

Green Individual Savings Accounts An Independent Report to the Conservative Party November 2009

Remit of this working group

In a speech to Imperial College London on 27 February 2008, the Shadow Chancellor announced that the Conservative Party would consider introducing Green Individual Savings Accounts, and would launch a technical working group on Green ISAs:

"I can announce for the first time that a Conservative government will look at introducing new Green Individual Savings Accounts, which will enable the public to save more than they currently are allowed tax free, provided these funds are invested only in environmentally friendly companies.

"These Green ISAs – or GISAs – will engage the public in a new way in the issues around climate change – and show them very clearly the economic benefits of green investment.

"And by providing lucrative new sources of that investment, Green ISAs will create a race to the top by incentivising businesses to adopt environmentally friendly policies."

Financing the low carbon transition

When the Conservative Party published its **Low Carbon Economy** paper earlier this year, the UK was facing the most severe economic downturn in decades. We were therefore encouraged to see that the initiatives set out in the paper to tackle climate change, and decarbonise our economy, were being put forward as part of the solution to our economic troubles.

Crucial to the move to a low carbon economy is the principle that economic prosperity and tackling climate change can go hand in hand. Environmental action is about what we can do together; how we can create whole new industries and jobs around a new green technology and the financial structure that will make that happen.

Leadership in financial innovation

A recent report by the Aldersgate Group, **Financing the Transition: A Strategy to Deliver Carbon Targets** argues that a more radical approach to financing low carbon projects is needed to ensure carbon targets are met.

The report found that major reform is required to significantly shift the UK's greenhouse gas emissions trajectory and ensure that over £250 billion of private sector investment flows into the low carbon economy by 2020. The adoption of new financial mechanisms, such as green bonds and a dedicated infrastructure bank, would reduce investor uncertainty and lending costs. Leadership in financial innovation would help cement the City of London's position as the global centre for green and sustainable finance.

The introduction of a Green/Low Carbon ISA could be one such innovation, engaging the public in a new way about the issues around climate change and demonstrating clearly the economic benefits of green investment. Designed to enable the public to save more money than they currently are allowed tax free, if these funds are invested in environmentally-friendly companies, the Green/Low Carbon ISA could be a good example of can-do environmentalism that is good for savers and green companies, as well as for the environment. The Green/Low Carbon ISA could help raise an important contribution to financing the transition to a low carbon economy.

This paper covers the following:

- Current ISA structure
- Proposed Green/Low Carbon ISA structure
- Green/Low Carbon equities
- Green/Low Carbon bonds
- Key recommendations and next steps

Contributors: Emma Howard Boyd (Chair), Sean Kidney, Penny Shepherd and Simon Thomas – please see Appendix 2 for bios.

Current ISA structure

ISAs were introduced on 6 April 1999 replacing the previous regimes of PEPs and TESSAs. They are the primary vehicle for tax-advantaged saving outside pensions. Over 18 million people – around one in three adults – now have an ISA¹. The tax wrapper has been successful in developing and extending the saving habit and ensuring a fairer distribution of tax relief. The value of monies in ISAs is estimated to be more than £220bn. Since 6 April 2008, the ISA limits have been £7,200, up to £3,600 of which can be held in cash with one provider. The remainder can be invested in stocks and shares with either the same or another provider.

It was announced in Budget 2009 that from 6 April 2010, ISA limits for every adult will rise to £10,200, up to £5,100 of which can be saved in cash. This will give over 18 million people the opportunity to increase their tax-advantaged savings and will directly benefit over 5 million individuals who make full use of either their cash limit or their overall investment limit.

Budget 2009 also announced that the Government was taking targeted action to help people aged 50 and over with their savings. On 6 October 2009, the ISA limits were raised to these new levels for people who will be aged 50 and over by 5 April 2010.

The stocks and shares component of an ISA can include:

- shares and corporate bonds issued by companies listed on a recognised stock exchange anywhere in the world
- gilt edged securities ('gilts'), similar securities issued by governments of other countries in the European Economic Area and 'strips' of all these securities
- units or shares in UK authorised unit trusts or open ended investment companies (OEICs) which invest in shares and securities (called securities schemes and warrant schemes) and fund of funds schemes which invest in them
- shares and securities in approved investment trusts (except property investment trusts)
- units or shares in Undertakings for Collective Investment in Transferable Securities (UCITS) funds based elsewhere in the European Union (these are similar to the UK authorised unit trusts and OEICs listed above)
- any shares which have been transferred from an HMRC approved all-employee scheme under the special rules
- after 5 April 2005, life insurance policies that would previously have qualified for the separate life insurance ISA component
- after 5 April 2005, stakeholder medium-term products.

The estimated cost to the Treasury of raising the ISA limits stands at £60m in 2011/12, a comparatively low sum, while offering an additional boost to savers.²

¹ http://www.england-legislation.hms.gov.uk/si/si2009/em/uksem_20091550_en.pdf.

² http://www.hm-treasury.gov.uk/d/bud09_chaptera_307.pdf, page 152.

Proposed Green/Low Carbon ISA structure

The working assumption is that any future tax-free savings limit increase would be exclusively for Green/Low Carbon ISAs.

This paper looks at asset classes that would typically fall into the **stocks and shares component** – in particular, funds that invest in **green/low carbon solutions companies** – often called clean/ green technology funds or climate change funds – and funds that invest in companies that are **reducing their carbon profile** - low carbon funds. For both types of companies, funds are available which are either **actively managed** (where the fund manager makes specific investments with the goal of outperforming an investment benchmark index), or **passively managed**, (where the fund replicates as closely as possible the investment weighting and returns of that index).

Subject to environmental interests, collective investment funds such as unit trusts and oeics are available in over a dozen of the investment sectors classified by the Investment Management Association. Also, exchange traded funds (ETFs) are available to track some green/low carbon indexes. For example, there are ETFs for clean energy companies, water-related businesses and large companies with low carbon emissions compared with others in their industry sector.

However, it should be noted that earlier this year HSBC launched an innovative Vaccine Investment ISA.³ This was the first of its kind in the UK and came about because of changes to the ISA regulations which allowed institutions who receive contributions for international humanitarian development projects to issue bonds and other securities that are now capable of being held within an ISA.

There are a number of different types of policy instruments currently being proposed called green bonds, carbon bonds or climate bonds, but in essence they are all providing ways of using the structure of government and private sector debt in order to stimulate additional investment in low carbon technologies and infrastructure.

We recommend that as more details of these instruments become available, research is carried out to ensure that the ISA regulations allow these instruments to be held within a Green/Low Carbon ISA.

Costings

Based on Treasury figures, it is reasonable to assume that a £3,000 increase in the tax-free saving limit would cost less than £50 million.

Based on Treasury figures, it is reasonable to assume that a £5,000 increase in the tax-free saving limit would cost less than £70 million.

Minimising the regulator burden

Many ISA providers give individuals the option to contribute on a monthly basis. As such it is advisable that the size of increase in the tax-free saving limit is easily divisible by 12 to minimise administrative costs to ISA providers.

³ <http://www.hsbc.co.uk/1/2/vaccine>.

Green/Low Carbon equities

For the purposes of this paper we have described two broad approaches to green/low carbon equity investment:

- investment in green/low carbon solutions companies – clean/green technology funds
- investment in companies that are reducing their carbon profile – low carbon funds

- **investment in green/low carbon solutions companies – clean/green technology funds**

These funds seek to invest in companies that have developed or plan to develop new technologies that could provide less carbon intensive (or environmentally intensive) substitutes for the goods or services currently produced by conventional technology.

The investment universe is currently seeing unparalleled support from governments around the world, both in terms of regulation and budget allocation. We have seen US\$510 billion pledged to the green investment area in the recent stimulus packages; this will have a direct impact on the investment universe.⁴ The HSBC Climate Change Index annual review indicated that total 2008 revenues of climate change-related businesses grew by 75% to US\$530bn and is expected to reach \$2 trillion by 2020.⁵

However, the companies that these funds invest in may be small and relatively illiquid because they are by definition at an early stage of development and often have promising but unproven technology. Whether they are suitable for all ISA investors will depend on individual risk appetite. In other words, these funds are probably not suitable for “widows and orphans”.

Some funds in this category seek to mitigate this risk by buying larger companies with promising clean technology subsidiaries or business units. A consensus is emerging that a suitable cut-off for a company’s inclusion in these ‘clean’ investment funds or indices is that 25% of company revenues should be derived from a qualifying ‘clean’ activity as defined by the index providers (although the HSBC Climate Change Index uses a cut-off of 10% of turnover for companies to be eligible).

Funds may use active stock-picking or track a specialist index. For example, in 2009, FTSE, the index provider, published an environmental markets classification system and a range of indices based on it to enable investors to identify and classify different types of environmental markets stocks.⁶

- **investment in companies that are reducing their carbon profile – low carbon funds**

These funds are sector diversified but invest more (or exclusively) in companies that are performing better than their sector peers. These funds will tend to own oil and gas companies but favour more environmentally/carbon efficient companies. This might mean picking the mining or energy company with the lowest carbon emissions or the commercial property investment that uses the least energy.

Passively managed low carbon index portfolios mirror the sector weightings of the underlying or parent benchmark such as the FTSE 350 or MSCI Europe, but rebalance the companies within sectors by overweighting less carbon intensive companies and underweighting more carbon intensive companies relative to the average intensity of the sector. No companies that are held in the parent index are necessarily excluded from the low carbon version; less carbon efficient companies are just underrepresented in the index. As the low carbon portfolio holds the same companies as the benchmark and is sector neutral, tracking error against the benchmark is very low (+/-0.5% per annum). However the carbon footprint of the optimised portfolio is typically 25-45% lower than the benchmark.⁷

Funds constructed in this way are considered well positioned to benefit from regulations that seek to control carbon emissions or that increase the cost of carbon emissions through carbon pricing, without sacrificing financial performance. These investment strategies also encourage and reward efficiency among the companies in which they invest.

⁴ *A Global Green Recovery? Yes, but in 2010*. HSBC research, 6th August 2009.

⁵ *Climate Change – September 2008 annual index review – from environmental challenge to economic opportunity*. HSBC research 17 September 2008, page 10.

⁶ www.ftse.com/Indices/FTSE_Environmental_Markets_Index_Series/Downloads/FTSE_Environmental_Markets_Classification_System.pdf.

⁷ www.trucost.com/pressreleases/CarbonRisksinUKEquityFunds.html, page 23.

Green/Low Carbon bonds

There are a number of different types of policy instrument currently being proposed called green bonds, carbon bonds or climate bonds. In essence they are all providing ways of using the structure of government and private sector debt in order to stimulate additional investment in low carbon technologies and infrastructure.

We see climate or green bonds as asset-backed bonds, collateralised against a portfolio of renewable energy or energy efficiency investments. For example, significant capital will be needed for energy efficient upgrades to existing housing and other property, and for low carbon infrastructure like smart electricity grids and charging points for electric cars. This may result in governments and companies issuing bonds either directly to private investors or to fund managers who may then offer fixed income climate change funds.

Green or climate bond options include:

- Zero-coupon bonds that pay out a guaranteed rate upon maturity
- Bonds paying a basic rate, with an upside indexed to carbon prices
- Sukuk or Islamic bonds, which are Sharia-compliant and suitable for Islamic investors
- Retail bonds, designed to provide small investors with an opportunity to both support climate change mitigation and invest their savings in lower risk instruments.

Bonds could be issued by governments, by off-balance sheet green investment banks, or even by corporations, possibly on the back of government purchase contracts such as feed-in tariffs.

The bulk of investors would be institutional, but there could be great political benefit in issuing retail bonds, along with a major marketing campaign: "Invest in Britain's Clean Energy Transition". Retail bonds could be regional in focus, such as "Welsh Wind Bonds" or "Birmingham Going Zero-Carbon Bonds".

The development of climate bonds would seed a new and important role for the City - financing the global transition to a low-carbon economy.

Key recommendations/Next Steps

Expert advisory committee

In order to encourage innovation, and to ensure that no particular form of green/low carbon investment is favoured over another at this stage in their development, we propose that the criteria for eligibility of a potential fund should be devised and governed by an expert advisory committee.

The panel should be composed of individuals that are capable of representing the different investment approaches, with an independent chair. It is proposed that this could be done under the aegis of a well established and carefully governed body such as UKSIF, the sustainable investment and finance association.

Accreditation

Funds or indices (on which for example exchange traded funds may be based) that are seeking accreditation should be required to provide information on the investment strategies that they seek to pursue. This could include:

- A description of the strategy
- A description of how the fund expects to benefit from the transition to a low carbon economy and how it expects to contribute to this
- The suitability of these funds for different investors (age, risk appetite etc)
- The anticipated tracking error compared to benchmark indices.

New instruments

We also recommend that as more details of new instruments become available, such as green/low carbon bonds, research is carried out to ensure that the ISA regulations allow these instruments to be held within a Green/Low Carbon ISA.

Appendix 1

Carbon disclosure in UK Listed Companies – current position

On 29 October 2009, the Accounting Standards Board (ASB) published a review of narrative reporting by UK listed companies in 2008/2009 (the review). The review examines how companies complied with the enhanced business review requirements in section 417 of the Companies Act 2006 (see Legal update, Environmental provisions in Companies Act 2006: Section 417).

A significant proportion (32%) of companies had not complied with the requirements in section 417 to use non-financial key performance indicators (KPIs) where appropriate. There is no evidence of significant improvement from a previous report in 2006. In January 2006, the Department for Environment, Food and Rural Affairs (Defra) published a set of guidelines that provide guidance for companies on how to report on their environmental performance using KPIs (see Environmental Key Performance Indicators: Reporting Guidelines for UK Businesses). The Defra guidelines define which KPIs are most relevant to which business sectors, and can be used in any type of corporate report, including business reviews under the Companies Act 2006.

In September 2009, Defra and the Department of Climate Change and Energy published guidance for companies and other organisations on how to measure and report on their greenhouse gas (GHG) emissions (see Legal update, Government publishes guidance on corporate reporting under the Climate Change Act 2008).

The Climate Change Act 2008 requires the Government to publish this guidance and:

- By 1 December 2010: review the contribution that GHG reporting is making to the achievement of the Government's climate change objectives, and report on this to Parliament.
- By 6 April 2012:
 - either make regulations under section 416(4) of the Companies Act 2006, requiring directors' reports to contain certain specified information about GHG emissions from activities for which a company is responsible; or
 - lay a report before Parliament explaining why no such regulations have been made.

Although the guidance on GHG reporting that was published in September 2009 is still only voluntary, companies required under the Companies Act 2006 to report on environmental matters in their business reviews are encouraged to follow this guidance in order to promote greater transparency and consistency in carbon reporting.

According to the latest Carbon Disclosure Project report (June 2009) only 55% of FTSE350 companies disclose carbon emissions.⁸ This demonstrates that voluntary disclosure is still at a sub-optimal level even among the UK's largest companies.

⁸ www.cdproject.net/CDPResults/CDP%202009%20FTSE%20350%20Report.pdf, page 8.

Appendix 2 Contributors

Emma Howard Boyd

Emma has been actively involved in socially responsible investment (SRI) since joining Jupiter Asset Management in 1994. As a Director and Head of SRI & Governance, Emma has overall responsibility for the management and development of Jupiter's Sustainable Investment business. She is also responsible for Jupiter's corporate governance and engagement services for institutional clients and Jupiter's retail funds. Emma has recently been appointed an independent non-executive director of the Environment Agency, is a former Chair of UKSIF, the sustainable investment and finance association, and was a member of the UK Government's Commission on Environmental Markets and Economic Performance, which reported in November 2007.

She is a faculty member of the Cambridge Programme for Sustainable Leadership and a director of the Triodos Renewables plc.

Sean Kidney

Sean is the convenor of the Climate Bonds Initiative (CBI), a project of the Carbon Disclosure Project and the Network for Sustainable Financial Markets. The CBI is promoting financial models for a rapid global transition to a low carbon economy. Sean is also Europe Manager for advisory firm Climate Risk Ltd, with clients ranging from Zurich Insurance to the Kuwaiti Petroleum Corporation and WWF. He is also a board member of Greenpeace Australia and of online business services company Cleardocs UK.

Penny Shepherd MBE

Penny Shepherd is Chief Executive of UKSIF, the sustainable investment and finance association. She is also a lay member of the Professional Regulation Committee of the Actuarial Profession and a former member of the London Sustainable Development Commission. She received an MBE in 2000 for "services to sustainable economic development and socially responsible investment".

Penny has over thirty years of experience working with financial services, including over fifteen years on sustainability and responsibility issues. Prior to joining UKSIF as Chief Executive in 2005, she was the first Chief Executive of the London Sustainability Exchange. At the start of her career, she spent twenty years in the computer industry, advising financial services and other companies on business solutions.

UKSIF promotes responsible investment and other forms of finance that support sustainable economic development, enhance quality of life and safeguard the environment. Founded in 1991, it has over 200 members including financial advisers, asset managers, research providers, pension funds, banks and nongovernmental organisations.

Simon Thomas

Simon Thomas is Chief Executive of Trucost Plc an environmental data company founded in January 2000. He has overseen the development of Trucost's methodology by its research team, with the support of an International Advisory Panel of leading academics in the fields of economics and the environment.

Simon is a regular commentator on the quantification of environmental impacts, reporting and analysis, and he frequently addresses the investment and corporate community on SRI and CSR-related issues. Trucost has undertaken research projects on behalf of the Department for Environment, Food & Rural Affairs, the Environment Agency, the Carbon Disclosure Project and many leading financial institutions worldwide.

Simon has 28 years senior business experience, previously working in the publishing and finance sectors.

Whilst this paper represents the views of the contributors, it does not necessarily represent the views of their organisations.

Appendix 3

Changing climate shifts ethical investors (Personal Finance FT Weekend – Nov 13 2009)

<http://www.ft.com/cms/s/2/15d6d8b6-d07e-11de-af9c-00144feabdc0.html>

Climate change funds, once dismissed as “gimmicky”, have been quietly out-performing the market, according to a new report. They have been helped by their exposure to energy stocks and defensive utility companies as governments increase spending on alternative energy and infrastructure to combat climate change. Holden & Partners, the ethical financial advisers, published data this week showing that climate change funds have outperformed the MSCI world index over two and three years, with some – such as Schroders Global Climate Change and F&C Climate Opportunities – outperforming over one year as well.

Over these periods, ethical investment strategies have undergone a subtle shift. Whereas the focus used to be on “screening” stocks to filter out those that invest in sectors such as tobacco or armaments, “positive” screening for companies that are combatting climate change has come to the fore. Most specialist climate change funds do not describe themselves as ethical – though they are likely to appeal to ethical investors. Managers of these funds say that there is a strong investment case for climate change technologies.

“There has been a strong development of the climate change sector despite the [financial] crisis, which has been a positive – in Asia, there have been subsidies and initiatives we haven’t seen before,” says Bruce Jenkyn-Jones, investment director at Impax Asset Management, the environmental specialist. He says valuations on renewable energy stocks, which had fallen as the sector found it hard to get funding, are looking very attractive. Energy efficiency stocks – such as insulating for buildings – have done well this year as projects have been able to get off the ground again. Climate change funds therefore outperformed conventional ethical “screening” funds, many of which had large holdings in bank stocks, which harmed their performance in 2008.

Ethical funds also tend to have a UK bias, while climate change funds take a more international approach. This has allowed them to benefit from the weakness of sterling, as well as to diversify into markets such as China, which is competing with the US to be a major producer of solar and wind energy. Some climate change funds struggle with volatility, however. Energy stocks are correlated to the oil price, while the paucity of bank funding has meant that many wind and solar projects have been put on hold. Nicola Donnelly, a fund manager at WHEB Asset Management, says one way to cope with volatility is to broaden beyond energy stocks to other climate change themes, such as water access and demographics. She is investing in Eaga Insulation, a UK company that advises low-income households on insulating their homes.

In fact, several climate change funds play a range of different themes, such as healthcare and agriculture. Schroders’ fund, the best performing climate change fund in the past year, has a large holding in Tesco. However, retail investors have yet to catch on to climate change. In spite of its strong performance in the past year, the Schroder Climate Change fund has less than £21m in assets under management.

“The retail investor is not getting this and I think they’re going to miss out,” warns Mark Hoskin at Holden & Partners, who says much of the interest is coming from institutions.

One reason could be that climate change funds pay little income – an average of 1 per cent a year. But, this could be set to change, with the introduction of a multi-asset climate change fund from Cheviot Asset Management. It’s the first of its kind and is expected to pay a yield of 3 per cent.

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