Insight INVESTMENT

SEPTEMBER 2023

TNFD: A NEW FRAMEWORK FOR NATURE-RELATED FINANCIAL DISCLOSURES

IMPLICATIONS FOR FIXED INCOME INVESTORS

- While it is becoming common for investors and asset owners to act on reducing climate change risk in their portfolios, natural-capital risk has received less scrutiny. The Task Force on Nature Related Financial Disclosures (TNFD) is a new market-led disclosure framework for measuring the impact of companies on nature, and their dependence on nature, building on the work of the Task Force on Climate-related Financial Disclosures (TCFD).
- The TNFD is a voluntary framework, but we expect it to shape future regulations and investment practices. We also expect its adoption and influence to accelerate over the next two years.
- Despite growing investor demand for biodiversity and nature-focused investments, the supply of credible use-of-proceeds bonds (also known as impact bonds) focused on these areas remains low.
- We expect such issuance to grow as the TNFD framework is adopted. Some issuers are in the early stages of setting nature-related targets, which could lead to new issuance.

BACKGROUND TO THE TNFD

While it is becoming common for investors and asset owners to act on reducing climate change risk in their portfolios, natural-capital risk has received less scrutiny. However, the market-led Taskforce on Nature-related Financial Disclosures (TNFD) has now published its final recommendations for standardised nature disclosures and risk management[1]. Over time we believe this will deepen understanding of the relevance of these issues for investors.

Notably, the framework has had detailed input across academia, policymakers, financial institutions, corporates and other stakeholders; and formal endorsement by the G7 and G20, and the IFRS International Sustainability Standards Board (ISSB) which is developing global standards on ESG disclosure.

The TNFD framework consists of:

1. a **standardised series of metrics and indicators** for analysis and disclosure of the impacts on companies of nature, and dependencies of those companies on nature, drawing on several thousand existing reporting indicators for global ESG standards;
2. core recommended and optional **disclosures aligned to the TCFD pillars**, encouraging firms to produce integrated ‘climate and nature’ reporting over time; and
3. an integrated **risk and opportunity assessment methodology**, LEAP (Locate, Evaluate, Assess and Prepare).

Interaction with existing reporting standards and data is at the heart of TNFD. A major challenge is the scarcity of data on how nature may impact an organisation’s performance, or the longer-term financial risks that may arise from how the organisation, positively or negatively, impacts nature.

Additionally, the local nature of many of these risks means that some companies in sectors for which nature-related factors are less relevant overall may have specific assets with high impacts and dependencies locally. The current version of the TNFD framework emphasises a bottom-up approach to assessing company nature risks, starting at the asset level.

[1] Taskforce on Nature-related Financial Disclosures (TNFD) Recommendations, September 2023, TNFD.

How the TNFD framework applies to financial institutions – including investment managers

The TNFD's **guidance for financial institutions**[2] emphasises a more flexible approach, with core metrics focused on screening of **exposure to material sectors** as the starting point for analysis followed by **exposure to sensitive locations** (reporting the absolute or percentage of invested assets with operations and value chains located in areas important for biodiversity, ecological integrity, areas of high physical climate risks exposure or areas of importance for ecosystem service provision).

Challenges for investors

- **Nature-sensitive sectors differ from climate-sensitive sectors:** The first metric, exposure to material sectors, may present interesting challenges for investors because industry sectors that typically have a high impact or dependency on nature often differ from those sectors with high materiality from a climate perspective. For example, consumer staples, packaged food and agriculture are typically priorities for nature-focused investors, while energy, utilities and transportation would be priorities from a climate perspective – **potentially necessitating a different approach to screening, engagement and asset-allocation decisions.**
- **Nature-related disclosures from corporates will lag behind investor demand:** As with many previous disclosure frameworks, general corporate disclosures are expected to lag investor expectations, **necessitating a phased approach to implementation and some reliance on modelled or estimated data over the short-to-medium term**. Nonetheless, as investors are ultimately dependent on data disclosure from the entities in which they invest and counterparties to provide detailed assessment of risks and opportunities, pressure from asset owners and asset managers for disclosure is set to increase.
- **Nature-related risks are many and varied:** Sources of nature-related financial risk are diverse (see Table 1), ranging from supply-chain disruptions, commodity-price impacts and regulatory compliance costs to rising environmental litigation risks. Insurability of assets is also a growing risk.

Table 1: Sources of nature-related financial risk

	Credit risk	Market risk	Operational risk
Transition risk	Losses due to sanctions, damages or increased taxes	Long-term raw material price increases as a result of biodiversity loss	Supply-chain disruption, reputational damage
Physical risk	Revaluation of debt-servicing capacity and required collateral	Rating downgrade/fall in valuation stemming from physical risk exposures	Asset damage/impairment from heightened exposure
Litigation risk	• Litigation pertaining to breach of legal frameworks • New regulatory rules limiting activities with a negative impact (e.g., EU Deforestation Regulation) • Damages due to false reporting of biodiversity risks • Damages due to greenwashing		
Systemic risk	Insurance coverage becomes prohibitively expensive for some sectors, regions	Spill-over effects from biodiversity loss into commodity markets	Insurance coverage becomes prohibitively expensive for some sectors, regions

Source: WWF, PwC, Sustainable Fitch.

WHAT TO EXPECT: TNFD IMPLEMENTATION

Over 1,000 institutions have endorsed the TNFD framework as members of the TNFD Forum, with a further 200 organisations piloting the TNFD standard. Early outputs from these pilots point to the challenges of limited data, but also the potential to scale the framework more widely as data improve. We expect this process to accelerate over the coming two years:

- **In the short term (one to six months) – Data expansion:** The first disclosures by companies and investors will rely heavily on top-down assessment of impacts and dependencies until data mature. Therefore, in the short term we will focus on improving our understanding of the data that we expect will continuously be published more over time. We also expect the TNFD framework to increasingly be mandated within national regulations, as has occurred with the TCFD framework. Such mainstreaming of the framework will allow data coverage to expand across the investable universe of our strategies.
- **In the medium to long term (six to 18 months) – Data maturity:** We foresee data and disclosures to reach levels of increasing maturity and coverage. Subsequently, we expect to be able to enhance our bottom-up credit analysis of companies by incorporating this data to assess risks from a natural capital depletion point of view. The outcome of this credit analysis could then inform our investment decision-making but also our engagement programme, both of which may reflect natural capital depletion risks.
- **In the long term (beyond 18 months) – Increasing issuance:** Additional disclosures, once mandated globally/more widely, could create additional investment opportunities. This could take the form of (a) increasing issuance of green bonds that focus on nature-aligned projects, as we expect the universe of green bonds targeting nature and biodiversity outcomes to grow in line with TNFD; and b) new strategies that focus on nature-aligned impact allocation as the investment universe of nature-aligned bonds expands.

[2] Sector guidance: Additional guidance for financial institutions, September 2023, TNFD.

CORPORATES ARE ALREADY SETTING NATURE-RELATED TARGETS – SETTING THE STAGE FOR MORE INVESTABLE ASSETS

The TNFD framework has been described as 'The Paris Agreement for Nature' in providing measurable international targets on a 'fair share' basis, and signatories are in the process of transposing the agreement into national legislation, which will increasingly place pressure on the private sector to demonstrate efforts to address nature loss. Over time, we expect this to result in a shift in focus to target setting (see Figure 1).

Figure 1: Risk screening to risk mitigation – responding to nature risks

Available now		Looking ahead
• **Exposure:** Materiality assessment to identify sectors and supply chains that are highly material to natural capital (e.g. drawing on the ENCORE tool of the Natural Capital Finance Alliance, focusing on operations; and the Exiobase 3 model, focusing on supply chains).	→	**Exposure**: Proximity of company assets to key protected areas and species.
• **Management**: The WWF Biodiversity Risk Filter can help assess how well an issuer manages biodiversity and land use risk and opportunities at the asset level.	→	**Management**: Alignment with the EU Platform on Sustainable Finance screening criteria on biodiversity and ecosystems.
• **Positive impact**: It is possible to identify companies issuing bonds, or with business activities supporting biodiversity, natural capital and water themes. Product sustainability certification schemes are available.	→	**Positive impact**: Annual spend on nature-based solutions for climate mitigation and biodiversity, in line with the recommendations of the Science Based Targets initiative.
		Forward-looking targets for nature conservation and restoration: In line with the 2030 Global Biodiversity Framework

For issuers, in addition to measuring and disclosing nature-related risks and opportunities, the TNFD framework emphasises the need to 'prepare to respond and report', including strategy and resource allocation as well as target setting and performance measurement. Notably, the Kunming-Montreal Global Biodiversity Framework (GBF), agreed in late 2022, includes specific targets for countries and the large corporates to contribute to the overall goal of 30% of the world's land, freshwater and ocean area to be set aside for nature protection and restoration by 2030[3].

A parallel initiative, endorsed by the TNFD, that could provide a template is the Science Based Targets Network (SBTN) corporate science-based targets for nature[4]. The SBTN is a coalition of over 80 environmental non-profits and organisations, and is building its nature targets on methodologies developed for climate target-setting. The initial guidance focuses on measures to help companies improve their impacts on freshwater quality (specifically, nitrogen and phosphorus emissions) and freshwater quantity, as well as measures to protect and restore terrestrial ecosystems.

The organisations initially piloting the guidance are heavily concentrated in the food and beverage and consumer goods sectors, reflecting the high materiality of nature issues to their business models. Nonetheless, analysis of existing nature-related corporate targets set shows the variety of approaches and methodologies employed, which creates challenges for comparability. We expect standardisation of target-setting through initiatives such as the SBTN to support deeper investor screening and engagement with corporates on these topics.

Table 2: Selected signatories to the SBTN science-based targets for nature pilot and existing targets

Issuers	Nature-related corporate targets
Nestle Corporation	Creating net positive impacts for biodiversity from own direct activities from 2025 onwards, and no net loss of biodiversity from all own direct activities by 2035.
AB InBev	By 2025, 100% of communities in water-stressed areas will have measurably improved water availability and quality.
Alpro	Zero deforestation and conversion on key commodities by 2025. Watershed restoration plans for operations in all water-stressed areas by 2030.
Bel	Farm supplier-level regenerative agriculture targets developed.
Carrefour	100% of sensitive raw materials covered by a risk reduction plan by 2025. 100% Brazilian beef zero deforestation for own brands by 2026 and for other brands by 2030.

[3] For more information, please see Nature risks come to the fore: Key takeaways from COP15, 21 December 2022, Insight Investment.

[4] The first science-based targets for nature, Science Based Targets Network.

Issuers	Nature-related corporate targets
GSK	Positive impact on biodiversity at all sites by 2030. 100% agricultural, forestry and marine-derived materials sustainably sourced and deforestation free by 2030.
H&M Group	Sourcing 30% of all materials/100% of polyester from recycled sources by 2025 to reduce land use related biodiversity impacts.
Hindustan Zinc Limited	Achieve no net deforestation through compensatory afforestation.
Holcim Group	100% of quarries to be covered by the Biodiversity Indicator Reporting System by 2024.
Kering	'Net zero impact on nature' by 2025.
L'Occitane Group	Raw material sourcing strategy including biodiversity risk screening.
LVMH	100% of raw materials certified to standards "guaranteeing the preservation of ecosystems and water resources" by 2026. Restoration of 5 million hectares of habitat by 2030.
Suntory	Replenishing more than 100% of water abstraction.
Tesco	LEAF (Linking Environment and Farming) standard certification for all global fruit and vegetable suppliers by 2025.
UPM	40% reduction in chemical oxygen demand per product by 2030. 30% reduction in wastewater volume. 100% use of nutrients from recycled sources by 2030.

Source: SBTN.

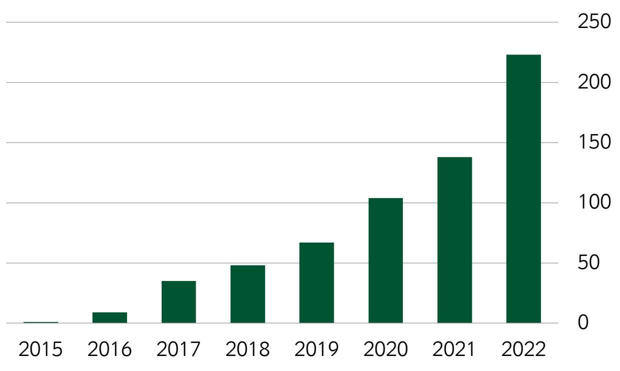
WHAT INVESTORS WANT: DEVELOPING CREDIBLE NATURE AND BIODIVERSITY BONDS

From an issuer perspective, developing a credible labelled bond framework clearly linking use of proceeds to material organisational targets on nature and biodiversity issues would be expected to maximise market access and investor perception. Investor appetite for such instruments is rising, and issuance of green and sustainable bonds targeting nature conservation activities explicitly has risen in recent years (see Figure 2).

However, nature-related projects represent a small share of labelled bond issuance. Analysis of issuance of green, social and sustainability bonds in 2022 highlights that around 14% included projects with a relevance to nature and biodiversity (see Figure 3) – predominantly focused on sustainable water management, followed by pollution prevention and control, and climate change adaptation. Issuance directly addressing terrestrial and aquatic biodiversity conservation represented an even smaller share (2%).

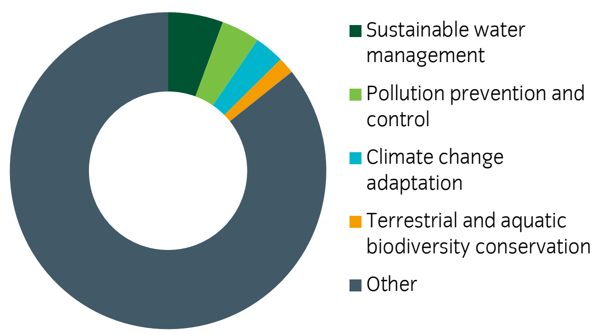
This issuance is typically dominated by sovereign, supranational and agency issuers (SSAs). This points to the key influence of state actors and public-policy decisions on nature and biodiversity management outcomes, which corporate issuers often perceive as a barrier to financing projects. Notably, issuance of sovereign frameworks directly addressing nature outcomes has increased since the introduction of the GBF, including Uruguay's sustainability-linked bond targeting key performance indicators related to forestry management. We expect this trend to intensify given the key influence of SSAs on nature and commitments to increase the flow of nature finance under the GBF.

Figure 2: The number of green and sustainable bonds targeting nature conservation activities is increasing



Source: Environmental Finance Database.

Figure 3: Nature-related projects represent a small share of green bond issuance



Source: Bloomberg. Labelled green, social and sustainability bond issuance in 2022.

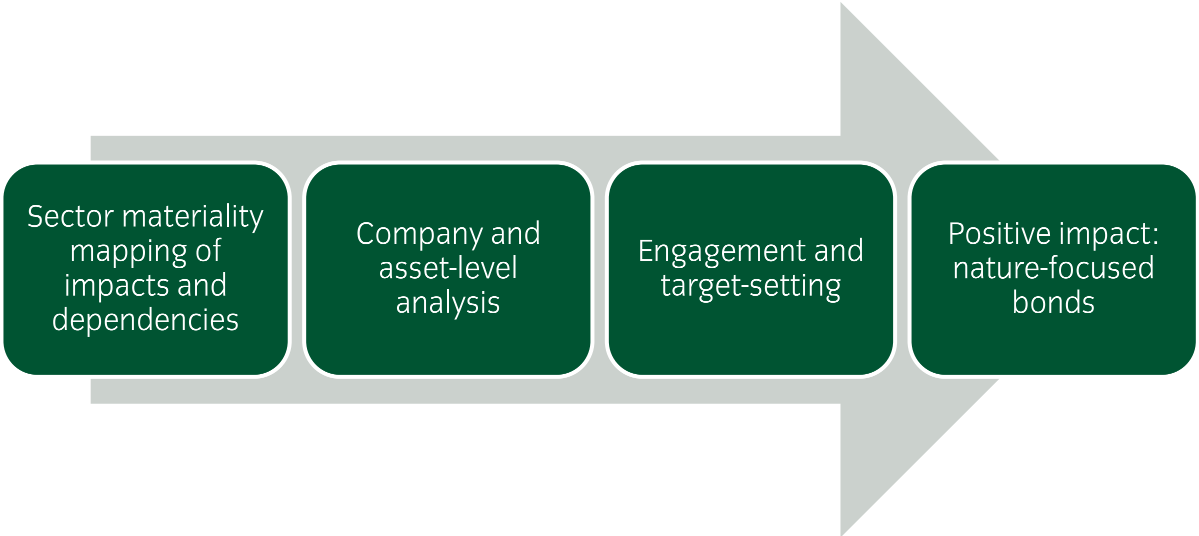
At the same time, the wording of the GBF, which is expected to increasingly influence national and sub-national nature policy over the coming years, emphasises the range of ways in which the private sector can influence nature, through direct conservation measures, changes to product design and use, natural resource management practices and water and wastewater treatment activities.

Impact bonds targeting natural capital and biodiversity outcomes can finance a range of relevant activities, including the following categories aligned to International Capital Markets Association (ICMA) standards.

- Environmentally sustainable management of living natural resources and land use
- Environmentally sustainable agriculture
- Sustainable water and wastewater management
- Pollution prevention and control
- Eco-efficient and/or circular economy adapted products
- Production technologies and processes
- Terrestrial and aquatic biodiversity conservation
- Sustainable land use

By conducting a full assessment of their value chain impacts and dependencies, corporates can identify opportunities for projects supporting nature outcomes. We expect this to increase the investable universe of nature-focused bonds available to investors.

Figure 4: Steps toward nature integration for investors



IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

ASSOCIATED INVESTMENT RISKS

ESG

- **Investment type:** The application and overall influence of ESG approaches may differ, potentially materially, across asset classes, geographies, sectors, specific investments or portfolios due to the nature of the specific securities and instruments available, the wide range of ESG factors which may be applied and ESG industry practices applicable in a particular investable universe.
- **Integration**: The integration of ESG factors refers to the inclusion of ESG risk factors alongside financial risk factors in investment analysis and research to judge the fair value of a particular investment and may also include the monitoring and reporting of such risks within a portfolio. Integrating ESG factors in this way will not typically restrict the potential investable universe, but rather aims to ensure that relevant and material ESG risks are taken into account by analysts and/or portfolio managers in their decision-making, alongside other relevant and material financial risks.

- **Ratings**: The use and influence of our ESG ratings in specific investment strategies will vary, potentially significantly, depending on a number of factors including the nature of the asset class and the structure of the investment mandate involved. For an investment portfolio with a financial objective, and without specific ESG or sustainability objectives, a high or low ESG rating may not automatically lead to a buy or sell decision: the rating will be one factor among others that may help a portfolio manager in evaluating potential investments consistently.
- **Engagement activity**: The applicability of Insight firm level ESG engagement activity and the outcomes of this activity relating to buy, hold and sell decisions made within specific investment strategies will vary, potentially significantly, depending on the nature of the asset class and the structure of the investment mandate involved.
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- **Costs**: The costs described will have an impact on the amount of the investment and expected returns.
- **Forward looking commitments and related targets**: Where we are required to provide details of forward-looking targets in line with commitments to external organisations, e.g. Net Zero Asset Managers Initiative, these goals are aspirational and defined to the extent that we are able and in accordance with the third party guidance provided. As such we do not guarantee that we will meet them in whole or in part or that the guidance will not evolve over time. Assumptions will vary, but include whether the investable universe evolves to make suitable investments available to us over time and the approval of our clients to allow us to align their assets with goals in the context of the implications for their investments and issues such as their fiduciary duty to beneficiaries.

Insight applies a wide range of customised ESG criteria to mandates which are tailored to reflect individual client requirements. Individual investor experience will vary depending on the investment strategy, investment objectives and the specific ESG criteria applicable to a Fund or portfolio. Please refer to the investment management agreement or offering documents such as the prospectus, Key Investor Information Document (KIID) or the latest Report and Accounts which can be found at www.insightinvestment.com and where applicable information in the following link for mandates in scope of certain EU sustainability regulations https://www.insightinvestment.com/regulatory-home/sustainability-regulations/; alternatively, speak to your main point of contact in order to obtain details of specific ESG parameters applicable to your investment.

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