

PRI'S RESPONSE TO THE UK PARLIAMENT ENVIROMENT AUDIT COMMITTEE: GREEN FINANCE INQUIRY

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United Nations
Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The United-Nations Principle for Responsible Investment (PRI) is the world's largest investor network on sustainable investment. The PRI has over 1800 signatories (pension funds, insurers, asset managers and service providers) globally with approximately US \$70 trillion in assets under management. Over 250 of these signatories are based in the UK¹.

In addition to investors, PRI also provides technical advice to governments on responsible investing guidance and regulation. PRI is a member of the EU High Level Expert Group and the UK Green Finance Taskforce. The PRI's Chair serves on the FSB Task Force in a personal capacity and PRI has actively contributed to development of the FSB Task Force's recommendations. This response represents the views of the PRI executive.

ABOUT THE INQUIRY

The Environmental Audit Committee launches a Green Finance inquiry to scrutinise the Government's strategy to develop 'world leading Green Finance capabilities'.

The inquiry will examine

- the measures set out in the Clean Growth Strategy;
- whether the Green Investment Group, formerly the Green Investment Bank, is fulfilling commitments made by its new owners Macquarie;
- the UK's future relationship with the European Investment Bank;
- how company reporting on climate liabilities and risks could be encouraged;
- whether the Government's policies are likely to deliver the levels of investment needed to meet the UK's national and international environmental commitments

¹See <https://www.unpri.org/signatory-directory/>

SUMMARY OF PRI'S POSITION

PRI warmly welcomes the UK Parliament Environmental Audit Committee Inquiry into green finance. The emergence of a global green bond market and a partnership between Bank of England and Peoples Bank of China at the G20 has put, for the first time, green finance on the agenda of finance ministries and central banks around the world. This has connected the long-separated agendas of the stability of the financial system and the sustainability of our environment.

Yet, joining the dots is only the first stage. Demand for green finance remains insufficient, with an estimated \$2-3 tr per annum funding gap² between current spend and what is needed to deliver the Sustainable Development Goals and climate goals. The UK green finance taskforce and EAC's inquiry is an opportunity leverage capital markets to support the delivery of UK policy goals and consolidate UK leadership in developing new green financial markets.

In order to capitalise on this opportunity and better align financial markets with the UK's carbon reduction and green finance objectives, PRI recommends measures on:

- 1) **Fiduciary duty.** Strengthen fiduciary duty provisions on climate risk and ESG to encourage long term investing and provide an alternative means of monitoring performance in the investment chain. Specific interventions include:
 - The Department of Work and Pensions should amend the Investment Regulations to clarify that fiduciary duty requires them to pay attention to long-term factors (including climate change and ESG factors) in their decision-making, and in the decision-making of their agents.
 - The Financial Reporting Council should extend the stewardship code to include explicit reference to ESG factors as part of its biennial review process.
 - The Financial Conduct Authority should strengthen Conduct of Business Rule 2.2.3 from requiring an investor to state the nature of its commitment to the Stewardship Code to a report or explain requirement against the Code.
 - Monitor developments in European law on duties of investors and align UK regulation in order to make it explicit that incorporating ESG into investment long term investment practices is part of fiduciary duty.
- 2) **Bring TCFD into the UK framework through a two-step process,** the UK should explicitly clarify that where climate is identified as a material risk, it should be included within companies' annual reports, based on international good practice such as the TCFD framework. Implementation of TCFD could be achieved through a two-step process: the UK Government and regulators create guidance and then integrate this into the corpus of relevant UK rules and codes.

² Mckinsey & Co "Financing change: how to mobilise private sector financing for sustainable infrastructure" January 2016.

3) Policy framework. Provide further details of the policy mechanisms that will deliver the Clean Growth Strategy, increase scale of opportunities for institutional investors and develop a pipeline of green infrastructure projects. Including:

- National green infrastructure centre. The government creates a specialised centre to bring together investors, banks, public authorities and project developers and build a catalogue of investable opportunities, in a transparent and easily comparable format.

In addition, we note that some financial institutions³ and industry bodies⁴ have called for the following policy measures and we believe that these should be examined by the government as possible solutions

- A new risk reduction mechanism for green infrastructure investing. Following the sale of the Green Investment Bank, how will the UK address construction risk on green infrastructure projects. Options include a long dated UK guild (sovereign green bond) the proceeds of which would be used to cover construction risk for infrastructure needed to deliver the Clean Growth Strategy. Or, a commitment to introduce long term Power Purchase Agreements for “subsidy free” renewables.
- Establish a regular timetable for low-carbon energy project auctions.
- Fast track planning development permissions of renewables on public land to increase deal flow.
- Align the tax status of infrastructure with that of real estate, where income from direct pension fund investment in non-residential property is tax exempt.
- Better align the capacity market with the Clean Growth Plan. Increase the allocation toward non-fossil back up generation.
- Clarify the UK’s carbon price beyond 2021.

4) Innovation. Develop public private sector fund (or funds) to replace the anticipated loss of the European Investment Fund when the UK leaves the EU.

5) Align with developments in Europe: Seek an early implementation of relevant EU sustainable finance recommendations flowing from the EU HLEG on sustainable finance, including on green taxonomy and investor duties, in the interests of maintaining competitiveness

³ “The Renewable Energy Infrastructure Investment Opportunity for UK Pension Funds” by Helene Winch, Senior Responsible Investment Specialist, HSBC Asset Management Group, and Gerard Wynn, Energy Finance Consultant, IEEFA, for the City of London Green Finance Initiative.

⁴ “Briefing: Emission reduction plan and low carbon investment”, The Aldersgate Group, November 2016

Further to this submission, PRI would be happy to present evidence in person to the Environment Audit Committee green finance inquiry.

How can the structure of incentives across the investment chain be changed to promote long-term sustainable development?

Capital markets can be better aligned with sustainable development goals by addressing barriers and dis-incentives that are holding back the flow of capital into green investments.

Barriers to increasing investor demand

- The **structure of public equity markets** which favour established incumbent companies who have a track record of delivering returns for investors and whose shares or related financial products are highly liquid (i.e. can easily be bought or sold).
- **Principal agent problems in the investment chain.** Investing is often undertaken under principal (asset owner) – agent (asset manager) arrangements, typically involving multiple layers of delegation. Problems arise from differences in principal and agent investment time horizons, information asymmetries (where the agents are better informed than the principals) and the tendency of asset owners to monitor and reward based on short term results. As a consequence, long term investing is more difficult to pursue.
- Related to this is the **short termism in financial markets**, the tendency to underinvest in physical assets, technology innovation, product development, employees skills or new fundamental operational capabilities in preference for nearer term gains from financial products, financial re-engineering, mergers and acquisitions or restructuring.
- **Lack of publicly available information** about companies' exposure to climate and environmental risks. This information failure means investor may lack awareness and the means to make informed investment decisions on climate change.
- **Investor capacity.** Few institutional investors have the experience, internal capability or established investment channels that allow them to interpret risks and opportunities associated with clean industry opportunities and invest in them at relatively low transaction cost. As a result, the price of institutional capital for clean investment is too rarely tested as due diligence and transaction costs are usually higher than those of alternative investment opportunities. Investors will usually seek additional returns to cover risks they do not fully understand. Further few investors treat environmental or social trends as factors for prioritising their investment allocations.
- **Insufficient scale.** Clean investment opportunities may be relatively small in financial terms compared to the large-scale investment model of institutional investors and pass under their opportunity radar. This is also an area of potential intervention to influence the availability of institutional capital.
- **Perceptions of green investing** as being concessionary, sub-commercial, finance. Whilst this is changing, thanks to growing market experience of renewables which once

built offer low risk and stable cash flows [source] and global green bond market, the negative perception of green still lingers for some investors.

These barriers are common to financial markets beyond the UK and have wider social implications beyond green investing. In addition, there are also **UK specific barriers**:

- **The fragmented nature of the UK pension sector.** Despite being home to one of the world's largest asset management hubs, the UK has only one pension fund in the global top 50 funds ranked by Wills Towers Watson⁵ [source]. The absence of scale exacerbates principal – agent problems and the capacity of UK asset owners to invest in physical assets like green infrastructure. By international standards, **UK pension funds are underinvested in domestic infrastructure**. A recent report for the City of London on UK green infrastructure found that UK-based defined benefit pension schemes allocate less than 2% of assets under management to infrastructure, compared with up to 5-10% at large pension schemes in other OECD countries⁶.

The consolidation of the 89 local government pensions funds into eight pools is an opportunity to catch up and double the allocation of infrastructure investing, estimated to be the equivalent of an additional £8 billion over the next five years⁷.

- **Development risks and fees.** Accessing clean investment opportunities, which usually require additional investment expertise in funds management, leads to increased investment management costs and fees. This is a particular challenge for UK defined contribution schemes as they are subject to a charge cap of 0.75%. Additional fees can make clean opportunity funds less accessible relative to larger scale, lower cost investment opportunities.
- **Liquidity constraints of UK DC investors.** Defined Contribution (DC) pension schemes are not required to trade daily, but operational requirements are such that offering the ability to liquidate a beneficiary position meant that it is often needed. This makes it more difficult to invest in illiquid assets like non-listed infrastructure. It is not obvious how to resolve this liquidity constraint without requiring customers to accept trade-offs in terms of the availability of funds.
- **UK planning regulation.** The UK prohibits onshore wind projects and excludes solar power from clean power auctions. Moreover, some investors report application process for investments that are permitted has doubled over the past 3-4 years, which in turn

⁵ Willis Tower Watson “The World’s Largest Pension Funds – year ended 2016”
<https://www.willistowerswatson.com/en/insights/2017/09/The-worlds-300-largest-pension-funds-year-ended-2016>

⁶ “The Renewable Energy Infrastructure Investment Opportunity for UK Pension Funds” by Helene Winch, Senior Responsible Investment Specialist, HSBC Asset Management Group, and Gerard Wynn, Energy Finance Consultant, IEEFA, for the City of London Green Finance Initiative. <http://greenfinanceinitiative.org/>

⁷ Op cit.

impacts directly on the cost of capital for green infrastructure⁸. Investors⁹ also report that Ofgem can demonstrate inflexibility planning applications. Deadlines missed by a matter of minutes can take 6 months to review applications.

- **First loss risk on infrastructure projects.** There is a tension between governments', which want investment new infrastructure projects, and investors interests', which want to invest in low risk and already established projects. Reducing or removing first lost risk on infrastructure projects is key to attracting private sector capital. However, following the sale of the UK Green Investment Bank it is not clear what the mechanism will be in the UK for achieving this.

Solutions

Options for partly addressing these entrenched barriers include:

Fiduciary duty. Strengthen fiduciary duty provisions on climate risk and ESG to encourage long term investing and provide an alternative means of monitoring performance in the investment chain. Specific interventions include:

- The Department of Work and Pensions should amend the Investment Regulations to clarify that fiduciary duty requires them to pay attention to long-term factors (including climate change and ESG factors) in their decision-making, and in the decision-making of their agents.
- The Financial Reporting Council should extend the stewardship code to include explicit reference to ESG factors as part of its biennial review process.
- The Financial Conduct Authority should strengthen Conduct of Business Rule 2.2.3 from requiring an investor to state the nature of its commitment to the Stewardship Code to a report or explain requirement against the Code.

Improve the access and availability of market information about climate risks. the UK should explicitly clarify that where climate is identified as a material risk, it should be included within companies' annual reports, based on international good practice such as the TCFD framework. Implementation of TCFD could be achieved through a two-step process: the UK Government and regulators create guidance and then integrate this into the corpus of relevant UK rules and codes.

Policy framework. Remove barriers and strengthen the institutional enabling environment for developing green finance in the UK. Recommendations include:

- National green infrastructure plan. The government creates a specialised centre to bring together investors, banks, public authorities and project developers and build a catalogue of investable opportunities, in a transparent and easily comparable format.

⁸ Private feedback from PRI signatories.

⁹ Private feedback from PRI singatories

In addition, we note that some financial institutions¹⁰ and industry bodies¹¹ have called for the following policy measures and we believe that these should be examined by the government as possible solutions.

- A risk reduction mechanism for green infrastructure investing. A new mechanism to reduce construction risk from green infrastructure investing. Options include a long dated UK gilt (sovereign green bond) the proceeds of which would be used to cover construction risk for infrastructure needed to deliver the Clean Growth Strategy. Or, a commitment to introduce long term Power Purchase Agreements for “subsidy free” renewables.
- Fast track planning development permissions of renewables on public land to increase deal flow.
- Align the tax status of infrastructure with that of real estate, where income from direct pension fund investment in non-residential property is tax exempt.

In addition, the PRI has a dedicated Sustainable Financial System¹² programme to addressing financial system barriers listed above. The programme focuses on solutions to obstacles within market practices, structures and regulation - in doing so, the programme aims to align the financial system with sustainable, equitable economies.

Is the Government’s level of ambition on green finance - and the mechanisms it sets out in the Clean Growth Strategy – sufficient to generate the investment needed for the UK to meet its environmental commitments?

PRI warmly welcomes the tone and ambition in the UK’s Clean Growth Strategy (CGS). Both are important for investor confidence and consolidating the UK’s position as a leader in clean growth. The CGS and the Autumn Statement also introduced new policy proposals which close important policy gaps, such as a new £400m EV charging infrastructure fund. Yet, outstanding issues remain. Notably on:

- The absence of a regular timetable for auctioning of low-power contracts. The schedule for the next £557 million Contracts for Differences (CfDs) is pencilled in for March 2019. If this was split into two or three well-spaced auctions it would provide investors in the UK wind sector with some much needed certainty in the medium term, especially in light of the Chancellor’s low-carbon subsidy moratorium until 2025, beyond the funds that have already committed.
- Government support for long term Power Purchasing Agreements for “subsidy free” renewables – which would guarantee an inflation linked price at a level below the

¹⁰ “The Renewable Energy Infrastructure Investment Opportunity for UK Pension Funds” by Helene Winch, Senior Responsible Investment Specialist, HSBC Asset Management Group, and Gerard Wynn, Energy Finance Consultant, IEEFA, for the City of London Green Finance Initiative.

¹¹ “Briefing: Emission reduction plan and low carbon investment”, The Aldersgate Group, November 2016

¹² Further information on this is available here <https://www.unpri.org/about/pri-teams/sustainable-financial-system>

wholesale rate. Analysis by Baringa Partners and BEIS' own projections show that onshore & offshore wind and solar could be close to being subsidy free by the early to mid-2020s¹³. As of yet, however, there is no explicit indication that the government would support subsidy free schemes.

- The absence of a clear commitment to the UK's carbon price floor beyond 2021.

In addition, as the former CEO of Centrica has pointed out the perverse incentives¹⁴ in taxing coal and gas power generation through the carbon price floor and then subsidising their thermal plants continued operation through the UK's capacity markets. This mechanism also allows diesel generators to bid as "demand response providers", despite being heavily polluting form of electricity generation. The capacity markets were designed to help bridge the gap between the introduction of variable renewables and affordable energy storage, yet a review how it could better align with the Clean Growth Plan and promote new clean energy solutions is recommended.

How will leaving the EU affect the UK's ability to leverage investment into low-carbon and environmentally friendly projects in the UK?

In addition to the European Investment Bank, the European Investment Fund (EIF) has been one of the largest investors in early stage UK technology and innovation. It has invested £500m across the UK, £100m of which in clean tech. The EIF is the largest cornerstone investor in Europe and the UK. As result, once the UK leaves the EU and no longer has access to the EIF, there is a risk of a hiatus in venture capital funding in the UK, the impact of this could ripple out across the wider economy. Fewer venture capital funds would translate into fewer home grown tech companies and jobs in the UK. The City may remain a financial centre, but it could be financing fewer British venture backed companies.

The CGS announced £20m of government funding for early stage technology and innovation. Developing this into a new mechanism that would replace the loss of EIF funding is highly recommended.

Given the work being carried out by the EU's High Level Expert Group on Sustainable Finance, where should the UK's newly created Green Finance Taskforce concentrate its efforts?

The scope of the two initiative differ slightly. The UK taskforce aims to develop policy recommendations that would deliver climate outcomes (fund the Clean Growth Strategy) and boost the competitiveness of the City. The EU HLEG also considers the social and governance (S and G of ESG) measures and is concerned with the sustainability of the financial system. That said, PRI does recommend that the UK consider:

¹³ Reported in Carbon Brief "Analysis: UK auction reveals offshore wind to be cheaper than new gas" 11th September 2017.

¹⁴ Reported in the Telegraph "Britain's Energy Paradox" 23rd October 2014

- Aligning where there is clear overlap, such as on the proposals to make climate risk and ESG factors explicit in EU wide regulation on fiduciary duty, for example. In addition the UK could consider endorsing HLEG's sustainable finance taxonomy. This would better position the City in the growth of a pan – EU green financial markets.
- Accelerated implementation of relevant EU HLEG recommendations. Assuming the European Commission endorses the final recommendations when they are published early this year, it could then take 18 months for commencement of EU wide legislations (the length of time require depends on the degree of alignment between Member States, the European Commission and the European Parliament). This gives the UK a window of opportunity to consolidate its leading position on green finance and move first to implement relevant EU recommendations.
- In addition, the UK government could also consider a formal response to the EU HLEG.

How effective are the Task Force on Climate-related Financial Disclosures' (TCFD) recommendations likely to be at moving investment into 'clean' sectors?

TCFD does not set out to shift capital allocations, but rather provide better information about the risk and opportunities of a changing climate for companies and investor portfolios. Whilst how this information is interpreted could have implications for investment decisions, this would be up to the market to determine, it is not the purpose of the recommendations and as a result a direct answer to this question is difficult to quantify.

The Government has said it will 'encourage' publicly-listed companies to adopt the TCFD's recommendations on climate risk disclosure. How could it do this? Is a voluntary approach sufficient?

The UK should explicitly clarify that where climate is identified as a material risk, it should be included within companies' annual reports, based on international good practice such as the TCFD framework. Implementing TCFD in the UK, could be achieved by:

- New TCFD guidance is published jointly by the UK Government and relevant regulators (e.g. Bank of England, Prudential Regulation Authority, Financial Conduct Authority, Financial Reporting Council, the Pensions Regulator).
- This guidance would then be properly integrated into, and referenced in, the corpus of relevant UK rules and codes such as listing rules, prospectus rules, corporate governance code, and stewardship code.