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Update to Green Finance Strategy: Call for Evidence by HM Government

ClientEarth response

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Contents

Executive summary

We welcome that the government is updating its Green Finance Strategy, in order to better ensure that the financial services industry is supporting the UK's climate and environmental objectives. We also support the government's ambition for the UK to become the first net-zero-aligned financial centre. This strategy provides an opportunity for the government to undertake a holistic review of the overarching policy and regulatory framework in order to ensure that it is fit to support a world-leading centre for green finance and to rapidly redirect financial flows to align them with limiting global warming to 1.5°C over pre-industrial levels.

In this call for evidence response, we provide evidence and proposals in relation to the following issues:

a) *Transition plans*: Effective mandatory transition plan regulation will be necessary to achieve the UK's ambition to be a net-zero financial centre. At a minimum: (a) the rules must apply to all financial services firms, listed companies and large companies (as defined in the Companies Act 2006); (b) it must be mandatory for in-scope companies to adopt a transition plan aligned with 1.5°C warming (including addressing overseas emissions and, in the case of insurers, insured emissions); (c) financial services firms' transition plans must include strategies in relation to financing carbon-intensive sectors that reflect science-based pathways (and in particular, reflect that there can be no new oil and gas field developed or new/expanded coal mines in a 1.5°C aligned pathway); (d) in-scope companies should be required to disclose concrete plans of action and evidence that their plan is, in fact, being implemented; (e) in order for the transition plan requirements to be effective, it is vital that they are backed up by effective accountability measures in which regulators call out instances of non-compliance; (f) transition plan rules must be introduced as soon as possible, and the government must clarify the timeline in light of the fact that they were not referred to in the Queen's Speech (question 26).

b) *Climate-related disclosures*: The UK's regime for climate-related narrative disclosures needs to be enhanced in order to ensure that investors have the data they need to make informed decisions to invest in sustainable activities. In particular, the disclosures should: (a) be required on a clear, mandatory basis; (b) include scope 3 emissions (including any financed and insured emissions); (c) include disclosures on the impact of firms on the environment and society (referred to as 'double materiality'); (d) be consistent and comparable with emerging international disclosure standards; (e) be subject to third party assurance to ensure their quality; and (f) be supported by effective enforcement by regulators (question 30).

c) *Climate accounting*: Climate-related financial risks and impacts (including those identified during transition planning) need to be better reflected in company financial statements, in order to ensure that they are effectively incorporated in financial decision-making, and to meet the requirements of existing accounting standards. In addition, accounting and audit should be "Paris-aligned". This means that companies should be required to state in their accounts whether their accounts are based on estimates and assumptions which are aligned with limiting warming to 1.5°C and, if they are not, to provide a sensitivity analysis showing what adjustments to the accounts would be required for them to be so aligned. Auditors should be required to check these assumptions and raise any concerns (question 30).

d) *Green taxonomy*: The proposed UK Green Taxonomy must be science-based and reflect the precautionary principle, in order to accurately identify activities that are genuinely sustainable (see question 30).

e) *Regulatory objectives*: The Financial Services and Markets Bill provides an opportunity to ensure that the statutory framework enables regulators to support the UK's environmental goals through an objective in relation to climate change, as well as a regulatory principle in relation to the conservation and restoration of nature and protection of biodiversity in a manner that respects the rights affected local communities and Indigenous peoples (question 28).

f) *Conditions for listing*: Applicants for listing should be required to demonstrate that they have a credible transition plan in place, so that the listing application process is consistent with the new ongoing disclosure requirements for listed companies, and to protect the market from uncontrolled capital flows into climate-exposed companies which are not Paris-aligned (questions 26).

g) *Stewardship*: Regulators must make clear that investors need to comply with their stewardship responsibilities in relation to environmental issues, and that failure to do so can breach existing regulation. Regulators should take enforcement action where firms breach such regulation (questions 26 and 28).

h) *Voluntary carbon markets*: The use of carbon credits as offsets (in place of emissions reductions) can reduce incentives for corporates to mitigate climate change and provide misleading information to the market. Carbon credits should therefore not be used as offsets in emissions disclosures or as a means to reach emissions reduction targets. If the UK government nevertheless plans to support the development of carbon markets and to allow the use of offsets in carbon accounting, it must ensure that offsets are closely and effectively regulated (including requiring that offsets are only used in carbon accounting in relation to residual emissions which are not technologically feasible to eliminate).

i) *Energy security*: The financial system should not seek to leverage private investment to meet the objectives of the current British Energy Security Strategy in relation to domestic oil and gas production, as doing so is inconsistent with UK's climate goals and would not be effective to increase energy security in the UK or alleviate energy poverty (question 8).

j) *Sustainable and transition bonds*: A unified system of labelling and benchmarking transition investment products is essential to mobilise private investment into transition activities (question 12).

k) *Capital requirements*: The Basel III and Solvency II capital regimes should be enhanced in order to ensure that banks and insurers are sufficiently resilient to climate risks, and in particular hold capital equivalent to 100% of exposures related to new exploration, expansion or development of fossil fuels and related infrastructure, so they can absorb the losses themselves if a full write-off of the exposure is necessary (question 28).

l) *Monitoring progress*: We outline principles for monitoring the progress of the UK financial sector towards becoming a centre for green finance and towards net-zero (questions 5 and 29).

m) *Retail customers*: Regulation should ensure that retail investors receive consistent, comparable and reliable sustainability-related information, so that they are supported to make investment choices more closely aligned to the UK's climate objectives and which better meet their own sustainability preferences. In particular: (a) financial advisors should be required to take account of investors' sustainability preferences in their advisory and portfolio management processes; (b) the Sustainability Disclosure Requirements ("**SDR**") and Investment Labels regime must be robust and understandable to consumers, and must reflect double materiality; (c) the government must support the Financial Conduct Authority ("**FCA**") in developing a robust regulatory regime governing Environmental, Social and Governance ("**ESG**") data and ratings agencies.

n) *Enforcement:* In order for the implementation of the UK's regulatory framework for green finance to be successful, it is necessary that there is proactive and robust accountability through enforcement action by regulators such as the FCA to call out egregious non-compliance. This should be a core component of the UK government's strategy to support the growth of transition finance. Accordingly, the FCA and other regulators must be adequately resourced and empowered to investigate and enforce against laggards on climate, as overseas regulators are already doing (questions 26 and 28).

Response to questions

Question 1: What are the key characteristics of a leading global centre for green finance?

1. Any centre for green finance needs effective regulation to ensure that investors and consumers have the information they need to make decisions in relation to sustainable finance and products, and to ensure that companies are properly incentivised to support the transition across all aspects of their business. In particular:

    a. there must be effective regulation (enforced by regulators) on mandatory transition planning that ensures that the private sector aligns business models with the UK's climate goals (see our response to question 26);

    b. there must be mandatory requirements for comprehensive climate-related narrative disclosures, alongside requirements for company financial statements to be based on estimates and assumptions consistent with limiting warming to 1.5°C (or disclose a sensitivity to such assumptions) and to reflect the climate-related financial risks and transition plan disclosed by the company (see question 30);

    c. regulated firms should comply with their stewardship responsibilities in relation to environmental issues, and regulators should make clear that failure to do so can breach existing regulation (see questions 26 and 28);

    d. applicants for listing should be required to demonstrate that they have a credible transition plan in place (see questions 26 and 28);

    e. a science-based green taxonomy is necessary to facilitate the directing of financial flows towards sustainable activities (see question 30); and

f. in order to ensure compliance with the rules, there must be prompt, robust accountability and enforcement action by financial regulators, and the regulators must have statutory objectives in relation to the environment that enable them to do so (see questions 26 and 28).

Question 5: How can the UK government measure progress towards becoming a leading global centre for green finance?

2. The growth of the UK's green finance market (if properly regulated) will be crucial to support the UK's transition to net-zero, as well as to support the global transition. In order to measure this, we propose that there should be:

   a. clear and qualitative metrics for green finance, linked to: (a) progress towards the UK government's legally binding commitments on climate change (such as the UK government's commitment to achieve a net-zero economy by 2050 under the Climate Change Act 2008) and other internationally endorsed pathways[1]; and (b) due diligence mechanisms which can ensure the identification, assessment and prevention of real world economic and environmental impacts[2];

   b. clear metrics to assess and monitor: (a) the credibility and implementation of company and financial institutions' transition plans[3] (see our response to question 26 on transition plan requirements); and (b) the volume of investments in companies with credible transition plans.

Question 7: How can the UK support a financial system that leverages private investment to meet the UK's climate and environmental objectives?

3. Investors need comprehensive and detailed information on the environmental impact of companies and activities, in order to direct investment towards sustainable activities that support the transition. See our response to 30 in relation to climate-related narrative disclosures, financial statements and the green taxonomy.

4. In addition, mandatory transition plan requirements will help to direct finance away from activities that are not aligned with the UK's climate objectives and towards those that support the transition. Disclosure requirements alone are not sufficient; firms need to be required adopt transition plans that align their business models and investment strategies with UK climate goals (including the UK's net-zero commitment and interim 2030 and 2035 emissions commitments). See our response to question 26 in relation to mandatory transition plan requirements.

Question 8: How can the UK support a financial system that leverages private investment to meet the objectives of the British Energy Security Strategy, including in areas such as nuclear, hydrogen, carbon capture and storage and domestic oil and gas production, to reduce our reliance on imported fossil fuels as part of a smooth energy transition?

5. The British Energy Security Strategy, in its current form, provides for the expansion of North Sea oil and gas production (in particular, in relation to gas). As set out more fully below: (a) this expansion of gas production is incompatible with the UK achieving its climate goals; and (b) expansion of North Sea

[1] See, for example, the International Energy Agency's Net Zero by 2050: A Roadmap for the Global Energy Sector flagship report (IEA, May 2021).
[2] For example, the UK must avoid mistakes made by other jurisdictions and not limit the scope of financial institutions' due diligence obligations on identifying human rights and environmental impacts in their value chains.
[3] See for example, our Principles for Paris-alignment, which set out our recommendations for Paris-aligned company net-zero strategies, and the Net Zero Company Benchmark | Climate Action 100+.

gas production would not be effective to increase energy security in the UK or to alleviate energy poverty. Accordingly, the financial system should not seek to leverage private investment to meet the objectives of the current Energy Security Strategy in relation to domestic oil and gas production.

Incompatibility of Energy Security Strategy with climate goals

6. The UK has committed under the Paris Agreement to pursue efforts to limit warming to 1.5°C and has set a nationally determined contribution to reduce emissions by 68% (compared to 1990 levels) by 2030.[4] In addition, the UK government has statutory obligations to reduce emissions by 78% (compared to 1990) by 2035 and to net-zero by 2050.[5]

7. The exploitation of new oil and gas fields is incompatible with these goals. Almost 40% of existing global fossil fuel reserves (from existing and under construction oil and gas fields and coal mines) need to be left unextracted in a science-based pathway aligned with 1.5°C,[6] so the exploitation of new reserves cannot be permitted in any reasonable science-based pathway. For example, the International Energy Agency's net-zero pathway indicates that, in order to limit warming to 1.5°C, there must be no new oil and gas fields approved for development and no new coal mines or mine extensions (beyond projects already committed as of 2021).[7] This means that investment in oil and gas must be limited to existing production facilities or those already approved for development.[8] Climate goals require both an end to new development of oil and gas fields and a planned phase out that leaves 40% of existing reserves unextracted.

8. The British Energy Security Strategy supports the development of new oil and gas fields, and is therefore incompatible with the above climate goals. The strategy states that *"we must fully utilise our great North Sea reserve"*, and that the North Sea Transition Authority will launch another licencing round in autumn 2022 to bring *"more domestic gas on the grid"*. It also states that the government will remain *"open-minded"* on exploring and developing onshore shale gas. The Energy Security Strategy claims that the UK will reduce its *"gas consumption by over 40% by 2030"*, but this targeted reduction is not consistent with the above policies to licence the exploration and development of new fields and to fully exploit North Sea reserves. This reduction is also inconsistent with the North Sea Transition Authority's current statutory principal objective, which is *"maximising the economic recovery of UK petroleum"*,[9] and with the government's previous statement that it plans to *"extract every drop of oil and gas that it is economic to extract".*[10]

9. To meet its climate goals, the UK needs to adopt a credible plan for a managed phase out of North Sea oil and gas production with annual decreases in production in line with climate science, which must include immediately ceasing the development of any new oil and gas fields. For the avoidance of doubt, this is not a call to end all North Sea oil and gas production now, but rather to adopt a coherent

[4] Article 1(a) Paris Agreement under the United Nations Framework Convention on Climate Change, and the government's UK Nationally Determined Contribution (2020).
[5] Sections 1 and 4 Climate Change Act 2008 and section 2 Carbon Budget Order 2021.
[6] Kelly Trout et al, Existing fossil fuel extraction would warm the world beyond 1.5 °C, 2022 Environ. Res. Lett. 17 064010.
[7] International Energy Agency, Net Zero by 2050: A Roadmap for the Global Energy Sector (2021).
[8] Oxford Sustainable Finance Group, Smith School of Enterprise and the Environment, University of Oxford, Implications of the International Energy Agency Net Zero Emissions by 2050 Scenario for Net Zero Committed Financial Institutions (2022). This analysis also found that (under the IEA's science-based pathway) natural gas and oil demand must fall 2.6% and 4% respectively each year between 2020 to 2050.
[9] Section 9A Petroleum Act 1998.
[10] Philip Hammond, UK Parliament Hansard, 18 July 2017.

phase out strategy that is consistent with climate science and the UK's climate commitments. Governments worldwide are planning to increase (rather than decrease) oil and gas production, which would result in over double the amount of fossil fuel production in 2030 than would be consistent with limiting warming to 1.5°C.[11] The UK needs to show leadership by adopting a credible science-based phase out plan.

10. In addition, the fact that exploring and developing new North Sea oil and gas fields is incompatible with climate goals and the transition to net-zero means that such activities will be subject to significant financial 'transition' risks. In particular, given the lifetime of new fossil fuel infrastructure, there is a substantial risk of stranded assets. This also poses an issue for financial regulators, as they may not be able to support the leveraging of private investment in oil and gas developments (and the associated exposure of financial markets to unacceptable financial risks) due to the risk that this could be incompatible with their statutory objectives.

Achieving energy security & ending energy poverty

11. Exploiting new North Sea oil and gas fields would not be effective to increase UK energy security, for two main reasons:

    a. The timeframe between the granting of licences by the North Sea Transition Authority and the commencement of production is too long to help meaningfully with current energy security issues. For example, it takes an average of 28 years between an exploration licence and commencement of oil or gas production.[12] While the Energy Security Strategy aims to *"facilitate the rapid development of projects"*, this cannot be sufficiently accelerated to help materially with energy security in the short to medium term (for example, up to 2030). Developing new North Sea oil and gas fields is therefore not a viable short-term solution for energy security, and the long-term solution is clearly to invest in clean energy (given the need to rapidly reduce fossil fuel production to meet UK climate goals).

    b. UK oil and gas is sold on the open market. As noted in the Energy Security Strategy itself, half of UK gas is sold overseas. This severely limits the impact of increased UK gas production on UK energy security.

12. Increased UK oil and gas production will also not help with energy poverty. The UK Climate Change Committee has found that increasing UK extraction of oil and gas would have *"at most, a marginal effect"* on energy prices for UK consumers, as oil and gas prices are set internationally. Instead, it found that the *"best way"* of reducing the UK's exposure to volatile fossil fuel prices is to cut fossil fuel consumption on the path to net-zero emissions.[13] In light of this, the development of new North Sea oil and gas fields cannot be justified for energy affordability reasons.

13. UN Secretary General Antonio Guterres has strongly criticised the suggestion that investing in fossil fuels is necessary for energy security in light of the war in Ukraine, stating that *"new funding for fossil fuel exploration and production infrastructure is delusional"* and would worsen climate change and pollution, and also stating: *"Had we invested massively in renewable energy in the past, we should not be so dramatically at the mercy of the instability of fossil fuel markets now".*[14]

[11] UN EP and others, The Production Gap (2021).
[12] Carbon Brief, Factcheck: Can new UK oil and gas licences ever be 'climate compatible'? (2022).
[13] Climate Change Committee, Letter to BEIS on climate compatibility of new oil and gas fields, 24 February 2022
[14] Reuters, UN chief says new fossil fuels is delusional (2022).

14. The most effective way both to increase energy security and to reduce energy poverty is to provide real support for energy efficiency and onshore wind. Boosting insulation can deliver cost savings to people now and over the long term, while reducing the UK's dependence on fossil fuels (from both domestic and overseas sources) and reducing UK greenhouse gas emissions. Additionally, onshore wind is the quickest and cheapest energy source to get online[15] and enjoys clear public support.[16] The Energy Security Strategy does not commit meaningfully to either energy efficiency or onshore wind, although the Energy Security Bill announced in the Queen's Speech provides an opportunity to remedy this. The government should consider means to leverage private investment to fund both energy efficiency and onshore wind, and not the development of new oil and gas fields.

Question 12: Are there barriers to the mobilisation of private investment into transition activities? If so, what are they and how might they be overcome?

Sustainable and transition bonds

15. A significant barrier to the mobilisation of private investment into transition activities is the disparate and unenforceable set of frameworks for the labelling and structuring of relevant investment products. This issue is acute in the fixed income markets in relation to sustainable bonds, where demand is great and money flows are sizeable[17] but sustainable and transition investments do not always live up to their names. A unified and enforceable framework is essential to ensuring that money flows are directed effectively to transition activities. Such a framework should be linked to and consistent with the UK Green Taxonomy.

16. Sustainable bonds, including green, sustainability and sustainability-linked bonds (some of which are labelled 'transition' bonds) can purport to finance transition activities, but their labels are interpreted differently by different market participants. The indices that include these products also use inconsistent labelling that can be misleading to investors. Indices labelled as 'ESG', 'Sustainable' or 'Climate' indices can include investments that have questionable eligibility, for example bonds issued by energy or utility companies which are expanding their fossil fuel capacity while claiming to be transitioning to lower carbon emissions.

17. The structuring of products also requires unified and enforceable standards. Taking sustainability-linked bonds as an example, as these are most often used for transition financing, their structures can prevent the effective direction of investment to transition activities. Sustainability-linked bonds are issued with Key Performance Indicators and/or Sustainability Performance Targets that can be misleading in the context of the issuer's overall business. For example, where small print limits sustainability goals to a discrete area of the business or alternatively specifies goals that appear ambitious, but have already been achieved. In some cases, sustainability-linked bonds have step-up coupons (penalties for the issuer not meeting its stated sustainability performance targets) that are insignificant in comparison to the 'greeniums' (the amount by which the yield on a green bond is lower than a conventional bond) afforded to the issuer and the reputational benefit of the sustainability label. There are also instances of sustainability-linked bonds issued as 'callable' bonds (meaning the issuer is able to repay the debt before maturity) where the debt is repaid before the sustainability performance targets are even measured, so the commitment to sustainability is never tested.

[15] Carbon Brief, Wind and solar are 30-50% cheaper than thought, admits UK government (2020).
[16] 38 Degrees, New poll results huge public support for onshore wind (2022).
[17] Total Green, Social, Sustainability and Sustainability-linked (GSSS) bonds issuance reached $1.03 trillion in 2021. See Environmental Finance, Sustainable Bonds Insight 2022.

18. The sustainable bond market is growing faster than the necessary regulatory framework is implemented, and industry bodies are introducing their own tools and frameworks by which firms can benchmark sustainable bonds for transition financing. For example, the International Capital Markets Association's Green[18] and Social Bond Principles[19] have been widely adopted, as well as the Climate Bond Initiative's Climate Bonds Taxonomy[20] and Climate Bonds Standard[21].

19. A proliferation of disparate frameworks increases uncertainty, in direct contradiction to their stated aims, due to the following:

    a. The criteria in new, non-regulatory frameworks can be vague, as financial innovators prioritise flexibility. This creates definitional grey areas and unclear requirements.

    b. Adherence to these frameworks is voluntary, and there is a lack of enforceability. This can make it difficult for investors to have recourse to issuers and other bond market institutions when sustainable bonds fall short of the frameworks' standards, which diminishes the incentive for market institutions to adhere to the frameworks.

    c. A variety of frameworks with differing criteria makes it difficult for investors to compare bonds and make informed choices in relation to the true sustainability of a bond, and to ensure that their investment strategies are fulfilled accurately.

20. The uncertainties inherent in these frameworks make it difficult to analyse corporate exposure to climate change risks and to assess accurately the financial risk profile of a bond, including the risk of stranded assets. Independent assessments of sustainability, like the second party opinions provided with sustainable bond issues, are of limited value when they cannot be compared effectively.

Question 14: Is there a role for the UK government to support the development of transition finance markets in the UK and internationally?

21. The UK can play a key role in supporting the development of transition finance markets internationally, in particular through its bilateral relationships. One example of where the UK influence on the international stage could be important is Japan. As the government will be aware, Japan is presently one of the more rapidly developing markets in terms of transition finance, and its framework is likely to influence transition finance across Asia via its Asia Energy Transition Initiative.[22]

22. We note the Comprehensive Economic Partnership Agreement between the UK and Japan and the holding of the inaugural Financial Regulatory Forum between HM Treasury ("**HMT**") and the Japanese Financial Services Authority ("**JFSA**") on 9 June 2022,[23] at which topics discussed included the respective countries' plans for transition finance and the setting up of a new UK-Japan sustainable finance working group, in order to:

[18] ICMA Group, Green Bond Principles (2021).
[19] ICMA Group, Social Bond Principles (2021).
[20] Climate Bonds Initiative, Climate Bonds Taxonomy (2021).
[21] Climate Bonds Initiative, Climate Bonds Standards Version 3.0 (2019).
[22] Japanese Ministry of Economy, Trade and Industry, Asia Energy Transition Initiative (2021).
[23] UK-Japan Financial Regulatory Forum 2022, Joint Statement; Japanese Financial Services Authority press release (2022).

"enable authority experts to exchange views and work towards international alignment on live topics such as building trust in ESG investment products and markets, supporting the transition to net-zero and nature-related financial disclosures."[24]

23. In the government's continued work with the JFSA, and with any other transition finance markets internationally, it should focus on encouraging the development of robust transition finance frameworks from a climate perspective. For example, it is of particular importance that transition finance frameworks should not include finance for climate "solutions" that are based on unproven or untested technological solutions that are non-aligned with the latest climate science.

Question 20: How can the UK financial sector support SMEs and retail customers to align with the UK's climate and environmental objectives?

24. In this response we focus specifically on the steps the UK financial sector can take to support retail investors. We note that other measures may be required to support other retail customers to align with UK climate and environmental objectives. The FCA's recent Financial Lives survey found "*80% of respondents wanted their money to 'do some good', while also providing a financial return, 71% wanted to 'invest in a way that is protecting the environment' and 71% would not put their money into 'investments which are unethical'*".[25] Retail investor appetite for investments which have a real world impact is clear.

25. However, the existing investment and disclosure infrastructure does not do enough to help such investors to invest in line with their preferences. Current limitations include the following:

    a. as recognised by the FCA in its 2021 letter the chairs of authorised funds[26], sustainability related claims made by or in relation to investment funds are not always clear or well substantiated, with the potential for greenwashing which mislead investors;

    b. retail investors' sustainability preferences are not always taken into account by their advisers during the assessment of which investments are suitable for them; and

    c. ESG ratings have a mixed and confusing effect on the market – ratings from different providers often conflict, methodologies are not clear and lack credibility, and aggregate ESG ratings often conflate ESG risk management and real-world environmental or social impact (or ignore the latter completely).

26. The following measures would, by improving the consistency, comparability and reliability of sustainability-related information presented to retail investors, support them to make investment choices more closely aligned to the UK's climate objectives, and which better meet their own sustainability preferences.

<u>Sustainability disclosures and product labelling</u>

27. In addition to climate-related disclosure requirements for corporates, a robust disclosure regime for investment products is necessary to support financial investment from asset owners and retail investors into investment products which are aligned with the UK's climate commitments.

[24] Ibid.
[25] FCA, Financial Lives 2020 survey: the impact of coronavirus (2021).
[26] See the FCA's guiding principles to authorised ESG & Sustainable Investment Funds (2021).

28. Broadly, we support the FCA's efforts to introduce a robust labelling and sustainability disclosure regime for investment products. To address the issues identified above, the FCA's proposed SDR and Investment Labels regime must be robust and understandable to consumers and must not inadvertently facilitate or formalise greenwashing. Investment labels, in particular, must not erroneously certify the sustainability credentials or real-world impact of investment funds or create distinctions that confuse retail investors. SDR disclosures must capture "double materiality", meaning both the financial risks posed to investment products by social and environmental factors and the impact of investment products and the companies they invest in on society and the environment[27]. The UK must ensure that financial products match the priorities of retail investors (whether to avoid "guilt by association", maximise financial returns or have an impact in the real world). And regulators must be clear that, in order to claim a positive impact, financial market participants must do more than simply invest in one listed equity rather than another.

Suitability of financial products for retail investors

29. UK regulation should require advisors to take account of investors' sustainability preferences when recommending suitable products for investment and when managing portfolios:

    a. The explanation by UK-regulated firms and advisors of sustainability preferences to their clients, advisors' understanding of clients' sustainability preferences and the assessment of suitability of investment products all need to take full account of: (a) clients' granular, issue-specific sustainability priorities (such as a focus on climate change (environmental), inequality (social), or tax transparency (governance) factors); and (b) clients' broader understanding of their own sustainability objectives in terms of real world impact, alignment with personal values (including avoiding guilt by association), and financial return.

    b. Climate-related preferences must be addressed specifically in any FCA or other relevant UK guidance, so that clients to whom these issues are important are not misled into selecting products that have an unsustainable emissions profile and/or negative climate impact due to a misunderstanding of what "sustainability" entails in relation to climate change.

    c. UK-regulated firms and advisors must be required and supported to develop the skills, knowledge and expertise necessary to advise competently on sustainability and climate-related preferences.

The role of ESG data and ratings agencies

30. It is also critical to preventing greenwash, ensuring market certainty, and protecting retail investment customers, that the UK government supports the FCA in regulating ESG data and ratings agencies. Their use, accuracy, transparency, and credibility will be of critical importance to those seeking to demonstrate compliance with the UK's SDR, once implemented, as well as for those seeking to use that information for investment decision making.

31. We note and welcome recent comments by Sacha Sadan, the FCA's Director of ESG, speaking about addressing greenwashing in the sustainable investing space, that "*The whole investment chain has to*

[27] See ClientEarth, Response to FCA discussion paper on Sustainability Disclosure Requirements and Investment Labels (DP21/4) (2022).

get involved, and ratings have to be regulated too”.[28] However, the FCA must not delay in implementing new regulation, otherwise it risks being too little, too late.

32. The use of ESG ratings and data products has grown exponentially in response to investors' mounting interest in investing in companies that take account of sustainability in the way they are run, resulting in the proliferation of participants in the industry, including established credit ratings agency participants (directly or through their affiliates)[29]. That growth is expected to continue, with some predicting the market may reach USD 1 billion by 2021, with an expected annual growth of 20%, while ESG indexes could grow by 35%[30]. In light of this, and as demand for sustainability and/or ESG-linked financial products increases, we expect that asset managers, among other users, will turn to ESG ratings and data to demonstrate or justify portfolio alignment. This risks giving rise to 'ratings shopping' and potential conflicts of interest. ESG ratings and data are also known to be subject to data gaps because they generally rely on publicly available data to support providers' rating judgments. Left unchecked, inconsistent or inaccurate ESG ratings and data which do not take proper account of all relevant factors, including climate-related risks and impacts, may give rise to the risk of greenwashing that misleads investors and other users. In other words, investors and other users may be misled to believe that financial products or companies are doing more to address ESG issues than they really are. This can give rise to significant negative consequences, such as market and share price instability[31], preventing the desired (re)allocation of capital towards a lower carbon economy, the mispricing of investments, and/or increased liability risk across the financial sector[32].

33. Retail investors will be particularly susceptible to these risks. Accordingly, to support retail investors seeking to align with the UK's (and their own) climate and environmental objectives, the government and the FCA should take the opportunity to pre-empt and mitigate these risks by implementing new due diligence requirements for users to verify the quality of ESG data and ratings, and to bring ESG data and ratings providers inside the FCA's regulatory perimeter without delay. As noted in our response to the FCA's own consultation on this topic[33], we strongly recommend that HMT work with the FCA to ensure that it:

    a. introduces a new requirement that asset managers and other FCA-regulated entities using ESG data and ratings when marketing funds with a sustainability and ESG focus, or to otherwise describe their investment strategies[34]:

        i. consider the fitness for purpose of ESG data and ratings providers in meeting investors' information needs;

        ii. exercise due skill, care and diligence when entering into, managing or terminating any arrangement with third party providers in relation to the performance of ESG risk management activities;

[28] Financial Times, Regulators take aim at ESG ratings in fight against greenwashing (28 May 2022).
[29] See for example IOSCO's recent consultation, CR02/21 on Environmental, Social and Governance (ESG) Ratings and Data Products Providers (2021).
[30] Ibid.
[31] See Bloomberg, Deutsche Bank's DWS Slumps After U.S., Germany ESG Probe (26 August 2021).
[32] See Bloomberg, Deutsche Bank's ESG Probe Triggers Review at Asset Managers (2 September 2021).
[33] ClientEarth, Response to FCA consultation on climate-related disclosures for standard listed issuers (CP21/18) (2021).
[34] This would be consistent with the FCA's guiding principles to authorised ESG & Sustainable Investment Funds (2021).

iii. establish methods for the ongoing assessment of the standard of performance of ESG third parties; and

iv. disclose details of that due diligence in a clear, accessible and comprehensible manner;

b. brings ESG data and ratings providers inside its regulatory perimeter. While there is a close connection between credit rating agencies and ESG data and ratings providers, we do not think that amending the existing UK Credit Rating Agencies Regulation[35] to take account of ESG ratings and data services would be appropriate. This is because ESG scores differ greatly from credit ratings in terms of how and for what purpose they are used, who they are used by, and in terms of incentives. Instead, we believe that protecting retail consumers and the integrity of the UK's fast-growing sustainable financial markets, and promoting effective competition, would best be achieved by creating an ESG data and ratings specific legislative and regulatory framework based on principles already applicable to credit ratings agencies. In particular, we strongly recommend that framework should require that ESG ratings providers:

i. disclose details of the methodologies and governance systems in place for providing ESG ratings; and

ii. take all necessary steps to ensure that the issuing of an ESG rating or outlook is not affected by any existing or potential conflicts of interest[36].

34. These recommendations, if adopted, would be consistent with and help to inform the current global focus on transparency and conflicts of interest[37], and significantly help to address the live risks we identify above.

Enforcement

35. Finally, rules affecting the conduct of both offerors of financial products, and firms providing investment advice to retail clients on the sustainability (including climate impact) of those products, must be underpinned by effective monitoring and enforcement. The UK's regulators (including the Competition and Markets Authority – through its Green Claims Code, the FCA – through its SDR and Investment Labels regime, and others) must, collectively, proactively monitor and call out instances of financial greenwashing (including inappropriate and/or misleading labelling and marketing of financial products as 'green' without properly substantiating those claims), as other international regulators are already doing.[38]

[35] The current EU Credit Rating Agencies Regulation was on-shored into UK law on 31 December 2020, with the necessary modifications contained in the CRA Regulations 2019.
[36] This could take the form of a requirement broadly consistent with that set out in Article 6 of the CRA Regulations on 'Independence and avoidance of conflicts of interest'.
[37] See, for example: ESMA's Call for evidence on the market characteristics for ESG rating providers in the EU (2022); ESMA's recent findings "*ESMA finds high level of divergence in disclosure of ESG factors in credit ratings*" (10 February 2022); IOSCO's Final Report setting out its concerns with the current operation of ESG data and ratings providers, including little clarity and alignment on definitions, a lack of transparency about methodologies underpinning ratings and data products, and uneven product coverage causing investor information gaps (November 2021); and AMF France, French and Dutch financial market authorities call for a European regulation of ESG data, ratings, and related services (15 December 2020).
[38] For example, further to recent findings by the SEC that BNY Mellon Investment Adviser had made misstatements and omissions concerning ESG considerations in making investment decisions for certain mutual funds that it managed, the SEC recently announced that it is also investigating Goldman Sachs' asset management division over certain environmental, social and governance claims made by its funds. German authorities are also investigating DWS, Deutsche Bank's asset management division, for possible greenwashing (Financial Times, 11 June 2022).

Question 21: Is there a role for the UK government to facilitate broad access to green finance for local authorities, SMEs or retail customers? If so, what should these roles be?

36. We repeat our comments above in response to question 20 on the steps the government should take to ensure retail investors can access green finance, and align themselves with the UK's (and their own) climate and environmental objectives.

Question 22: How can the UK best support the development of high integrity voluntary markets for carbon and other ecosystem service markets?

37. The use of carbon credits purchased on voluntary carbon markets as offsets (in place of emissions reductions) can undermine climate mitigation by disincentivising companies from implementing the emissions reductions needed to achieve the UK's climate goals. In addition, it can mislead investors and customers as to companies' climate impact. It is therefore critical that carbon credits are not used as offsets in emissions disclosures or as a means to reach emissions reduction targets. If the UK government nevertheless plans to support the development of voluntary carbon markets and the use of offsets, it must ensure that offsets are closely and effectively regulated, as set out below.

38. Purchasing carbon credits does not effectively mitigate a company's climate impact, for a number of reasons:

    a. Offset schemes often do not achieve the emissions reductions that they claim to, due to the issues of additionality and leakage:

        i. Establishing what would have happened in the counterfactual, where the offset scheme was not run, is inherently uncertain and difficult. For example, it is hard to establish whether deforestation would have occurred, absent the funding for forest protection. Similarly, it is inherently uncertain whether a renewable energy project would have received funding from the market in any event, or whether the project actually causes a reduction in emissions from fossil fuel based energy, as this is subject to a wide range of variables. This issue is referred to as *"additionality"*.

        ii. Implementing an offset policy in one place can simply lead to a relocation of emissions. For example, protecting forests in one area can lead to the same deforestation occurring elsewhere. This issue is referred to as *"leakage"*.

    Additionality and leakage are significant limitations to offsetting.[39] There is evidence that the majority of offset projects do not produce any of the carbon emissions reductions they claim to for these reasons, including for offsets certified under schemes such as the Gold Standard and Verified Carbon Standard certification schemes.[40]

    b. Offset schemes assume that any emissions removals or avoidance is permanent, and therefore equivalent to emitted greenhouse gases which last for hundreds of years in the atmosphere. However, the longevity of carbon offsets projects cannot be guaranteed (referred to as the

[39] Belfast Centre for Science and International Affairs, Policy brief: the future of carbon offset markets (2020).

[40] Cames et al., How Additional Is the Clean Development Mechanism? (2016). This European Union study found that 85% of the offset projects it reviewed that were established under the Kyoto Protocol's Clean Development Mechanism didn't produce additional carbon emissions reductions to what would have occurred without the investments. This study noted that its findings *"are to a large extent also relevant and valid"* for the Gold Standard and Verified Carbon Standard certification schemes.

issue of *"permanence"*). For example, it cannot be proved that protected or new growth forests will last for the many centuries which the equivalent carbon emissions will (not least due to climate change itself, which will alter ecosystems and, for example, increase the frequency and severity of wildfires). So even where offset schemes do reduce emissions, those reductions cannot reliably be assumed to be permanent, and are therefore not equivalent to the long-lasting carbon emissions they are claimed to offset.

c. Achieving climate goals requires the significant reduction of emissions year on year, and we have no 'room' in the global carbon budget for incurring avoidable emissions on the basis that they are balanced by offsets.[41] As stated by the Climate Change Committee in the Sixth Carbon Budget, reaching net-zero requires that *"all UK emissions must be tackled, without reliance on offsets from elsewhere"*.[42] The Science Based Targets Initiative summarised this problem as follows: *"Understanding that reaching net-zero emissions globally requires all sources of emissions to be eliminated or neutralized with an equivalent amount of negative emissions, this strategy [of carbon offsetting] is not consistent with reaching a state that is consistent with reaching net-zero emissions at the planetary level"*, and *"The widespread adoption of a practice that leaves a ton of emissions unabated for every ton of emissions abated somewhere else would not be consistent with phasing out nearly all sources of anthropogenic GHG emissions"*.[43] Using offsets in carbon accounting undermines the achievement of climate goals by removing incentives for companies to mitigate emissions where it is feasible to do so.

39. Many investors and customers will not be aware of the above issues, and so may assume (or be misinformed) that companies can effectively and completely mitigate their climate impact through the use of offsets. Investors and customers may therefore be misled by companies that use offsets in their carbon accounting to make claims of carbon neutrality or to claim they have reduced their climate impact. For example, the Dutch advertising regulator (The Advertising Code Committee) sanctioned Shell's 'CO2-neutral' offsets marketing twice in August 2021, finding that Shell was unable to demonstrate its claims that offsets neutralised the climate impact of car fuel.[44]

40. In short, voluntary carbon market schemes overstate their climate impact, as they assume that the avoidance or removal of emissions is both certain and permanent (when in fact they are neither), disincentivise companies from taking necessary action to mitigate their emissions, and risk misleading investors and customers. In order to avoid these issues, the purchase of carbon credits should not be used as offsets in emissions disclosures or as a means to reach emissions reduction targets. Companies which wish to purchase carbon credits as a contribution to climate mitigation projects are

[41] As put by Carbon Watch in its Carbon markets 101, offsetting mechanisms: *"are based on a logic which does not hold in the long term. In order to be able to offset one's emissions, someone else needs to have "extra" emission reductions available to sell. Yet, the Paris Agreement requires all countries to reduce emissions as much as they can. This means that there is no room to offset, because there are no "extra emission reductions" available when countries are already doing their maximum"*. The Voluntary Carbon Markets Integrity Initiative's Aligning Voluntary Carbon Markets with the 1.5C Paris Agreement Ambition concludes that *"The imperative for overall and absolute emissions reductions globally, to keep 1.5˚C within reach, necessarily means the end to 'traditional' offsetting"* at page 31. See also the Green Biz article by Kate Dooley, Carbon offsets are only delaying emissions (2021).
[42] See SBTi's Foundations for Net-Zero which states that offsetting using emission reductions *"is not consistent with reaching a state that is consistent with reaching net-zero emissions at the planetary level".*
[43] Ibid.
[44] (Google translation) See https://www.reclamecode.nl/uitspraken/resultaten/vervoer-2021-00190/304997/ and https://www.reclamecode.nl/uitspraken/resultaten/vervoer-2021-00180/301504/ The limitations of carbon offsetting are set out in detail in the complaint submitted by Greenpeace and others to the Advertising Code Committee for this case.

free to do so and to communicate this, but such credits should not be applied misleadingly to 'offset' emissions which need to be reduced.

41. If, in spite of these issues, the UK decides to support voluntary carbon markets and allow the use of carbon credits as offsets in emission disclosures, they must be carefully regulated to avoid the current problem that the use of offsets undermines the achievement of emissions reductions. At a minimum this should include the following:

    a. Companies should only be permitted to use carbon credits as offsets in carbon accounting for residual emissions which are genuinely not technologically feasible to eliminate (and should be required to demonstrate why the relevant emissions are not technologically feasible to eliminate).

    b. Where offsets are used in carbon accounting, there should be clear disclosures. This should include disclosing the amount of emissions (or emissions reductions) without taking into account offsets, as well as specifying the volume of offsets purchased by project type,[45] vintage (i.e. the year the emissions reduction took place), location and standard (such as the Verified Carbon Standard, Gold Standard, American Carbon Registry or Climate Action Reserve). In addition, there should be mandatory disclosures explaining the limitations of offsets outlined above.

Question 26: What are the key characteristics of a Net Zero-aligned Financial Centre? How would these characteristics apply to a typical UK-based:

a. Bank

b. Insurer

c. Asset manager

d. Regulated asset owner

e. Listed company

f. Large private company

g. Small and medium size enterprise (SME)

h. Retail investor

i. Professional services firm

j. or any other relevant industry participant

42. We welcome the government's ambition for the UK to be the first net-zero-aligned financial centre, which was announced during COP26. The government has not yet brought forward legislation or policy to deliver on this ambition. Accordingly, it is unclear precisely what the scope and content of the policy will be. The Green Finance Strategy provides an opportunity for the government to clarify its vision for a net-zero financial sector and set a whole-of-government plan for aligning financial flows with 1.5°C.

[45] See University of Oxford's The Oxford Principles for Net Zero Aligned Carbon Offsetting (2020) at page 7 for a taxonomy of carbon offsets.

43. As set out below, the UK's net-zero financial centre must (among other matters): (a) have a broad scope, including overseas emissions and insured emissions; (b) include effective regulation (enforced by regulators) on mandatory transition planning that ensures that the private sector aligns business models with the UK's climate goals; (c) require regulated firms to fulfil their stewardship responsibilities in relation to environmental issues; (d) require applicants for listing to demonstrate that they have a credible transition plan in place; and (e) as set out in more detail at in our response to question 30, have mandatory requirements for comprehensive climate-related narrative disclosures, Paris-aligned financial statements and a science-based green taxonomy.

Scope of net-zero financial centre

44. It is crucial that the government includes all activities of the UK's financial centre within its net-zero ambition. In particular:

    a. The government must be clear (across all areas of policy and regulation) that its net-zero ambition includes overseas emissions associated with the UK financial sector (i.e. emissions of overseas companies and activities that are financed or underwritten by the UK financial sector), and is not limited to the net-zero commitments in the Climate Change Act 2008 (which relate only to domestic emissions). The UK's financial 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).[46] Achieving a net-zero financial centre will therefore be impossible unless the significant role of UK finance in overseas emissions is addressed. In addition, the government must address the significant overseas impact of the UK's financial centre in order to deliver on the aims of the Paris Agreement, including to limit global temperature rises to 1.5°C and making finance flows consistent with a pathway towards low emissions and climate-resilient development.

    b. The net-zero ambition must include insured emissions (i.e. emissions of the companies and activities underwritten by the insurance sector). London is the largest global (re)insurance hub,[47] and the UK insurance sector has a substantial emission footprint from the companies and projects in underwrites across the globe. However, the insurance industry is not yet measuring and disclosing the emissions associated with its underwriting portfolios, or setting targets to reduce them in line with national climate goals. In this regard, the management of insured emission lags far behind financed emissions. Whilst many firms have emissions reduction targets in relation to their financed emissions, insurers are not yet doing the same for insured emissions. This lacuna must be addressed if the UK is to achieve its ambition to be a net-zero financial centre. Currently, methodologies for measuring the emissions associated with underwriting portfolios and their alignment with climate goals are underdeveloped, and there is no accepted industry standard methodology. This is a significant concern, as it hinders insurers setting meaningful climate targets in respect of their insurance business. We note that the members of the Net Zero Insurance Alliance (formed in 2021) have committed to aligning their underwriting portfolios with net-zero emissions, and are currently developing an industry standard methodology for insured emission disclosures with the intention that the members will start setting interim emission reduction targets in 2023. However, this alliance is voluntary and

[46] WWF and Greenpeace, The Big Smoke: the global emissions of the UK financial sector (2021).
[47] The London Market Group, London Matters 2020.

in its early stages. Regulation is needed to ensure that the whole UK insurance sector starts measuring, disclosing and then reducing its insured emissions in line with climate goals.

Mandatory transition plans

45. The UK cannot achieve its climate goals, or become a net-zero financial sector, unless the private sector is effectively incentivised to fully align business models with these goals. We therefore welcome the government's announcement that it will introduce express rules in relation to mandatory transition plan disclosure in the SDR.[48] The disclosure of credible transition plans by UK corporate and financial actors will underline the integrity and resilience of the UK's financial markets and foster trust around the markets' real world impact and sustainability. We set out below the steps the government can take to ensure that transition plan requirements are robust and credible.

Timing

46. Given the urgent need for climate action this decade, rules in relation to transition planning need to be introduced as soon as possible. The government announced during COP26 (in its fact sheet on the net-zero-aligned financial centre[49]) that the transition plan requirements in the SDR would be introduced from 2023. However, we are concerned that legislation in relation to transition plans was not referred to in the Queen's Speech, and may therefore be delayed. The government should clarify the status of these proposals and the timeline for their introduction as soon as possible.

Scope

47. The government's fact sheet on the net-zero financial centre states that the transition plan rules will apply to *"asset managers, regulated asset owners and listed companies"*. In order for the UK to achieve its commitment to a net-zero financial sector, transition plan requirements must apply to: (a) all FCA regulated firms (including all banks and insurers), not just asset owners and asset managers; (b) all listed companies (in line with the government's proposal); and (c) all large companies (as defined in the Companies Act 2006[50]).

Transition plan standards and implementation

48. We welcome the recent launch of the UK's Transition Plan Taskforce ("**TPT**"), and support its ambition to help drive decarbonisation by ensuring that financial institutions and companies prepare rigorous plans to achieve net-zero and support efforts to tackle greenwashing. We agree that robust regulatory standards for transition plans are necessary to ensure that mandatory disclosure does not result in widespread greenwashing. Without this, there is a risk that companies disclose plans that are not credible, not aligned with climate goals and/or not implemented. We will be providing a comprehensive response to the TPT's call for evidence on its proposed sector-neutral framework for private sector transition plans, and are therefore providing only a high-level outline of some of the key principles for transition plan standards in this response. Transition plan standards should at a minimum include the following:

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[48] We note that existing regulation already includes requirements in relation to transition plan disclosure. The FCA's rules on climate-related disclosures for standard listed companies and for asset managers, life insurers and regulated pension providers (P21/23 and PS21/24) refer to the TCFD's updated Annex on Implementing the Recommendations of the TCFD, which includes recommendations in relation to transition plan disclosures.
[49] HM Government, Fact sheet: on net zero-aligned financial centre (2021).
[50] Being companies that do not meet the size criteria for medium-sized companies set out at section 465 to 467 Companies Act 2006.

a. *Emissions targets*: The regulation should specify that companies' transition plans should be consistent with science-based pathways limiting warming to 1.5°C (including aligning with the UK's commitments to reduce emissions (compared to 1990 levels) by 68% by 2030 and by 78% by 2035, and to net-zero by 2050). Transition plans should include short, mid and long-term emissions reductions targets aligned with this goal. The government's aim to achieve a net-zero financial centre and to limit warming to 1.5°C cannot be achieved if companies do not set a level of ambition in their emissions reduction targets that is consistent with those goals. The government's fact sheet suggests that it will not be mandatory for companies to set net-zero targets or to align with any particular climate goals. This would be a missed opportunity, and would undermine the government's ambition for a net-zero financial centre.

b. *Finance for carbon-intensive sectors*: Financial services firms' transition plans must include transition strategies for investments (and for insurers, underwriting) in individual carbon-intensive sectors (such as fossil fuels). These strategies must provide for a phase out of investments (or insurance) in such carbon-intensive sectors that is consistent with sector-specific science-based pathways for limiting warming to 1.5°C. For example, investments in developing new oil and gas fields or in new/expanded coal mines is not consistent with any reasonable science-based pathway aligned with 1.5°C, given that 40% of existing reserves need to be left unexploited in order to reach that temperature goal (as set out in our response to question 8) and so should not be permitted in transition plans. Transition plans must reflect the science and include appropriate exclusion and phase out strategies.

c. *Offsets:* The UK has an opportunity to lead by example, but to do so it must keep ahead of the curve and not allow the use of carbon credits as offsets (i.e. in place of emissions reductions) which would undermine a swift and stable transition[51]. Our response to question 22 outlines the reasons why the improper use of carbon credits undermines the achievement of climate goals and can mislead investors and customers. We note that the EU's European Financial Reporting Advisory Group's ("**EFRAG**") proposals on transition plans in its exposure draft climate standard require the separate reporting of carbon credits (on which, see our further comments in paragraph 49 below).[52] In addition, the commonly used industry standard designed by the Science Based Targets Initiative also restricts the use of carbon credits in achieving emissions reduction targets.[53] UK regulation should not fall behind EU and industry standards in this area.

d. *Implementation*: Mandatory disclosure of transition plans could lead to extensive greenwashing and be reduced to mere 'intentions to act', if companies are not held accountable where they do not take appropriate steps to actually implement their disclosed transition plans. The transition plan rules should therefore include requirements to disclose: (a) concrete plans of action; and (b) evidence that the plan is, in fact being implemented. In order to ensure that transition plans are implemented in practice, regulators and other stakeholders need to be

[51] See our comments in response to question 22 below for more information on the issues associated with offsets.
[52] See page 37 of the exposure draft climate standard at paragraphs AG 63-65. Disclosure Requirement E1-13 of the EU's exposure draft climate standard already proposes to require in-scope companies to "*not disclose carbon credits as a counterbalance or offset for its GHG emissions*", "*not disclose carbon credits as a means to reach GHG emission reduction targets*", and "*to disclose, separately from the GHG emissions (ESRS E1 Disclosure Requirement 10) and GHG emission reduction targets (ESRS E1 Disclosure Requirement 3), whether it uses carbon credits*" [emphases added].
[53] SBTi, Science-Based Net-Zero Targets: 'Less Net, more Zero' (2021).

empowered to hold companies to account where they fail to fully embed their transition plans in their business strategy and financial planning.

49. In developing its standards for transition plans, the UK government should have close regard to EU developments in this area, including but not limited to the latest draft European Sustainability Reporting Standards ("**ESRSs**") developed by EFRAG, which are due to be finalised and adopted as Delegated Acts to the European Commission's proposal for a Corporate Sustainability Reporting Directive ("**CSRD**")[54] (capturing, at a high level, large companies operating in the EU). In particular, ESRS E1 Climate Change (the exposure draft climate standard) sets out detailed requirements on in-scope undertakings' transition plans by reference to the goals of the Paris Agreement. We note that many of EFRAG's proposed requirements are in line with our proposals above, including that transition plans must be aligned with limiting warming to 1.5°C, include concrete plans for action, include strategies for carbon-intensive sectors, demonstrate that the plan is embedded in the actual business strategy and financial planning, and include disclosures on progress made in implementing the plan.[55] The UK risks falling behind its international competitors if it does not include these requirements as a minimum, which would undermine the government's ambition for the UK to be the first net-zero financial centre.

Accountability and enforcement

50. In order for the transition plan requirements to be effective, it is vital that they are backed up by effective accountability measures. Unless regulators effectively supervise compliance of transition plans with the TPT's standards (including that the plan is aligned with 1.5°C) and ensure that firms disclose evidence that they are actually implementing the plans that they disclose, mandatory disclosure of transition plans could lead to a deluge of greenwash as firms set plans that are not realistic, not 1.5°C aligned or not implemented. For example, financial services firms must be held accountable if they fail to implement systems to ensure that their investment strategy is aligned with their transition plan. In order to achieve this, regulators will need to be adequately resourced (both in terms of staffing numbers and expertise) and the regulation will need to enable regulators to take action against firms that disclose plans that are not credible or which do not implement their plans.

51. It is inherent in the effective implementation of any new legal and regulatory requirements that there must be robust accountability and enforcement action by regulators such as the FCA to call out

[54] See, most recently, EFRAG's public consultation on the subject, which sets out all draft ESRSs to date.
[55] See pages 5-6 of the exposure draft climate standard at paragraphs 13-15. Disclosure Requirement E1-1 provides that an undertaking "*shall disclose plans to ensure that its business model and strategy are compatible with the transition to a climate-neutral economy and with limiting global warming to 1.5 °C in line with the Paris Agreement*" [emphasis added], and that such disclosures must include the following information: *(a) by reference to GHG emission reduction targets (ESRS E1 Disclosure Requirement 3), an explanation of their alignment with limiting global warming to 1.5°C; (b) by reference to GHG emission reduction targets (ESRS E1 Disclosure Requirement 3) and the climate change mitigation action plan (ESRS E1 Disclosure Requirement 4), an explanation of the decarbonisation levers identified, and key actions planned, including changes in the undertaking's product and service portfolio and the adoption of new technologies; (c) by reference to the climate change mitigation action plan (ESRS E1 Disclosure Requirement 4), an explanation of the financial resources supporting the implementation of the transition plan; (d) the locked-in GHG emissions from key assets and products, including an explanation if and how these can jeopardise the achievement of GHG emission reduction targets and drive transition risk, and the plans to manage GHG- and energy-intensive assets and products; (e) an explanation of the role of aligning economic activities with the provisions of Regulation (EU) 2020/852, including any delegated regulations related to climate change mitigation and adaptation, and the plans for future Taxonomy alignment; (f) an explanation of how the transition plan is embedded in and aligned with its overall business strategy and financial planning and whether it is approved by the administrative, management and supervisory bodies of the undertaking; and (g) an explanation of the progress made in implementing the transition plan.*" [emphases added]

egregious non-compliance. This should be a core component of the UK government's strategy to support of the growth of the UK's green finance sector and achieve its ambition on net-zero. If the FCA is not adequately resourced and empowered to investigate and enforce against laggards on climate, as other international regulators are already doing,[56] it risks becoming a laggard itself. Supporting the FCA to deliver on its promises to be a forward-looking, assertive, and proactive regulator[57] is an obvious and important lever that the UK government has the power to exercise now. This will allow it in turn uphold its own ambitions to home the world's first net-zero-aligned finance centre.

Stewardship

52. As set more fully out in our response to question 28 below, effective stewardship (including voting) is a key characteristic of a net-zero-aligned financial sector, and regulators must take action (under existing regulation) where investors fail to properly exercise their stewardship rights and responsibilities.

53. Finance is provided to companies, and financial products are small slices of the companies whose processes and supply chains emit greenhouse gases. Against this backdrop, there cannot be a net-zero financial centre if the companies to whom finance is provided are not transitioning to net-zero. Just as companies must allocate capital to projects that align with net-zero, investor stewardship (by banks, insurers, asset managers and regulated asset owners) must press these same companies to make the transition quickly and effectively. Ensuring that companies have robust transition plans in place (and voting against management where they do not) is a key aspect of stewardship in a net-zero financial centre.

Transition plan requirement for applicants for listing

54. In order to meet the government's objectives of greening the financial system and aligning financial flows with net-zero, climate-related disclosure and transition planning requirements should be applied consistently at all points of engagement between a company and the financial markets. This includes the recently introduced ongoing requirements for listed companies to make climate related disclosures aligned with the TCFD recommendations. However, as explained in more detail in our answer to question 28, to ensure a consistent approach across the listing regime, applicants for listing should also be required as a condition of listing, to demonstrate that they have a credible transition plan in place. This would help limit exposure of UK investors (including pension savers and retail investors) to risky climate-exposed investments that are incompatible with net-zero and the UK's climate commitments and where the relevant company has no (or inadequate) plans to transition.

Question 28: What should the role of the UK government or regulators be to support the greening of the financial system? How could they go further?

55. We set out at question 26 some of the characteristics that a net-zero financial centre should embody. The government and regulators will have a significant role in supporting the financial centre to attain the characteristics at question 26, including:

[56] Further to recent findings by the SEC that BNY Mellon Investment Adviser had made misstatements and omissions concerning ESG considerations in making investment decisions for certain mutual funds that it managed, the SEC recently announced that it is also investigating Goldman Sachs' asset management division over certain environmental, social and governance claims made by its funds, and German authorities are also investigating DWS, Deutsche Bank's asset management division, for possible greenwashing (Financial Times, 11 June 2022).
[57] See last year's speech by the FCA's CEO, Nikhil Rathi (15 July 2021).

a. mandatory transition planning;

b. effective stewardship; and

c. requiring applicants for listing to have credible transition plans.

In addition, the government and regulators will have a role in:

d. setting appropriate statutory regulator objectives to support the UK's environmental goals; and

e. ensuring that the capital requirements regime is sufficiently resilient to climate risks.

56. We set out below the steps the government and regulators can take in relation to each of the above points (a) to (e) in turn.

(a) Mandatory transition planning

57. As set out more fully in our response to question 26 above, rules in relation to mandatory transition plans will be key to greening the financial system. In order to be effective in aligning private sector business models with UK climate goals, the regulation must stipulate that firms not only disclose 1.5°C aligned transition plans, but disclose evidence that their plan is, in fact, being implemented. Regulators must have sufficient resourcing (in staffing numbers and expertise) to supervise whether the disclosed plans meet the required standards (including alignment with 1.5°C) and whether firms are implementing their plans.

58. Effective accountability is essential to ensure compliance with rules; regulators must take enforcement action where firms fail to do so. In addition, the government and regulators must ensure that there are clear standards for firms on science-based pathways for carbon intensive sectors (such as fossil fuels) which specify pathways for phasing down investments in those sectors.

(b) Stewardship

59. Regulators must make clear their expectations around stewardship, and also take action (under existing regulation) against firms that fail to properly exercise their stewardship rights and responsibilities. Effective stewardship (including voting) is critical to the functioning of the economy, which goes hand in hand with the protection of value for investors. The FCA acknowledged in its 2019 discussion paper on stewardship that:

> *By exercising stewardship and challenging issuers' strategies and decisions, asset owners and their asset managers can improve issuers' understanding of their interests and influence corporate strategy to further those interests. This can be expected to contribute to the long-term efficiency and effectiveness of capital allocation throughout the real economy, benefitting investors and society.*
>
> *The Kay Review observed: 'The principal role of equity markets in the allocation of capital relates to the oversight of capital allocation within companies rather than the allocation of capital between companies. Promoting good governance and stewardship is therefore a central, rather than incidental, function of UK equity markets.'*

In recent research, to which the FCA contributed, James, Kotak and Tsomocos find that financial market quality has a strong positive impact on economic performance. They find that it supports sustainable economic growth over the long term and reduces the risk of financial crises.'[58]

60. Yet we find that many asset managers, in spite of net-zero commitments, are failing to follow through with robust stewardship. A report[59] by Reclaim Finance found that, of the 30 asset managers assessed, 25 state that they engage with companies to push for improvements on climate-related issues but none call for a decrease of companies' overall fossil fuel production or a stop to all new fossil fuel supply projects. None of the asset managers were assessed to have clear, comprehensive demands for fossil fuel companies; only 8 asked for short term (2025) absolute emission reduction targets; and only 1 required absolute emissions reductions including scope 3. There were no calls for immediate and progressive decrease in production or ceasing all new supply projects (as is required if we are to reach net-zero), and escalation processes were not clear – only LGIM and Schroders' policies linked to deadlines and sanctions. These failings undermine the credibility of asset managers' net-zero pledges, and arguably represent a failure to properly manage the risks associated with climate change.

61. These failures require regulatory action for two reasons:

    a. Where asset managers and asset owners make net-zero commitments, they are committing to invest in a way that supports the transition to net-zero. Where these same financial market participants fail to take a stance against fossil fuel extraction and use that is inconsistent with limiting global temperature rise to 1.5 degrees, that is in breach of those net-zero commitments. This risk misleading clients and beneficiaries alike. Regulators must make clear to their regulated community that misleading climate and net-zero commitments risk breaching regulatory rules, for example under COBS 4.2.1 (fair, clear and not misleading communications), and may be subject to regulatory action.

    b. More broadly, these failures to properly exercise stewardship rights and responsibilities may put investors in breach of their duties to clients and/or beneficiaries (for example under COBS 2.1.1 (client's best interest rule)). Again, regulators should make these points clear to the regulated community, and take public enforcement action where firms fail to meet these duties.

<u>(c) Transition plan requirement for applicants for listing</u>

62. As things stand, high risk oil and gas, coal and other climate-exposed / carbon-intensive companies would currently be able to list on the main market of the LSE with relatively little scrutiny of their climate risks, impacts, commitments and plans. This would have the effect of directing financial flows (for example, from index tracking or "passive" funds, included those invested on behalf of workplace pension schemes) towards risky investments that are incompatible with the transition to net-zero and the UK's climate commitments. Currently, therefore, the UK listing regime may operate contrary to investor interests, commitments made by the UK government at COP26 and the FCA's objectives and remit, undermining the government's intention to green the financial system. Several recent and planned listings demonstrate that this is a live issue needing to be addressed by the government and regulators.[60]

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[58] FCA, Discussion Paper 19-01 (2019).
[59] Reclaim Finance, Asset_Manager_Climate_Scorecard_2022.
[60] For example, it was reported in May 2021 that Neptune Energy had appointed financial adviser Rothschild & Co to explore potential liquidity options including a UK initial public offering (**IPO**) at a potential valuation of more than

63. The UK government and regulators have made significant progress to enhance ongoing requirements for climate-related disclosures by listed companies, including the introduction by the FCA of mandatory TCFD reporting for premium and standard listed issuers, but there is currently a missed opportunity to use the pressure point of listing itself to protect consumers and the integrity of the UK market from increasing climate risk, and ensure that finance does not flow to carbon intensive assets in an uncontrolled way.

64. The government and the FCA should be using all the tools at their disposal to align financial flows with the UK's climate commitments. We recommend imposing a requirement for all carbon-intensive companies to demonstrate at the point of listing that they have a credible climate transition plan in place, aligned with the temperature goals of the Paris Agreement – if they cannot demonstrate this, listing should be refused to protect consumers and the integrity of the financial markets.

65. In our view, it would be within the FCA's existing powers to impose this condition upon listing approvals in order to protect investors, but the government and the FCA may consider that the introduction of a new explicit rule would provide more certainty to the market. The requirement for applicants to demonstrate a credible transition plan should be developed in light of the work of the TPT in setting the "gold standard" for transition plans. It would not amount to an outright ban on fossil fuel listings (provided those companies have credible transition plans in place prioritising absolute emissions reduction), but would be a proportionate condition to such listings to protect investors and would be entirely consistent with existing ongoing TCFD disclosure requirements for premium listed companies, and the UK government's intention to make disclosure of transition plans mandatory in the UK for listed companies.

(d) Capital requirements

66. The updated Green Finance Strategy should incorporate the introduction of higher capital requirements for banks and insurers for any exposures which involve new exploration, expansion or development of fossil fuels and related infrastructure – activities that are fundamentally incompatible with limiting temperature rise to 1.5°C above pre-industrial levels in line with the Paris Agreement.[61] These activities will lock in fossil fuel infrastructure for decades to come, many of these assets will become stranded when transition policies inevitably accelerate globally, and this will lead to the accumulation of climate risk in the financial system.

67. In relation to Basel III requirements for banks, this could be achieved by imposing a 'risk weighting' of 1250% on such exposures, which would require banks to hold capital equivalent to 100% of the

USD$5 billion, making it one of the largest listings of a pure-play O&G explorer and producer for several years – see Energy Voice, Neptune Energy working with Rothschild as it studies IPO (2021). There are also widespread suggestions that rising oil and gas prices may lead to a revival of interest in O&G IPOs in 2022 – see Energy Voice, Uptick in North Sea IPOs forecast with high oil and gas prices on course to continue (2022).

[61] The IEA's 'Net Zero by 2050 Roadmap' published in May 2021 stated that there need to be no new oil and gas fields, new coal mines, coal mine extensions, or new unabated coal plants approved for development after the time of publication if net-zero is to be reached by 2050: IEA, 'Net Zero by 2050: A Roadmap for the Global Energy Sector' (May 2021).

exposure,[62] so they can absorb the losses themselves if a full write-off of the exposure is necessary.[63,64]

68. In relation to Solvency II requirements for insurers, we note that capital requirements are currently being updated under HMT's review of Solvency II, which provides an opportunity to similarly amend the rules to provide for 100% capital for exposures related to new exploration, expansion or development of fossil fuels and related infrastructure. In addition, such exposures should be excluded from the matching adjustment (which is based on insurers holding assets for longer periods, which can exposure them to longer term climate risks).

69. Such regulation would improve banks' and insurers' capital adequacy against climate-related losses and shocks, and drive behavioural change by disincentivising the continuation of financial flows to assets exacerbating climate change and undermining financial stability. It would acknowledge the 'double materiality' aspect of climate change, in both strengthening individual firms and the whole banking and insurance sectors against climate-related risks, as well as helping to mitigate the impact that the sectors are having on climate change. It would also help to correct the mispricing of climate-related risks and prevent the accumulation of assets which may: (a) become stranded, thereby causing direct financial losses to the firms holding those exposures; or (b) contribute to exacerbating climate change, leading to the build-up of systemic risks in the financial system.

70. Importantly, it would be within each individual bank and insurer's control whether and to what extent it will feel the consequences of this new regulation, as it would only apply to banks that choose to continue financing activities that are clearly not aligned with the Paris Goals.

(e) Regulator objectives

Climate objective

71. The Financial Services and Markets Bill review provides an opportunity to embed environmental objectives into the regulatory framework, so that the financial systems plays an appropriate role in supporting the mitigation of climate change and the protection of the natural world. The FCA and PRA should be given a new objective in relation to climate change, which requires them to support all of the UK's climate targets (including the 2050 net-zero emissions target, interim carbon budgets, nationally determined contributions and the Paris Agreement goal to limit global warming to 1.5°C above pre-industrial levels). HMT's consultation paper on the Future Regulatory Framework proposed a regulatory principle requiring the FCA and PRA to take into account the UK's net-zero commitment in the Climate Change Act 2008 (although it is unclear whether this is proposed to be included in the Financial Services and Markets Bill, as it was not referred to in the briefing pack for the Queen's Speech). Our proposed climate objective would amend the proposals in HMT's consultation paper on in two ways.

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[62] The rationale for the 1250% risk weighting is as follows: a £100m loan to a fossil fuel company would usually be given a 100% risk weighting, and the bank would need to hold 8% capital against that risk weighted asset, so the bank would be required to hold £8m capital. If the same £100m loan was given a 1250% risk weighting instead, then applying the 8% capital ratio to that risk weighted asset means that the bank would be required to hold £100m capital, i.e. the full value of that loan.

[63] For more detail setting out the content and rationale for this proposal, see Finance Watch, Breaking the climate-finance doom loop. (2020).

[64] There is precedent for this suggestion: a 1250% risk weighting has recently been proposed by the Basel Committee on Banking Supervision for certain cryptoassets as a 'new conservative prudential treatment': see BCBS, Consultative document: prudential treatment of cryptoasset exposures (2021).

72. Firstly, HMT has proposed a regulatory principle in relation to climate change. In order to enable the regulators to fully support the UK's climate goals, climate change needs to be included as an objective, instead of regulatory principle. This would impose a positive duty on the regulators to advance climate goals (in contrast to a regulatory principle, which would only require regulators to take climate goals into account when advancing their other objectives).[65] A climate objective would make clear that climate mitigation alone is sufficient reason for regulatory action (across new regulation, supervision and enforcement), allowing regulators to move beyond treating climate change solely as a financial risk and enabling them to actively support climate goals. This reflects the UK Climate Change Committee's advice that 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.[66]

73. There would be a number of benefits of including climate as an objective (instead of a regulatory principle), for example it would: (1) enable regulators to aim to reduce emissions in line with climate goals in the design of new or amended regulation on issues such as transition plans or the green taxonomy; (2) enable regulators to allocate sufficient resource to supervising climate change related issues (for example, in relation to supervising climate-related disclosures and transition plans, or taking action enforcement against firms with inadequate disclosures); (3) increase the competitiveness of the UK financial sector, as establishing a climate objective at the heart of the UK's financial regulatory regime will send a clear message on the UK's commitment to becoming the world's first net-zero financial sector and therefore help to drive innovation on green finance, as well as underlining the UK's resilience to the upcoming transition.

74. Overall, an objective (instead of a regulatory principle) 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, and it would not add any additional complexity to the regime (given that HMT is already proposing a climate regulatory principle). Indeed, it would simplify matters by allowing regulators to take action directly for climate reasons, instead of having to justify such action through other objectives.

75. The second amendment we propose to HMT's climate objective is that it should refer not only to the UK's net-zero goal, but also its other climate goals: reducing emissions (compared to 1990 levels) by 68% by 2030 and by 78% by 2035; and the Paris Agreement aim to limit warming to 1.5°C. 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. The UK needs the financial sector to play its role in meeting all of its commitments. In addition, reference to the Paris Agreement goals would allow regulators to take action in relation to the overseas emissions that are financed or underwritten by the UK financial sector. As set out in question 26 above, the UK cannot achieve its ambition to be a net-zero financial sector unless the sector's significant global impact is addressed.

[65] Under the current regime, we note that some UK regulators must already take climate change into account when advancing their objectives. For example, the FCA acknowledges in several of its publications that it considers its actions on climate advances its existing statutory objectives in respect of market integrity and consumer protection (see for example CP21/18). The proposed climate objective offers an opportunity to strengthen the FCA's remit in this regard.

[66] The Advisory Group on Finance for the UK's Climate Change Committee, The Road to Net-Zero Finance (2020).

Nature and biodiversity regulatory principle

76. A new regulatory principle should be added that requires the FCA and PRA to have regard to the desirability of conserving and restoring nature and protecting biodiversity internationally in a manner that respects the rights of affected local communities and Indigenous peoples. Aside from the obvious intrinsic benefits of a healthy natural world and flourishing biodiversity and the need for the UK to meet its legal commitments in relation to nature, biodiversity and the rights of Indigenous peoples,[67] there 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.[68] 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.[69] Nature and biodiversity risks encompass physical risks from the degradation of natural assets utilised by businesses, transition risks as governments take action to protect assets and social norms shift, and litigation/regulatory risks in connection to the damage that businesses cause to natural assets.[70]

77. The finance sector must play a significant role in the restoration and conservation of nature. 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.[71] 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.[72]

    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.[73]

    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,[74] 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

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[67] Including under the Environment Act 2021, the Convention on Biological Diversity, the G7 2030 Nature Compact, the Glasgow Declaration on Forests and Land Use, the Glasgow Climate Pact, the United Nations Declaration on the Rights of Indigenous Peoples and the International Labour Organisation's Indigenous and Tribal Peoples Convention (C169).
[68] World Economic Forum and PwC, Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy (2020).
[69] World Economic Forum, 2020 Global Risks Report. Biodiversity loss was also ranked as the third most likely risk.
[70] See HMT, The Economics of Biodiversity: The Dasgupta Review (2021).
[71] 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"*.
[72] For further detail, see ClientEarth, Communities' rights – the need for recognition (2018).
[73] Global Witness, Deforestation Dividends (2021).
[74] HMT, The Economics of Biodiversity: The Dasgupta Review (2021).

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.

78. 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. Given the substantial financial risks outlined above, as well as the UK's legal commitments in relation to nature, biodiversity and rights of Indigenous peoples, it is crucial that regulators are expressly required to take these matters into account. This 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. In addition, it would help the UK be the leader in development of regulation on nature and biodiversity risks, which is currently less advanced compared to climate risk and consequently will need to be a key area of focus in the development of new regulation.

Clarification of the growth and competitiveness objective

79. HMT is proposing a new objective for the FCA and PRA to support the growth and international competitiveness of the UK economy (including the financial sector). If this objective is added, it must be made clear that it cannot be used as a reason for deregulation that negatively impacts the FCA/PRA achieving their other objectives (including the new climate objective). We understand from HMT's consultation on the Future Regulatory Framework that HMT does not intend for the existing objectives to be negatively affected by deregulation; it is vital that the wording of the new objective clearly reflects that the competitiveness objective can only be advanced only insofar as doing so does not negatively impact the advancement of other objectives.

80. For more information on enhancing regulator objectives, see our response to HMT's consultation on the Future Regulatory Framework.[75]

Question 29: How can the UK government measure progress towards greening the financial system?

81. In order for the UK to achieve its goals to be a net-zero-aligned financial centre, the government must measure and disclose progress towards that target. At a minimum, this should include annual disclosures on:

    a. the total disclosed scopes 1-3 emissions of listed companies, including breakdowns for specific sectors;

    b. the total disclosed scopes 1-3 emissions of regulated financial services firms, including financed and insured emissions;

    c. the amount and proportion of assets invested in activities that are classified as sustainable in the proposed UK Green Taxonomy; and

    d. the volume of investments in companies with credible transition plans in place (see also our response to question 5 in relation to measuring progress towards the UK becoming a leading global centre for green finance).

[75] ClientEarth, Response to HMT Consultation on Future Regulatory Framework Review (2022).

82. In order for the government to be able to collate this information, companies will need to make comprehensive disclose on their scopes 1-3 emissions. See our response to question 30 below on the regulation of climate-related disclosures.

Question 30: What steps can the UK government take to support a robust investment data ecosystem to attract green finance flows?

83. We agree that robust climate-related and nature-related data is a critical enabler of the UK's green finance priorities, and we welcome progress made so far by the UK government and the FCA towards mandatory TCFD-aligned climate-related financial risk disclosures for companies across the economy, the UK government's support for the TNFD and the proposal to adopt a UK Green Taxonomy. Our response to this question includes recommendations in relation to the following points (a) to (d) in turn:

    a. how the UK's approach to climate and nature-related disclosures should be strengthened further;

    b. introducing regulation to ensure that the financial information included in company annual financial statements incorporates proper consideration of climate-related risks, and their impact on the company's financial position;

    c. strengthening the investment product labels and disclosure regime; and

    d. the key principles that a green taxonomy should embody.

<u>(a) Improved climate and nature-related disclosures</u>

84. The introduction of requirements to disclose of 1.5°C aligned transition plans will provide key data points for the market to help direct green finance flows. See our response to question 26 on transition plans.

85. In addition, the UK's regime for other climate-related narrative disclosures needs to be enhanced in order to ensure that investors have the data they need to make informed decisions to invest in sustainable activities. In particular:

    a. *Mandatory basis*: Climate-related disclosures should be mandatory, as the transition to net-zero will affect all parts of the UK's economy and investors have made clear that they expect issuers to use the TCFD Recommendations and Recommended Disclosures to provide material climate-related information.[76] Such information is necessary to enable the redirection of capital urgently required to achieve the UK's climate goals. The current FCA rules for listed companies ask them to make climate-related disclosures on a 'comply or explain' approach, which will lead to material omissions where companies to fail to properly consider and disclose climate risk (which will increase legal risk and uncertainty).

    b. *Enforcement*: The FCA must procure that it is adequately empowered and resourced to hold laggards accountable for failures to satisfy climate change-related reporting obligations, and must commit to taking such action. See our response to question 28 on the need for accountability through effective enforcement by regulators.

    c. *Scope 3 emissions*: The FCA must expressly require that all in-scope companies, across all sectors, disclose all categories of scope 3 emissions for which they are responsible (including

[76] For example, see Larry Fink's 2021 <u>letter to CEOs</u> which states *"we asked all companies to report in alignment with the recommendations of the Task Force on Climate-related Financial Disclosures"*.

financed and insured emissions). Currently, disclosure of scope 3 emissions is not mandatory under the Streamlined Energy and Carbon Reporting regime. Scope 3 emissions are the largest source of a company's emissions in most sectors,[77] so disclosing only scope 1 and 2 emissions provides only an incomplete picture of a company's climate impact. By way of example, it is estimated that the scope 3 emissions of oil and gas companies are six times their scope 1 and 2 emissions,[78] and that the portfolio emissions of global financial institutions are over 700 times greater than their operational emissions.[79] The current system of voluntary scope 3 disclosures is not working, as companies are largely choosing not to disclose. Two thirds of FTSE 250 companies do not disclose their scope 3 emissions, and those that do are often not fully transparent about the methodology and exclusions they have applied in their calculations.[80] As a consequence, many companies' net-zero commitments do not include scope 3 emissions.[81] Not only does this render the commitments less effective, but it also risks giving a misleading impression to investors and the public as to companies' climate goals.

d. *Double materiality*: We are encouraged by the FCA's proposals to ensure that sustainability reporting under the SDR captures the impact investment firms and products have on the environment and society (in addition to the financial risks and opportunities posed by environment and society to the firm or product).[82] The SDR regime should be designed to ensure that this "double materiality" is transparently captured and presented to investors.[83] Two potential limitations of a TCFD-based sustainability disclosure regime are that it becomes overly focussed on financial risk to the entity or product, rather than the impact of the entity or product on the environment and society,[84] and that disclosures are overly focused on process (i.e. governance, strategy and risk management) rather than measurable impact and sustainability outcomes. The SDR should therefore include mandatory disclosures capturing the impact (at entity and product level) of investment activities on the environment and society.[85]

e. *Consistency and comparability of sustainability disclosures:* UK climate and nature-related disclosure requirements should be designed to provide consistent, comparable and decision-useful information to investors and the other users of such information. To enable information users to make decision-useful comparisons between companies, every effort should be made to align new requirements in the UK sustainability information ecosystem with other global

[77] Science Based Target Initiative, 'Value Change in the Value Chain: Best Practices in Scope 3 Greenhouse Gas Management' (2018).
[78] MSCI, 'Scope 3 Carbon Emissions: Seeing the Full Picture' (2020).
[79] CDP, 'Financial Services Disclosure Report 2020: The Time to Green Finance (2020). This report also identified that only 25% of financial institutions reporting to CDP disclosed their financed emissions, and only 27% of insurance companies are taking steps to align their underwriting portfolios with limiting warming to 2°C.
[80] ClientEarth, 'Accountability Emergency, A review of UK-listed companies' climate change-related reporting' (2019-20)' (2021).
[81] The Climate Action 100+ Company Net-Zero Benchmark evaluated the climate disclosures of 159 of the world's largest emitters. It found that 52% of companies announced an ambition to achieve net-zero by 2050 or sooner, but only 53% of those companies (28% of the total companies in scope) included scope 3 emissions. See Climate Action 100+'s press release.
[82] See paragraph 4.2 of FCA Discussion Paper 21/4.
[83] Confusion between the "outside in" and "inside out" elements of double materiality is rife. See, for example Bloomberg Businessweek, The ESG Mirage: MSCI, the largest ESG rating company, doesn't even try to measure the impact of a corporation on the world. It's all about whether the world might mess with the bottom line (10 December 2021) which illustrates this confusion in the context of ESG ratings provided by MSCI.
[84] See the comments regarding 'double materiality' at page 4 of ShareAction, Combatting Greenwashing: TCFD Reporting (2021).
[85] See ClientEarth, Consultation response to FCA Discission Paper 21/4 for more detail.

climate and sustainability disclosure standards (through endorsement and / or design) such as those developed by the International Sustainability Standards Board ("**ISSB**") of the IFRS Foundation and EU sustainability reporting standards to be issued under the CSRD, which are currently being consulted upon by EFRAG, insofar as doing so is compatible with the UK adopting world-leadings standards for climate and nature-related disclosures).

f. *High quality, assured disclosures*: There is currently a low level of confidence in the quality and reliability of the broader financial and non-financial information included in annual reports, including in relation to climate change, nature and sustainability. From our observations and research there are currently significant problems with 'greenwashing', where companies convey a misleading picture for users of annual reports or otherwise provide very poor quality disclosures. There are also significant problems with inconsistency between the narrative and risk disclosures made in annual reports and the financial statements, which auditors do not appear to be correcting.

   There is a risk that similar concerns will arise in relation to specific climate and sustainability disclosures made under new frameworks. Given the materiality of this information to investors, regulators and other stakeholders, its quality and reliability is paramount. As such, independent third party assurance (to at least a "limited" standard initially, with the possibility to move towards "reasonable" assurance) of sustainability disclosures should be made mandatory. The government's recently announced plans to require some large companies to explain, in the Audit and Assurance Policy, how they assure the quality and reliability of information disclosed in their annual reports outside the financial statements would be a positive first step, but does not go far enough in relation to the assurance of sustainability information disclosed under new rules.[86]

g. *Regulated, consistent, comparable and decision-useful ESG data and ratings*: We repeat our comments in response to question 20 above in relation to the need for the FCA to bring ESG data and ratings providers inside the FCA's regulatory perimeter without delay. Ensuring that ESG data and ratings relied upon to justify portfolio alignment by asset managers and other actors are regulated, consistent, comparable and decision-useful, and their underlying methodologies clearly disclosed, will be critical to ensuring the integrity and reliability of that data, to preventing greenwash as a result of inflated or inaccurate ratings, and to facilitating the (re)allocation of capital towards a lower carbon economy and the UK realising its ambition to become the world's first net-zero aligned finance centre.

(b) Consistent climate accounting requirements

86. It is crucial that the financial information included in company annual financial statements incorporates proper consideration of climate-related risks, and their impact on the company's financial position, in a manner which is clear and transparent, and that this information is subjected to adequate audit scrutiny. Without this information, investors and other users of the financial statements cannot make informed financial decisions.

87. Climate-related risks and impacts which are identified during transition planning, TCFD or other sustainability disclosure or risk-management processes will not be effectively incorporated into

[86] See the FCA's Press release on audit regime overhaul to help restore trust in big business (2022), and the government's response to its 2021 audit consultation (2022).

financial decision-making unless the impact they have on a company's financial health and prospects is also clearly disclosed in the financial statements.

88. This information is clearly material to the world's leading investors, who have repeatedly called for company accounts which: (a) properly reflect the impact of material climate-related risks; and (b) are Paris-aligned (a concept we explain further below).[87]

89. Moreover, the International Accounting Standards Board (**IASB**) has issued clear guidance confirming that, where climate risks are material, they should be taken into account in preparing company financial statements - for example in relation to longer-term considerations of cash flows and potential impairment of fixed and intangible assets, estimated lives used to determine depreciation or amortisation of long-lived assets, and the amount and timing of asset retirement obligations. Significant estimates and assumptions should be disclosed in the accounts, and should be consistent with climate-related disclosures and commitments elsewhere in the company's annual reporting. However, existing standards are not being met by companies in practice. Despite climate risk representing both business and financial risk (and in some cases opportunities) for most companies, evidence suggests that even for companies where climate risk is most clearly material (such as oil and gas companies), existing financial statement requirements are not being properly followed by companies, and auditors are failing to call out related failures and inconsistencies.[88] These issues have been acknowledged by the FRC in its own Climate Thematic assessment of 2020 financial reporting.[89]

90. The following measures would improve the integration of climate-related risks and commitments into mainstream financial reporting and therefore support a robust investment data ecosystem to attract green finance flows:

    a. *Integrate climate-risk in financial statements*: The government should use the introduction of new climate and sustainability-related reporting requirements as an opportunity to clarify and strengthen requirements for companies to ensure that their financial statements fully integrate the impacts of any climate and nature related risks and commitments identified or made by the company, and are consistent with the company's other climate and sustainability reporting (including reflecting the impact of the company's transition plan in the financial statements).

    b. *Paris-aligned accounting*: To enable investors to make more informed financial decisions about companies affected by the transition to a low carbon economy, the government should introduce a requirement for companies to state in their accounts whether their accounts are based on estimates and assumptions are aligned with the Paris Agreement goal of limiting global temperature rise to 1.5°C (and any climate commitments or plans made by the company) and, if they are not, to provide a sensitivity analysis showing what adjustments to the accounts would be required for them to be so aligned. This would ensure that transition plan disclosures resonate throughout the company's financial accounts so that financial and narrative reporting around climate risk is consistent overall and would allow investors to see how the company's

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87 See, for example: IIGCC, Investor Expectations for Paris-aligned Accounts (2020); Sarasin & Partners, Investor Expectations: Net-Zero Audits (2021); and IIGCC, Investors put Audit Committee Chairs on notice over continued omission of climate risks in financial reporting ahead of 2022 AGM season (5 April 2022).

88 A full discussion of IFRS standards, of investor requests to companies and auditors as regards financial reporting, and of the apparent failure to meet standards can be found on the website of the UN Principles for Responsible Investment (**UNPRI**). See also the findings of Carbon Tracker and the Climate Accounting Project, Flying Blind – the glaring absence of climate risks in financial reporting (2021) and ClientEarth, Accountability Emergency: A review of UK-listed companies' climate change-related reporting (2019-20) (2021).

89 See FRC, Climate Thematic Review 2020.

financial position would be affected by transition – material information which investors have repeatedly asked for.

c. *Paris-aligned audit*: To uphold the quality of company financial disclosures (including how they are affected by climate change) and the integrity of the information ecosystem needed to support green transition, it is essential that auditors provide appropriate scrutiny of the assumptions used in the preparation of company accounts (including in relation to climate change) to determine whether there is a risk of material misstatement. However, the evidence referred to above suggests this is not happening, despite IAASB providing guidance which explains that climate related matters may affect the susceptibility of accounts to misstatement. government should take the opportunity presented by its wider program of audit reform and the establishment of ARGA, to ensure that climate-risk is put at the center of high quality audit practice. Auditors of public interest entities should be explicitly required to undertake Paris-aligned audits, which test whether the company's accounting assumptions are consistent with global climate goals and the company's own commitments, and to warn shareholders of any concerns about the reasonableness of the assumptions used.[90]

d. *Enforcement*: Finally, it is essential the new accounting and audit regulator (ARGA) is appropriately empowered and resourced to take robust enforcement action against companies and auditors that fail to meet their accounting and audit duties in relation to climate change. As noted above, effective enforcement is critical in order to ensure compliance with new regulation.

<u>(c) Robust investment product labels and disclosure regime</u>

91. In addition to taking measures to strengthen corporate climate- and nature-related disclosures, the UK's investment data ecosystem needs to be supported by a robust regime for sustainability-related investment product labels and other clear, decision-useful disclosures at the investment product level to attract green finance flows. This is essential to enable asset owners and retail and other investors to allocate capital in a manner more closely aligned to the UK's climate objectives (and investors' own sustainability objectives and preferences). Please see our responses to questions 12 and 20 for our comments on this topic.

<u>(d) Green taxonomy</u>

92. The UK has an opportunity to adopt a world-leading science-based green taxonomy that is based on the precautionary principle and that accurately identifies activities that are genuinely sustainable. Such a taxonomy would help prevent greenwash and support investors in directing financial flows towards sustainable activities, which is necessary for the UK to achieve its net-zero target and interim carbon budgets.

93. We welcome that the UK Green Finance Roadmap states that UK Green Taxonomy *"will take an objective and science-based approach to assessing sustainability."* In order to achieve this, the government must rely on conclusive scientific evidence (through obtaining extensive scientific and technical input) and the precautionary principle to develop definitions of green economic activities, including their technical criteria. In addition, there must be transparency as to the methodologies for

[90] ClientEarth called for Paris-Aligned accounting and audit in its <u>response to the government's 2021 consultation on restoring trust in audit and corporate governance</u>. However, the government's response did not take these proposals on board and the government's current proposals do not go far enough to ensure that climate change is adequately reflected in accounting and audit. See Greenpeace, <u>Audit proposals not enough to clean-up scandal-ridden industry, campaigners say</u> (2022).

developing these definitions (which should be subject to thorough consultation in order to ensure that they are based on the best available science). At a minimum, green economic activities must be aligned with the transition to net-zero in line with a 1.5°C pathway, be resilient to the long-term impacts of climate change, and do no significant harm to the other environmental objectives in the taxonomy.

94. In particular, activities based on the use of fossil gas cannot be considered as contributing to climate change mitigation or as otherwise environmentally sustainable. In a 1.5°C aligned pathway, fossil gas demand must fall 2.6% annually between 2020 and 2050, and there can be no new gas fields approved for development.[91] The EU has been debating the inclusion of certain fossil gas based activities within its taxonomy. The potential inclusion of such activities has been strongly criticised, including by investors and banks who need reliable information based on international standards about the environmental impact of the activities they consider financing. While the EU debate on this is still ongoing, we note that the European Parliament committees for Economic and Monetary Affairs and for Environment, Public Health and Food Safety voted against the inclusion of fossil gas and nuclear as green activities in the taxonomy as sustainable and contributing substantially to climate change mitigation on 14 June 2022.

95. Regardless of the final position in the EU taxonomy, the UK Green Taxonomy must reflect climate science and exclude fossil gas from green economic activities. The UK Green Taxonomy is an opportunity for the UK to be a global leader and to use use its diplomatic position to encourage other jurisdictions to adopt similarly high standards based on the best available science, as well as to ensure that UK financial markets have reliable information on the environmental impact of activities on which to base investment decisions.

Question 31: Are Scope 3 (supply chain) emissions data important for investors to assess and manage climate-related risks and opportunities?

96. As set out in our response to question 30, scope 3 emissions data is critical for investors.

Question 33: Up to 2030, how can the UK government best support the global transition to a net-zero, nature-positive financial system that is both inclusive and resilient?

97. Given the UK's leadership in implementation of climate-related financial disclosures, there is an opportunity to encourage the international community to do likewise through engaging on a ministerial level with international counterparts, including in the United States where the disclosure of climate-related financial risks has become a politically polarized issue. There is a real challenge to the UK's leadership on this issue given the apparent de-prioritisation of the proposed SDR. However, there remains an opportunity to lead the way if the UK can successfully pioneer a robust framework for transition plans and further encourage the international community to do likewise.

98. Finally, achieving the transition to a net-zero, nature-positive financial system will be contingent on the deployment of robust accountability and enforcement action by regulators such as FCA to call out egregious non-compliance with new rules and regulations on greening UK finance. This should be a core component of the UK government's strategy to support of the growth of the UK's green finance sector and achieve its ambition on net-zero. If the FCA is not adequately resourced and empowered to investigate and enforce against laggards on climate, as other international regulators are already

[91] International Energy Agency's 'Net Zero by 2050: A Roadmap for the Global Energy Sector' flagship report (2021) and Oxford Sustainable Finance Group, Smith School of Enterprise and the Environment, University of Oxford, Implications of the International Energy Agency Net Zero Emissions by 2050 Scenario for Net Zero Committed Financial Institutions (2022).

doing,[92] it risks becoming a laggard itself. Supporting the FCA to deliver on its promises to be a forward-looking, assertive, and proactive regulator[93] is an obvious and important lever the UK government has the power to exercise now. This will allow it in turn uphold its own ambitions to become the world's first net-zero-aligned finance centre.

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[92] Further to recent findings by the SEC that BNY Mellon Investment Adviser had made misstatements and omissions concerning ESG considerations in making investment decisions for certain mutual funds that it managed, the SEC recently announced that it is also investigating Goldman Sachs' asset management division over certain environmental, social and governance claims made by its funds, and German authorities are also investigating DWS, Deutsche Bank's asset management division, for possible greenwashing, as reported in the Financial Times (11 June 2022).
[93] See last year's speech by the FCA's CEO, Nikhil Rathi (15 July 2021).