

ClientEarth Consultation Response

HM Treasury Phase II Consultation

Financial Services Future Regulatory Framework Review (October 2020)

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 wishes to make submissions in relation to two areas of the Financial Services Future Regulatory Framework Review Phase II Consultation (the “**Consultation**”), as set out in more detail below.
2. First, 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 any policy framework legislation under the proposed regulatory framework must commit regulators to aligning the financial sector with the goals of the Paris Agreement.
3. Second, the proposed regulatory framework would significantly increase the rule-making role of the regulators. As regulators are not directly accountable to the public, this runs the risk of a democratic

deficit and lack of accountability. It is therefore vital that means of regulator accountability to Ministers and Parliament (including through select committees, remit/recommendation letters and ministerial allocation of responsibilities) are enhanced.

4. We recognise that the Treasury is in the process of developing more detailed proposals which will be the subject of a further consultation in the first half of 2021. We would welcome the opportunity to input further into the development of the proposals and to participate in any stakeholder engagement, in advance of any further consultations. Please contact Dan Eziefula at DEziefula@clientearth.org if you would like any further input from us.

2 Proposed policy framework legislation & regulatory objectives

Question 2 – What is your view of the proposed post-EU framework blueprint for adapting the FSMA model? In particular:

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What is your view of the proposal for high-level policy framework legislation for government and Parliament to set the overall policy approach in key areas of regulation?

Question 4 – Do you have views on whether the existing statutory objectives for the regulators should be changed or added to? What do you see as the benefits and risks of changing the existing objectives? How would changing the objectives compare with the proposal for new activity-specific regulatory principles?

5. The Consultation proposes that a policy framework be set out in legislation that would provide more detail on the objectives and policies that regulators should pursue, compared to the current objectives and principles in the Financial Services and Markets Act 2000 (“**FSMA**”). In particular, the Consultation proposes that the legislation specifies “*core elements of the regulatory approach*” which direct how the regulators must exercise their general functions, as well as “*Activity-specific regulatory principles*” which direct regulators to have regard to specific broader public policy issues. We understand that this is intended to ensure that the regulators follow Government policy when exercising their proposed expanded rule-making roles.
6. If this proposal is to be adopted, it will be vital that the legislative policy framework provides sufficient clarity and detail to ensure that rule-making by regulators follows the direction of Government policy and international commitments. If the policy framework is too high-level, then it would run the risk that regulators do not focus on issues that are a priority within Government policy.
7. In particular, it is imperative that the legislative policy framework reflects Government policy to take urgent action on climate change, in light of widely recognised risks to economic and financial stability¹

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

and 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. 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

8. 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
9. Any legislative policy framework must contain clear and detailed objectives in relation to mitigating climate change (including requirements to align the financial sector with Paris Agreement Goals and the requirements of the Climate Change Act 2008, and to consider the impact of regulation or policies on climate change), in order to ensure that the regulators use their rule-making powers consistently with current Government policy and the UK's commitment to Paris Agreement Goals. These objectives should be included within the mandatory "*core elements of the regulatory approach*", rather than the "*activity-specific regulatory principles*" (which regulators would only be required to have regard to). In particular, we note that the Paris Agreement Goal to align financial flows with low emissions is not yet adequately reflected in national legislation or financial regulation. Introduction of these objectives would help the UK meet this commitment.
10. The introduction of such climate-related regulatory objectives would help mitigate climate transition risks 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 firms to plan for the impact of transition on assets.⁴ Furthermore, establishing such clear objectives at the heart of the UK's financial regulatory regime will

(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.

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 1.5°C 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 1.5°C*' at <https://www.ipcc.ch/sr15/chapter/spm/>.

⁴ 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/>.

be essential to ensuring the credibility 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.

11. The introduction of an express regulatory objective to align the financial sector with Paris Agreement Goals is also supported by the Advisory Group on Finance for the UK's Climate Change Committee. It has recently recommended⁵ 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 2050.⁶ 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 firm focussing only on managing its own individual financial exposure) is not sufficient to prevent firms financing companies and activities that contribute to warming in excess of Paris Agreement Goals and the associated systemic economic and financial risks.⁷
12. We note that the Consultation provides an example⁸ of a potential policy framework for the insurance prudential regime. Whilst we understand the example for insurance prudential regulation was included for illustrative purposes, we note that it does not specifically refer to climate change policy. Instead, it refers (in the "*activity-specific regulatory principles*") to the insurance industry "*facilitating sustainable growth*" and "*providing sustainable finance*". Whilst these references to sustainability would require the PRA to take into account climate risks to some degree, it would not give sufficient direction as regards the degree of focus and priority that the PRA should apply to climate risks (given their priority within Government policy) or on the specific goals that the PRA should be seeking to achieve. Accordingly, it would not be sufficient to ensure that PRA fulfils the aims of the Green Finance Strategy or Paris Agreement Goals.

3 Regulator accountability to Ministers and Parliament

Question 6 – Do you think the focus for review and adaptation of key accountability, scrutiny and public engagement mechanisms for the regulators, as set out in the consultation, is the right one? Are there other issues that should be reviewed?

Question 7 - How do you think the role of Parliament in scrutinising financial services policy and regulation might be adapted?

13. The proposed regulatory framework in the Consultation would significantly expand the regulators' rule-making role. The Consultation acknowledges that "*in most areas of regulatory policy, this approach will result in greater policy responsibility and discretion for UK regulators than has existed at any time since the early operation of FSMA following its introduction 20 years ago*". This expanded rule-making

⁵ 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/>.

⁶ ClientEarth's October 2020 position paper '*Principles for Paris-alignment*' sets out further detail on the principles that we consider should underpin all companies' net-zero emission targets at <https://www.clientearth.org/media/400meroa/2020-10-16-principles-for-paris-alignment-position-paper-ce-en.pdf>.

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 At paragraphs 2.34 to 2.37 of the Consultation.

role runs the risk of a lack of accountability and democratic deficit. Whilst regulators are called to account through consultations, they cannot be held to account by the public in the same manner as elected officials. It is therefore vital that processes for regulatory accountability are robust, if the proposed regulatory framework is adopted.

14. The Consultation notes that select committees play a significant role in holding regulators to account under the current framework, and states that the Treasury intends to work with Parliament to explore how the select committee system will provide Parliamentary scrutiny in future. We agree that select committees should continue to play a significant role in holding regulators to account and that the Treasury should consider ways to enhance their function, in view of the regulators' proposed expanded rule-making role. In particular, it is vital that: (1) a select committee (e.g. the Treasury Select Committee) holds regular accountability hearings with the FCA and PRA, which must include consideration of how the regulators have exercised their rule-making powers and of their intended direction of travel for future rule-making; and (2) the select committee provides written reports to Parliament in respect of its accountability hearings.
15. The Consultation envisages that there will be increased use by Treasury Ministers of remit letters setting out recommendations to regulators on economic policy. We agree that increased use of remit letters would be helpful under the proposed framework. The Consultation notes that this will help update regulators on the Treasury's position in relation to "*topical issues or challenges*". In addition, we consider that increased use of formal, published recommendations will provide useful evidence for holding regulators and Treasury Ministers to account. Currently, the Treasury is required under FSMA to send remit letters to the FCA and PRA at least once each Parliament. In view of the above and the need for additional accountability under the proposed framework, we consider that a requirement to send remit letters at least once in every calendar year would be appropriate.
16. The Consultation also suggests that regulators be expressly obliged to respond to remit letters explaining how they have taken into account the recommendations. We consider that enhancing and formalising the procedure for such responses would again ensure that there is useful evidence for holding regulators and Treasury Ministers to account. Accordingly, we agree with this proposal (and for the avoidance of doubt, there should be an obligation to publish such responses). If remit letters are to be sent annually, we consider that it would be appropriate to require responses to be sent promptly (e.g. within 3 months) setting out how the regulator intends to address the recommendations in the current remit letter, and detailing how the recommendations in previous remit letters have been implemented.
17. Finally, effective accountability relies on there being clear lines of responsibility that can be allocated to individual Ministers. We note that, although the Consultation refers to the role of Treasury Ministers, it does not specifically address the allocation of responsibilities to individual Treasury Ministers. Currently, the Economic Secretary to the Treasury has responsibility for the Treasury's relationship with the FCA and PRA. The Government must commit to continuing to allocate responsibility for the FCA and PRA to a single Treasury Minister (or one Minister for each regulator), and it should be made explicitly clear that this role includes responsibility for scrutinising the exercise of rule-making powers by regulators (with the assistance of analysis and recommendations from select committee reporting) and for keeping under review whether amendments to the legislative policy framework are desirable. Allocating clear responsibilities in this manner will ensure that there is an elected official to whom the public can raise any issues or concerns regarding regulators, and will also ensure that a Minister is ultimately accountable for correcting any deficiencies in the regulators' approach to rule-making (through amendments to the legislative policy framework).

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