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GREEN FINANCE

MONDAY 11 NOVEMBER 2013

JOSH RYAN-COLLINS, CATHERINE HOWARTH, STEPHANIE MAIER and IAN SIMM

Evidence heard in Public Questions 153 - 185

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Oral Evidence

Taken before the Environmental Audit Committee

on Monday 11 November 2013

Members present:

Joan Walley (Chair)
Peter Aldous
Martin Caton
Zac Goldsmith
Mark Lazarowicz
Caroline Lucas
Dr Alan Whitehead
Simon Wright

Examination of Witnesses

Witnesses: **Josh Ryan-Collins**, Senior Researcher, Finance and Business Team, New Economics Foundation, **Catherine Howarth**, Chief Executive Officer, ShareAction, **Stephanie Maier**, Head of Corporate Responsibility, Aviva Investors, and **Ian Simm**, Chief Executive, Impax Asset Management, Steering Committee, Low Carbon Finance Group, gave evidence.

Q153 Chair: I would like to start our session this afternoon by welcoming all four of you. We have some quite detailed questions on very specific issues in our third session on the green finance inquiry. What we want to do today is just try to see what sources of green finance there are for green investment. We will be looking at community issues at a later stage.

My first question is, how effective are the financial markets in matching available finance to the required investment in renewable energy and other green projects? We would like to get a feel from each of you as to just how fit for purpose the current financial markets are. I do not know who wants to go first. You are conferring—it is a bit like *University Challenge.* Catherine Howarth.

Catherine Howarth: I think they are not very effective overall. My expertise is in relation to pension fund investors. Pension fund investors in principle should be the absolutely ideal long-term, patient capital providers for the investment in a smooth transition to low-carbon prosperity that we need, but for a variety of reasons, relatively little pension fund investment flows into the kind of low-carbon and green investments that this Committee is looking into. I might say a bit later in the evidence session what those barriers are, but they are very mixed. One of them is misunderstanding of investors' fiduciary duties.

Chair: We will come on to fiduciary review later on.

Catherine Howarth: Another is that many pension savers are very interested in seeing some of their regularly monthly pension contributions flow into low-carbon investments, but pension savers have pretty little voice in this system overall. There are a number of things we can do about that. The organisation I work for, ShareAction, is trying to enable pension fund members to advocate for more of their pension fund savings to flow into low-carbon investments, but it is quite uphill work at times. But there are solutions to these things, and I would be happy to say a bit more about those.

Chair: Do the other witnesses agree or disagree with that? Mr Simm.

Ian Simm: Yes, I generally agree with what Catherine has said, except perhaps for her first remark. My view is that financial markets, generally speaking, are pretty efficient in allocating capital and that the issue lies at the project or investment level. Environmental investments, generally speaking, are too risky and/or fundamentally unsuitable for many pension funds. That is where our focus should lie in trying to solve the problem.

Stephanie Maier: Yes, I would agree. The whole capital market does not integrate sustainability in the way it should. That is along the capital investment chain from the pension fund holder—the individual, as Catherine has mentioned—up through the investment at institutional level and the advice that investment consultants make, to the relationship between asset owners and their asset managers, and more broadly, the various information flows that help oil that system.

One of the things we have been working on at Aviva Investors is forming a coalition calling for integrated sustainability reporting, which is essentially asking all large companies to disclose the extent to which they integrate environmental, social or governance issues into their business strategy, because that is one of the areas of inefficiencies, which mean the flow of capital does not go towards the most sustainable companies, it often goes to the less sustainable companies. One of the areas to look at is how we can connect the dots between the investors understanding the real risks and impacts that some of these environmental issues can have on businesses in the long term and directing their capital towards those more sustainable companies.

Q154 Chair: Is that part of the whole agenda about behaviour change, as well, and wider understanding?

Stephanie Maier: Yes. Part of the requirement for reporting is not just for the sake of reporting, it is about seeing the extent to which reporting can drive behaviour. Certainly within the greenhouse gas reporting requirements that have just come into effect, one of the elements that the Government itself drew up was the estimated savings that would come purely from the actions that are driven by a company better understanding its impacts. It is about the company seeing, and having to evaluate, how those issues impact on business strategy, thereby causing it to consider them, embed them in the strategy and change behaviour towards a more sustainable path.

Josh Ryan-Collins: Nicholas Stern called climate change “the world’s biggest market failure”, and I just want to emphasise the point that social and ecological environmental externalities are not incorporated into the price mechanism in a way that necessarily allows companies or pension funds to invest easily in long-term renewable energy or climate change adaptation, or other such policies. I think some sort of intervention is a priori required on the part of the state in this area, and I do not think corporate social responsibility is going to be enough.

Q155 Chair: But when you say some sort of special intervention is required, whose responsibility would it be to do that?

Josh Ryan-Collins: I think the state has to take that on, and of course there is a range of different ways that could happen—taxation, Government spending, subsidies. I am sure you have been discussing those, but there is just a broader point—let’s not leave it to the market, basically. Let’s make the case for state intervention.

Q156 Chair: If you are saying it should be the state that should do it, would you go so far as to say which Government Departments should particularly have the responsibility for doing that?

Josh Ryan-Collins: Obviously DECC, but also BIS and ultimately the Treasury, because it is the Treasury that is determining the fiscal rules. I would also point to the Bank of England in terms of monetary policy, which I will be talking about in more depth later.

Q157 Chair: Just turning to the Green Investment Bank—we went up to Edinburgh as part of our current inquiry—how do you see the impact that it is having on the whole investment agenda? Is what the Green Investment Bank is doing making a difference, or do you see what they are doing as being an additional add-on?

Josh Ryan-Collins: Much more an add-on at the moment, given its very, very small size and scale. I am not that keen on calling it a bank, either, because it does not have the right to make loans or borrow on capital markets, as most investment banks do. I prefer to call it a fund, and I think it needs seriously upscaling. If you look at similar organisations in other countries, they are many, many times larger.

Q158 Chair: On a scale of one to 10, where 10 is good and one is not so good, what would you say the impact and the difference that is making is? How would you rate it?

Josh Ryan-Collins: The mere fact of its existence makes a difference. It has already proved that it can leverage in some private sector capital, but I think it has the potential to be an eight or nine, and currently it is a two or a three.

Q159 Peter Aldous: Taking into account the parameters within which it has been set up, the seedcorn funding and the restrictions on where it can and cannot invest, how do you think it is performing?

Josh Ryan-Collins: Given the very tight parameters, the fact that it is not allowed to borrow in the financial markets and the small amount of capital, I think it is doing okay. It is almost too early to say—I think you need to evaluate it in a couple of years.

Q160 Peter Aldous: Would you say that the model, with opportunities to borrow and a wider parameter, can mirror what has been done in the Netherlands and Germany?

Josh Ryan-Collins: I see no reason why it should not be given the same kind of banking licence and credit-creating powers that similar models have, the KfW in Germany being the most obvious one, which is more like 25% of GDP in terms of its assets. It is about 0.2% in the UK if you take the Green Investment Bank and the Business Investment Bank.

Chair: What do your colleagues think? Yes, Mr Simm.

Ian Simm: I would agree with Mr Ryan-Collins that the Green Investment Bank is at a very early stage in its lifetime and we should not judge it just yet, but it has been very successful in identifying projects that fit its mandate, in my view, and as has been observed, it has attracted a significant volume of pure private sector capital into the areas that it is supposed to be focusing on. I think from the current vantage point it is doing a good job. It appears to be successful in catalysing investment into offshore wind, waste management and biomass in the energy sector. I understand it has been less successful in attracting deal flow in energy efficiency, where there are a number of other barriers to project creation and project development that the Green Investment Bank is trying to solve and struggling. But at the moment it is doing very well in three out of the four areas, and it needs support, encouragement and ideally a licence to borrow.

Stephanie Maier: I would just add the point that it is an investor in one of our funds, which is a fund for a new energy centre through the NHS trust up in Cambridge. I agree that it is early days, but it has provided that investment within the fund, which will deliver both financially and in terms of cost savings and carbon savings to the trust. Yes, it is in the early stages of finding projects to invest in, and as with any new organisation, especially with the specific remit that it has in terms of additionality and delivering carbon reductions, I think it will need to review how all those things are measured. But it has started, and it has found some investments to make, and that is a positive starting point.

Q161 Chair: Yes, we wanted to ask you about that investment with the energy efficiency at the Cambridge University Hospital Trust. Would that investment have happened without the Green Investment Bank or did it only come about because of the Green Investment Bank?

Stephanie Maier: It is hard to say. It is open to other investors, but that is the one investor in that fund at the moment, so to a certain extent that would not have happened without it. Having said that, we have a range of infrastructure investments that look at renewable energy and energy efficiency, so it is an asset class and project type that we offer and invest in for ourselves and for our clients. Hopefully we will see more of that particular element. What is interesting there is that because it has the energy efficiency element to it as well, it is not just pure renewable investment.

Q162 Chair: What sort of an experience was it working with the Green Investment Bank on that project?

Stephanie Maier: It was certainly positive in terms of the outcome. It was certainly early on in the Green Investment Bank process, so they were still defining some of the broader investment framework as we were going through the investment. There is an element of learning by doing, and I am sure they will learn from it, but we are certainly happy with the end result.

Q163 Dr Whitehead: Josh Ryan-Collins of the New Economics Foundation, you have mentioned that the state needs to head up a lot of this investment in some form. That is essentially what you are saying. Is that view because of the estimation of the sheer scale that is needed over the next few years, or because it is likely that institutional investors are simply going to think that this is all too difficult or not remunerative enough—or remunerative only over a time scale that is too long to contemplate given how the market works? Which way does it lean, and what sort of effect might that have on the proportion that you think could indeed be funded from the market and the proportion that could be funded otherwise?

Josh Ryan-Collins: It is very much a chicken and egg problem. My colleague was right to say that investing in these kinds of projects is very high-risk for private companies, and in a way it is up to the state to step forward and derisk those projects by showing that they have confidence that these type of projects have long-term potential. Of course the best way to do that, if not by directly investing in them, is to capitalise organisations such as the Green Investment Bank, but you could also have a Green Deal company of some kind that was equally responsible for these kinds of investments. It needs to be at a very large scale, a much larger scale than we are seeing now. The target is £550 billion of investment in low-carbon infrastructure over the next 10 years.

Q164 Dr Whitehead: Forgive me, that is your analysis, isn’t it? That is not generally shared, is it?

Josh Ryan-Collins: That is a calculation that has been widely accepted, I think. I am sure there is somebody here who can give me a perspective on it.

Q165 Dr Whitehead: A £200 billion figure, and about half of that for low-carbon generation, seems to be more prevalent.

Josh Ryan-Collins: Okay. If that is the figure, I will come back to you on that. Even if it is half of that, as you suggest—

Dr Whitehead: Yes. It is a rather large sum of money, I would say.

Josh Ryan-Collins: Yes. We are not getting there at the moment, and the Green Investment Bank, with a couple of billion, is not going to do it.

I would also make a broader point that when you have systemic market failure such as in this area, there is an a priori obligation on the state to intervene. There should not be issues around state aid, because it clearly is an example of a market failure. I think that will draw in the private investment; pension funds, as colleagues here will know, are looking for good, solid, long-term opportunities for patient capital. We just need to create those opportunities.

The other point I would like to make—perhaps it is a bit soon—is that this does not have to be taxpayers' money. The Bank of England could purchase bonds to stimulate this in the Green Investment Bank or any other similar type of vehicle, and it would not create cost for the Treasury. If we were in a much better fiscal situation, one could make the case that the Green Investment Bank should be capitalised to a much higher degree just through taxpayers' money, but we are not in that situation, as everyone knows, so I think we need to look to alternatives.

Q166 Dr Whitehead: Do other panel members share that particular view? Bearing in mind the difference in estimates as to the overall likely requirement for green infrastructure and low-carbon investment over the next period, the extent that the market can finance this one way or another and the extent that other measures may be necessary, what is your view on that?

Ian Simm: My general view is that the state should minimise its intervention wherever possible in order to have an efficient capital market and allocate capital around the world efficiently, which leads to job creation and growth. The state has intervened quite effectively in the renewable energy sector in the UK over slightly more than the last decade, in particular with the renewables obligation. We have seen a progressive increase—in fact, we would argue almost an exponential increase—in private sector capital coming into renewable energy projects in the UK over the last five years, first of all as institutional investors have sought out more exposure to infrastructure. Secondly, they have fewer opportunities to make money elsewhere in their portfolios because cash returns are low and bond yields are very low. Thirdly, they are increasingly comfortable with the regulatory framework that the renewables obligation has provided—with some modifications and evolution, but consistently—since the early part of the last decade.

As you will know, Dr Whitehead, the electricity market reform was intended to be an evolution of the renewables obligation. Having been part of the discussions around EMR, I believe that I speak for many people in the finance community in the private sector who believe that with the correct detail it, it could be a very successful natural evolution of the renewables obligation, taking account of a wider range of factors. But it still involves state intervention, so I personally would encourage discussion about other areas, to err on the side of minimal state intervention or less state intervention, recognising that we already have a lot of state intervention.

Q167 Dr Whitehead: Just to be clear, you would characterise the CfD regime as not essentially state intervention, but state encouragement?

Ian Simm: It is not state intervention in the sense of taxpayers' money being used to subsidise the market, because it is the electricity or energy consumer who ultimately provides a subsidy, but the state is certainly intervening in structuring the market in a way in which it would not be structured without that intervention.

Stephanie Maier: Going back to broader funding, ideally you want as many sources of capital as you can, so that is why we are looking at how you can make the whole capital system more geared towards preferring the sustainable investments as opposed to the less sustainable ones. Yes, the Green Investment Bank is there as a pot of money. Clearly, whatever number you take for what is required, it is a small part of that. The role that it plays in leveraging other investors is a key role, but it is also looking at how you can make those investments more attractive across the board and at different points. We tend to look at assets that are already up and running. We do not tend to look at the development and construction risk, but that is because our clients tend to be more risk-averse and that profile does not fit in with the risk/return profile, but for other investors within the private sector, that may be a more attractive proposition.

More broadly on the point about state intervention, it is about having a stable regulatory framework so that you know as an investor what is coming and as the developer what you can expect. That helps all the decisions be more efficient as it goes along.

Q168 Dr Whitehead: Interesting. Bearing in mind that you mention that your particular forte is looking at projects that are already up and running, is there any sense that the considering the role of either state encouragement or state intervention, the overall requirement might be seen as de-risking the construction and the installation of those low-carbon developments? Is it effectively—almost literally—about selling those on when the risk is at a point where you say, "That is rather interesting for investment, because a lot of that has gone, so I can now take it on"? Is there a sense in which that model might be—

Stephanie Maier: Yes. We certainly have the capacity, if we saw an attractive project, to invest in the earlier stage of that asset. Yes, having a larger pipeline of projects that we could invest in that were up and running to the point where they met our risk profile better would certainly be good. That is another part of the policy or regulatory framework—having stability and consistency of policy, but also having a pipeline for understanding what sort of assets will be coming online so that we can take a view on those.

Ian Simm: To add to that, there is an interesting contrast to be made between the onshore wind sector and the offshore wind sector when it comes to the need for additional state intervention. In the onshore wind sector, which is very well established in the UK and in other countries, there has been and remains a relatively large amount of capital to support and fund the construction of onshore wind farms, because the construction risks are well understood and the risk of cost overrun is almost invariably borne by a private sector contractor. Once those projects are effectively constructed, which typically takes between nine and 15 months, they can increasingly be sold on to pension funds, fund managers and other providers of long-term capital. In contrast, the offshore wind sector has a number of very significant uncertainties for investors, not least of which is the capital cost of the construction, which is linked in part to the uncertainty around the engineering and in part to the time frame for deploying the equipment. There has been a well identified and well publicised gap in the financing market, and this is where the Green Investment Bank has provided additional funding, so there has been an additionality argument for Green Investment Bank intervention.

It is entirely anticipated that provided that the CfD structures work under EMR, the evidence of construction risk and cost from the early offshore wind projects will provide—hopefully, if they are successful—sufficient positive evidence to the private sector that the risks and costs of construction are knowable. They can therefore start to commit capital based on a much more detailed set of investment facts. Therefore—this is perhaps the crux of the point—state intervention in offshore wind is essential, given the rate at which the UK is seeking to build out this industry, but it should not be required forever. It is simply a bridging mechanism until the private sector is comfortable coming in.

Q169 Dr Whitehead: You have very much anticipated the thrust of my next question, which is what appraisal you might make of the appetite for different forms of low-carbon generation among investors, either in terms of the sort of issues that you have raised, Mr Simm, about what the overall risks look like, or even in terms of the extent that certain projects may be found fundable at all. For example, there is the distinction not just between wind and tide, biomass, wave and other things, wave, but there are also things such as demand-side response and demand-side management, where you are dealing with a difference in how you invest. You are investing in things that do not happen, rather than things that do happen, and therefore the extent to which you can put that easily on an asset base makes it a rather different proposition from more traditional forms of investment. What sort of distinction is made between those sort of investments and the appetites for them?

Ian Simm: Perhaps from the perspective of a fund manager sitting within a pension fund, they are almost invariably not looking for green investments per se, but they are looking to make deployment of capital to meet liabilities over a usually long-term time frame. They are typically looking for a number of factors: cash flow, because if you have cash you can meet liabilities such as paying pensioners; inflation link, for obvious reasons; liquidity, so that you can change your mind if things are not working out; currency risk, and so on. Typically and historically, pension funds have invested in fixed income or equities and are increasingly looking at alternatives, of which infrastructure is a component. Typically, a UK pension fund would have less than 5% of its assets in infrastructure, possibly down to zero, so infrastructure as a concept is a new asset class.

Infrastructure to a pension fund is not what we would all call infrastructure—bricks and mortar—per se. For a pension fund, it is all about regulatory framework, cash flow and inflation link, and therefore infrastructure must have a minimum set of financial attributes for it to qualify for that bucket. Within that framework is the question of how one can tailor green projects to meet the latent or emerging demand for infrastructure investment from institutions. The renewable energy power-generating sector fits well in the infrastructure bucket, provided that there is price certainty and ideally an inflation link. What does not fit well is merchant risk, so we can make that first distinction.

If you then look to other types of green investments or green project, many of them fall down on technology risk. Onshore wind is typically seen as low-risk, proven technology where the pension fund has a very low likelihood of losing money because the equipment does not work. If you could switch over to some of the more emerging marine technologies like wave or tidal, although there has been strong progress in those areas, they are still not effective with the consistency and reliability that the pension funds will need to see. One could make similar comments about energy efficiency or some of the more advanced waste energy technologies. As soon as you lose the argument on technology risk or the argument on pricing, you are highly likely to fail to qualify for that emerging bucket and then you become lost, in my view, in the mêlée of mixed opportunities that are being offered to pension funds from all corners of the economy.

Catherine Howarth: Can I just follow up on that? I think that quite clearly pension funds can be put off by what they see as political risk or policy risk, and equally they are not necessarily going to be the first wave of investors into the most high-risk technologies, but there are now quite a number of reasonably well proven low-carbon technologies, as Mr Simm has said. We need to look at why is there not more appetite and demand from pension funds to move into that area, and I think it is partly because at the moment most of them see these investments as they would any other investments. That is fair enough, but one of the things we want to try to introduce—and it is beginning to happen—is an awareness among pension fund investors, who have an obligation to look after people who will retire many decades hence, that a real threat is posed to well-being and the cost of living in retirement, and to the investment returns of those people, by failing to address climate change and not putting in the investments that prevent catastrophic climate change.

There are some pension funds, a very small number, that have that. Probably not very surprisingly, the Environment Agency pension fund is globally a pioneer on this. It has understood its fiduciary duties to act in the best interests of the members of the fund, and it is taking quite an enlightened view of ensuring that we make that transition across the economy as a whole. Clearly an individual pension fund, even a giant pension fund, cannot by any means make that happen alone, but if we can begin to create a bit more comfort in the industry as a whole, which a number of policy signals would help to achieve, we could begin to see a much accelerated flow of investment from pension funds, not all of which have DB liabilities. Many of them are investing on behalf of defined-contribution young pension savers, who bear all the investment risk and who are exposed to the risks of climate change in the future.

I think we do need the right signals from policy makers and from the political establishment. We probably need the right fiscal regimes and so on, but there is a lot of room to create movement within the pensions industry if we can overcome some of the very narrow views of the duty to maximise investment return in the short term and not take account of the positives for pension savers that could be achieved if that transition happens.

Chair: We will come on to fiduciary commitments in a short while, but interesting that you mentioned the Environment Agency pension scheme. It might be useful for the Committee to get some details of how it came to have such an ahead-of-its-time pension scheme, because that was an interesting reference.

I will move on to Caroline Lucas.

Q170 Caroline Lucas: Thank you. Before I start, I apologise for the fact I have to leave at 5 pm to go to a Green Alliance thing that I am speaking at. This session is slightly out of synch from our normal Committee sessions, so I do apologise.

I wanted to ask you a question about institutional investors and some of the key drivers of what makes them decide on the types of investments they include in their portfolios. I know you have touched on it already, but in the case of investors who were contemplating supporting energy or environmental projects, what relative weight would they give, do you think, to questions of possible financial returns on one hand versus the carbon impact and the environmental impact on the other? What kind of trade-offs are they considering?

Catherine Howarth: I think it is almost totally geared to the financial considerations, and that is fine. Within taking a view of the financial interests of the scheme and its members, it is quite possible to begin to look for the investment opportunities that exist in the low-carbon economy; Mr Simm's company is a provider of those investment opportunities. While we want pension funds to take quite an enlightened view, it can be a view that is focused on the long-term financial wellbeing of fund members, but a more enlightened view would help to increase the demand for the kind of low-carbon investments that we need capital flowing into. But currently pension funds look for financial first.

Q171 Caroline Lucas: Can I just follow that up? Are they apprised of the Carbon Tracker reports and the whole idea of stranded assets and so forth? Is there much of a discussion yet going in that particular community about the fact that they could be undermined by not being able to exploit some of the resources?

Catherine Howarth: There is just beginning to be. Obviously, Carbon Tracker's analysis is relatively new to the scene, and we at ShareAction have been trying to accelerate awareness of that analysis by enabling pension fund members to e-mail their schemes asking them for a view on the risk that they compute to a stranded asset in a carbon bubble. Very interestingly, there is a complete mix of responses from schemes. Some said, "We take this very seriously. We are beginning to do some analysis on it, and we want to look at that potential stranded asset risk and minimise it". Others dismissed the possibility entirely. It is not surprising, because they are all different actors in the market and they come to different views. That is okay. What we think is very important is that funds give consideration to that risk and that trustees then have discretion, so that in the light of the evidence before them they can come to a view about whether it is something they want to incorporate into asset allocation decisions, for example.

Ian Simm: Just to build on Ms Howarth's two points, in our experience, which goes back 15 years, institutional investors, including pension funds, do put financial criteria ahead of everything else. Yes, we can talk about fiduciary responsibility in a moment, but financial criteria do include risks as well as opportunities. There is increasing evidence that pension fund managers are open to being persuaded that environmental investing does offer both an opportunity set that they have not seen before and a way of mitigating certain risks where mitigation has not been available hitherto. The financial crisis of 2007 and 2008, which hopefully we are now largely out of, has shaken many pension funds to their core and has persuaded them and their consultants to go back to basics on asset allocation and risk.

On the topic of the carbon bubble, I would certainly agree with Ms Howarth that this is a very new debate and that it is uncertain where pension funds and other institutional investors will come out on it, but I think it has immediately put the searchlight on to the potential risk of regulatory change having an impact on carbon prices. If you look at how the carbon bubble idea could feed through to destruction of value, it is largely through the imposition of carbon taxes on carbon prices as they affect the break-even point of carbon resource extraction. That is a very fertile area for discussion at the moment.

Chair: Stephanie, I think you wanted to come in.

Stephanie Maier: Just to say that I sit within the global responsible investment team within Aviva Investors. Part of our role is to talk to fund managers and work with them to help them integrate environmental, social and governance considerations into the investment decision-making process. In terms of the balance between financial and environmental, increasingly it is not a trade-off between the two. We look at it from a long-term perspective, and the more companies understand the exposure and the risks—and the opportunities as well—that they face through a range of these broader issues, including climate change, the more material those issues will be to the future value of that company. It is about understanding the apparent financial return, but also understanding what that means in a long-term perspective under a range of different scenarios.

On the point about the beneficiaries challenging where their money is being invested, that is an important point and it does seem that they are too far removed from that process. Happily, we fall into the camp that says that we are addressing the issue about the potential for stranded assets. It is an issue that we need to look at, but it is not just for individual investors or even collectively for the investment sector. When you look at the proportion of the FTSE 100 that is invested in these energy-intensive, carbon-intensive stocks, it is potentially a more systemic issue than that. One of the things we like to see the Bank of England do is assess the extent of climate change and the high-carbon exposure that the UK has, and what impact that has on financial stability. If it is a systemic risk, how do you start addressing it? We do not want to see a point where you fall off the cliff and these assets become devalued. You want to find a way to understand the true value of these assets.

Chair: Were you going to add to that, Mr Ryan-Collins?

Josh Ryan-Collins: Just to make a broader point, which is that it is cheaper and more profitable at the moment, and there is less risk, to invest in fossil fuel-intensive forms of production. I am not sure that will change unless somebody steps in and starts creating in this country a real industry in alternative forms of provision. If you look at China, the reason that their solar panels are undercutting everyone in Europe and the rest of the world is because the Government—obviously they have cheap labour costs—basically runs the banks over there and has those banks investing in producing these. The cost of renewable energy infrastructure is very, very high at the outset, which makes the lifetime cost appear prohibitive, but of course the real lifetime costs are much lower for renewable energy because it is free. It comes from the sun. It is that initial up-front cost that is creating the problem, and that is where the barrier is. You have to have investment. I do not think it is enough to rely on pension providers to do that.

Q172 Peter Aldous: At the outset, I draw attention to the Register of Members' Financial Interests; I am involved in farmland where renewable energy policies or projects are being pursued.

I was going to ask about blockages to investment and risk. We have covered an awful lot of that in looking at the various financial criteria, technology risk and construction risk, and we have touched on political risk. How significant is political risk to investors from possible changes to the Government's energy and environmental policies? As an addendum to that, if we had go back four or five months, would your answer to that question have been different from today?

Stephanie Maier: We would still stay with the perspective that policy risk is through policy uncertainty, so where you have stable, predictable, simple policy, we can make investment decisions in that context. I think that remains true. What I suppose the recent debate has highlighted is the difficulties that that can pose to Governments and why it is important that the policy framework is sufficiently long-term to help support what the UK Government want to achieve in the energy mix of the future. Part of what we are discussing is how best to facilitate that, but ultimately it is also as simple as setting a clear message about what the priorities are and, how will we get to the point we want to get to in our energy mix. On a more technical point, policy certainty is part of what makes infrastructure investments deliver certainty of returns, and any change to that would change the view of that infrastructure and the viability of that project.

Ian Simm: It is important to deconstruct political risk. If we start from the perspective of projects that are already on the ground, I think it is absolutely essential—as has been well-rehearsed in these sorts of fora—that there are no retrospective changes to support in any form, and that includes taxation for existing infrastructure assets. If that is not possible, then there will be a very direct consequence—the risk appetite for future investments among the private sector will drop. We have seen that particularly in Spain, as you will be aware. If that is area number one to consider, the second area would be the policy uncertainty surrounding future projects.

It is important for the Committee to recognise that for a project to come to the point where it is ready for construction, somebody needs to take a risk to get the project developed, which includes getting the land rights and scoping out the engineering and utility connections and so on. That is a particularly risky exercise at the best of times, but it is even more risky if there is uncertainty around the economics of the project once it is built. Policy uncertainty and political uncertainty around future projects has a dampening effect on project development activity today. To put that in the context of where we are in UK energy policy, the electricity market reform is moving to a final conclusion, with policy details being worked out right now. All being well into 2014, we will know exactly what sort of economics to expect when those projects are built. Those developing projects are waiting at the moment in many case, because we do not know what the outcome is going to be. When there is policy and political change in this type of infrastructure area, there is almost invariably a hiatus created.

From the perspective of a pension fund, there is also the third area to consider, which is media concern and media discussion. Perhaps this goes to the second part of your question. One could take a view that the political climate, as represented by the media at the moment, is not very conducive to investment or supporting investment in the UK energy sector, but I think the pension fund managers are experienced enough to look beneath the surface and are discounting the media confusion in favour of waiting to see what the details of EMR are when they forthcoming at the end of the year.

Q173 Mark Lazarowicz: I have a question with regard to some specifics. There have been two areas where possible changes in energy policy have been announced on different sides of the political spectrum, so I am interested to know, particularly from Ian Simm and Stephanie Maier, whether they have had an impact in your area of work. First there was the Government's announcement of a review of green levies—we do not know what that is going to be, but it has been announced—and then on the other side there was Ed Miliband's announcement of a freeze in energy prices for 20 months. Have either of these two policies had an impact on your area of activity? That was for Stephanie and Ian particularly, but obviously the others may want to comment.

Chair: Who do you want to answer?

Mark Lazarowicz: Probably Ian Simm and Stephanie Maier first, I would have thought. I am just interested in whether you can give a bit more detail.

Ian Simm: On the review of the green levies, the Secretary of State for Energy and the Minister have made it clear, to my understanding, that there will be no impact on the renewables obligation or the support that is envisaged in the EMR legislation, and therefore the searchlight is being turned towards ECO in particular. Therefore, because my company is investing in the former and not the latter, we are not concerned, although I can understand that those private sector businesses that are developing projects in the energy efficiency sector may be concerned.

With regard to statements around retail prices, it is generally our view as an investor that we look at the wholesale market and the wholesale price as the driver of our investment returns or prospective returns. What happens beyond the dispatch of the energy into the grid system, the exposure to taxation and any Government intervention on the retail prices is not our concern, so from the narrow view of our own investment world, it is not making any difference. But we are sympathetic to views from outside the UK, possibly outside the European Union, that this media confusion, which I referred to a moment ago, is less well understood and less easy to interpret if you are sitting in Korea or California. It may therefore be having a negative impact on the perception of the UK as a destination for energy investing.

Stephanie Maier: Again, this about the broad point of what messages it sends and the uncertainty around what might happen. In general, we will see what specifics come out of it. We look at it not just from the infrastructure perspective, but also from the perspective of equity in some energy companies. At any point, Government intervention on something like pricing is going to be a sensitive issue and brings up issues about how a company responds and manages within that context.

Having said that, the broader point is about looking at the broader operating context. UK energy firms operating in the UK set their business strategy on the basis of the current policy framework, but they are definitely aware that ultimately their consumers are going to have an impact on that company's business strategy. We look to companies that understand the impact on their ultimate consumers, because that is also what makes better businesses—those that understand and act responsibly in accordance with their customer base.

Q174 Martin Caton: We are going to look at fiduciary duties now, so I think it is sensible to ask Ms Howarth the first question, but obviously I will be interested in other panel members' ideas. In your written evidence, Ms Howarth, you say that fiduciary duties are generally interpreted narrowly as a duty to maximise returns, which in turn is interpreted as meaning short-term returns. You have said something very similar already today. Is there evidence that fiduciary duty is responsible for institutions avoiding investment in green projects?

Catherine Howarth: No, I do not think there is evidence of that. What there is good evidence of is quite significant confusion among pension investors about what their duties mean in practice. I mentioned that earlier in the spring, we had enabled pension fund members to e-mail their schemes, encouraging them to give a response as to whether they were concerned about the possibility of a carbon bubble. Although we had not mentioned the words "fiduciary duty" at all, about quarter of the schemes that responded to members invoked fiduciary duty. Half of them invoked fiduciary duty as a reason that they should take account of the potential environmental risk and the financial implications of a carbon bubble, and the other half of those that invoked fiduciary duty used it for precisely the opposite reasons. They said, "We cannot take this kind of consideration into account because we have our duty to meet the best interests of the members by maximising returns, and this is a long-term factor".

So we think that it would be helpful—this is one of the things that the Law Commission is currently looking at—to help to clarify and codify investors' duties by introducing statutory clarification of investors' duties. That would make it clear that this is a permissive regime, in that they can look at the long-term financial implications of environmental risk and environmental cost and also take account of the wider well-being of beneficiaries who may retire into a world where climate change has imposed great changes upon the environment. The Law Commission is currently reviewing the situation. It has just brought out its interim paper and is seeking responses to that. It says some very helpful things in the paper. For example, it has clarified that pension funds who are universal owners—in other words, they have holdings right across the economy—are not necessarily obliged to seek to maximise each and every stockholding if that imposes costs upon the wider portfolio. Climate change and environmental considerations would be a classic example of that particular dynamic. But it has stopped short; it looks like it is not going to recommend statutory clarification, which we think would help to unblock some of the current inhibitions and blockages to pension funds thinking about investing in low carbon and green investments.

Q175 Martin Caton: You talked about the different interpretations of fiduciary duties. Do you pick up that certain types of investment institutions are taking what we would regard as a more progressive approach, and other types of fund managers would tend to take a more traditional financial approach?

Catherine Howarth: I must say, there is a great mix in both the pension fund and the asset manager community when it comes to this matter. There are an increasing number of pension funds that think that in order to act in the best interests of the fund members, they must take a long-term view of issues like climate change and the impact that they might have, but there are other pension funds that just still take a very narrow view.

Similarly, in the asset management community, last year we organised a letter to Vince Cable and a public letter to the *Times*, which was signed by a number of asset managers, including Hermes and Aviva Investors and Generation Investment Management and others, but there are quite a number of asset managers who are less confident about that point. There are those whose entire strategies are based on very short-term trading, and for them such considerations do not have an impact on their investment success or otherwise, so they are less inclined to engage with this debate.

Q176 Martin Caton: Do fund managers need better guidance about fiduciary duty?

Catherine Howarth: I believe so. That is one of the recommendations coming out of the Kay Review—that the FCA could give a stronger steer to asset managers, as the regulator for the asset management community, and try to ensure that fiduciary standards are built into the regulatory standards that govern the asset management community. I do think that greater regulatory clarity would be helpful for asset managers and for pension funds as fiduciaries. We think that statutory clarification will help to clear up once and for all the scope that trustees have to take a long-term view and think about the best interests of the beneficiaries and the costs of things like climate change upon them.

Q177 Martin Caton: Could I just ask Ms Howarth, could you give us a bit more of an idea of what you would like in this statutory clarification? What would it look like?

Catherine Howarth: We have drafted up a short draft statute, and I can provide it to the Committee after this session, yes.

Chair: Mr Simm, you wanted to come in.

Ian Simm: Yes, I just wanted to add a couple of points to expand the issue. The vast majority of pension funds in the UK are small relative to international standards, and as a result there are very few of them that have the resources to employ specialist staff to assess infrastructure investments directly or green investments specifically. The vast majority of UK pension funds employ consultants—groups such as Hymans Robertson, Mercer and Towers Watson—to give the trustees advice on asset allocation at the top level. Then within each asset bucket—for example, fixed income, equities or infrastructure—the consultant advises the trustees and the pension fund manager on how to deploy that capital, typically through a competitive tendering process to identify a fund manager. That could be a group like Impax Asset Management—in other words, not the pension fund manager but a third-party service provider. They manage the money over a specified timeframe.

I think the context of fiduciary duty is one that needs to be seen at the level of both the pension fund, where there is a debate between the trustees, the consultant and the individual fund manager about what scope they have within the limitations of fiduciary duty, and how that is translated down into implementation at the asset manager level. Speaking as somebody who is executing similar contracts, I can say with some certainty that the mandates that are given by pension funds to groups such as ourselves are very tightly defined. The risk tolerance—risk budget, if you like—target returns and scope for making investment decisions are generally speaking quite tightly specified. As asset managers, we therefore have quite limited room for manoeuvre.

Chair: I think Stephanie Maier wanted to come in.

Stephanie Maier: Yes. I suppose I would say that fundamentally, fiduciary duty is about acting in the best interest of the beneficiary, and we would see that as taking into account these broader sustainability issues to deliver that long-term return. But I would make two points. One is that the UN Environment Programme Finance Initiative has produced two reports now. It commissioned Freshfields Bruckhaus Deringer to form a legal opinion, and it looked across a number of different jurisdictions and was clear that fiduciary duties should include a look at the longer-term issues, taking the broader elements into account. The point is that it is not required in UK statute, and I definitely back up the point that there is an ambiguity there. Some choose to interpret the current framework in a longer-term way, and others choose to look at it in a more limited way. But there has certainly already been legal advice sought on those elements, and it may be helpful to look at those. I can forward the links to that.

The other point is looking at the Stewardship Code. This is for equities, but there is a requirement on a fund manager to have appropriate oversight of the assets that they manage. At the moment, we have a number of asset managers signing up to this code, which is a set of principles that looks at how you hold the board to account, effectively. On the asset owner side, very few sign up to that. If we had more asset owners looking from a stewardship perspective at how they invest, and instructing their fund managers to do the same, that would also be an enabling mechanism to help drive all investment in a more responsible, sustainable direction.

Q178 Mark Lazarowicz: Briefly on that point, the Kay Review obviously does allow the potential for providing extra comfort to managers who are nervous about looking at the longer-term aspects of some of the environmental climate change concerns and so on. But is it going to have a sufficient impact, since fund managers and people in the field—people like yourselves—can already decide to look at it longer-term and will do so under the present rules and legislation? Those who are either very cautious or who are looking at short-term returns will be made to look longer-term by the Kay Review. Is that going to have a sufficient impact? Also, I would be interested in knowing where is the Kay Review in terms of implementation from your perspective.

Stephanie Maier: On the fiduciary duty question, the Law Commission is consulting on that now, so the opportunity should be taken now, because it is there on the table. That would be an element that could help facilitate this debate. On whether it is going to change the direction of all investment—no. It is just one of the elements that fit within the capital structure and how capital is allocated at the moment. Certainly the need for understanding the broader context and sustainability impact of investments at different levels is part of. It is part of beneficiaries understanding how investments are made at institutional investors, and how they instruct their fund managers to invest through management agreements. Key players like investment consultants, who have been referred to already, play a key gatekeeper role—or can for certain pension funds—for which fund managers are selected.

Catherine Howarth: Obviously the Kay Review looked at whether short-termism exists in capital markets and what are the drivers of it, and it looked at things beyond fiduciary duty, absolutely. It looked at the whole question of misaligned interests, where asset managers frankly know that they are going to get their bonus payments and they are remunerated on the basis of outperforming a benchmark index, usually over quite a short time horizon. That drives behaviour. It also looked at the problem of trustees thinking that they have a duty to ensure that they maximise returns over the short term, which they cannot move out of There are a variety of factors, and fiduciary duty is not a silver bullet for all of them.

We need remuneration incentives in the asset management world that help to align the long-term financial interests of the underlying risk-taking pension savers with the incentives of the agents in the chain—particularly asset managers, but also company directors, who also, as we know, can often be pursuing quite short-term strategies, because that is what they are incentivised to do. But Kay did conclude that fiduciary duty was an issue, and as Stephanie says, we have this very interesting opportunity just now to ensure that the Law Commission, which is looking at it, comes to the conclusion that we hope it will. That is that we need statutory clarification and codification that puts aside once and for all the misconception that you have to pursue the short-term financial interest and profitability and exclude long-term factors, even though those might influence the well-being of fund members.

Q179 Chair: You talked about the conclusion that you hope the Law Commission will come to. What will it take to ensure that the Law Commission will come up with that recommendation, do you think?

Catherine Howarth: It is interesting. They have just brought out their paper, and as I say, there is some excellent things in it. They are very much emphasising that where environmental, social and governance factors are financially material, trustees should take account of them, but that they do not have to take a narrow view and can take a universal view of systemic risks, including climate change. But they are not currently, it would appear, minded to recommend clarification in statute. We think that is largely because they have looked at the law in theory and have not looked enough at how the law is applied in practice. The evidence coming out of pension schemes is that in fact they take a very narrow view and are very confused about what the law allows them to do, so we are presenting the Commission with evidence that in practice, on the ground, pension fund trustees feel quite constrained and that they might be in breach of legal obligation if they do not take a very narrow view. There is a bit of a challenge in making sure that that is fed through to the Commission, and we will be undertaking—

Q180 Chair: But as you say, it is a big challenge in so far as the Kay Review did not specifically mention fossil fuel emissions, climate change or greenhouse gases, did it?

Catherine Howarth: No, it did not, which was interesting, because in a way it is the classic long-termism/short-termism dilemma and problem. The very fact that the Kay Review came out so strongly to say that there is quite problematic short-termism in capital markets, but had not even incorporated the environmental issues that we have been talking about today, does suggest that those problems he identified are very big ones. I think the Kay Review recommendations are only amplified when we consider the factors that are in front of the Committee today.

Q181 Mark Lazarowicz: To be fair to the Kay Review, I think I did come across a reference to environmental considerations in the statement of good practice of directors, so there is certainly some reference to it in the report.

This is a question that is perhaps unfair to ask you, and maybe I should ask the Minister in due course, but what is your understanding of the time scale for the consultation to conclude and for any decisions thereafter? It is probably in our papers here somewhere, but I am not able to find it. Do you know off the top of your head?

Catherine Howarth: It has only just released its major paper, for which it is seeking consultation responses. That will close in January, I believe, and then the Commission is due to make a final report and recommendations in June of 2014.

Q182 Simon Wright: I have a few questions for the New Economics Foundation regarding the evidence that you have submitted, which suggests that the Bank of England should direct the Asset Purchase Fund to buy bonds with a specific remit for sustainable investment. I wonder if you could say a bit about what you believe the risks are in using quantitative easing in this way and how, for example, you would avoid the Bank of England simply picking winners and choosing some sectors over others.

Josh Ryan-Collins: Sure. I would just like to frame that question in a broader context initially, which is that the Bank of England has purchased £375 billion-worth of almost entirely corporate bonds to date, and that has not been neutral in its outcome for the UK economy. The effects have been documented, but they include essentially supporting people who own assets already, because it has led to an increase in asset prices, so it is basically a fairly aggressive policy and may well be stoking up the house price bubble that we are seeing at the moment. I would like to make that initial first point—that the current system is not in some way neutral and what I am proposing dangerous and not neutral.

What we propose in the report is that rather than the Bank of England directly creating money to go into particular projects, there would be a new body created, what we call the Monetary Allocation Committee, which would be separate from the Monetary Policy Committee. The Monetary Policy Committee would continue to determine the total amount of central bank money that is created, but another body staffed by macro-economic experts—it could be from the Treasury and the Bank of England—would decide on the allocation of that money, based upon a wide range of factors, including inflation, regional spare capacity across the UK and ecological sustainability issues. Those are longer-term factors. What we propose in the report is that they would use that funding to capitalise agencies such as the Green Investment Bank or the Business Investment Bank. We have also suggested that the Green Deal could have an agency that could also take capital. You could achieve a massive upscale in what these agencies are currently doing in a very short space of time.

Even if there is no additional quantitative easing, and there has not been the last couple of quarters—the Governor has chosen not to increase it—£100 billion-worth of corporate bonds will reach maturity over the next 10 years and the Bank of England is then faced with the decision as to whether it renews those bonds or the Government just pay them back. My prediction would be they will be renewing them, because I do not think the economy is strong enough at the moment to pay them back, so the question is then what do you do with that £100 billion? If you just put £30 billion of it into some of these policies, you can achieve a massive change and we have been talking for the last hour about pension funds changing this or that. This could just sort out the problem much more rapidly, potentially. The key thing in terms of picking winners is that you would have that division between the people who create the amount of money, where it is allocated, and then a third stage, which is the actual investment agencies who are making the individual decisions, so I think the risk there of political influence is minimised.

Q183 Simon Wright: Thank you. On the model that you described and the structure within that, with the creation of the Monetary Allocation Committee, you are suggesting that the role of the Monetary Policy Committee would largely be unchanged, but obviously there would be quite a high degree of interaction between the two.

Josh Ryan-Collins: Yes.

Q184 Simon Wright: Just coming on to the future of quantitative easing, there is speculation that it may be coming to an end altogether. Would you advocate though that we should continue with quantitative easing as part of your proposal here?

Josh Ryan-Collins: The first point to make is that when you say that QE may be coming to an end, it is not coming to an end if, when the bonds come to maturity, the central bank buys them. Then it is just rolling over—the total amount is not increasing, but it is just being rolled over. In the US context, the tapering is about the US Government not buying at £85 billion every time, so just keeping it the same is not the end of QE. We would advocate, as I say, when the existing £375 billion comes up for renewal, buying different kinds of assets, different kinds of bonds—bonds that are going to direct investment into productive sectors of the economy—building houses, supporting green infrastructure and development and insulating homes all across the country.

The current problem with QE is that in buying corporate bonds, many from pension funds, the hope is that those pension funds will then invest in more productive assets, but there is very little evidence that is happening. Typically, where there is lack of confidence, capital markets will not necessarily move in the direction you are hoping. They will just potentially buy other kinds of bonds or other kinds of assets—existing assets rather than new assets. The other hope is that banks start lending more to the productive sector. Neither of those things has happened, so we would suggest using what we call strategic QE to enable that and then reviewing how it is going. Look at spare capacity in the economy and let that be what decides whether you reduce or increase the total credit creation by the Bank of England.

Simon Wright: Very helpful, thank you.

Q185 Dr Whitehead: Just a brief thought on financial transaction tax. Is there any appetite for the introduction of that in the UK? As you know, a number of EU members appear to be in favour of Europe-wide financial transaction tax. The UK is putting it under legal challenge at present, but are there any thoughts on the suggestion that such a tax could be hypothecated for green investments?

Josh Ryan-Collins: Yes, I would like to kick off. The financial transaction tax is an idea that has been around for a long time, and there are a lot of myths out there about what its effect would be. The fact is that there are many examples of successful unilateral implementations of financial transaction taxes without requiring multi-state collaboration. A good example is here in the UK with the stamp duty on shares, which has been around for many hundreds of years, the latest since the 1980s. It does not seem to have caused companies to run away from this country, and it raises billions of pounds every year, but there are also good examples from Brazil, South Korea, Hong Kong, Taiwan and many others. That is one point to make.

Another point to make is that the financial transaction tax, as the current proposals are laid out, would fall most heavily on those parts of the financial sector that trade most frequently—high-frequency trading, as it is known—and there is a lot of research that has come out recently to suggest that that kind of trading is net socially negative in terms of welfare costs, because it is fine in the good times, but in the bad times it pulls liquidity out of countries when they most need it. So there is a broader systemic value to it that I think potentially could tie into the broader discussion we have been having about fiduciary duties. If part of the fiduciary duty is to have broad long-term macro-economic stability, one can argue that taxes of this kind that slow down very, very high-frequency trades could be beneficial on the investment side.

Stephanie Maier: I can certainly see the commercial attraction of it. I think the challenge is that the cost would not just be borne by the high-frequency traders, it would be borne ultimately by pension fund beneficiaries. The likelihood is that the charges would be passed on.

One thing we are looking at to target high-frequency trading—which we agree is short-termist and is undermining the sustainability of the capital markets—is a trade cancellation fee, because one of the distorting elements of high-frequency trading is that essentially the trades are placed and then are withdrawn milliseconds later to distort the market, to get the benefit from the trading. Putting on a cancellation fee would focus more on the behaviour we are trying to mediate, which is high-frequency trading, rather than all trading, so we would have a more specific impact rather than a diluted impact on all trading.

Ian Simm: The issue with green finance, in my view, is not the supply of capital for green finance, it is the risk of the underlying projects, which is high relative to many other opportunities faced by institutional investors. I would much rather see public policy effort put into bringing down risk where appropriate, addressing market failure and providing funding for public goods than into trying to create a different levelling of the playing field through the supply of capital, which I think has a lot of danger of unintended consequences.

Josh Ryan-Collins: Just a few more points. The kind of level we are talking about for this tax, between 0.1% and 0.01% on trades, would bring back the total relative cost of trading back to what it was 10 years ago before the crisis if it was implemented now. There did not seem to be any great liquidity problems or costs to players in the financial markets back in 2003—rather the opposite. They were booming. So we just need to be quite clear about the potential impact of this. The whole point about this tax in one sense is to support pension funds and other long-term, patient capital investors, because is likely to fall much more on those kinds of institutions and traders than it will on very high-frequency kinds of traders.

The other point to make is that the institutions that it will most hit are the big banks and hedge funds and other types of institutions, many of which are already receiving enormous public subsidies—the figure for 2012 is £37 billion for the big four banks. These institutions are not efficient in a market sense, they are being massively heavily subsidised, and the proposal is to make a very small transaction tax on part of their trading. So we need to be quite clear: nine EU countries are going ahead with this tax, previously with one exception, Sweden. These kinds of systems seem to have worked, so obviously the proof is in the pudding and let us see what happenes, but I very much hope that the UK can embrace this, and I think green infrastructure would be an excellent way of hypothecating those funds.

Chair: We have reached the end of the questions that we had for you. It is a complex and wide-ranging issue, so I thank each and every one of you for making time to come and give evidence this afternoon to the Committee. Thank you to all of you.