Institute and Faculty of Actuaries

27 October 2022

Department for Business, Energy & Industrial Strategy Review of Net Zero: call for evidence

IFoA response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the BEIS Call for Evidence on the Secretary of State's independent review of the government's approach to delivering its net zero target. This response was written by the IFoA's Sustainability Board and has been considered from an independent, public interest perspective.

The IFoA has a global membership of over 32,000 actuaries, working across the financial sector. Actuaries have a crucial role to play in promoting the understanding and integration of climate risks and opportunities within decision-making, and in supporting making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. By evaluating systemic sustainability impacts on the financial systems, actuaries are involved in assessing how sustainability topics and the transition to net zero may impact on our assessment of future liabilities and the adequacy of returns to meet these future liabilities.

We would like to response specifically on numbers 1 - 5 of the overarching questions.

1. How does net zero enable us to meet our economic growth target of 2.5% a year?

There are considerable growth opportunities in the transition to net zero, given the level of technical innovation and scale up required. Increasing the level of green investment will create jobs and economies of scale will lead to energy efficiencies that will contribute to economic growth. However, it is clear from our scenario modelling that the level of technological advance required (whether energy efficiency or nature-based solutions) to meet net zero outcomes is significant, multi-faceted and requires strategic systems level thinking to attract sufficient levels of private sector investment. Targeted policy drivers will be needed to help companies and investors move into these new sectors, and these targets should consider the long-time horizons over which the benefits will be felt, not just short term growth targets.

A wider definition of growth should also be considered, beyond the traditional measures of GDP, extended to include measures of well-being, social, natural and human capital, inequality and environmental quality. As the

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Dasgupta Review[1] noted, the biosphere is bounded, so the global economy is bounded. Economic growth should not be at the expense of global or intergenerational fairness, social justice or the wider social policy objectives of the Government.[2]

2. What challenges and obstacles have you identified to decarbonisation?

Our response to this question focuses on the role of institutional investors.

The level of risk associated with decarbonising is generally outside the risk appetite of institutional investors such as pension active funds and insurance companies. Many pension schemes are in wind-down and have a restrained investment mandate (largely fixed income) whilst insurance companies are limited by their solvency requirements. Influence is limited to active stewardship roles as shareholders, where collaboration with other shareholders is required but difficult to achieve. It is rare for institutional investors to contribute directly to the transition (e.g., in renewables) because of high transaction costs, small project sizes or high risk. This can be reduced by incentives such as tax breaks and risk-sharing initiatives such as blended finance.

Fiduciary duty

Additionally, institutional investors are restrained by their fiduciary duty to members, policyholders and other stakeholders. Undertaking reform to remove the perceived barriers which limit the integration and management of climate and environmental, social and governance (ESG) risks within investment decisions will be instrumental in increasing financial flows toward green and sustainable solutions.

Law Commission guidance, DWP regulation and TPR guidance says non-financial factors can be taken into account where pension trustees have good reason to think that scheme members share the concern, and where there is no risk of significant financial detriment to the fund. However, many issues, including those relating to climate-change will have both financial and non-financial aspects. In addition, some issues that start out as non-financial may become financial (e.g., where public criticism translates into reputational damage or reduced customer demand, or where social issues and rising inequality contributes to deterioration in long-term economic growth).

This two-step process for non-financial factors creates barriers and complexity, leading fiduciaries to believe they do not need to consider these risks. The IFoA has therefore recommended[3] the Law Commission undertake an urgent review into the Fiduciary Duties of Investment Intermediaries to remove the distinction between financial and non-financial factors. Instead, the focus should be on investor purpose. This should incorporate the concept of ‘double materiality’; investors should not only factor in the impacts of social and environmental issues on their investments, but should also consider the impact their investment decisions have on the society and the environment.

A clearer definition of fiduciary duty, in line with the recommendation of the UNEP-FI report[4], would be a major enabling factor for sustainable investing within the UK, and the UK could lead the way in harmonising this definition globally.

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[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962785/The_Economics_of_Biodiversity_The_Dasgupta_Review_Full_Report.pdf

[2] IFoA Council member Nick Spencer’s oral evidence to the Environmental Audit Committee: https://blog.actuaries.org.uk/blog/moving-beyond-gdp-ifoa-gives-evidence-parliamentary-committee

[3] https://www.actuaries.org.uk/system/files/field/document/07-31-Law-Commission-14th-Programme-of-Review.pdf

[4] https://www.unpri.org/policy/a-legal-framework-for-impact#:~:text=A%20Legal%20Framework%20for%20Impact%2C%20a%20ground%2Dbreaking%20report%2C,produce%20assessable%20positive%20sustainability%20impacts.

Regulatory and accounting / reporting framework

The regulatory and accounting / reporting framework carries incentives that encourage financial sector participants to chase some risks and to avoid other risks, with insufficient focus on the long-term and systemic risk, and too much focus in short term asset and price volatility (marked to market). This leads to undesirable outcomes, including a focus on trading of existing assets with insufficient attention paid to the long term risk-taking that creates new (including green) assets for society. The economy is a complex adaptive system with emergent behaviour, and we need to look at it through a system lens which takes in social, environmental and economic outcomes. The current framework focuses on narrow aspects, and risks losing the overarching objectives of consumer needs. Moreover, as everyone focuses on these narrow short term risks, systemic risks are forgotten about. A 20-year risk is not the same as a 1-year risk looked at over 20 consecutive time periods.

3. What opportunities are there for new/amended measures to stimulate or facilitate the transition to net zero in a way that is pro-growth and/or pro-business?

Renewables and other technologies can present high upfront costs with returns only seen at a later stage. And although prices of renewables have fallen significantly over recent years, they can still present a risk to institutional investors.

Financing the transition cannot be undertaken by public resources alone, and the Government should work to crowd-in more institutional capital to bring sustainable investment within adequate risk tolerances by, for example, offering catalytic grants, technical assistance, guarantees or first loss. Examples of blended finance are commonplace in development finance with pensions schemes becoming increasingly involved.[5] [6] [7] The Government should learn from these examples and work with institutional investors and other finance providers to design finance models that make maximum use of the trillions of institutional capital potentially available in the UK. The UK Infrastructure Bank is already doing this in its new Strategy Plan[8], and this example just needs building upon.

4. What more could government do to support businesses, consumers and other actors to decarbonise?

Investors and businesses want stability and clarity on policies to support long-term investment, and a level playing field internationally. Policies such as incentives, taxes, carbon pricing or shadow carbon pricing (policies that give a pseudo price on carbon, such as banning the sale of new petrol and diesel cars) need to be clear, coherent and consistent in order to progress business cases.

Carbon pricing is a key assumption used to model financial impacts. The large rise in Emissions Trading System prices over 2021 is an indication that carbon pricing will play an increasing economic role across all sectors of the economy and will have a significant impact on creditworthiness. The Government needs to work internationally to build frameworks that either directly impose carbon pricing (through taxes or emission trading systems), encourage internal carbon pricing, or shape shadow carbon price policies (see for example the work of the UN-Convened Net Zero Asset Owners Alliance [9]).

[5] https://www.pensiondanmark.com/en/about-us/history/
[6] https://www.businesswire.com/news/home/20180103005684/en/The-Church-Pension-Fund-Invests-in-75-Million-Off-Grid-Solar-and-Financial-Access-Senior-Debt-Fund
[7] https://www.impactinvest.org.uk/wp-content/uploads/2021/10/Pensioenfonds-voor-het-Slagersbedrijf-the-Butchers-Pension-Fund.pdf
[8] https://www.ukib.org.uk/strategic-plan
[9] https://www.unepfi.org/themes/net-zero-asset-owner-alliance-position-paper-on-governmental-carbon-pricing/

It is important to have credible transition plans so that investors have confidence in their investees' plans. Government could support this through some overarching guidance or regulation to give confidence to investors that plans are credible.

Stability, clarity and a clear road map, including more cross-party consensus, are all essential to enable planning for change. The Climate Change Committee's 2022 Progress Report to Parliament[10] highlighted important policy gaps and slow progress on wider enablers. We urge the Government to match progress with policy ambition in reducing emissions, and suggest a more important, possibly regulatory role, for the CCC.

5. Where and in what areas of policy focus could net zero be achieved in a more economically efficient manner?

Actions should not be restricted to what is most economically efficient in the short term, as many of the important benefits of investments in mitigation and adaptation only materialise over time. We should not be limited to measures around GDP but also take into account environmental quality, inequality and natural, human and social capital.

Institutional investors and the businesses they invest are currently working hard to meet disclosure requirements. Disclosures are important as they help investors and market participants assess and measure an entity's enterprise value, both current and in the long term, and evaluate its response to and strategy for managing climate-related risks and opportunities. In order to manage those risks and opportunities, the investment industry needs these metrics and disclosures to be transparent and consistent across regulatory frameworks. However, current sustainability disclosure requirements (including TCFD, FCA product level disclosures, SASB Standards and the EUs Taxonomy and Sustainable Finance Disclosure Regulations, as well as the potential for an additional UK level of disclosure from proposals for the UK Green Taxonomy and Sustainable Disclosure Requirements) are a maze to navigate and a huge cost and burden to companies. To ensure that this plethora of disclosure requirements provide "decision useful" information, there needs to be clear leadership across all disclosure areas to minimise the frictional costs to businesses. International collaboration to ensure that disclosures are comparable across a global portfolio will be critical to the usefulness of these disclosure requirements. We would urge the UK Government to work closely with the international approach being developed by the International Sustainability Standards Board (ISSB) and adopt its single global baseline of sustainability-related disclosure standards.

If you would like to discuss any of the points raised in this response please contact Caroline Winchester, Policy Manager (caroline.winchester@actuaries.org.uk).

[10] https://www.theccc.org.uk/publication/2022-progress-report-to-parliament/#key-messages