UKSIF
UK Sustainable Investment and Finance Association

11 April 2017

Rt Hon Greg Clark
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London, SW1H 0ET

Dear Secretary of State,

I am writing in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association (UKSIF) in relation to your industrial strategy green paper. This response is meant to provide some context for the importance of rules and regulations which promote long-term investment by asset owners and others in the investment chain. As such we responded to questions relevant to that aim.

14. How can we enable and encourage people to retrain and upskill throughout their working lives, particularly in places where industries are changing or declining? Are there particular sectors where this could be appropriate?

As North Sea oil and gas production enters the final phase of its life, it is essential the Government looks at ways in which it can support people who will face inevitable job losses. In the spring budget statement the Chancellor announced a new discussion paper to examine how tax relief might be used to support oil and gas fields. It is essential the Government starts to consider – as early as possible – ways in which it can mitigate the impact of the sector's decline and support an increase in green infrastructure. Ways in which this would benefit the UK include:

- An increase in renewable energy generation capacity;
- Support for commitments made in the Climate Change Act and the Paris Agreement;
- Softening the blow to local communities currently dependent on North Sea oil and gas fields through new investment and the creation of new jobs.

We note that, given renewables and energy efficiency are more labour intensive than fossil fuel power generation, they have the potential to create more jobs over the short-term. Currently 1.7% of all paid employment in the EU is linked to the 'green' sector.[1] There will doubtless be additional opportunities stemming from the decommissioning of the North Sea.

15. Are there further actions we could take to support private investment in infrastructure?

Infrastructure is a particularly attractive prospect for UK pension funds. In addition to increased portfolio diversification it enables schemes to match their long-term liabilities. UKSIF has recently engaged with members on infrastructure investment which formed a significant part of our response to a recent Law Commission consultation.[2] One member described infrastructure as an appealing asset class provided it was "cheap and relatively easy" but noted this was rarely the case so most DC schemes would struggle to invest. Currently only the biggest DB schemes are able to do so. This

[1] UK Energy Research Council, *Low carbon jobs: The evidence for net job creation from policy support for energy efficiency and renewable energy*, 2014 available at http://www.ukerc.ac.uk/publications/low-carbon-jobs-the-evidence-for-net-job-creation-from-policy-support-for-energy-efficiency-and-renewable-energy.html
[2] UKSIF response to the Law Commission inquiry into social investment and pensions, 2016 available at http://uksif.org/wp-content/uploads/2017/01/UKSIF-response-to-LC-consultation-on-DC-pension-funds-and-social-investments.pdf

includes schemes like USS, an UKSIF member, which considers infrastructure a good investment proposition as it can provide inflation-linked, steady cash flows over a long time horizon, which match USS's long-term liabilities.[3]

Despite the benefits of infrastructure as an asset class for pension schemes, UKSIF member feedback emphasised several obstacles for pension schemes looking to invest. A lack of knowledge and experience in-house and on trustee boards as well as the small size of most funds (particularly DC) present two clear issues which can and should be addressed. Lessons may be learnt from the approach being taken by the Local Government Pension Scheme (LGPS).

First, LGPS schemes have recently been required to pool assets to save on costs and to enable them to invest in infrastructure more easily. Benefits of scale mean infrastructure is more attractive as an investible asset and this is evidenced in countries with bigger fund pools. For example, in Australia the pensions market is characterised by large superannuation funds, and schemes will typically have around 8-15% infrastructure exposure. This compares to average UK scheme exposure at around 1%.[4] The Pensions Infrastructure Platform was intended to resolve this problem by pooling assets, but has so far failed to reach its intended £2bn target. UKSIF member feedback has indicated that unexpected fees involved in PIP were a major drawback to schemes engaging and investing as part of the platform. The Government should review what went wrong and what steps are necessary to address these issues.

Second, new rules for LGPS administering authorities mean that they are required to have policies on Environmental, Social and Governance (ESG) factors and stewardship.[5] Due to the long-term nature of infrastructure assets they impact on and are impacted by a range of ESG factors, particularly climate change- the precise impact of which is dependent on the type, age and location of the asset. It is therefore crucial investors have a policy on their approach to dealing with ESG issues. Not all ESG factors will be relevant to all investments nor will they be symmetric across asset classes but they will probably be financially material to the investor, especially over the long-term. UKSIF advocates a clear fiduciary duty for institutional investors which is consistent across the fragmented UK pension market, something we will discuss later. Nonetheless, a publicly stated approach on how these factors are considered in the investment process and beyond is beneficial in setting out investors' expectation of agents and helping to manage risks to investments over the long-term.

Other problems remain, however. Being generally illiquid, infrastructure as an investible asset class can be difficult for some institutional owners. This was emphasised to policy makers at an UKSIF organised roundtable at the House of Commons in 2015 at which it was stated that, due to certain investment rules, it is easier for British pension funds to invest in infrastructure in Australia than in the UK. The problem is more acute for trust-based DC schemes, which are set to grow exponentially due to automatic enrolment (AE). The primary issues are the rules surrounding daily pricing and daily liquidity. This "daily dealing" has put DC schemes at a disadvantage when it comes to being able to

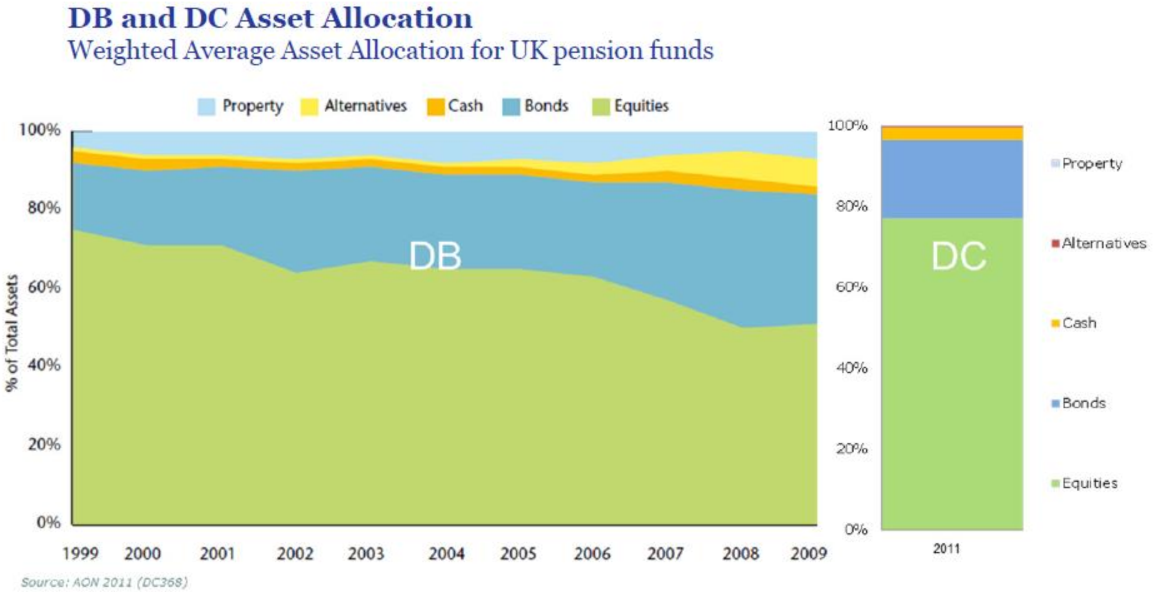
---

[3] USS press release, *USS invests in Heathrow Airport*, available at https://www.uss.co.uk/news/all-news/2014/03/uss-invests-in-heathrow-airport
[4] UK Parliament briefing note, *Infrastructure policies and investment*, available at http://researchbriefings.files.parliament.uk/documents/SN06594/SN06594.pdf
[5] The UKSIF LGPS brief is available at http://uksif.org/wp-content/uploads/2016/11/Policy-update-LGPS-Investment-Strategy-Statement-Guidance.pdf

directly invest in infrastructure. One solution has been to "wrap" infrastructure funds with more liquid equity funds, but this tends to be the preserve of only larger funds and is clearly not a desirable solution.

The DC Investment Forum (DCIF) made clear that there is no regulatory rule for daily dealing: it is not a legal requirement but something that has evolved with the DC market. In particular it developed as a market norm for platforms which require daily priced funds to meet the consequences of members switching, retiring and dying on different dates. DC schemes were designed to be flexible savings vehicles to allow these members to easily and regularly transfer in and out of funds. However these needs have evolved since the rules on daily dealing were established and will continue to do so because of AE. DC members are currently at a significant disadvantage since they are denied the benefits of diversification and the illiquidity premium received by members of other types of scheme. The focus should now be to encourage long-term default investment options for DC members, including by investing more in illiquid assets. It is also worth noting that the DCIF have stated that as much as 35bps of DC performance could be gained from illiquid investments, producing 5% larger pots. This 'focus on fees rather than value' has acted as an obstacle to DC schemes gaining access to the benefits of diversification.[6]

UKSIF has argued in the past that a key barrier is expense. We hear that investment in infrastructure and other illiquid asset classes can be very expensive to deliver in the context of the 75bps charge cap on default funds. Although the cap does not apply to chosen funds, we have heard that it tends to apply in practice anyway. Given the tiny size of chosen funds there would be little impact in boosting infrastructure investment unless default funds were targeted. As a side note, we hear from members that although well intentioned, the 75bps charge cap has forced more schemes to invest in cheap passive equity funds. The result has been unbalanced portfolios which tend to be dominated by equities. The 2013 DCIF report illustrates this point with an asset allocation comparison showing that DC schemes have much larger equity weightings and shows clearly that only DB schemes had invested in infrastructure:



[6] DC Investment Forum, *Mind the Gap: The case for a relaxation of daily dealing requirements for DC pension funds,* 2013

19. What are the most important factors which constrain quoted companies and fund managers from making longer term investment decisions, and how can we best address these factors?

There are a variety of factors which have hampered the ability of UK companies to make longer-term investment decisions. One underlying problem is that many UK investors and businesses find themselves rooted in a system which continues to reward short-term practices. The Kay Review described short-termism as 'myopic behaviour' which may occur 'when companies invest too little, either in the physical assets of the business or in the intangibles which are generally the source of their competitive advantage'. Short-termism is an issue that has become embedded in the cultures of many organisations which play a part in the investment chain. This includes asset owners, fund managers and the companies in which they invest. Ultimately it is to the detriment of those companies, UK savers and the wider economy.

An overarching result of this culture of short-termism has been to 'erode incentives to invest in long-term technological development and breakthrough research and development [and to] reduce the incentives to undertake the types of transformational change that might bring long-term gains at the cost of short-term profits'.[7] The 2012 Kay Review highlighted short-termism as a major obstacle to well-functioning equity markets and made various recommendations on how to address it. Five years later still more work is needed.

One of Kay's recommendations was clarifying pension scheme trustees' fiduciary duties. The Law Commission 2014 report into fiduciary duties outlined various recommendations including a clear distinction in the Investment Regulations which refer to 'social, ethical and environmental factors'. The Law Commission wanted clarity between factors which are financially material, which it argued should always be taken into account, and those which are non-financial, which may be taken into account in certain circumstances. Despite the recommendations the Government decided not to introduce the changes, prolonging the uncertainty for trustees and their advisers.[8] The Pensions Regulator has recently published new guidance for trustees which accurately reflects the Law Commission's thinking. This is very helpful, although we now have a situation where trustees are operating in a system where regulatory guidance conflicts with the underlying message in the statutory requirements. We therefore recommend the Government consults on changes to the OPSR to bring it in-line with the new guidance.

We talk more about encouraging long-term behaviours by companies in our response to the BEIS corporate governance review.[9]

---

[7] Cambridge Institute of Sustainable Leadership, *UK Industrial Strategy – Navigating a changing world,* 2017 available at http://www.cisl.cam.ac.uk/publications/publication-pdfs/UK-Industrial-Strategy-Report.pdf

[8] UKSIF Press Release, *UKSIF reaction to Government announcement fiduciary duty will not be clarified in law*, 12th November 2015 available at http://uksif.org/wp-content/uploads/2015/11/Government-Announcement-of-Fiduciary-Duty.pdf

[9] UKSIF response to the BEIS corporate governance reform green paper, 2017 available athttp://uksif.org/wp-content/uploads/2017/03/UKSIF-Corporate-governance-review-FINAL.pdf

27. What are the most important steps the Government should take to limit energy costs over the long-term?

The Government should take lessons from the approach of the Germans, regarded as a leader in the global energy transition.[10] The Energiewende is the country's national vision to transition to an energy efficient and low-carbon economy. We were pleased to see the Government announce the Fifth Carbon Budget, with emission reductions of 57% by 2030 in-line with the Committee on Climate Change recommendations. A clear policy on the UK's approach to the transition to a low carbon economy which both sets out how we are to meet our domestic commitments under the Climate Change Act and begins to rebuild trust with institutional investors should remain a priority. Consultation with the public is important. Renewable energy schemes designed for domestic users have been a success in Germany, with polls showing support of up to 90% in favour of the goals of the Energiewende and citizen ownership accounting for nearly half of all biogas, solar and onshore wind capacity.[11]

The cost of renewables is both stable and comparable to that of fossil fuels. The International Renewable Energy Agency highlights biomass, hydropower, geothermal and onshore wind in particular as being able to provide electricity competitively compared to fossil fuel generation.[12] Subsidies for renewable based energy sources were worth around $150bn globally in 2015 while subsidies for fossil fuels were around $325bn. A 2015 IMF working paper suggests the costs linked to power generation by fossil fuel far exceed that estimate and rises to $5.3tn or 6.5% global GDP.[13] This is rooted in a failure to price-in longer-term externalities associated with fossil fuel power generation which result in environmental damage including air pollution and climate change.

28. How can we move towards a position in which energy is supplied by competitive markets without the requirement for on-going subsidy?

Sustainability issues must be properly integrated into capital markets. This is not a moral or ethical question. The base of evidence continues to grow which shows that building sustainability into capital markets will bring economic benefits; failure to do so could lead to economic loss. A recent paper published by Arabesque Partners (an UKSIF member) and the University of Oxford makes clear the link between sustainability considerations, corporate performance and investment returns. The report expects the inclusion of sustainability parameters across the investment will become the norm in the years to come, but support from policy makers is crucial. This is something that the European Union has begun to understand as it develops its Capital Markets Union in-line with this position. Other EU legislation such as IORPs II, PRIIPs, and the Shareholder Rights Directive all include specific reference to sustainability parameters and ESG. By redirecting capital flows to more sustainable projects the need for on-going subsidy is reduced while investment in green infrastructure will increase. A proper understanding of investors' own fiduciary duties – i.e. that all

---

[10] https://energytransition.org/

[11] Clean Energy Wire, *Germany between citizens' energy and Nimbyism*, 2015 available at https://www.cleanenergywire.org/dossiers/peoples-energiewende

[12] International Renewable Energy Agency, *Renewable Power Generation Costs,* 2014 available at http://www.irena.org/documentdownloads/publications/irena_re_power_costs_2014_report.pdf

[13] IMF working paper, *How large are global energy subsidies?*, 2015 available at http://www.imf.org/external/pubs/ft/wp/2015/wp15105.pdf

financially material factors should be taken into account during the investment process – is a key step towards this goal.

The Government should also consider the role of regulatory mechanisms which can encourage investment in the transition to a low-carbon economy without the need for subsidies. In France, the Energy Transition Law requires *investors* to report how the integrate ESG factors into their investment policies (which we have called for in the UK for many years and as previously discussed is the case now for LGPS funds) and also specific disclosures including risks to their investments stemming from climate change.[14] The UK already has mandatory carbon reporting for *listed companies* geared towards enabling businesses to measure and manage emissions, provide a consistent standard and to save money through reduced energy costs and help investors understand their exposure to climate risks and opportunities.[15] The FSB's Task Force on Climate-related Financial Disclosures has also recently published recommendations for voluntary corporate reporting in relation to climate factors. A new reporting duty for investors akin to the French approach would speed up the transition to a low carbon economy, send a strong message to companies about the expectations of their shareholders and encourage further private investment in renewable and low-carbon energy generation. Investors reporting, measuring and managing long-term, often externalised, risks to their portfolios is a crucial step in creating a more resilient economy.

We hope our views are clear. If you have any questions on this or require any further information please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely,

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)

[14] Rust. S. 2016, *France aims high with first-ever investor climate-reporting law*, IPE available at https://www.ipe.com/countries/france/france-aims-high-with-first-ever-investor-climate-reporting-law/10011722.fullarticle

[15] Government press release, *Leading businesses to disclose greenhouse gas emissions*, 2012 available at https://www.gov.uk/government/news/leading-businesses-to-disclose-greenhouse-gas-emissions