Appendix 2

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THE INVESTMENT ASSOCIATION
MAKING INVESTMENT BETTER

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Date: 09/01/2015

Dear Lady Jones

RE: Economic impact of climate change in London

Thank you for your letter of 25 November 2014.

In early January, the IMA became The Investment Association. Our change of name reflects our wider remit since we incorporated the Investment Affairs division of the Association of British Insurers (ABI) last summer. The merger consolidated the industry's focus on the interests of institutional investors as major shareholders in UK-listed companies, and has positioned the industry to deepen and broaden its focus in a number of long-term stewardship matters.

Climate change is clearly rising up the agenda as a material investment risk for investors. For general context, I refer you to our survey of adherence to the FRC's Stewardship Code, which provides a detailed review of practices on an annual basis[1]. The survey of 2014 practices will be published this May, however the 2013 report found investors ranked environmental issues in the top 10 of most important issues for engagement, as well as in the top 10 most frequently addressed issues.

You will also be aware that a number of specialist umbrella organisations exist with the primary focus of promoting the integration of climate change and other environmental, social and governance (ESG) factors into institutional investment[2]. These have often been the natural home for institutional investors' contribution to the broad lexicon of climate change, and will also assist the London Assembly's investigation.

Taking account of the diversity of approaches from a commercial and investment strategy perspective, and the specialist initiatives referred to above, climate change has historically been considered on an individual member basis, rather than through the Investment Association. However, drawing on feedback from our Corporate Governance and Engagement Committee,

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[1] See: http://www.theinvestmentassociation.org/assets/files/surveys/20140501-01_stewardshipcode.pdf

[2] For example, the UNEP Financial Initiative, UN-backed Principles for Responsible Investment, the Carbon Disclosure Project, The UK Social Investment Forum, and the Institutional Investor Group on Climate Change.

which comprises 14 leading investment managers, we summarise responses to your specific questions below.

Supporting adaptation

- **Fundamentals:** The Committee believes that investors can play an important role in driving investments in companies that are positioned to provide adaptation solutions. However, consistent with fiduciary duties, the conditions for investment need to be right. The merits of any investment will ultimately be decided by financial fundamentals (e.g. growth prospects, Government and International policies and regulatory stability, and risk and return etc.).
- **Client demand:** The merits of an investment will also be subject to demand from, and the requirements of, institutional asset owner clients. Individual clients have differing investment objectives and risk appetites governed by the specific parameters agreed under the Investment Management Agreement. Therefore, without significant support from asset owners, investing in riskier new technologies necessary for adaptation may not meet the set investment criteria.
- **Integration and engagement:** Committee members stressed the importance of highlighting the key risks relating to climate change in their investment processes and engaging with their investee companies on how these risks are being managed, mitigated and incorporated into long-term strategic decision-making. Ultimately, this is with the intention of reflecting these aspects in company valuations. This was generally adopted across the investment process, firm-wide, and not limited to specific products or silos.
- **Product & service innovation:** Committee members referred to a notable increase in the number of products they are offering to their clients with a specific investment strategy to identify opportunities in climate change-related areas, for example water, renewable energy, resource efficiency and sustainability thematic funds. Others offered tailored segregated mandates for clients with a specific carbon budget or strategy. There is also evidence of innovation in reporting to clients on the climate change exposure of funds' portfolio holdings, with some disclosing the total carbon emissions of investee holdings. Some, however, commented that there was limited client demand for such solutions.

Identifying the scale of this risk and managing it effectively

- **"Stranded assets" debate:** An increasing number of members are actively considering the risks associated with the impairments of investee companies' fossil fuel assets under a carbon-constrained environment. However, many see this as part of their normal analysis of a company's business model and future prospects. While climate change is perhaps unique in its complexity, the term "stranded assets" is in some way an expression of long-standing thinking and analysis of assets across the value chain.
- **Spectrum of risks**: There are, of course, also numerous risks that might cause the impairment of assets that investors will consider, as recent Brent crude prices serve to demonstrate. So investors will consider the full spectrum of risks, balancing shorter-term market dynamics and geo-political factors with longer-term risks such as technological innovation/replacement and concerted government policy action on climate change. This spectrum of risks is actively considered in the work of members in the integration and engagement referred to above. For some investors this has led to the conclusion that the risks outweigh the prospective returns, as recent high-profile divestments have demonstrated.

- **Complexity:** I refer you to some of the reports on "stranded assets" published by our members[3]. These do not point to a black-and-white scenario. The risk of impairment to assets varies significantly between different types of fossil fuels (and even between different types of the same fossil fuel) and over varying time-spans. In addition, company level diversification is an important consideration, for example: a coal miner many also mine uranium (used in cleaner nuclear energy); an oil and gas major may be involved in tar sands but also investing in adaptation solutions (such as CCS) and/or involved in procuring gas (a cleaner alternative); car manufactures make both traditional fuelled vehicles and are investing in electric cars; utility companies may have a portfolio that includes coal fired power stations, wind farms and nuclear energy. This may serve to spread climate risk.
- **Concerted government action:** While many Investment Association members publicly advocate for strong domestic and international climate change and clean energy policies[4], the challenges around reaching agreement in Lima have left greater doubts over the outcome of the COP in Paris 2015. Without significant government support for a low carbon future, investors are left with uncertainty and instability around future investment risks and opportunities. While recent research has invigorated the debate about stranded assets, and this is to be welcomed and supported, our members believe that more long-term modelling is required on the climate and economic effects of different policy interventions.

As I noted by way of introduction, the recent merger of the ABI's Investment Affairs division will enable the industry to focus on a wider range of stewardship-related matters. We will reviewing this focus during 2015. If you have any questions on the above information or would like to discuss these topics more broadly, please contact Phineas Glover on 020 7831 0898 or phineas.glover@theinvestmentassociation.org.

Yours sincerely,

Daniel Godfrey
Chief Executive Officer

The Investment Association represents UK investment managers. We have over 200 members who manage more than £5 trillion for clients around the world, helping them to achieve their financial goals. Our aim is to make the investment process better for clients, companies and the economy so that everyone prospers.

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[3] See Standard Life Investments:
http://www.standardlifeinvestments.com/WP_Stranded_Assets_White_Paper/getLatest.pdf and Threadneedle Investments: The Energy transition and the stranded assets debate – an investment risk or opportunity?
[4] See the Global Investor Statement on Climate Change: http://www.iigcc.org/files/publication-files/GISCC2Dec2014.pdf