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HM Treasury Consultation on Financial Services Future Regulatory Framework Review: Proposals for Reform

ClientEarth Response

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Contents

Top Lines

1. We welcome that HM Treasury recognises that the statutory framework for financial regulators should be enhanced to clarify the role of regulators in mitigating climate change, and is therefore proposing amending the regulatory principles in the Financial Services and Markets Act 2000 ("**FSMA**") to refer to the UK Government's net-zero emissions target.

2. However, in order to ensure that the UK Government's legal commitments and policy aims regarding both climate change mitigation and broader environmental protection are adequately reflected in the regulatory framework and supported by regulators, HM Treasury should make the following changes to the proposals in its consultation on the financial services future regulatory framework review (the "**Consultation**"):

   a. Climate objective: Regulators should be given a new statutory objective in relation to climate change (instead of the regulatory principle proposed in the Consultation), requiring them to facilitate the meeting of all of the UK's commitments in relation to climate change. The relevant commitments are the UK's net-zero 2050 target, carbon budgets set under the Climate Change Act 2008, UK nationally determined contributions set under the Paris Agreement, and the Paris Agreement goal to limit global warming to 1.5°C above pre-industrial levels.[1]

   b. Nature and biodiversity regulatory principle: A new regulatory principle should be added that requires regulators to have regard to the desirability of restoring and conserving nature and protecting biodiversity internationally in a manner that respects the rights of affected local communities and indigenous peoples.

   c. Clarification of the growth and competitiveness objective: HM Treasury's proposed new statutory objective in relation to growth and international competitiveness must be drafted so as to clarify that regulators may only advance this objective insofar as doing so does not negatively impact the advancement of the regulators' other objectives (including our proposed objective in relation to climate change).

Climate objective

Responding to Consultation question 2: Do you agree that the regulatory principle for sustainable growth should be updated to reference climate change and a net zero economy?

3. As noted above, we welcome that HM Treasury recognises the need to enhance the regulatory framework in relation to the regulators' role in mitigating climate change. The Consultation proposes to amend the current regulatory principle that requires regulators to have regard to *"the desirability of sustainable growth in the economy of the United Kingdom in the medium or long term"* to clarify that

[1] In particular, Article 2.1a of the Paris Agreement under the United Nations Framework Convention on Climate Change sets the goal of *"Holding the increase in the global average temperature to well below 2°C above preindustrial levels and pursuing efforts to limit the temperature increase to 1.5°C above preindustrial levels"* and Article 2.1.c sets the goal of *"Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"*.

such growth should occur in a sustainable way that is consistent with the Government's commitment to achieve a net-zero economy by 2050.

4. Whilst this is a welcome development, it is not sufficient to ensure that the regulators take action to support the UK Government meeting its legal commitments in relation to climate change. For the reasons set out below, this must: (a) be upgraded from a regulatory principle to a statutory objective (equivalent to the FCA's operational objectives and the PRA's general objective); (b) incorporate the UK's commitments to interim emissions reductions in its carbon budgets set pursuant to the Climate Change Act 2008 and nationally determined contributions under the Paris Agreement; (c) incorporate the UK's commitment under the Paris Agreement to aiming to limit global warming to 1.5°C above pre-industrial levels. See also our response to the previous phase II consultation on the financial services future regulatory framework review, which also advocated for an objective in relation to climate change.[2]

Regulatory principle vs objective

5. Achieving the transition to net-zero is both a legislative requirement in the UK and a central tenet of Government policy. It is an ambitious goal that will require transformational changes to the UK economy, and the financial sector must play a critical role in supporting this (as the Government recognises).[3] It is estimated that between US $100 trillion and $150 trillion of investment is required over the next three decades in order to support the transition to net-zero.[4] Conversely, absent appropriate direction from regulators, the financial sector will continue to allocate capital to companies that are not effectively transitioning or to unsustainable activities, for example supporting expansion of coal production.[5]

6. The Consultation proposes a regulatory principle in relation to climate change, which is a much lower obligation than an objective. Regulators are required to actively advance their regulatory objectives. In contrast, regulators need only have regard to regulatory principles. As summarised in the Consultation: "*the regulators are not required to act to advance their regulatory principles; instead they must take them into account when pursuing their statutory objectives*", and the aim of regulatory principles is *"to promote regulatory good practice across the range of the regulators' policymaking"*.

7. In order for the financial sector to fully support the UK's climate goals, climate considerations must form a core part of the development of regulation, supervision, and enforcement in the upcoming decades. To enable this, the regulatory framework needs to impose a positive duty on regulators to

[2] ClientEarth, Response to HM Treasury Phase II Consultation: Future Regulatory Framework Review (2021).
[3] See HM Government, Greening Finance: A Roadmap to Sustainable Investing (2021). This states that, to achieve the UK's 2035 and 2050 emissions reduction targets, *"the whole economy will have to transform"* and also states that *"This transition cannot be achieved without a significant shift of investment into sustainable projects and green technology. The financial system is therefore critical to achieving net zero and protecting the UK's natural environment".*
[4] The Glasgow Financial Alliance for Net Zero, Our progress and plan towards a net-zero global economy (2021) at page 4. See also International Energy Agency, Net Zero by 2050: A Roadmap for the Global Energy Sector (2020) at section 4.2, which finds that investments in clean energy must triple by 2030.
[5] It has been estimated that the UK investors had US $4.59 invested in companies with coal expansion plans as at January 2021, and that the UK financial sector provided US $56 billion to coal companies through loans and underwriting between October 2018 and October 2020. See Reclaim Finance and Urgewald, City of Coal: The Climate Crimes of UK Finance (2021).

advance the UK's climate goals through a statutory objective. A regulatory principle would not enable regulators to take the degree of action required to achieve the UK's climate goals, for three main reasons.

8. Firstly, a positive obligation for regulators to advance a climate objective is needed to empower regulators to focus on designing new regulation that advances climate change mitigation. In particular:

   a. Mitigating climate change must be a central goal of new climate-related regulation, given the transformational changes that are required to achieve net-zero. Mitigating climate change is not merely a matter of *"regulatory good practice"* or a principle to be taken account of when advancing other goals, but an imperative. It therefore cannot be adequately achieved through a regulatory principle. The Consultation notes that a regulatory principle to support international competitiveness would have limited effect and would not support *"the government's vision for the sector"*. Given the significant changes to the financial sector and wider economy needed to meet the Government's vision on climate change (including its vision for a net-zero financial sector), the same argument applies to climate where a new objective (rather than a principle) is needed.

   b. A new objective would future-proof the regime by giving regulators the power to help achieve the UK's climate goals during the transition to net-zero over the next three decades. Currently, HM Treasury is driving much of the upcoming climate-related regulation through the Sustainability Disclosure Requirements and UK Green Taxonomy. However, regulators must also be empowered to support the UK's climate commitments without needing intervention from Acts of Parliament, in particular given the increased role for regulators in rule-making post-Brexit under the Future Regulatory Framework.

   c. Including a climate objective would make clear that climate mitigation alone is sufficient reason for new regulation. This would both clarify that regulators have the powers to act on climate, and simplify the process for justifying new regulation on climate. Currently, in order to take action that might help to mitigate climate change, regulators have to justify taking that action under their existing objectives. Regulators must therefore analyse climate as a financial risk that (for example) affects consumers, market integrity or the prudential safety of firms within the UK financial sector.[6] As is widely recognised, climate change poses substantial financial risks (both to individual firms and consumers, and to the wider economy through system-level macro-economic and financial stability risks). Addressing climate-related financial risks must be a central goal for regulators during the transition to net-zero. However, treating climate change solely as a financial risk within the regulatory framework is not sufficient. In line with the UK Climate Change Committee's recommendations, the financial sector must move away from viewing climate change as solely a financial risk towards also targeting the transition to net-zero as an additional goal in itself, in order for the UK to meet its emissions reduction targets.[7] To allow regulators to support this, mitigating climate change must therefore be an objective itself. This would allow regulators to take action that may not have an appreciable benefit to current objectives (for example, because it does not reduce risk to investors) which is intended solely to bring about a reduction in emissions. For example, the design of regulation on a green taxonomy or transition plan requirements may

[6] For example, the FCA's Policy Statement 21/23 justifies climate-related disclosures for standard listed companies by explaining that the proposed rules contribute to *"efficient capital allocation"*, the meeting of *"consumers' climate-related preferences"* and the assessment of product suitability for consumers.
[7] The Advisory Group on Finance for the UK's Climate Change Committee, The Road to Net-Zero Finance (2020).

include aspects that are designed solely to reduce emissions through those regimes, rather than to reduce financial risk for consumers or market participants within the UK financial sector.

d. Similarly, including a climate objective would make clear that regulators can include the mitigation of climate change as a factor in cost benefit analysis. The regulators consider cost benefit analysis by reference to their statutory objectives.[8] Under the current regime, regulators consider benefits to market participants and consumers, but are not permitted to consider the broader benefits of mitigating climate change.[9]

9. Secondly, a positive obligation on climate would help regulators to allocate sufficient resource to climate matters. Regulators have finite resources and are required by a regulatory principle in FSMA to apply their resources in an efficient and economic way. As regulators are required to act in a way that advances their objectives, they must assess the efficient use of their resources primarily by reference to the advancement of their statutory objectives. A climate objective would therefore assist regulators in providing the necessary resources to climate issues across all areas of supervision and enforcement. For example, regulators would be able to allocate more resource to assessing climate-related disclosures and transition plans, or taking enforcement action against firms with inadequate disclosures.

10. Thirdly, establishing a climate objective at the heart of the UK's financial regulatory regime will increase the competitiveness of the UK financial sector, by sending a clear message on the UK's commitment to becoming the world's first net-zero financial sector. This would drive the UK's leadership in the innovation of green products and initiatives, and underline its credibility and resilience to the upcoming transition. A climate objective can cement the UK's role as the global leader in climate-aligned finance.

11. Aside from the benefits set out above, we do not consider there to be any downsides of adding a climate objective. A new climate objective would not add significant complexity to the statutory regime, in particular given that HM Treasury is already proposing a climate regulatory principle. Indeed, it simplifies matters by allowing regulators to take action directly for climate reasons, instead of having to justify such action through other objectives, as noted above.

Interim targets

12. The Consultation proposes only that the UK's 2050 net-zero target be included within its proposed climate change regulatory principle. However, this omits the UK's commitments to interim emission reductions:

a. Section 4 of the Climate Change Act 2008 requires the government to set and meet five yearly carbon budgets. Pursuant to this, the Carbon Budget Order 2021[10] sets a carbon budget that implies a 78% reduction in emissions (compared to 1990 levels) by 2035.

[8] See FCA, How we analyse the costs and benefits of our policies (2018) at page 4.
[9] For example, in the FCA's Consultation Paper 21/18 on climate-related disclosures for stranded listed issuers, the cost benefit analysis considers *"the likely benefits to issuers and the wider market"*, but does not consider the wider benefits of mitigating climate change.
[10] See the Carbon Budget Order 2021.

b. The UK Government is required to set nationally determined contributions under the Paris Agreement. The UK's nationally determined contribution[11] commits to reduce emissions by 68% (compared to 1990 levels) by 2030.

13. Referring solely to the 2050 commitment in a regulatory objective or principle would not provide sufficient clarity to regulators on the transition pathway they should seek to support, and could inhibit them taking action to meet the UK's interim emissions commitments. To ensure that regulators support a transition to net-zero in line with the UK's interim commitments, these commitments should be expressly referred to in the climate objective.

<u>Targets for overseas emissions</u>

14. The UK's emissions reduction commitments under the Climate Change Act and related carbon budgets apply only to domestic emissions. They do not include emissions emitted overseas that are caused by the UK economy. In particular, they do not include emissions from overseas companies and projects that are financed or underwritten by the UK financial sector.

15. The UK's finance sector plays a significant role in financing projects across the globe, and therefore has a substantial overseas scope 3 emissions footprint. It has been estimated that financing by UK banks and investors is responsible for 1.8 times the UK's annual domestic carbon emissions (which would make the City of London the ninth largest emitter of carbon dioxide in the world, if it were a country).[12]

16. Legal commitments and Government policy require the UK to take action to address these overseas financed emissions:

a. The UK is a signatory to the Paris Agreement, which aims to limit global temperature rises to 1.5°C. In order to achieve this global goal, the UK must address the overseas emissions financed in the UK.

b. The Government has committed to achieving a net-zero financial centre by 2050.[13] Achieving a net-zero financial centre will be impossible unless the significant role of UK finance in overseas emissions is addressed.

17. Regulators must be required to address these overseas financed emissions, in order to help the UK meet these commitments. We therefore propose that the regulators' climate objective should include facilitating the limitation of global warming to 1.5°C (in line with the aims of the Paris Agreement), which would require regulators to seek to reduce overseas financed emissions. In addition, HM Treasury's next remit letters to the FCA, PRC and FPC should set out the UK's commitment to achieving a net-zero financial centre (including overseas financed emissions).

18. In line with the above, we suggest the following potential wording for a climate objective:

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[11] See HM Government, <u>The United Kingdom of Great Britain and Northern Ireland's Nationally Determined Contribution</u> (2020).
[12] WWF and Greenpeace, <u>The Big Smoke: the global emissions of the UK financial sector</u> (2021).
[13] See HM Treasury, <u>News Story: Chancellor: UK will be the world's first net zero financial centre</u> (2021).

"The climate objective is: facilitating the achievement of the UK's commitments in relation to climate change.

The UK's commitments in relation to climate change include:

a) *the climate targets and carbon budgets set in (or pursuant to) the Climate Change Act 2008;*
b) *the UK's nationally determined contributions set pursuant to the Paris Agreement;*
c) *aiming to limit global warming to 1.5°C above pre-industrial levels in accordance with the Paris Agreement; and*
d) *any other commitments specified by the Secretary of State."*

Nature and biodiversity regulatory principle

Responding to Consultation question 2: Do you agree that the regulatory principle for sustainable growth should be updated to reference climate change and a net zero economy?

19. Climate change should not be the only environmental issue embedded in the regulatory framework. The Future Regulatory Framework Review provides an opportunity to add a new regulatory principle that requires regulators to have regard to the desirability of restoring and conserving nature and protecting biodiversity internationally in a manner that respects the rights of affected local communities and indigenous peoples.

20. Aside from the obvious intrinsic benefits of a healthy natural world and flourishing biodiversity, there is is a clear economic imperative to protect global ecosystems. The world economy, and the support systems necessary for human life, depend heavily on the natural world and biodiversity. An estimated US $44 trillion of economic value generation (over half of the world's total GDP) is moderately or highly dependent on nature, and therefore exposed to the risk of nature and biodiversity loss.[14] These risks are significant; the World Economic Forum's multistakeholder network rates biodiversity loss as the second most impactful risk (behind climate change) over the next decade.[15] Nature and biodiversity risks encompass physical, transition and litigation/regulatory risks: [16]

    a. Physical risks arise from the degradation of natural assets utilised by businesses, as the ecosystem benefits upon which they depend are destroyed. For example, deforestation may lead to more erratic regional rainfall, directly impacting agribusinesses, mining companies, water utilities and hydropower generators.

    b. Transition risks arise as governments take action to protect natural assets and social norms shift. Businesses face potential financial losses if they are poorly positioned for the transition to a nature-friendly economy, and may suffer stranded assets. For example, pesticide companies may lose business and be forced to close manufacturing plants, if agricultural subsidies are diverted towards nature-friendly farming or more pesticide use is banned.

[14] World Economic Forum and PwC, Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy (2020).
[15] World Economic Forum, 2020 Global Risks Report. Biodiversity loss was also ranked as the third most likely risk.
[16] See HM Treasury, The Economics of Biodiversity: The Dasgupta Review (2021).

c. Litigation and regulatory risks arise in connection to the damage that businesses cause to natural assets. Businesses may face claims for negligence or nuisance as a result of adverse biodiversity impacts that cause ecological, human or economic loss.

21. The finance sector must play a significant role in restoration and conservation of nature, as the Government recognises.[17] In particular:

a. The UN Environment Programme estimates that there must be a three-fold increase in the financing of nature-based solutions which protect ecosystems by 2030 and a four-fold increase by 2050, in order to achieve global targets on climate change, biodiversity and land degradation.[18] It is crucial that such nature-based solutions are implemented in a manner that respects the rights of affected local communities and indigenous peoples, including rights over land and forest resources and rights to participate in decision-making processes.[19]

b. Conversely, absent adequate regulation, the financial sector can act as an enabler of the destruction of ecosystems. For example, it has been estimated that between 2016 and 2020 UK banks and assets managers provided US $16.6 billion in funding to companies accused of destroying tropical forests in Brazil, Southeast Asia and Africa.[20]

c. More generally, the financial sector must allocate appropriate value to natural assets and support the prudent management of those assets. As articulated by the Dasgupta Review,[21] economic theory must be expanded to include the value of natural capital, both in terms of its intrinsic value and the value of the ecosystem services which it provides and that underlie our global financial systems. The Dasgupta Review demonstrates that the world's natural capital is currently being grossly mismanaged, posing tremendous threat to the global economic order.

22. The UK has legal commitments in relation to the protection of nature and biodiversity and respect for the rights of indigenous peoples, including the following:

a. Under the Environment Act 2021, the Government is required to: (1) set long-term targets in relation to air quality, water, biodiversity, and resource efficiency and waste reduction (section 1 of the Act); and (2) set an environmental improvement plan designed to significantly improve the natural environment (section 8 of the Act).

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[17] See HM Government, Green Finance Strategy (2019) at page 14, which states: *"the financial sector has a crucial role to play in the transformative change needed to restore and conserve nature, and this in turn helps us tackle climate change by storing carbon in our forests, wetlands and other ecosystems. These form part of the world's natural capital assets and we need to value and manage them properly"*.
[18] UN Environment Programme, State of Finance for Nature (2021), which states that current annual investments in nature-based solutions of US $133 billion must increase to $536 billion by 2050. Nature-based solutions are defined as: *"Actions to protect, sustainably manage, and restore natural or modified ecosystems, that address societal challenges effectively and adaptively, simultaneously providing human well-being and biodiversity benefits"*.
[19] For further detail, see ClientEarth, Communities' rights – the need for recognition (2018).
[20] Global Witness, Deforestation Dividends (2021).
[21] HM Treasury, The Economics of Biodiversity: The Dasgupta Review (2021).

b. The Convention on Biological Diversity aims to achieve the conservation of biodiversity, the sustainable use of its components and the fair and equitable sharing of the benefits arising out of the utilization of genetic resources.[22]

c. The UK has made commitments to halt and reverse biodiversity loss by 2030 in the G7 2030 Nature Compact.[23]

d. The Glasgow Declaration on Forests and Land Use commits the UK to working collectively to halt and reverse forest loss and land degradation by 2030.[24] In addition, the Glasgow Climate Pact recognised the link between climate change and the protection of nature and biodiversity, including through carbon sinks.[25]

e. The UK has commitments to respecting the rights of indigenous peoples in the United Nations Declaration on the Rights of Indigenous Peoples[26] and the International Labour Organisation's Indigenous and Tribal Peoples Convention (C169).[27]

23. The current regulatory framework does not expressly require regulators to take into account the protection of nature and biodiversity, or the rights of indigenous peoples. Our proposed nature and biodiversity regulatory principle would allow the regulators to support the UK in meeting the legal commitments listed above and support the UK financial sector in playing a leading role in driving the restoration and conservation of nature and the protection of biodiversity across the globe. There are clear benefits to the UK in taking such a leading role. It would help the UK financial sector become the global centre for innovative products offering nature-based solutions, and ensure its resilience to risks that are currently underrepresented in financial centres worldwide. There are two main reasons why a new regulatory principle is needed to achieve these goals.

24. Firstly, the new regulatory principle would allow regulators to take into account matters related to the protection of nature and biodiversity, and respect for the rights of indigenous peoples, even where there is no clear demonstrable financial benefit to the UK financial sector. Under the current regime, regulators can take action in relation to the financial impacts of nature-related issues on the UK financial sector (which may for example have an impact on the FCA's consumer protection and market integrity objectives, or the PRA's general objective on the safety and soundness of firms). For example, as noted above, enhanced disclosures can help with efficient capital allocation and meeting of consumer preferences. However, this will not enable regulators to take action to protect nature or biodiversity where there would not be any clear demonstrable financial benefit to the UK financial sector. A new regulatory principle will therefore help regulators support the Government in achieving the above legal commitments in relation to nature, biodiversity and the rights of indigenous peoples (including the impact on nature, biodiversity and the rights of indigenous peoples overseas).

[22] Convention on Biological Diversity (1992).
[23] G7 2030 Nature Compact (2021).
[24] Glasgow Leaders' Declaration on Forests and Land Use (2021).
[25] Glasgow Climate Pact (2021) at paragraphs 21 and 50.
[26] UN Declaration on the Rights of Indigenous Peoples (2007).
[27] ILO, Indigenous and Tribal Peoples Convention 169 (1989).

25. Secondly, the integration of nature and biodiversity risks into financial regulation is currently less advanced compared to climate risk, and consequently nature and biodiversity will need to be a key area of focus in the development of new regulation. The Government has committed to working to catalyse market-led action on nature-related disclosures,[28] and such market-led action will inevitably need to be replaced by regulation in future (as has occurred with climate-related disclosures). A new regulatory principle will help direct regulators to focus on the development of new regulation targeted at the protection of nature and biodiversity, and to apply adequate resources to the supervision and enforcement of such rules. In line with the findings of the Dasgupta Review, the new regulatory principle would encourage regulators to embed the assessment of the real value of natural capital within the financial system (including through disclosures), so that markets are appropriately incentivised to preserve and increase (rather than deplete) natural capital through the appropriate allocation of financial capital.

26. If HM Treasury is not minded to so incorporate such a regulatory principle in FSMA, then at a minimum the regulators' role in the protection of nature and biodiversity and respect for the rights of indigenous peoples must be clarified in HM Treasury's next remit letters to the FCA, PRC and FPC.

Clarification of growth & competitiveness objective

Responding to Consultation question 1: Do you agree with the government's approach to add new growth and international competitiveness secondary objectives for the PRA and the FCA?

27. The Consultation proposes a new statutory objective in relation to the growth and international competitiveness of the UK economy (including the financial sector). We do not currently make any submission in relation to whether this objective should be included in the updated regulatory framework, although we are not persuaded that it is necessary, given that the UK's financial sector is already world-leading and the FSMA regulatory principles already incorporate the desirability of sustainable growth in the UK economy.

28. If a new growth and international competitiveness objective is included in the updated framework, then it is crucial that its interrelationship with the regulators' existing objectives is clarified. The Consultation states that the new objective will be a secondary objective, and will *"not require or authorise"* the regulators *"to take any action inconsistent with"* the FCA's strategic or operational objectives or the PRA's primary objectives. We agree that any new growth and international competitiveness objective should be subordinate to the existing objectives. In particular, the new objective (if included) must not be used as a reason for deregulation that negatively impacts the existing objectives (for example, removing regulation on consumer protection). We understand from the Consultation that HM Treasury does not intend for the existing objectives to be negatively affected by deregulation; it is vital that the wording of the new objective reflects this.

29. The Consultation does not propose the exact legislative language that will be used for the new objective. However, we consider that prohibition of actions *"inconsistent"* with existing objectives would not be sufficiently clear to demonstrate the intended relation between the objectives. We therefore

[28] HM Government, Greening Finance: A Roadmap to Sustainable Investing (2021) at page 7 and HM Government, Green Finance Strategy (2019) at page 25.

propose that the legislation should provide that regulators may advance the new growth and international competitiveness objective *"only insofar as doing so does not negatively impact the advancement of"* the regulators' other objectives (including our proposed climate objective).

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