

## Interview with Rothesay's David Land

The UK insurer's head of investment strategy, speaks to **David Walker** about the firm's commitment to the UN-convened Net-Zero Asset Owner Alliance, and from climate risk modelling to green infrastructure, what is required to achieve the carbon goal



David Land

### What has driven Rothesay's engagement with ESG investing principles?

We often describe our engagement with ESG principles, such as our pledge to achieve net zero across our business by 2050, as a fundamental part of our commitment to providing our policyholders with security for the future.

Protecting the pensions we secure means we need to take a very long view on managing risk. We also need to ensure that we invest in assets that drive predictable, dependable returns over the long term. In our view, you cannot do this effectively unless you carefully measure and manage the risks associated with ESG principles in your investment portfolio and ensure that your lending is aligned with businesses that will successfully navigate these risks in the future.

We are happy to describe the progress we have made on climate-focused investing, and we're pleased about the feedback we've received so far from a range of stakeholders, but we readily accept there is more to do in the future.

### Do you see your role extending to a kind of societal advocacy of such awareness when investing, or will the activity be a wholly internal one, for you?

We want to hold ourselves to the highest standard possible internally and, as we learn along the way, we are very happy to share our insights. Our business model, and the fact that we manage all our assets in-house, puts us in a strong position to do this and we have also found that investing in our own, purpose-built risk management systems has proved invaluable.

We are clear in our own mind that our whole industry, and the wider financial services community, needs to work together to tackle climate change and where we can champion this in a meaningful way we always will - like joining the UN-convened Net-Zero Asset Owner Alliance.

We also want to support the Government in its efforts to develop low carbon generation and infrastructure, but you've got to bear in mind we are not a venture capital fund and need to make loans that have strong investment-grade creditworthiness. There's a huge opportunity to scale and speed up the UK's net zero plans if we unlock the potential funding pool for green infrastructure from the bulk annuity sector, but it requires some regulatory change and Government support.

Could you guide us on how the decision to invest in a climate-aware way evolved? For instance, did it also involve examining the profile of your liabilities, and how they may evolve over time?

I think in many ways it's been part of the culture of the business since it was founded. We've always been very data-driven in our approach to managing risk and sought as much disclosure as possible. Combine this with the fact that we have very long-dated liabilities, many of which are likely to persist well past 2050, means that climate change has always been part of our thinking.

We aim to match the cashflows of our liabilities by deploying into assets that, once purchased, we hope to hold until maturity and so it is very important to account for climate risk over the long term. Our lending to high carbon intensity sectors with uncertain future emission pathways, like the automotive sector, is therefore relatively limited and we have deliberately restricted ourselves to shorter duration bonds. This could change, though, for companies that have a credible pathway to carbon reduction, for instance a car manufacturer [being] able to effectively switch to electric vehicles.

Our longer duration assets are often secured by real estate, of one kind or another, and an important part of our underwriting and ongoing risk management is climate scenario analysis, in which we assess the possible costliness of damage caused by flooding, or more positive but still material factors, like the cost of complying to new climate legislation.

Many people speak of 'avoiding coal', 'divesting from oil & gas' etc. On the 'negative'/exclusion side, have you instituted a fossil fuel policy? And, to the 'positive', have you found investment opportunities, even that might not otherwise have caught your eye?

We've not currently instituted any blanket voluntary exclusion policies, but there are certainly investments we won't make, and have rejected, on climate grounds. We are very mindful that companies' reactions to climate change are developing rapidly so that within a year a company can go from making no useful disclosure to introducing the beginnings of a credible transition plan, which may include elements that our lending could support.

There have been some interesting new investment opportunities but we would like to see more. We stand ready, for instance, to invest more in green infrastructure, but to do this requires partnership with Government and some changes to our current policy framework.

Ultimately, to protect our policyholders' pensions for the long term, our lending needs to be aligned with businesses that will successfully navigate climate risks in the future and can clearly demonstrate credible pathways to do so. Our portfolio reflects this.

Rothesay is developing its own climate change stress testing capabilities. Was this driven by considerations perhaps akin to having a partial internal mode (PIM) for some of your SCR calculations - such as bespoke models to reflect an individual risk profile? Or did other drivers underlie your decision?

We continue to invest significantly in our own, purpose-built risk management systems and we have found that this has given us a unique opportunity to embed climate change into our stress testing capabilities. The key similarity with a PIM is that within our system it is easy to specify stresses to any financial variables and see how they propagate to all the valuation and capital adequacy measures that we care about. The key difference is that there is no precedent for climate change in the historical data for financial variables that can guide us to a reasonable size of stress. Translating shocks either in climate variables, like sea level, or policy variables, such as a carbon tax rate, into corresponding stresses to financial variables is new territory.

In terms of our approach, so far, to climate stress testing, we have concluded that there is no substitute for carrying out single name credit analysis through a climate lens, trying to uncover a company's greatest climate sensitivities and then constructing scenarios that will cause appropriate stresses to their bond prices. This way we don't accidentally give a bond a clean bill of health because its issuer is not affected by a limited standard set of scenarios. Conversely, we don't waste time assessing irrelevant risks, for instance, trying to calculate potential losses caused by wildfires for a business based somewhere like Edinburgh, where they just don't occur.

Investing in your own stress testing capabilities is really important as, ultimately, to make a meaningful contribution to carbon reduction you need to know where in the portfolio the biggest climate risks are and then be transparent about how, and how frequently, you measure and report them. That's one of the reasons why, along with investing in stress testing, we've also committed to five-year reduction targets on the way to net zero in 2050.

Our CIO webinars on the topic have suggested that climate modelling can sometimes seem a 'practice in development', for investors. What challenges have you faced in developing capabilities in-house, and what 'extra' do you hope to derive from having such capabilities yourself?

I would answer in a similar way to the previous question. One of the expectations that people seem to have of climate change scenario analysis is that it should somehow be incorporated within already extremely complicated physical climate models. In other words, that we ought to be able not only to go from an emissions pathway to predictions for climate variables, like temperature and sea level, but then also have corresponding predictions for GDP, unemployment, FX, inflation, interest rates and even credit spreads and default rates. We are a bit sceptical of the expectation that a model can work usefully on so many scales, hence the approach we have taken to carrying out single name credit analysis through a climate lens.

However, we do want to be able to subject our whole portfolio to a consistent set of stresses and we have engaged Planetrics (formerly Vivid Economics) to help us explore this and develop a model which will provide the most useful information.

In terms of asset types, it appears your analysis has gone well beyond credit and equities, to foreign mortgages, for instance. What remains in your GA, and what might be the 'difficult' assets to fold into your programme?

I don't think any asset is inherently very difficult, it's really about disclosure. It's true that different types of assets are currently providing different levels of data and that there is a difference between assets where we can find the data ourselves and assets where we are more reliant on the issuer.

Some issuers are also only just getting used to the idea that their investors want and need emissions related data from them and are therefore having to do extra work - with differing degrees of reluctance or enthusiasm! European issuers are currently leading the way, but we're seeing positive progress almost across the board.

What are three pieces of key advice you would give to investment managers and CIOs on how they may begin their own path towards climate change-aware investing?

1. Make sure you set meaningful interim targets and report on them regularly - long-term ambitions are important, but there needs to be a credible pathway in which people can see near-term change too.
2. Don't hide behind incomplete data - where it doesn't exist, come up with proactive ways to address this and report on what you can transparently.
3. Integrate responsible investing across not only your whole investment team, but your whole business - at Rothesay all parts of our business are expected and want to contribute to our climate change efforts. Businesses that have an isolated responsible investing team beg the question, 'what is everybody else doing?'