Response to call for evidence for UK Green Finance Strategy update

Insight Investment

June 2022

Insight INVESTMENT
BNY MELLON | INVESTMENT MANAGEMENT

Executive summary

Insight Investment is one of the UK's largest investment managers, managing over £836bn 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 (primarily liability-driven investment, or LDI) 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.[2] We welcome the UK government's desire to understand and develop the role of the financial sector in delivering global and domestic climate and environmental objectives, and are pleased to respond to the call for evidence regarding an update to the UK Green Finance Strategy.

Key themes we wish to highlight in our response include the following:

- **Uncertainty over legal obligations creates challenges to investment by UK defined benefit pension schemes:** Clarifying how pension scheme trustees' obligations apply regarding non-financial factors could allow for a larger proportion of UK schemes' assets under management to be invested in support of environmental and climate targets.
- **Financial markets and the public sector need to collaborate to address environmental goals:** Financial markets and tools focus on pricing specific rather than systemic risks. These present inherent barriers to integrating long-term, systemic environmental factors into financial decision-making. We believe the government and other stakeholders have significant roles to play alongside the financial markets to ensure environmental factors, such as climate change, are addressed holistically and effectively.
- **The UK can play a key role in supporting high-quality green bond issuance globally:** The UK can play a leadership role in its own green issuance. The UK financial industry has extensive expertise, and specialists may share their experience and knowledge with counterparts in other economies to collaborate in developing best practice across green bond issuance globally.

We would be delighted to engage further with the UK government on these issues, and to discuss our response in greater detail.

Insight Investment

June 2022

---

[1] As at 30 September 2021. 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.

[2] More information on Insight's responsible investment approach and activities is available at https://www.insightinvestment.com/investing-responsibly/.

Questions and answers

Financing the UK's energy security, climate and environmental objectives

9 What barriers are there to unlocking private investment to support the UK's energy security, climate and environmental objectives?

Uncertainty over pension scheme trustees' legal obligations creates challenges to investment in support of non-financial objectives, including environmental goals.

Defined benefit pension schemes account for c.£2.2 trillion of assets under management in the UK[3]. 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 that have a climate related/environmental goals). Despite extensive work on the topic in recent years[4] 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 in relation to investments with climate or environmental goals.

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[5]. We also have pension scheme clients with trustees who consider that their fiduciary and/or legal duties may fetter their ability to enter into 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, the lack of clarity is leading 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 financial and non-financial factors can be incorporated 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.

12 Are there barriers to the mobilisation of private investment into transition activities? If so, what are they and how might they be overcome?

Uncertainty over pension scheme trustees' legal obligations creates challenges to investment in support of non-financial objectives, including environmental goals, as explained in our answer to Question 9.

We believe this also applies to investment by UK pension schemes in transition activities. Along with clarity on pension scheme trustees' legal obligations, we believe that to mobilise private investment into transition activities clarity is required on the definition, scope and transparency of these activities. We expect meaningful progress on these issues: large companies and some financial sector firms in the UK will be required to publish a transition plan from 2023, and the Treasury has established the Transition Plan Taskforce (TPT) to develop detailed templates suitable for incorporation within UK regulatory frameworks.[6]

Greening the financial system

26 (c) What are the key characteristics of a Net Zero-aligned Financial Centre? How would these characteristics apply to a typical UK-based asset manager?

We believe a net-zero-aligned financial centre would exhibit the following characteristics:

---

[3] Source: Investment Management in the UK 2020-2021: The Investment Association Annual Survey, September 2021, The Investment Association.
[4] Pension scheme investments and climate change, 7 October 2021, House of Commons Library Research Briefing; Pension Funds and Social Investment, June 2017, Law Commission.
[5] https://www.unepfi.org/net-zero-alliance/
[6] https://transitiontaskforce.net/

- **Focus on developing financial instruments** that help to direct the flow of capital towards climate solutions
- **Act as a centre of excellence** regarding emerging frameworks and policies related to achieving net-zero goals
- **Encourage collaboration between the public and private sectors** to drive progress in understanding how to achieve net-zero goals
- **Adopt a transparent approach to progress** including on the link between financial activity and real-world outcomes

Taking the above into account, we believe a net zero-aligned UK-based asset manager would be characterised by the following:

- **Publicly committed to achieving a net-zero outcome:** This may be through support for an effort such as the Net Zero Asset Managers initiative[7] or equivalent project, which requires clear commitments and reports on progress over time.
- **Focused on innovation regarding instruments and investment strategies targeting progress towards net zero:** The growth of assets such as green bonds present clear opportunities to make progress towards net-zero goals, but there remains scope for new approaches that more clearly target a reduction in emissions.
- **Desire to develop and share expertise:** Net-zero goals require efforts by stakeholders around the world, and will require ongoing research and extensive expertise. As well as working to develop their capabilities, we would expect a net zero-aligned manager to seek to share its expertise with global counterparts.
- **Collaborating to driving progress in understanding how best to achieve net zero:** Achieving an effective and sustainable reduction in greenhouse gas emissions will require extensive collaboration across the public and private sectors globally. Depending on their reach and resources, we would expect asset managers to collaborate with relevant stakeholders in pursuit of net-zero targets.
- **Transparent about climate-related data and metrics in reporting:** Achieving net zero will require significant progress in reducing emissions over the short and long term. This will require detailed data on standardised carbon metrics for portfolio holdings. Asset managers will need to develop reporting on such metrics which includes details on the assumptions and methodologies underlying them, and reflects the different approaches required for different asset classes.

27 What market barriers are there to the integration of environmental-related factors into financial decision-making?

There are a range of challenges facing the integration of long-term environmental factors, such as climate change, in financial decision-making.

Uncertainty over pension scheme trustees' legal obligations creates challenges to their investment in support of non-financial objectives, including environmental goals, as explained in our answer to Question 9.

A key challenge is that financial markets and tools focus on pricing specific risks, rather than systemic risks. These present inherent barriers to integrating long-term, systemic environmental factors into financial decision-making.

We outline a range of these issues, specifically with regard to how the financial markets and investors might approach environmental factors, below. We broadly categorise these as **data challenges**, **materiality assessment challenges** and **the legal challenge**.

Data challenges

- **Information failures:** The market needs to accurately price environmental risks before investors can hedge and transfer them between each other. The unavailability and asymmetry of information makes this inefficient, if not impossible.
- **Gaps in data and data applicability for different asset classes:** Environmental data, such as climate change-related metrics, may be available for larger equity and corporate bond issuers but there are still significant gaps presenting challenges for investors in other instruments – including for smaller issuers and different asset classes. For example, for asset-backed securities (ABS), there are data gaps for legacy ABS which are not practically

[7] https://www.netzeroassetmanagers.org/

possible to fill as there is no corporate entity to provide the data; and for newly issued ABS, there are not always data available. Treatment of derivatives also requires further consideration: metrics may be relevant for some derivatives but not others. We encourage policymakers and other stakeholders to reflect such considerations as standards for sustainability disclosures are developed.

- **Inconclusive research:** Studies focused on the impact of environmental, social and governance (ESG) factors on investment are often flawed, focusing on short time periods, specific relationships and variables from which it is hard to generalise, and correlations rather than causations. Research therefore does not provide a clear foundation for investors focused on projected returns.

Materiality assessment challenges

- **Externalities:** The presence of externalities means that the consequences of a transaction are not wholly borne by those involved in it. A factory may create greenhouse gases, but it is the whole world, not just its customers, that bear the costs. How to consider both the costs and benefits of financial decisions regarding the factory requires the decision-maker to make assumptions and/or judgements regarding the factory's operations.
- **Time horizon:** The environmental impacts of an investor's decisions may extend beyond the investor's time horizon. For example, a defined benefit pension scheme may pay its last benefits to a pensioner before the environmental consequences of its investment decisions are apparent.
- **Front-loaded costs:** Tackling some environmental issues like climate change involve significant front-loaded costs while the benefits accrue in the distant future. In financial terms, the higher the 'discount rate' applied for future damage, the lower their present value. For the private sector, it is very difficult to justify investment if the projected returns are below the cost of capital.
- **Inapplicability of historical risk management tools:** Climate change has no precedent, meaning that backward-looking tools (based on metrics such as historical volatility and downside risk) may prove inapplicable and ineffective.

Legal challenge

- **Legal duties:** Uncertainty over pension scheme trustees' legal obligations creates challenges to investment in support of non-financial objectives, including environmental goals, as explained in our answer to Question 9.

We believe these challenges demonstrate that the government and other stakeholders have significant roles to play alongside the financial markets to ensure environmental factors, such as climate change, are addressed holistically and effectively. Please also see our answer to Question 28.

28 What should the role of the UK government or regulators be to support the greening of the financial system? How could they go further?

There are significant barriers to the private sector alone supporting climate and environmental objectives, as outlined in our answers to Question 9 and Question 27.

Perhaps most notably, tackling climate change involves significant front-loaded costs while the benefits accrue in the distant future. Financial markets are arguably not an appropriate means for engineering the long-term, intergenerational cost/benefit trade-off required to tackle climate change; they are also not best placed to reflect non-financial impacts in their activity, such as socio-economic effects.

It is an open question as to whether it is possible for financial markets to be restructured to become more suitable for addressing such challenges. Even if this is possible, we believe that public funding approaches to these issues must work alongside any financial market solutions to tackle this issue.

Providing the market with the right data

30 What steps can the UK government take to support a robust investment data ecosystem to attract green finance flows?

The richness and variety of data available to inform investment decisions has grown significantly in recent years and this has enabled investors to take much more considered views on factors they consider relevant to achieving their objectives. However, the variety and gaps in data present a risk to investors. Different data providers follow different approaches, and their application and relevance varies according to asset class, as noted in our answer to Question 27.

We therefore welcome the news that the Financial Conduct Authority (FCA) has committed to a wide range of ESG-related target outcomes including the following[8]:

- high-quality climate- and wider sustainability-related disclosures to support accurate market pricing, helping consumers choose sustainable investments and drive fair value
- integrity in the market for ESG-labelled securities, supported by the growth of effective service providers – including providers of ESG data, ratings, assurance and verification services

We support the following:

- ensuring greater consistency of data, including consistency of methodologies behind assimilating the data;
- greater accessibility of data, which currently can be limited by the licensing agreements of data providers;
- a regulatory focus on ESG data and ratings providers;
- continued engagement and co-ordination by UK government with international standards to ensure consistency;
- encouragement of market-led best practice, as exemplified by the contributions of collaborative industry groups such as the Glasgow Financial Alliance for Net Zero and Green Taxonomy Group; and
- appropriate sequencing of any regulatory disclosures, such as ensuring issuers are required to report before asset owners and asset managers. Incorrect sequencing could lead to market participants being forced to estimate data, with each financial market participant potentially adopting different approaches, leading to poor-quality outcomes.

31 Are Scope 3 (supply chain) emissions data important for investors to assess and manage climate-related risks and opportunities?

We believe Scope 3 emissions can present both material risks and opportunities for investors, and so relevant data can be important.

However, unlike Scope 1 and Scope 2 emissions, Scope 3 emissions require extensive assumptions and different methodologies may be applied. In theory, companies in the same industry with similar operations could publish very different Scope 3 emissions data as a result of taking different approaches.

We note that the Task Force on Climate-related Financial Disclosures (TCFD) encourages organisations to disclose Scope 3 greenhouse gas emissions, though this is subject to materiality, unlike its recommendation to disclose all Scope 1 and Scope 2 emissions[9].

We believe it is important that consistent methodologies and standards are developed for Scope 3 emissions before any mandatory reporting is required.

32 Is there a role for the UK government to support businesses (of different types and sizes) to make good quality Scope 3 emissions disclosures (including SMEs in the value chain of disclosing entities)? If so, what should this be?

Scope 3 emissions require extensive assumptions and different methodologies may be applied (as explained in our answer to Question 31). As with the Transition Plan Taskforce (see our answer to Question 12), we encourage the UK government to lead on initiatives aimed developing standardised methodologies for Scope 3 emissions both at the UK and international levels.

---

[8] A strategy for positive change: our ESG priorities, 3 November 2021, FCA.
[9] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures (PDF), October 2021, TCFD.

Leading internationally

33 Considering the key market incentives and barriers, how can the UK best support an increase in high quality, green bond issuances for emerging and developing economies?

The UK can play a key role in supporting high-quality green bond issuance by continuing to play a leadership role in its own green issuance, employing best practice in areas such as project selection, reporting frameworks and independent verification, and through the development of guidelines or standards regarding such issuance. UK specialists may also share experience and expertise with counterparts in other economies to collaborate in developing best practice across green bond issuance globally.

An alternative to green bond issuance is sustainability-linked issuance, whereby an issuer structures a bond to allow for coupons to increase or decrease depending on whether specified sustainability objectives are achieved (for example, a specified reduction in greenhouse gas emissions). This is potentially another area within which the UK could play a leadership role with sustainability-linked issuance that encourages and reflects a transition to net zero.

Contact

Main contact	Vanaja Indra
Title	Market and Regulatory Reform Director
Telephone	+44 20 7321 1110
Email	vanaja.indra@insightinvestment.com
Address	160 Queen Victoria Street London EC4V 4LA

Other disclosures

This document is a financial promotion/marketing communication and is not investment advice.

This document is not a contractually binding document and must not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or otherwise not permitted. This document should not be duplicated, amended or forwarded to a third party without consent from Insight Investment.

Insight does not provide tax or legal advice to its clients and all investors are strongly urged to seek professional advice regarding any potential strategy or investment.

For a full list of applicable risks, investor rights, KIID risk profile, financial and non-financial investment terms and before investing, where applicable, investors should refer to the Prospectus, other offering documents, and the KIID which is available in English and an official language of the jurisdictions in which the fund(s) are registered for public sale. Do not base any final investment decision on this communication alone. Please go to www.insightinvestment.com.

Unless otherwise stated, the source of information and any views and opinions are those of Insight Investment.

Telephone conversations may be recorded in accordance with applicable laws.

For clients and prospects of Insight Investment Management (Global) Limited:

Issued by Insight Investment Management (Global) Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 00827982.

For clients and prospects of Insight Investment Funds Management Limited:

Issued by Insight Investment Funds Management Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 01835691.

For clients and prospects of Insight Investment Management (Europe) Limited:

Issued by Insight Investment Management (Europe) Limited. Registered office Riverside Two, 43-49 Sir John Rogerson's Quay, Dublin, D02 KV60. Registered in Ireland. Registered number 581405. Insight Investment Management (Europe) Limited is regulated by the Central Bank of Ireland. CBI reference number C154503.

For clients and prospects of Insight Investment International Limited:

Issued by Insight Investment International Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 03169281.

Insight Investment Management (Global) Limited, Insight Investment Funds Management Limited and Insight Investment International Limited are authorised and regulated by the Financial Conduct Authority in the UK. Insight Investment Management (Global) Limited and Insight Investment International Limited may operate in certain European countries in accordance with local regulatory requirements.

For clients and prospects based in Singapore:

This material is for Institutional Investors only. This documentation has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, it and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of Shares may not be circulated or distributed, nor may Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the 'SFA') or (ii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

For clients and prospects based in Australia and New Zealand:

This material is for wholesale investors only (as defined under the Corporations Act in Australia or under the Financial Markets Conduct Act in New Zealand) and is not intended for distribution to, nor should it be relied upon by, retail investors.

Both Insight Investment Management (Global) Limited and Insight Investment International Limited are exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 in respect of the financial services; and both are authorised and regulated by the Financial Conduct Authority (FCA) under UK laws, which differ from Australian laws. If this document is used or distributed in Australia, it is issued by Insight Investment Australia Pty Ltd (ABN 69 076 812 381, AFS License No. 230541) located at Level 2, 1-7 Bligh Street, Sydney, NSW 2000.