26 July 2019

ClientEarth Written Evidence

Treasury Select Committee Inquiry into Decarbonisation of the UK Economy and Green Finance

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Summary

- HMT's approach to decarbonisation does not appear to be fit for purpose.
- There is a lack of transparency about how HMT works with other government departments to meet the goals of the Clean Growth Strategy, and carbon budgets more generally.
- The Climate Change Committee's recommendation to institute a Climate Cabinet should be followed.
- The government should institute a parallel budget that tracks the adequacy of climate policy to meeting legal targets, and forewarns of any prospective shortfalls just as a financial budget would.
- On green finance, generally any work that has been done has been around recognising that climate change poses a risk to financial institutions and not on the fact that supporting the transition is a form of risk management.
- Regulators must take a more active stance to ensure that an orderly transition takes place through ensuring that firms focus on their role in the transition.
- Asset owners and managers need to consider climate change as a financial (rather than an ethical) concern.
- Investor action on climate change is not robust enough, and nor does it account for enough of the investment market.

HMT's Strategy

What is HMT's current strategy, and approach to, UK decarbonisation, and is it fit for purpose?

The UK's decarbonisation can only succeed if HMT supports the climate policy-making of other departments; if it internalises the economic benefits that the low-carbon transition will bring as well as the costs that it will avoid. However the perception is of HMT being an obstacle to the development of ambitious climate policy.

HMT certainly does not give the impression of being supportive of the UK's decarbonisation targets. It was the Treasury which sought (unsuccessfully) to water down the UK's 4th carbon budget (2023-2027). Most recently, the previous Chancellor appears to have sought (again, unsuccessfully) to deter the former Prime Minister from adopting a net zero target in keeping with the ambition of the Paris Agreement, by highlighting the (highly contested) "£1 trillion costs" of the transition.

A more specific illustration of HMT's priorities may be its continued support to maximise the economic extraction of oil and gas from the North Sea at a time when the majority of existing fossil fuel reserves cannot be burned without seeing warming of more than 2C.

In short, HMT's approach to decarbonisation does not appear to be fit for purpose.

How does HMT work with the Clean Growth Strategy and government departments to support decarbonisation? Is this working well?

This is unclear – and this lack of clarity is a big problem. There is a lack of transparency about how HMT works with other government departments to meet the goals of the Clean Growth Strategy, and carbon budgets more generally. This lack of transparency may be said to be contrary to the philosophy of the Climate Change Act, which relies on public accountability to ensure the transition is effective.

Again, however, the 'macro' picture of a lack of progress towards meeting our carbon budgets must, at the least, suggest that government as a whole (and, given its importance, HMT specifically) is not working well to support decarbonisation.

In what is surely indicative of this problem, the Committee on Climate Change (CCC) has been compelled, in its recently published annual progress report, to recommend the establishment of a "Climate Cabinet" to include the Chancellor and other Secretaries of State to drive more joined-up and ambitious climate action. It asks the government to:

"Embed net-zero policy across all levels and departments of government, with strong leadership and coordination at the centre. This is likely to require changes to the Government's overall approach to driving down emissions. For example, the Prime Minister could chair regular meetings of a Climate Cabinet that includes the Chancellor and relevant Secretaries of State, with transparent public reporting of progress and plans."

This follows past failed attempts to integrate climate concerns across government. The National Emissions Target (NET) Board was earlier established as, according to the Government's description: "the principal governance mechanism for co-ordinating action [in managing carbon budgets] across government and ensuring that departments are accountable for their share of emissions reductions." By 2015, however, the NET Board had ceased to be, following criticisms from the National Audit Office that it met infrequently, that attendance of senior officials was rare and that there was little evidence of the Board "taking action to hold Departments to account on progress against individual policies in the Carbon Plan [ie. the predecessor to the Clean Growth Strategy]." There is little to suggest that the situation has improved.

HMT's progress in keeping to the Clean Growth Strategy is now judged according to the Actions and Milestones set out in the Strategy, plus updates each October in the Government's response to the CCC's annual progress report. (It may be noted that in past years, updated lists were published quarterly: regrettably, this practice was abandoned in 2013.)

However, the current situation sees HMT given 'responsibility' for only a handful of actions, compared with many dozens of actions attributed to a department such as BEIS, which has so far led in achieving emissions savings. This attribution of responsibility is surely out of kilter with the critical role than HMT plays in the delivery of policy by other departments across government.

There appears to be an inverse relationship between the number of actions attributed to a government department, and the need/capacity of that department to take ambitious action on climate.

It is no surprise, therefore, that policy progress is lacking. This appears to be a system that effectively allows HMT to wash its hands of climate policy even though it may be the single department most critical to achieving it. At present, HMT appears to have power without responsibility when it comes to climate action.

How should HMT's approach evolve to ensure the Government meets the legally binding carbon budgets and the net zero target?

- The CCC's recommendation to institute a Climate Cabinet should be followed. It should meet at regular intervals (at least quarterly) and a list of Ministerial attendees should be published for each meeting.
- Progress milestones from the Clean Growth Strategy should again be updated and published quarterly.
- HMT should be listed as sharing responsibility for any action/milestone that will require HMT approval or buy-in.
- Those milestones should be defined more precisely so as to facilitate more 'granular' accountability within government.

It does appear that, at present, HMT is too 'distant' from the UK's legally binding carbon targets. HMT should consider how to systematise how its work aligns with carbon budgets. One way might be for HMT to work more proactively with BEIS to constantly reappraise the impacts of government action on emissions projections and how they will (or won't) see carbon budgets being met. In other words, it may be possible to institute, in parallel to HMG's budget, a budget that tracks the adequacy of climate policy to meeting legal targets, and forewarns of any prospective shortfalls just as a financial budget would.

As things stand, all of this will not be enough to ensure Government meet its legally binding carbon budgets, let alone the net zero target. The Clean Growth Strategy, if implemented in full, is not sufficient to deliver the 4th or 5th carbon budgets. The 4th and 5th carbon budgets are themselves far too lenient to keep the UK on course to meeting its net zero target. Therefore:

- The 4th and 5th carbon budgets need to be tightened so as to be in line with the 2050 net zero target.
- A new plan, adequate for meeting the 4th and 5th carbon budgets, must replace or update the Clean Growth Strategy.

Green Finance

What role do UK financial services firms currently play in the decarbonisation of the economy, (for example, through stewardship, capital allocation to green projects, green financial products)? What more can they do?
Before financial services firms can play a full role in the decarbonisation of the economy, they must understand the risks posed by climate change both generally for the economy and the financial services sector, and adequately assess and manage those risks for their specific firm. This understanding will lay the groundwork for decarbonising the economy, as financial services firms will understand that keeping warming to a minimum is key to future prosperity for all, underpinned by a healthy planet.

ClientEarth has been advocating for asset owners and managers to consider climate change as a financial (rather than an ethical) concern for a number of years. Progress has been painfully slow, as illustrated by research published in late 2018 by law firm Pinsent Masons that found that only five percent of the UK's biggest pension funds have a policy on climate change.
This reflects ClientEarth's own findings, including:

- Our 2017 referral of Local Government Pension Schemes to the Pensions Regulator, pointing out that many schemes were not considering and managing climate change as a financially material risk, a problem we viewed to be widespread across the pensions industry. A subsequent survey confirmed that 80% of LGPS schemes did not mention climate risk in their Investment Strategy Statements.
- Our 2018 recommendations to the FCA, setting out our findings that contract-based pension providers were failing to consider and manage climate change in relation to their customers' savings. Many providers were not able to tell us how they were dealing with climate risk in respect of their contract-based pension schemes and had not considered the effects of climate risk for strategic asset allocation in their product design and offering.

The reasons for this inaction are varied. Some pension scheme trustees still do not understand that climate change poses material financial risks, in spite of regulatory guidance on the issue. However, many understand the nature of the risk but, given its novelty, feel justified in taking no action on the grounds that many of their peers are taking the same approach. This "herd mentality" stifles innovation as investors are reluctant to take steps they know they should be taking on the grounds that it is "safer" to follow their peers and do nothing.

In our view, there are two (inextricably linked) sides to dealing with climate change as a financial services firm:

- Firstly, financial risks associated with climate change (whether physical risks or risks associated with the transition to a low carbon economy) need to be recognised as such and adequately managed in relation to firms' own investments, and also those made on behalf of their clients. Opportunities should likewise be exploited as far as practicable. Management of climate change related risks would likely lead to decarbonisation of portfolios, forceful stewardship on the alignment of companies' business plans with the Paris Agreement, and capital allocation to "green" assets.
- Secondly, on a proper interpretation of fiduciary duty, financial institutions should be exercising investment discretion in a way that ensures a smooth transition to a low carbon economy, based on an understanding that their investment decisions can have an impact on the real economy. This interpretation of investor duties focuses on the impact that warming along current trajectories would have on the global economy (not to mention the quality of life of the world's inhabitants, including savers), underlining the financial imperative to limit warming. In practice, this view results in many of the same actions being taken by investors, but should strengthen investor motivation to see positive "impact" result from their investments and stewardship activities.

The two are inextricably linked, since the second can be seen as a mechanism by which the risks associated with runaway climate change (a real risk if we continue along current warming trajectories) can be mitigated.

Some investors are already taking action on climate change, including through investor collaborations, such as the Institutional Investors' Group on Climate Change (IIGCC) and the Climate Action 100+. With 170 members with over €23 trillion in AUM, the IIGCC is the European membership body for investor collaboration on climate change, whose stated mission is to mobilise capital for the low carbon transition by working with business, policy makers and fellow investors.

Climate Action 100+, an investor collaboration with the aim of driving business transition, represents more than 320 investors with more than USD $33 trillion in AUM, and has taken the lead on forceful engagement. The '100' refers to 100 "systemically important emitters", accounting for two-thirds of annual global industrial emissions, alongside more than 60 others with significant opportunity to drive the clean energy transition.

However, it remains the case that investor action on climate change is not robust enough, and nor does it account for enough of the investment market. While representative of significant AUM, the whole industry should be behind such initiatives if properly managing risks associated with climate change.

Stewardship should be stronger still. As the Association for Member-Nominated Trustees recently reported, more than half of asset managers disclosing a voting policy to the AMNT did not have a climate change-related voting policy or guideline, calling into question the seriousness with which these managers treat climate change. As a well-resourced and highly profitable industry for whom effective stewardship of assets is a core aspect of the mandate, asset managers should be ensuring that stewardship is adequately resourced and prioritised.

Further, given the potential for state- and privately-owned fossil fuel companies alone to extract enough raw materials to far exceed Paris Agreement goals, stewardship activities must also focus on accelerating the demands of companies consuming energy (i.e. companies throughout the economy, not just in high carbon sectors) for that energy (and the companies themselves) to be carbon neutral by 2050 at the latest.

What steps have UK banks, asset managers, and pension funds taken to 'green' their business models, investments strategies and balance sheets, taking in to account climate and transition risks?

Our experience in this area is primarily in relation to pension funds, though we have some experience of the actions asset managers are taking through that lens. Broadly speaking, some steps are being taken, though they are not being taken quickly enough.

Pension funds

During 2017, ClientEarth wrote to, and met with, a cross-section of providers of contract-based pensions to find out how those providers were managing climate risk on behalf of their customers. The report was provided to the FCA in February 2018. The report highlighted a number of findings in relation to contract-based pension providers' management of risks to their customers, including that:

- Many providers were not able to tell us how they were dealing with climate risk in respect of their contract-based pension schemes and had not considered the effects of climate risk for strategic asset allocation in their product design and offering.
- In many cases there was a disconnect between a pension provider's group stance on climate risk (publishing strong policies and external strategies on investment of the provider's assets) and its consideration in the provision of pensions for its customers. This was the case even where contract-based pensions are provided by insurance companies, whose catastrophe and/or general insurance arm has already developed a view on the wide-ranging risks and opportunities associated with climate risk. This disconnect and, for some firms, complete failure to consider climate risk in respect of the provision of contract-based pensions was acknowledged in a number of face-to-face meetings.
- Where default funds are passive index tracker funds, providers had not always considered whether the fund was vulnerable to climate risk, sometimes citing an inability to make investment/disinvestment choices in relation to passive funds.

Little appears to have changed since that report was written, in spite of frequent attention in the mainstream media and amongst industry professionals around the catastrophic effects of climate change. Indeed, the experience of individuals who have contacted their contract-based pension schemes in recent months to ask how risks associated with climate change are being managed is that schemes are unable to provide a meaningful response.

It is clear that this is the case throughout the industry from the extremely limited reporting of climate-change related risks and opportunities in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). As part of its Inquiry into Green Finance, the Environmental Audit Committee (EAC) wrote to the UK's largest 25 pension schemes, asking what they were doing to manage the risks associated with climate change. Only 7 of those schemes were committed to reporting in line with the TCFD recommendations, leading the EAC to find that there is a need for "TCFD reporting to become a mandatory requirement for all large asset owners by 2022". We agree with the EAC's recommendation. Indeed, if nearly a sixth of the UK's 25 largest pension funds are classed as "less engaged" on climate risk by the EAC, it is unlikely that the remaining 4,000 or so schemes are performing well on this issue.

Asset managers

As set out above, asset manager stewardship and engagement on climate risk is disappointing, in spite of the work of some industry leaders. While the number of "low carbon" or "climate tilted" products available is growing, the lack of transparency around asset manager voting policies and guidelines makes it hard for asset owners to gauge the effectiveness of prospective managers' approach to climate change.

Given the increase in passive investing, the largest passive managers, including BlackRock, State Street and Vanguard, also have a big role to play in ensuring that their stewardship and engagement activities are fit for purpose, and effective value creation and risk management tools. But, as the FCA has recently pointed out in its joint discussion paper with the FRC, Building a regulatory framework for effective stewardship, exercising effective stewardship requires an investment in people and processes which is costly. While the FCA considers that the benefits outweigh the costs, and many firms see their stewardship capabilities as a competitive advantage, there is a clear incentive to "free ride", enjoying the benefits of the stewardship activities carried out by others while avoiding the attendant costs. Increased regulatory scrutiny of stewardship activities (and emphasis that stewardship is a key part of the asset managers' duties) is essential to ensure that free-riding does not take place.

Are there any barriers (regulatory or otherwise) preventing financial services firms from delivering green finance or investing in 'green' assets?

There are a number of barriers preventing financial services firms from investing in "green assets". The Green Finance Taskforce's report, Accelerating Green Finance highlights many of the barriers to investing in green. In particular, we would highlight:

- Misunderstandings around the financial materiality of "ESG risks" including climate change, and associated perceived legal barriers to investing in "green". While expectations have, to some extent, been clarified for occupational pension schemes as a result of updates to regulations, education will be needed to ensure that the investment community understands the position.
- Caps on costs and charges for pensions investments in practice results in incentives to use passive index-tracking funds for default investments, which may incentivise the exclusion of actively managed "green" investments from asset allocation decisions.
- Likewise, scale can be a major obstacle to larger investors investing in innovative green projects which in many cases need only a fraction of the financing that institutional investors are looking to invest. The Green Finance Taskforce's recommendations that the government establish a Green Investment Accelerator (GIA) for early stage technology grant funding, and a dedicated public-private green venture capital fund (amongst others) would help address this issue, but setting expectations that institutional investors invest in "green" would be of great value.

- While investing in “green” assets is clearly critical, attention should also be given to running down investment in “brown”. At governmental level, fossil fuel production still attracts more subsidy than renewables, while the FTSE 100 remains heavily weighted towards fossil fuel companies, meaning that many are investing in fossil fuel generation through passive index-tracking funds. Regulators should be highlighting the problems inherent within this continued investment in brown, and setting out expectations that firms consider the goals of the Paris Agreement, and the UK’s net zero target, when making investments.
- While many investor fiduciaries’ duties require them to consider and manage the impact of financially material “ESG” risks (including climate change) on their investments, they are not currently required to consider the impact of their investments on the environment. Such a requirement would nudge investors to a more long-term view of the impact they can have on the real economy – and the real world – through their investments. There is precedent for such requirements at the EU level. The IORP II directive (much of which is to be implemented in the UK by a Code of Practice issued by the Pensions Regulator to be consulted on later this year) contains a provision that “Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors”. Similar provisions are proposed for insurers and – if well implemented - could form the basis of regulatory engagement with firms on climate change.

What prudential risks does climate change pose?
Climate change poses various prudential risks which have been explored in some detail by the Bank of England. As the Bank of England has been one of the pioneers in analysing the financial risks associated with climate change, we would point the Committee towards their resources as a first step (https://www.bankofengland.co.uk/climate-change).

To date, prudential regulation has largely been focused on issues of solvency and whether financial institutions hold sufficient capital to withstand sudden market shocks. However, maintaining financial stability in the face of climate change will require a broader approach to ensure equitable outcomes. This can be illustrated with two examples, one from the insurance sector and one from the banking sector.

Climate change is expected to lead to more extreme weather events worldwide. This has significant ramifications for property insurers who saw some of the largest losses on record in 2017 and 2018 due to natural catastrophes. Many of those natural catastrophes were attributable in part to climate change. Property insurance contracts typically cover a twelve month period. As a result, property insurers often suggest that they will be able to adapt to climate change by repricing annually to reflect increasing risk over time.

This approach is insufficient on two counts. First, it assumes climate change will follow a gradual and manageable trajectory. However, we know that climate change is not linear, and may result in abrupt changes and climate tipping points. Second, an over-reliance on repricing means that premiums are likely to keep rising. Nevertheless, there is a limit to how far premiums can rise before insurance becomes unaffordable. This results in a so-called protection gap which has severe consequences for society. Although this is not a question of insurer solvency, it is nevertheless relevant to the effective functioning of the financial system.

Consequently, prudential regulators should be considering these issues and addressing how insurers can mitigate the risks from climate change beyond simply adjusting premiums. EIOPA has begun to consider these issues in its latest draft opinion to the EU commission on integrating sustainability into Solvency II and UK regulators should follow suit (https://eiopa.europa.eu/Pages/News/EIOPA-launches-consultation-on-opinion-on-sustainability-within-Solvency-II-.aspx).

The second example is drawn from the banking sector. As the financial risks of climate change become better understood, it is important that financial institutions like banks factor those risks into their decision making. This will lead to a range of real-world consequences. One such consequence is that the cost of capital will likely increase for those developing countries facing the most severe consequences of climate change. Despite this, banks still continue to finance the most polluting fossil fuel projects.

We should ask ourselves if banks should be permitted to finance climate-destroying projects while increasing the cost of capital for developing countries struggling to cope with the consequences. In our view, it is not enough for banks to simply adjust the cost of capital to reflect climate risk. Prudential regulators should be ensuring that UK banks are taking a strategic approach and are not financing activities which contravene either the UK's own climate commitments, or the aims of the Paris Agreement.

These examples show that prudential risks extend beyond issues of solvency and require a strategic approach from the financial sector. Climate change is a systemic risk which will not be abated merely through repricing capital. Government and prudential regulators must recognise that financial institutions are actively contributing to climate change through financing and underwriting activities. Curbing these activities is vital to reducing the systemic risks of climate change.

What is the Financial Conduct Authority and the Prudential Regulation Authority doing to support decarbonisation and a 'greening' of the financial system? (b) What expectations do (and should) they place on regulated firms about their role in the transition through their policy and supervisory activities?

Both the FCA and PRA have brought out a number of discussion papers touching on this subject, and in the case of the latter produced new supervisory expectations for industry. It is unclear how much of an impact this has had on industry practice so far. In our view, the utility of these measures is limited unless regulators demonstrate they are actually willing to enforce the law.

In recent years, ClientEarth has reported nine companies to financial regulators (including the FCA) for breaching legal duties to disclose material risk. In each case, the annual report of the company made no reference to climate change. This was despite the fact that all these companies operate in sectors that are highly exposed to financial climate-related risk. The regulators have never taken any enforcement action with respect to these cases.

This is highly significant because unless regulators are willing to enforce the law, there is no incentive for market participants to comply with them. As a result, we still see listed companies in

high-risk sectors that are failing to disclose any risks from climate change, despite ostensibly having a legal duty to do so. Summaries and copies of ClientEarth's previous complaints can be accessed via the following links:
https://www.clientearth.org/easyjet-among-companies-reported-to-regulator-by-clientearth/
https://www.clientearth.org/clientearth-triggers-review-companies-climate-disclosures/ .

In addition, most of the discussion by regulators has been on how companies will be impacted by climate change. Climate change is, however, a two way street. Many companies are also contributing to climate change through their business activities. That could be through direct emissions or by facilitating emissions through financing or underwriting. There is a fundamental hypocrisy in the UK committing to a net-zero emissions target, but then enabling unsustainable emissions in other countries through the London financial markets. In order to combat this, financial regulators need to not only consider the impact of climate change on companies, but also how companies are impacting on the climate. To date they have not done this.

What is the consumer demand for 'green' financial products?
There is now strong evidence to show that consumers have a strong interest in pursuing 'green', 'sustainable' or 'climate change-related' objectives with their investments and pension funds.

In 2018 ClientEarth commissioned a survey by YouGov to investigate UK attitudes towards climate change and its impacts. Among other things, the results showed that:

- Over half of surveyed participants would expect their pension or investments to avoid fossil fuel projects that contribute to climate change;
- 50% would consider moving their pension or other investments to another provider if they found out that their current fund was investing in companies that have a significant exposure to fossil fuel projects; and
- Three fifths would be interested in a pension fund or financial institution that considers climate change impacts of the companies it invests in.
- In 2019, DFID commissioned a similar survey to find out more about the UK public's views on and interest in ethical, responsible, and impactful investment practices. In its initial results, it found that:
- 2 in 3 people agree that they have a responsibility to make the world better, and want their investment choices to make a difference;
- 2 in 3 people agree that financial institutions should avoid investing in companies that harm people or the planet; and
- Nearly 40% of people with over £25,000 in savings said they would accept a lower return on their investments if it made a difference to something they really cared about.

At a broader European level, leading think tank 2 Degrees Investing Initiative has also published a report with results of a survey carried out by Natixis, which found that over two thirds of retail investors in 22 countries consider non-financial factors in their investment decisions to be "important". It also notes similar findings in equivalent surveys and opinion polls carried out by Schroders and Morgan Stanley.

As these reports and surveys show there is clear demand from consumers to pursue 'non financial' objectives with their investments. At the same time there is a clear lack of information available to consumers and a significant danger of 'greenwash', where products offered as 'green' or 'sustainable' do not in fact achieve, or even pursue, their stated objectives.

Are there a range of accessible options available to consumers seeking to source 'green' financial products across the product suite (for example, mortgages, bonds, investment products, savings accounts, loans)? Do certain instruments dominate the green finance landscape, and if so, why?

Our experience in this area relates primarily to the pensions sector. In this sector the options for pension fund members to select 'green', 'sustainable' or 'climate impact' funds remain limited. While many pension funds profess to integrate financially material environmental, social and governance (ESG) factors into their investment strategies, it is often difficult for pension fund members to assess what this means in practice, both from a risk and return perspective, as well as from a 'green' or 'climate' impact perspective.

As has recently been made clear by the government and major financial regulators such as the FCA and the Pensions Regulator, the integration of financially material ESG or climate change-related factors into investment and stewardship strategies is already a legal requirement for pension funds and other investor fiduciaries. While this clarification is an important development, in our view it is also important to differentiate risk/return objectives from sustainable, green or climate related impact objectives, which customers are increasingly demanding, and which may also be relevant for investor fiduciaries to take into account, where they adopt a broader 'system level' perspective.

Do accompanying documents for 'green' instruments (bonds, funds, etc.) articulate why and how the composite holdings within that instrument are 'green'?

In our experience there is significant problem with the lack of transparency and potentially misleading information and marketing about 'green' financial products. This includes a lack of transparency about underlying holdings of green financial products but, more importantly, this lack of transparency includes what and how the objectives of a particular 'green', 'sustainable' or 'climate-related' financial product are pursued, achieved and communicated.

As a recent report from think tank 2 Degrees Investing Initiative has noted, over the past twenty years, many sustainability-related investment techniques have been developed by asset managers and others, including: exclusions, positive screening, thematic investing, impact investing, shareholder action, etc.

While one can argue that each of these techniques may indirectly contribute to reorienting investments in the real economy, most of them are not explicitly designed to deliver this outcome, and often do not provide a measurement of their effectiveness in delivering this type of benefit. Accordingly, while many consumers may be seeking to purchase financial products which contribute to 'green' real world impacts, many funds or products fail to articulate how this objective is being pursued or achieved.

In our view, it is critical that transparency and accountability in relation to 'green' claims is prioritized as the market for these products increases. Failure to do so will severely undermine consumer confidence and the achievement of consumer and public policy objectives, to create a greener more sustainable economy which addresses climate change risks and impacts.

Are obligations placed upon listed companies, to report their carbon emissions, to inform fund composition?

In the UK, all 'quoted' companies are required to report information on greenhouse gas (GHG) emissions in their annual report, as well as to disclose information about risks and impacts to and from their business in relation to environmental matters. Recently, new regulations have been adopted which extend these requirements to include many large 'unquoted' companies and limited liability partnerships.

While these requirements are important, in our view, they do not provide adequate information to allow investors to determine if and how companies' business strategies are aligned with the goals of the Paris Agreement on a forward-looking basis, and therefore what actions fund managers and other investors should take in relation to their investment and stewardship decisions.

Accordingly, we believe that it is critical that, as soon as possible, companies are required to report in line with recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), including providing detailed information about Scope 3 GHG emissions and reduction targets, and detailed information about a companies business strategy to align future capital expenditure with the objectives of the Paris Agreement, informed by robust scenario analysis.

Financial regulators and auditors must also play an active role in supervising and ensuring accountability in relation to this information, to ensure that investors and fund managers can confidently trust that it is fair, balanced, and reasonable.

Does the current advice and KYC process effectively facilitate a consideration of sustainability preferences?

In our experience, both retail investment advisers and investment consultants advising pension funds frequently fail to adequately advise customers and clients on issues related to financially material ESG and climate-related risks and impacts, as well as on sustainability preferences and objectives.

Investment consultants

As evidenced in a recent report by the UN Principles for Responsible Investment (PRI), most consultants are still failing to consider and advise on ESG issues in investment practice despite growing evidence of the financial materiality of ESG issues to portfolio value. In our experience this issue is particularly acute when it comes to investment consultant advice on financially-material climate change related factors. This presents a significant roadblock for pension funds seeking to integrate these issues into their investment strategy and stewardship decisions, as they are required to do so in accordance with the law and recent investment guidance from the Pension Regulator.

Because investment consultants are not currently regulated for much of the advice they provide to pension funds there is very limited accountability to ensure that this situation improves. For this reason we strongly recommend that Treasury urgently act on the recent recommendations of the Competition and Market Authority (CMA) to bring investment consultants within the regulatory perimeter of the FCA. In doing so, consideration should also be given to the competence and ability of investment consultants to provide advice to pension schemes in relation to the 'non-financial' preferences and objectives of scheme members.

Retail investment advisers

In our work to date, we have not directly considered the extent to which the KYC process requires investment advisers to take into account customers' sustainability preferences. An area we have looked at more closely however is the extent to which financial advisers should be required to considers clients' sustainability objectives in accordance with the suitability assessment process required under the Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (together MiFID II).

Our analysis has found that investment advisors should arguably already be considering their clients' non-financial investment objectives as part of the suitability assessment required under MiFID II, and that where they fail to do so they may be in breach of their legal duties. Arguably this should require advisers to take into account ESG or sustainability-related objectives. This is not-withstanding changes currently being proposed at the EU level which will much more explicitly require investment advisers to ask customers about their ESG preferences.

Despite this requirement, our understanding is that generally, financial advisers are providing very poor quality advice (if any) about how particular products may be suitable for meeting an individual client's sustainability objectives or preferences. In many cases they will fail to even raise this question in client interviews and meetings. In our view this is a highly unsatisfactory state of affairs and must be addressed directly through clarification and regulatory enforcement.

In addition, a recent report from 2 Degrees Investing Initiative sets out further details about a best practice approach to ensuring that investment advisers are able to adequately provide advice on ensuring clients ESG and sustainability objectives are met.

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ClientEarth is funded by the generous support of philanthropic foundations, institutional donors and engaged individuals.

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