential of the British Isles in an international context. Q2 2022 saw the UK become a net electricity exporter for the first time in 12 years. Further development of domestic renewable capacity offers opportunities to offset energy imports and some potential for further exports via interconnectors.

Developing the UK electricity grid and transmission and distribution infrastructure to better capitalise on the opportunities of large-scale renewable deployment will prove crucial. Falling levelized costs of energy across all UK sources of renewable energy in the past decade have been offset by rising grid balancing, demand management and transmission and distribution costs due to sub-optimal grid integration and electricity market structure. In particular, disparities in the costs charged for grid transmission by generators across the UK remains a challenge for renewable deployment. Revising rules that allow grid-scale battery storage should also be explored as the technology rapidly matures.

7. What export opportunities does the transition to net zero present for the UK economy or UK businesses?

As detailed above, the financial services industry remains the core of the UK's comparative advantage in exports and strengthening the capabilities of the UK in green financing will be vital to ensuring the UK's continued competitiveness internationally, in line with the aspirations of the Green Finance Strategy.

Moreover, research by the London School of Economics has identified a range of promising export opportunities, including areas where the UK does not currently have a comparative advantage, such as battery manufacturing, energy efficient domestic appliances and zero emissions vehicles. The rapid expansion of demand for these products globally in the coming decade presents strong export growth opportunities overall.

The UK's strong track record of scientific research also points to opportunities for low-carbon technology innovation in areas such as carbon capture and storage, with as many as two-thirds of the required technologies for countries to meet net-zero not existing currently or being prohibitively expensive to be deployed at scale. Leveraging links between the UK's academic community and industry will be vital in developing export opportunities.

The age of the UK's oil and gas fields means the sector is particularly well placed to export expertise and assets in oil and gas decommissioning, which remains a nascent industry. As a growing number of global oil and gas assets mature, demand for these skills will rise.

Questions for businesses

8. What growth benefits/opportunities have you had, or do you envisage having, from the net zero transition?

We have seen strong growth in demand for climate-focused investment strategies in recent years. We expect to see these client requests continue to grow as reporting infrastructure is increasingly standardised (e.g. SFDR, SDR) and clients become increasingly sophisticated in their literacy of climate risks and opportunities. Challenges around the interpretation and integration of climate data into the investment process present particular commercial opportunities for active managers such as Insight.

9. What barriers do you have face in decarbonising your business and its operations?

As a financial services company, decarbonising our direct operational emissions (Scope 1&2) is relatively straightforward. We have made energy efficiency renovations to our London headquarters, reduced business travel in recent years, and we have put in place vendor management practices regarding emissions reduction in our supply chain.

For Insight, Scope 3 (Financed Emissions) are by far the largest contributor to our overall emissions footprint. While we have made strides to reduce the emissions intensity and impact of our book of business, we expect decarbonisation to become incrementally harder as our targets progress in the absence of governmental net zero policy development. As mentioned above, these targets were set on the expectation of sustained governmental action to deliver net zero, which will increase the investable universe of net zero aligned assets over time.

For corporate investees, Insight's AUM is currently aligned with an Implied Temperature Rise of 2.2C. Delivering emissions reductions in line with our targets in the absence of structural decarbonisation in the industries in which we invest will gradually limit the diversification of our portfolios. In the absence of a clear public policy movement towards net zero, this may result in a breach of our fiduciary duty to our clients.

This picture is further complicated by the volume of UK gilts within Insight's book, representing the the core of our AUM and predominantly held for matching purposes against pension scheme liabilities. This means our ability to reduce exposure to UK sovereign debt is limited. However, we still closely monitor UK climate policy and emissions performance and pursue other channels to influence government action on climate change.

10. Looking at the international market in your sector, what green opportunities seem to be nascent or growing?

As detailed in our response to Q8, the range and complexity of climate-focused financial products continues to grow. In particular, clients increasingly seek to demonstrate 'real economy' climate impact from their investments and are increasingly sensitive to greenwashing concerns. This is leading to rapidly expanding demand for use of proceeds-based debt instruments such as green or sustainability bonds, sustainability-linked loans, and green debt markets.

Transition finance to support high climate impact sectors is an area of increasing importance and scrutiny and will play a key role in delivering real-economy emissions reductions. In this respect, we welcome the UK's leadership on the Transition Plan Taskforce.

Similarly, emerging market focused climate and ESG strategies are seeing growing client interest despite continued challenges around a fragmented data landscape and scarce disclosures. In the absence of direct disclosures (and given the dominant role of private companies and SOEs in many emerging markets), we see an increasing reliance on asset-level data and shadow reporting by data providers to help support this demand.

Overall, we believe standardisation measures such as SDR and the TPT will support the sector's continued growth and, over time, reduce data collection and monitoring costs whilst improving the quality of manager oversight of climate risks and opportunities.

11. What challenges has net zero presented to your business?

Major challenges for Insight as a manager include the high number of global investee companies with a presence in the UK market, coupled with the lack of a consistent global regime for asset manager ESG integration (for example, differing interpretations of fiduciary duty regarding climate change or different disclosure requirements across jurisdictions).

Data quality remains a challenge for the industry, as climate-related factors becoming increasingly influential on investment decisions but underlying data from third party providers lacks the integrity of financial reporting.

12. What impacts have changing consumer choices/demand had on your business?

Rising client and investor demand for more granular information on investment ESG risks and impacts have led to substantial new investments in skills, people, and data to help meet this demand. SFDR compliance is one aspect of this but largely reflects shifting client expectations regarding disclosure. Rising demand for SFDR Article 8 and 9 labelled funds reflects the growing sophistication of clients around climate and sustainability issues and has led to asset reallocations to satisfy the requirements of these labels.

13. What impacts have decarbonisation/net zero measures had on your business?

Insight and its peers are making substantial investments in climate and ESG data, in particular, costs of which have expanded 20% per year for typical asset managers, according to research by Morningstar. This enhanced focus on decarbonisation has also led us to reconsider our product offerings and, in some cases, bring new products to market to cater to areas of fixed income that we feel are underserved regarding climate change. In addition, rising client literacy around climate risk and sensitivity around investment decisions has necessitated more frequent manager engagement and focus on climate change and substantial additional resources (human capital and data infrastructure) to meet these requirements.

Over time, we expect the decarbonisation and zero measures to have a greater impact on portfolio compositions as well.

14. What more could be done to support your business and/or sector to decarbonise?

Clarity on the policy trajectory for domestic delivery of net zero and the UK's carbon budgets is the overriding priority for Insight. Linked to this is a requirement for legal clarity on the influence of climate change on fiduciary duty for pension fund trustees set out below.

A continued push for alignment of international standards would be beneficial for the sector as a whole, in particular common international agreement on the treatment of materiality assessment (e.g. ISSB, double or single materiality).

Linked to this, greater international cohesiveness on climate integration and interoperability of management practices across jurisdictions would support for the sector.

Lack of clarity over fiduciary duty of pension funds:

Defined benefit pension schemes account for c.£2.2 trillion of assets under management in the UK[2]. Trustees for these schemes are legally required to act in the best interests of pension scheme members. This generally encompasses a duty to act in the best financial interests of the members by considering "financial factors" when making investments (including those with climate related/environmental goals). Despite extensive work on the topic in recent years[3] and various guidance notes from industry bodies, a lack of clarity still remains as to what extent 'non-financial factors' can be taken into account as part of the investment process concerning investments with climate or environmental goals.

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[2] Source: Investment Management in the UK 2020-2021: The Investment Association Annual Survey, September 2021, The Investment Association.
[3] Pension scheme investments and climate change, 7 October 2021, House of Commons Library Research Briefing; Pension Funds and Social Investment, June 2017, Law Commission.

This is leading UK pension schemes to adopt a variety of approaches. Our clients include pension schemes with trustees who believe tackling climate change is in the best interests of their members and have supported the inclusion of green gilts within their portfolios, with some schemes having publicly committed to the UN-convened Net-Zero Asset Owner Alliance.[4] We also have pension scheme clients with trustees who consider that their fiduciary and/or legal duties may fetter their ability to enter certain investments (including those that support environmental or climate-related goals, such as green gilts) because of a belief that non-financial factors should be subordinate to financial factors.

In our experience, more clarity is needed to lead some pension schemes to opt for a more cautious approach regarding non-financial objectives. Clarifying how pension scheme trustees' obligations apply regarding such goals and having clarity on the extent to which they can incorporate financial and non-financial factors within the investment decision-making process could remove this barrier, allowing for a larger proportion of UK schemes' assets under management to be invested in support of such targets.

15. Do you foresee a role for your business within an expanded UK supply of heat pumps, energy efficiency, electric vehicles, hydrogen economy or clean power?

As above, we see key growth opportunities in funding green energy solutions (global and international). Rising demand for labelled fixed income instruments such as green bonds by our clients has been restrained by a lack of investible activities in many sectors and geographies. These instruments have a key role to play in channelling capital towards low-carbon technology solutions.

16. For clean power industry: what barriers to entry have you found in deploying new plant and technologies?

N/A

17. How many green jobs do you estimate will be created in your sector by 2030?

Financial services are the lynchpin of UK exports and value added, and a key source of our comparative advantage. We expect the Green Finance Strategy to support the growth of green finance jobs to maintain the international competitiveness of UK financial services. A March 2022 study by WPI Economics pointed to around 50,000 green finance jobs in London, is projected to rise to in excess of 170,000 by 2030 and 380,000 by 2050 to meet rising demand for green financing and products.

[4] https://www.unepfi.org/net-zero-alliance/

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