ClientEarth

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ClientEarth Consultation Response

House of Commons Treasury Committee Call For Evidence

Future of Financial Services

ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding practical solutions for the world's biggest environmental challenges. From our offices in London, Brussels, Warsaw, Berlin, Madrid, Beijing, Luxembourg and Los Angeles, we work on laws throughout their lifetime, from the earliest stages to implementation and enforcement.

1 Introduction

1. ClientEarth welcomes that the Treasury Committee has issued a call for evidence (the "**Call for Evidence**") to seek public and stakeholder input into the future direction of the financial services sector.

2. Urgent action is needed to ensure that private sector financial flows are aligned with environmentally sustainable growth (in line with the objectives of the Government's Green Finance Strategy) and with a pathway towards low greenhouse gas emissions (in accordance with the Paris Agreement). Accordingly, it is vital that new regulatory objectives be introduced that commit regulators to aligning the financial sector with the goals of the Paris Agreement (as set out at paragraph 6 below) and that financial institutions be mandated to adopt and implement strategies in line with the goals of the Paris Agreement, in line with the approach recommended by the UK's Climate Change Committee (see paragraph 11 below). The Treasury Committee's inquiry represents an opportunity to formulate a strategy to deliver the urgent action required to green the financial sector and meet the UK's Paris Agreement commitments.

3. We understand that the Call for Evidence will be used to inform the Treasury Committee's inquiry into the future of financial services and any future recommendations it makes. We would welcome the opportunity to input further into the development of any recommendations and to participate in any further stakeholder engagement. Please contact Dan Eziefula at DEziefula@clientearth.org if you would like any further input from us.

2 Statutory regulatory objectives & mandating Paris-alignment

What changes should be made to the UK's financial services regulations and regulatory framework once the UK is independent of the European Union?

Should the mandate and statutory objectives of the financial services regulators change to include wider public policy issues?

Government policy and international commitments

4. It is widely recognised that climate change poses substantial risks to economic and financial stability.[1] The financial sector must play a crucial role in not only managing the financial risks associated with climate change, but also ensuring that financial flows are consistent with the necessary transition to a net-zero emissions world, in light of the UK's legally binding target to achieve net-zero greenhouse gas emissions by 2050 (as set out in section 1 of the Climate Change Act 2008).

5. Government policy recognises the need for the financial sector to take urgent action on climate change. The Government's Green Finance Strategy states that the Government is committed to *"Exploring initiatives to accelerate the alignment of financial flows to the Paris Agreement's objectives"* and to *"Aligning private sector financial flows with clean, environmentally sustainable and resilient growth"*, and recognises that climate risks require *"urgent, ambitious and concerted action"* within the next decade. In addition, the Green Finance Strategy stated that the Treasury would recommend in its next remit letters to the Financial Conduct Authority ("**FCA**") and Prudential Regulation Authority ("**PRA**") that the regulators have regard to the Paris Agreement, although no such recommendation was included in the Treasury's subsequent remit letters to the FCA and PRA.[2]

[1] See for example: Network for Greening the Financial System (2019), *'Technical supplement to the First NGFS Comprehensive Report'* at https://www.ngfs.net/en/technical-supplement-first-ngfs-comprehensive-report; PRA *'Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change'* at https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss; PRA (2018), *'Transition in thinking: The impact of climate change on the UK banking sector'* at https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector; PRA (2015), *'The impact of climate change on the UK insurance sector'* at https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-impact-of-climate-change-on-the-uk-insurance-sector; and Bank of England *'Quarterly Bulletin 2017 Q2: The Bank of England's response to climate change'* at https://www.bankofengland.co.uk/quarterly-bulletin/2017/q2/the-banks-response-to-climate-change.

[2] The Green Finance Strategy (dated July 2019) states at page 22: "*For the Prudential Regulation Authority and Financial Conduct Authority, we will ensure that the need to have regard to the COP21 Paris Agreement when considering how to advance their objectives and discharge their functions is reflected in the next Letter of Recommendations that HM Treasury issues to each authority"*. This was not reflected in the Treasury's remit letters sent to the FCA and PRA on 4 November 2019.

6. Furthermore, as a signatory to the Paris Agreement, the UK has committed to the goals of *"Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels"* and also *"making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"*, which would entail reducing greenhouse gas emissions 45% from 2010 levels by 2030 and achieving net-zero emissions by 2050 (the "**Paris Agreement Goals**").[3] However, the Paris Agreement Goal to align financial flows with low emissions is not yet adequately reflected in national legislation or financial regulation.

Statutory regulatory objectives in relation to climate change

7. The Call for Evidence asks whether wider public policy issues should be added to statutory regulatory objectives. Current regulatory objectives (e.g. objectives to ensure the stability of the UK financial system) clearly require regulators to manage the financial risks associated with climate change. However, there is no express objective to facilitate the transition to a net-zero emissions world. As a result, regulators may not act in accordance with the Government policy outlined above or in line with the Paris Agreement Goals.

8. It is therefore imperative that clear and detailed statutory regulatory objectives are added in relation to mitigating climate change, including requirements to: (1) align the financial sector with Paris Agreement Goals and the emissions targets of the Climate Change Act 2008; and (2) consider the impact of regulation or policies on climate change. Such objectives would ensure that the regulators use their rule-making powers consistently with current Government policy and the UK's commitment to the Paris Agreement Goals.

Requirement for financial institutions to align with Paris Agreement Goals

9. For the same reasons, it is vital that financial institutions be legally required to adopt strategies to align their businesses with the Paris Agreement Goals and, in particular, to achieve net-zero emissions (including emissions from the companies and activities which they finance and underwrite) by 2050. ClientEarth's October 2020 position paper *'Principles for Paris-alignment'*[4] details the principles that we consider should underpin any net-zero emission targets. However, in outline, we recommend the introduction of requirements for financial institutions to:

   a. Adopt and implement a credible transition strategy to align their businesses with the Paris Agreement Goals and to achieve net-zero emissions (including Scope 1, 2 and 3 emissions) by 2050 at the latest.

   b. As part of that strategy, adopt short, medium and long-term emission reduction targets, including 2025 and 2030 targets.

   c. Seek annual shareholder approval for their transition strategy (including the interim targets), where publicly listed.[5]

[3] See Article 2.i of the Paris Agreement under the United Nations Framework Convention on Climate Change at https://unfccc.int/sites/default/files/english_paris_agreement.pdf. The best available science indicates that, in order to limit warming to 1.5ºC above pre-industrial levels, global greenhouse gas emissions must decline by 45% from 2010 levels by 2030 and reach net zero by 2050; see the Intergovernmental Panel on Climate Change (2018), *'Special report on global warming of 1.5ºC'* at https://www.ipcc.ch/sr15/chapter/spm/.
[4] At https://www.clientearth.org/media/40omeroa/2020-10-16-principles-for-paris-alignment-position-paper-ce-en.pdf.
[5] See the Say on Climate initiative at https://www.sayonclimate.org/.

d. Disclose their transition strategy and targets (including their underlying methodologies for setting targets and measuring progress) and report annually on progress against them.

e. Allocate responsibility for implementing the transition strategy to specific individuals within the financial institution, and adopt a remuneration policy that incentivises senior managers to implement its transition strategy and to meet the targets.

10. As noted above, the targets should include reductions in emissions from financial institutions' asset and underwriting portfolios. Such reductions can be driven by requiring counterparties to adopt credible and effective Paris-aligned strategies before providing finance or insurance coverage/renewals and through stewardship activities as shareholders. However, these must drive actual reductions in emissions (as monitored by the financial institution and disclosed annually) and therefore cannot rely on long-term net-zero commitments made by companies which do not in practice result in short-term emission reduction.

Climate Change Committee recommendations

11. The above proposals are supported by the Advisory Group on Finance for the UK's Climate Change Committee. It has recently recommended[6] that the UK should commit to being a net-zero financial system, including by fully integrating climate risk and targets for net-zero emissions by 2050 into financial regulation and monetary policy, and by mandating for all financial institutions to adopt targets and plans for net-zero emissions by 2050. It has advised that a shift in focus away from managing climate risks and towards net-zero goals is necessary in order to deliver on the UK's Paris Agreement commitments. A regulatory framework based on climate risk management (with each financial institution focussing only on managing its own individual financial exposure) is not sufficient to prevent the sector financing companies and activities that contribute to warming in excess of the Paris Agreement Goals and the consequential system-level economic and financial stability risks.[7]

Impact of Paris-alignment on the UK financial sector

12. The introduction of such climate-related statutory regulatory objectives and a requirement for financial institutions to align their businesses with the Paris Agreement Goals would help mitigate climate transition risks (including the system-level macro-economic and financial stabiity risks posed by climate change) and would therefore be supportive of other regulatory objectives, such as protecting the stability and integrity of the UK financial system, promoting the soundness of financial institutions and protecting consumers. In particular, taking effective policy action at an earlier stage will result in a smoother transition and will make it easier for financial institutions to plan for the impact of the transition on assets.[8]

13. Furthermore, establishing such clear objectives and requirements at the heart of the UK's financial regulatory regime will be essential to ensuring the credibility and resilience of the UK financial sector and supporting innovation of green products and initiatives, which can help position the UK ahead of the EU, US and China as a global leader in climate-aligned finance in an increasingly competitive market for financial services activity and pave the way for sustainable, long-term growth.

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[6] In its December 2020 paper for the Sixth Carbon Budget Advisory Group *'The road to Net-Zero Finance'* at https://www.theccc.org.uk/publication/the-road-to-net-zero-finance-sixth-carbon-budget-advisory-group/.
[7] Ben Caldecott (2020*), 'With the TCFD in its fifth year, it's time to make 'net zero' mandatory for financial institutions'*, Responsible Investor, at https://www.responsible-investor.com/articles/with-the-tcfd-in-its-fifth-year-it-s-time-to-make-net-zero-mandatory-for-financial-institutions.
[8] See Carbon Tracker (2020), *'Handbrake Turn: The cost of failing to anticipate an Inevitable Policy Response to climate change'* at https://www.carbontracker.org/reports/handbrake-turn/.

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