www.pwc.co.uk/fsrr
December 2017

Stand out for the right reasons

Financial Services Risk and Regulation

Hot topic

Sustainable Investing: Doing Well by Doing Good

Highlights

Environmental, social and governance (ESG) factors can impact the financial performance and the sustainability of an investment over the long-term. Therefore, it is important for long-term investors to consider their investments through the ESG lens as it provides them a useful tool to assess risks and generate sustainable risk-adjusted returns.

'Investing for the long-term' is a phrase one hears often when in the company of insurers, pension funds and other institutions with long-term liabilities and corresponding large assets under their management and safe-keeping. Yet there has not been a concerted effort, until now, to understand what that long-term really entails and how one should think about managing the risks.

In this Hot Topic, we take a look at what sustainable investing is about and why it is important for long-term investors. We focus on recent developments in this space and what insurers and other long-term investors can do to make their investments more resilient in an increasingly volatile world.

What is sustainable investment and why is it important?

Sustainable investing is an investment approach that takes into consideration not only financial metrics but also Environmental, Social and Governance (ESG) risk factors. These risk factors could arise due to environmental and climate change, or because of increasing social inequity or as a result of lack of governance. They increasingly have the potential to impact financial metrics. Sustainable investing looks beyond the 3-5 year business cycle so that risks that could manifest and impact in the medium to long-term can be appropriately considered.

In the UK, issues such as 'intergenerational fairness' and 'social fairness' have been at the forefront of both policymakers' and the public's mind. Older workers have benefited from defined benefit pensions which means that today's pensioners are better off than they have ever been, with increases in pensioner incomes outpacing those in work. Many in work today will have to work longer and save harder than their parents to enjoy the same standard of living in retirement. With real incomes stagnant for the past decade and an acute housing shortage, younger generations today are also struggling to get on the housing ladder.

pwc

Case studies

Ground rent is a rent paid by the lessee of a property to the freeholder of the property. In the past, leaseholders were typically charged nominal amounts such as £50 per year and sometimes as low as £1 known as 'peppercorn' ground rent to be paid to the freeholder on demand. The situation changed earlier this century when some developers started to insert new clauses whereby the ground rent was set at higher nominal amounts. In July 2017, a report was published highlighting aspects of the ground rents system with new homebuyers facing higher annual amounts in their contracts. In response the government has published a consultation paper reviewing the features of ground rents.

The introduction of the UK's Modern Slavery Act in 2015 requires firms with turnover of £36m or higher to publicly disclose how they guarantee there is no slavery in their businesses and supply chains. Forced labour in companies' supply chains was, for example, reported by several firms last year.[1]

These examples put into focus how intertwined one's investments could be to issues that impact society and the importance of understanding that impact and analysing one's footprint.

Along with climate change, such social issues can negatively impact the sustainability of our investments over the long term as highlighted by the case studies above.

Considering sustainability risks is also important from a 'fiduciary duty' standpoint. The European Commission is currently consulting on whether institutional investors and asset managers should explicitly integrate material ESG factors and sustainability as part of their fiduciary duties. It is therefore important for long-term investors to look at their investments through the ESG lens as it provides them with another useful tool to assess risks and generate sustainable risk-adjusted returns that are resilient to future upheavals.

Recent regulatory developments

Environmental developments

In December 2015, Mark Carney, as chair of the Financial Stability Board (FSB)[2] convened the Task-Force on Climate-related Financial Disclosures (TCFD). This Task-Force was set up in recognition of the fact that without sufficient information, financial market participants are unable to analyse and price in climate risks, which is a threat to financial stability and long-term investment returns. The industry-led Task Force's objectives were to develop recommendations on climate disclosures that would promote better-informed investment-, lending- and insurance underwriting decisions.

On 29 June 2017, the final TCFD Recommendations report was released which encourages companies to provide climate-related financial disclosures. Although this reporting is currently voluntary, there is momentum in several countries where companies are looking to implement these recommendations. 150 financial institutions, responsible for $82 trillion of assets, have so far committed to implement the TCFD recommendations. To find out more about how companies could prepare for such disclosures, listen to PwC Partner and member of the TCFD, Jon Williams, here.

Governance developments

The EU has pledged to take the lead in implementing the historic Paris Agreement and delivering the transition to a low-carbon and resource efficient economy.[3] As part of its commitment to develop the overall vision for sustainable finance, the European Commission (EC) appointed in 2016 a High-Level Expert Group (HLEG) on sustainable finance. On 13 July 2017, the HLEG published its first report setting out concrete steps to create a financial system that supports sustainable investments.

The interim report by the HLEG maps out the challenges and opportunities that the EU faces in developing a sustainable finance policy agenda. It also presents a first set of early recommendations to the EC. This includes a) developing a classification system for sustainable assets b) establishing a European standard and label for green bonds and other sustainable assets and c) enhancing the role of the European Supervisory Authorities (ESAs) in assessing ESG-related risks amongst other recommendations. The expert group will explore other policy areas to provide further recommendations in the final report, due in December 2017.

Another development in this area was the introduction of Directive 2014/95/EU which is a set of guidelines on the disclosure of non-financial information by large companies. This was introduced by the EU with the aim of improving transparency in environmental, social and governance areas whilst harmonising reporting efforts. The UK transposition of Directive 2014/95/EU came into force on 26 December 2016. Companies are now required to include non-financial statements in their annual reports from 2018 onwards.

---

[1] https://www.ft.com/content/397bcdf6-3bb7-11e7-ac89-b01cc67cfeec

[2] FSB is an international body that monitors and makes recommendations about the global financial system.

[3] Financing a Sustainable European Economy: Interim Report, July 2017 by the High-Level Expert Group on Sustainable Finance.

Current market landscape

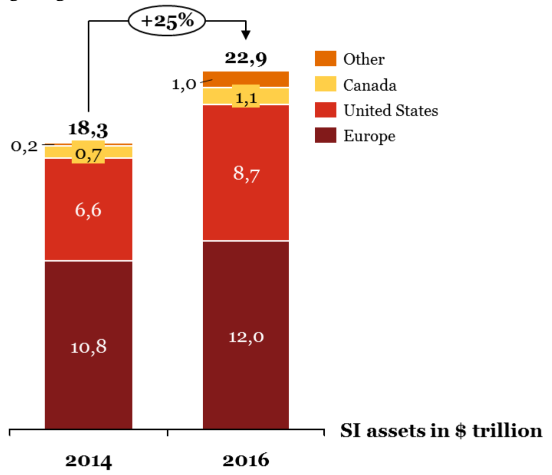
The Global Sustainable Investment Alliance (GSIA)[4] estimates at least $23 trillion of assets being professionally managed under sustainable investment strategies globally. This represents more than a quarter of all professionally managed assets and relates to an increase of 25% over a two year period from 2014 to 2016.

The GSIA definitions of sustainable investment strategies have developed as a global standard of classification. These strategies include:[5]

Strategy	Negative/ exclusionary screening	Positive/ best-in-class screening	Norms-based screening	ESG integration	Sustainability themed investing	Impact/ community investing	Corporate engagement and shareholder action
Criteria	The exclusion of instruments based on specific ESG criteria.	Investment in instruments selected for positive ESG performance relative to industry peers.	Screening of investments against minimum standards of business practice based on international norms.	The systematic and explicit inclusion by investment managers of ESG factors into financial analysis.	Investment in themes or assets specifically related to sustainability (for example green technology or sustainable agriculture).	Targeted investments aimed at solving social or environmental problems where capital is directed to traditionally underserved individuals, communities or businesses with a clear social or environmental purpose.	The use of shareholder power to influence corporate behaviour, including through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting.

Europe contributes more than 50% of the total assets managed globally under sustainable investment strategies (see Figure 1)[6].

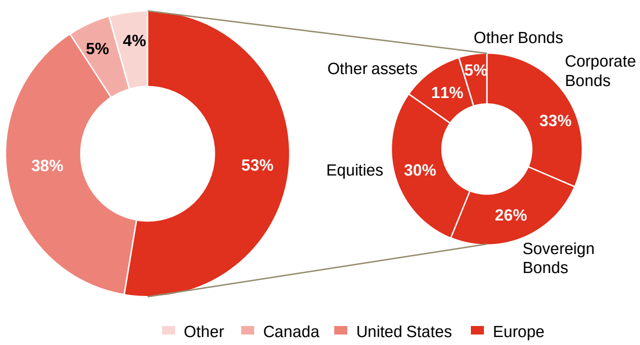
Figure 1: Growth of sustainable investment assets by region



Source: PwC illustration based on GSIA data

In terms of the European sustainable asset allocation, Eurosif[7] estimates more than 60% of such assets to be invested in bonds, c. 30% in equities and c. 10% in other asset classes (see Figure 2).

Figure 2: European SI asset allocation



Source: PwC illustration based on Eurosif data

[4] The GSIA is a collaboration of membership-based sustainable investment organisation across the world.

[5] http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf, page 6.

[6] http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf, page 7.

[7] Eurosif is a European membership association for the promotion and advancement of sustainable investment across Europe.

In the UK, the sustainable investment market is well-diversified and amounts to c. £3.9 trillion. Corporate engagement (e.g. the exercise of voting rights) remains the main strategy with a share of more than 50% of the total c. £3.9 trillion. In Europe, impact investing (e.g. green bonds where proceeds are linked to climate change solutions) is the smallest but fastest growing strategy.[8]

Impact and sustainability themed investments offer immense development potential as concerns about climate change rise. Around 0.2% or c. $120 billion of the global bond market is currently labelled as 'green'.[9] The post-issuance performance of so-called 'green bonds' is currently comparable to normal corporate bonds.[10] Therefore, a joint promotion and development of sustainable investments across the numerous industry bodies is crucial for further substantial growth and uptake from investors. Diverse green definitions are also a challenge to investors.

Despite the challenges however, various large institutional investors have committed to promoting and incorporating sustainable investments as part of their investment principles, for example:

- Zurich Insurance reached their commitment of $2bn green bond investment target in August 2017 and expanded its commitment to impact investments to $5bn in November 2017.[11, 12]
- In July 2017, Swiss Re announced that it would start using a suite of ESG benchmarks for its equities and fixed income portfolios. The reinsurer believes that this creates the right incentives for portfolio managers to build a culture of long-term and sustainable thinking.[13]
- In the UK, Aviva Investors' responsible investment philosophy is based on ESG considerations, engagement and voting as well as supporting sustainable policy measures.[14]
- Manulife, the Canadian insurer, issued a green bond in November 2017. It is the first green bond directly issued by a life insurance company and the proceeds are directed towards green initiatives.[15]

Rising up to the challenge

Firms with successful sustainable investment engagements experience improved accounting performance, governance and increased institutional ownership.[16] Given the regulatory and climate change headwinds, long-term investors such as insurers, pension funds and sovereign asset managers will need to raise the bar and step up to the challenges posed by the threat of climate change, social and reputational risks.

Governments, industry bodies and other stakeholders today are demanding greater transparency, disclosure and impact analysis to ensure that these risks are studied, analysed and actioned upon.

How can PwC help?

When you decide to make sustainable investing a reality in your investment principles, PwC can support you to tackle the various challenges. Our team has expertise in working with investors on the various components of a sustainable investment framework and strategy. We can support you on:

- Knowing where your assets are exposed to ESG risks and how relatively risky that exposure is.
- Modelling ESG risks to understand the implications for the credit quality and risk-return profiles of your investment strategy.
- Developing a sustainable investment framework that is aligned with market expectations and industry best practices.
- Helping you to choose ESG benchmarks/ indices for specific portfolios.
- Undertaking impact assessment of moving assets by comparing risk-adjusted returns of a traditional vs. sustainable portfolios.
- Going to market and assisting in sourcing sustainable assets.
- Offering an independent review of existing sustainable investments.

[8] http://www.eurosif.org/wp-content/uploads/2016/11/SRI-study-2016-HR.pdf

[9] https://www.climatebonds.net/files/files/CBI%20State%20of%20the%20Market%202016%20A3.pdf.

[10] https://www.bis.org/publ/qtrpdf/r_qt1709h.htm

[11] https://www.zurich.com/en/corporate-responsibility/responsible-investment

[12] https://www.zurich.com/en/media/news-releases/2017/2017-1123-01

[13] http://www.swissre.com/media/news_releases/nr20170706_MSCI_ESG_investing.html

[14] https://www.avivainvestors.com/content/dam/aviva-investors/united-kingdom/documents/Responsible%20Investment%202016.pdf

[15] http://www.manulife.com/Master-Article-Detail?content_id=a0Q5000000PKcOPEA1

[16] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724%20

Contacts

Shazia Azim, Partner
ALM and Asset Advisory
T: +44 (0)20 7213 2096
E: shazia.azim@pwc.com

Jon Williams, Partner
Sustainability and Climate Change
T: +44 (0)20 7804 3978
E: jon.d.williams@pwc.com

William Gibbons
T: +44 (0)20 7804 4140
E: william.gibbons@pwc.com

Pallavi Konwar
T: +44 (0)20 7804 2543
E: pallavi.konwar@pwc.com

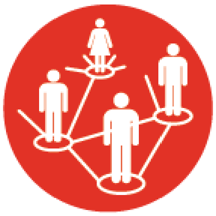
Jan Furrer
T: +44 (0)20 7804 5864
E: jan.furrer@pwc.com

171127-133436-PK-OS

Stand out for the right reasons

Alert

Protect



Adapt

Repair

Financial services risk and regulation is an opportunity

At PwC we work with you to embrace change in a way that delivers value to your customers, and long-term growth and profits for your business. With our help, you won't just avoid potential problems, you'll also get ahead.

We support you in four key areas:

- By alerting you to financial and regulatory risks we help you to understand the position you're in and how to comply with regulations. You can then turn risk and regulation to your advantage.
- We help you to prepare for issues such as technical difficulties, operational failure or cyber attacks. By working with you to develop the systems and processes that protect your business you can become more resilient, reliable and effective.
- Adapting your business to achieve cultural change is right for your customers and your people. By equipping you with the insights and tools you need, we will help transform your business and turn uncertainty into opportunity.
- Even the best processes or products sometimes fail. We help repair any damage swiftly to build even greater levels of trust and confidence.

Working with PwC brings a clearer understanding of where you are and where you want to be. Together, we can develop transparent and compelling business strategies for customers, regulators, employees and stakeholders. By adding our skills, experience and expertise to yours, your business can stand out for the right reasons.

For more information on how we can help you to stand out visit *www.pwc.co.uk.*