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Devising a Green Finance Strategy that's fit for the future

Introduction

UK financial institutions urgently need to decarbonise their investment portfolios in line with the UK's own legally binding climate commitments[i] and the goals of the Paris Agreement.

We welcome the Government's increased recognition of the need to put the UK financial services sector on a more sustainable footing. If the City of London were a country, it would be ranked 9th biggest emitter of CO2 in the world – ahead of Germany[ii].

In July 2019, the Government published its Green Finance Strategy[iii]. An announcement from the Treasury on progress towards this strategy can be expected imminently. Whilst the 2019 Green Finance Strategy is a strong start, certain opportunities to green finance so far remain unaddressed. Crucially, the Government must disincentivise investments in fossil fuels if it is serious about greening our economy.

We're recommending seven changes across four key policy areas where the Government should focus its attention.

Summary of Policy Recommendations

To meet the Prime Minister's ambition of making the UK the world's first net zero financial centre[iv], the UK government should:

Reform regulatory mandates:

1. **Regulators should have clear mandates on climate and nature.**
   Introduce a secondary statutory objective for the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) on climate and nature. This would sit alongside the proposed competitiveness and growth objective, requiring (where possible) the FCA and PRA to actively facilitate net zero and nature recovery through their policies, rules, guidance

and supervision of the financial sector.

2. **Place sustainability at the heart of Solvency II reforms.**
   If the PRA had a mandate on climate and nature, then sustainability would be prioritised within Solvency II reforms. In particular, higher capital requirements should be applied to assets which compound climate risk.

Broaden the objectives for UK pension funds to promote sustainability:

3. **Amend the law on fiduciary duty.**
   Explicitly require the consideration of the impacts of investment activities on society and the environment ('double materiality'), and the views of beneficiaries, within the fiduciary duty of occupational pension schemes.

Address perceived barriers to investor stewardship from acting in concert rules:

4. **Address investor concerns around risks of breaching "acting in concert" rules when undertaking collaborative stewardship of companies.**
   Stewardship is a critical tool to enable investors to promote sustainable business practices and support the transition to net zero. Despite this, concerns around triggering 'acting in concert' rules often represent a major obstacle to investors wishing to engage companies collaboratively. By clarifying when enforcement action will – and will not – be taken, regulators can remove this barrier and help the UK meet its national and international climate commitments.

Develop robust, mandatory reporting frameworks:

5. **Make the publication of net zero transition plans mandatory, building on the work of the Transition Plan Taskforce (TPT).**
   Extensive ShareAction research has found that financial institutions are consistently lagging behind what is required to align the UK's financial sector with the goals of the Paris Agreement. Robust transition plan reporting would help fix the net zero pledge accountability gap. It is crucial that this reporting is mandatory, rather than on a 'comply or explain' basis.

6. **Enact the green taxonomy as soon as possible.**
   We need a green taxonomy which is science-based, accessible and harmonised with the EU taxonomy and others around the world. This would help tackle 'greenwashing', set out science-based criteria for organisations to be considered environmentally sustainable, and enable better data to help companies, investors and consumers make informed green choices.

7. **Extend the new Sustainable Disclosure Requirements (SDR) labelling regime to institutional funds.**
   ShareAction warmly welcomed the FCA's proposed investment labelling system as a key way to tackle greenwashing and boost capital flows towards genuinely sustainable retail investments. But the retail market is dwarfed by UK institutional funds by 70 to 1. To becoming the world's first net-zero financial centre, the UK must ensure the new regime also covers institutional funds.

Reforming regulatory mandates

Regulators should have clear mandates on climate and nature

The Government's proposed Future Regulatory Framework[v] for financial services in the UK post-Brexit entails adding growth and international competitiveness as secondary objectives for the FCA and PRA. These proposals have since formed the basis of the Financial Services and Markets Bill[vi], which is now (at the time of publication) at committee stage in the House of Lords.

As we outlined in ShareAction's consultation response[vii] in February 2022, we have significant concerns about this proposal. An over-focus on competitiveness has been widely acknowledged as a factor in bringing about the 2007/8 financial crisis[viii], including by Andrew Bailey, then head of the FCA and now Governor of the Bank of England.

The Financial Services and Markets Bill (FSMB) also included a regulatory principle regarding climate change and a net zero economy. However, this mechanism is insufficient and inferior to a secondary statutory objective and does not address nature. The Treasury itself has pointed out that "the regulators are not required to act to advance their regulatory principles." In January, Minister Baroness Penn said in the FSMB second reading debate in the House of Lords that regulators are only "required to take into account" a regulatory principle on net zero[ix].

Furthermore, legal analysis by international law firm CMS confirms that a regulatory principle would not provide an appropriate legal basis for regulators to facilitate the rapid growth of the green finance sector which considers climate and nature[x]. The Government's proposed regulatory principle would also fail to require the regulators to even consider the vital role of nature in achieving net zero.

It is impossible to achieve a net zero and nature-positive financial sector without giving financial regulators a mandate to actively support it.

This is why we – along with a coalition of NGOs[xi] – believe the Government should introduce a secondary statutory objective for the FCA and PRA on climate and nature. This would sit alongside the proposed competitiveness and growth objective, requiring (where possible) the FCA and PRA to actively facilitate net zero and nature recovery through their policies, rules, guidance and supervision of the financial sector, which currently funds environmentally harmful activities. Such an amendment would help align the UK economy and financial services sector with the Government's net zero target and the targets in the 2021 Environment Act.

There is growing private sector support for regulatory mandates on climate and net zero:

During the Commons committee stage of the FSMB, a group of 12 major financial services businesses including Aviva Investors, Phoenix, Hargreaves Lansdown, Aegon UK and Federated Hermes submitted evidence declaring their support for a statutory objective to facilitate the transition of financial services to net zero, stating that "the proposed regulatory principle will not provide a sufficiently strong legal basis for regulators to promote a thriving net zero financial sector. It certainly won't encourage the regulators to ensure that the UK becomes the world's leading green financial centre."[xii]

At COP27, finance experts including the former Governor of the Bank of England, Mark Carney, demanded the alignment of financial regulation with net zero[xiii]. He also reaffirmed this when being questioned by the Environmental Audit Committee on GFANZ's progress to net zero in the Autumn of 2022[xiv].

There is growing cross-party support for a secondary statutory objective on climate and net zero in the Financial Services and Markets Bill.

At committee stage in the House of Lords, cross-party Peers called for this vital amendment to the Bill:

Lord Randall of Uxbridge (Conservative) implored his colleagues to be forward-thinking, noting "the future for our grandchildren is very grim."

Baroness Hayman (Crossbencher) said leaving net zero and nature-alignment out of the Bill would be a "ridiculous and wrong omission."

Lord Vaux of Harrowden (Crossbencher) noted this amendment could be a "driver of growth" and a "huge opportunity for the UK."

Baroness Northover (Liberal Democrat) was the fourth Peer to sign on to this amendment.

Place sustainability at the heart of Solvency II reforms

The Government's Solvency II proposals serve as a case study of how the lack of climate and nature mandates for regulators negatively impacts sustainable finance policy. The proposals include reducing the risk margins for long-term life insurers and changes to the matching adjustment (assets insurers are incentivised to invest in). Disappointingly, no sustainability safeguards have been embedded into Solvency II legislation. Insurers are supposed to manage risk, and yet they are failing to account for – and often actively compound – climate risk through their investment and underwriting decisions.

The Government has claimed that the 'freed up' capital from reductions in capital requirements will be invested in green infrastructure, but nothing is in place to ensure this. In fact, there is no guarantee that the tens of billions of capital previously set aside to protect policyholders will not be used to continue to invest in and/or underwrite fossil fuel projects (or other socially and environmentally harmful assets) that expose both policyholders and insurers to greater risks. Matching adjustment reforms miss an opportunity to redirect capital flows away from high-carbon investment to green alternatives – we agree with ClientEarth that investments in fossil fuel or greenhouse gas (GHG) intensive projects and companies should be ineligible for the matching adjustment[xv].

Voluntary initiatives aren't going far enough – regulators must step in

ShareAction's report, Insuring Disaster: A ranking of the world's largest insurers approaches to responsible investment and underwriting[xvi], finds that insurers' current approach to responsible investment and underwriting is insufficient to safeguard a 1.5C future. Almost half (46 per cent) of those surveyed received the lowest sustainability rating (E), with another 17 per cent receiving a D rating. No insurer received an AA or AAA rating.

Our policy briefing, Going Beyond Insurers' Voluntary Initiatives: Why policymakers must embed mandatory insurance regulation in Solvency II[xvii], paints a similar picture, highlighting the extent to which insurance companies – even those in the Net Zero Insurance Alliance (NZIA) – continue to underwrite and invest in new fossil fuel projects. There is no room for new oil and gas (O&G) fields in the International Energy Agency (IEA)'s pathway for the global energy sector to achieve net zero CO2 emissions by 2050. But despite this, only thirteen of the world's insurers have committed to end or restrict underwriting for O&G development at the time of writing[xviii].

Major insurers AXA (France), Allianz (Germany) and Aviva (UK) – some of the founding NZIA members – were among the top five insurance company investors in North Sea fossil fuels between 2019 and 2021[xix], having invested a combined total of US $4.7 billion in O&G companies in the region. The overarching reality of the insurance industry's position on climate is alarming.

How regulators can intervene: higher capital requirements on assets compounding climate risk

The UK could face[xx] a banking crisis worse than 2008 if the city fails to prepare for the collapse of the fossil fuel industry[xxi]. A growing coalition of experts[xxii], MPs and Peers are proposing a simple solution to this impending crisis: implementing 'one-for-one' capital requirements for financing new fossil fuels. This is a form of financial regulation that means for every pound that finances fossil fuels, financial institutions should have a pound of their own funds held liable for potential losses (these could range from losses caused by a burst oil pipeline to environmental disasters, to stranded assets). Not only do capital requirements act as a 'safety cushion', but they also make climate-damaging investments comparatively more expensive than green ones, thus incentivising the kind of investment needed to facilitate the green energy transition.

The insurance sector – and the financial sector at large – urgently needs to account better for climate risk. But until the PRA and other regulators are mandated to consider climate, net zero and nature, progress will be too slow. Voluntary initiatives are failing to achieve progress at the pace required. It is high time regulators stepped in for the stability of financial markets, to protect policy holders, and the planet.

Broadening the objectives of UK pension funds to promote sustainability

Amend the law on fiduciary duty

The purpose of a pension is to provide for a good quality of life in retirement. But quality of life is about much more than financial returns.

Trustees' fiduciary duties must evolve, allowing them to truly act in the best interests of savers, including mobilising pension savings to pursue broader environmental and societal goals.

The pensions sector is an immensely powerful component of our financial system - UK pension schemes alone hold approximately $3.9 trillion in assets under management (AUM)[xxiii]. The decisions made in pension trustee boardrooms, and by those who advise them or manage investments on their behalf, have huge ramifications for the lives of present and future retirees. If pension savers' money is not being managed to contribute to a sustainable environment, society and financial system for their retirement, is it truly being managed in their best interest?

UK financial regulation is slowly beginning to reflect these ambitions. Mandatory disclosure requirements for pension schemes to report on climate-related financial risks and opportunities, and on aligning portfolios with the Paris Agreement – are steps in the right direction. But disclosure can only go so far. Recent research shows that pension trustees remain unsure whether fiduciary duty allows them to addressing climate change. Trustees have even less clarity what they are allowed to do when trying to improve social outcomes through their investments[xxiv]. Trustees, consultants, fiduciary managers and asset managers still frame and understand their fiduciary duty to mean prioritising financial return over all else.

This narrow interpretation inhibits investors from making decisions that align with and contribute to broader environmental and societal goals, including the UK Government's legally binding net zero targets and the Paris Agreement temperature target, which are highly relevant to savers' lives and interests.

Pension schemes must be empowered to consider savers' views when making investment decisions.

Savers are increasingly concerned about the sustainability impacts of their pension savings[xxv]. Those managing pension schemes ought to be required by law to seek to understand those concerns and take account of them, whilst retaining full discretion and independence. Acting in savers' best interests should also require schemes to take active steps to understand savers' views and preferences, helping trustees to serve their interests.

We recommend amending the law to explicitly include consideration of the impacts of investment activities on society and the environment ('double materiality'), and the views of beneficiaries, within the fiduciary duty of pension schemes.

The law should clarify that acting in beneficiaries' 'best interests' requires the consideration of:

1. the likely consequences of any investment activities in the long term;
2. the impact of any investment activities on the financial system, the economy, communities and beneficiaries' quality of life and the environment;
3. environmental, social and governance considerations (including, but not limited to, climate change) which the fiduciary investor considers financially material; and
4. the views of beneficiaries.

Addressing perceived barriers to investor stewardship from acting in concert rules

Address investor concerns about financial regulators acting in concert

Stewardship is a critical tool in enabling investors to shape corporate behaviours and create positive, sustainable outcomes. One way of doing this is through collaborative engagement, where investors come together to influence companies' performance on one or more ESG themes.

Collaborative engagement helps institutional investors to pool their knowledge and resources, reduce engagement costs and maximise their legitimacy when in dialogue with companies[xxvi]. ShareAction often convenes investors to conduct collaborative stewardship activities. Last year we galvanised investors to engage with HSBC, which ultimately committed to phase down its fossil fuel financing[xxvii].

Despite the potential for positive outcomes through collaborative engagement, many jurisdictions have regulatory requirements which prohibit certain types of co-ordination by investors. ShareAction research has found that both equity investors and fixed income investors cite rules around 'acting in concert' including anti-trust rules as being particularly problematic and an obstacle to collaborative engagement[xxviii]. Mark Carney has also highlighted fears around anti-trust enforcement action preventing investors from taking collaborative action on climate change through GFANZ[xxix].

We welcomed the commitment by the Competition and Markets Authority to ease anti-trust rules for businesses with regard to collaborative action on climate change issues and we have been working with the FCA on this issue[xxx]. These steps are positive, but as part of its Green Finance Strategy the Government should engage with financial regulators to ensure the new rules are aligned with the UK's broader sustainability objectives. For instance, while we welcome steps to address enforcement concerns in relation to collective action on climate, neither the CMA or FCA are currently considering widening their scope beyond climate change. Collaborative stewardship across all sustainability issues should be in the scope of the regulator's review so that collaborative action by investors can support a just transition.

Developing robust mandatory reporting frameworks

Make the publication of net zero transition plans mandatory, building on the work of the Transition Plan Taskforce (TPT)

Financial institutions are not decarbonising their investment portfolios rapidly enough by developing fossil fuel restriction policies to safeguard a climate-safe future. The International Energy Agency (IEA) recently outlined in explicit detail what is required for a climate-safe world[xxxi]. Namely, there is no room for new oil and gas fields in its pathway for the global energy sector to achieve net zero CO2 emissions by 2050.

As we outlined in our consultation response to the Transition Plan Taskforce (TPT)[xxxii], a transition plan should set out how an organisation will align with a pathway to net-zero GHG emissions that delivers real-economy emissions reductions, giving due consideration to nature related risks, dependencies and impacts. It should include: a) targets the organisation is using to mitigate climate risks and impacts b) interim milestones c) actionable steps the organisation commits to

Financial institutions are far from net zero-aligned

Extensive ShareAction research has shown that financial institutions are not following the IEA's science-based scenario on reaching net zero by 2050:

- European banks have financed upstream O&G expanders with over US$400 billion since 2016. Two of the UK's four largest banks top this dubious league – HSBC comes top, followed by Barclays in finance provided. A quarter of all financing within Europe comes from these two UK banks. Between 2016 and 2021, HSBC and Barclays provided US$107.44 billion to 50 oil and gas expanders.

- In February 2023, Barclays announced it would radically reduce financing for oil sands, but failed to update other key aspects of its oil and gas policy despite investor concerns. At the very least, banks should be restricting financing for new O&G, but also taking steps to phase down financing of current projects.

ShareAction's latest ranking of banks, In Debt to the Planet, finds that Europe's largest banks are not doing enough to address the twin crises of climate change and biodiversity loss:

- The average overall score achieved in this survey is 43.7 per cent and 19 banks did not even score half of the available points.

- The quality and scope of net zero targets varies widely, with most using intensity-based emissions reductions rather than absolute emissions reductions. Reductions in emissions intensity do not necessarily correlate to the overall reduction in emissions needed to transition to net zero.

- Only three surveyed banks have specific financing restrictions for companies expanding oil and gas regardless of supply segment.

take to hit those targets, including a corrective action plan and d) an assessment of how the plan will be funded, including how capital will be accessed.

In simple terms, a financial institution's net zero transition plan is not credible unless it leads to:

- absolute emissions reductions;
- financing restrictions in relation to new oil and gas;
- the phasing down of fossil fuels on timelines aligned with 1.5C pathways.

Make it mandatory for financial institutions to publish their net zero transition plans, building on the work of the Transition Plan Taskforce (TPT). Extensive ShareAction research has found that financial institutions are consistently failing to align the UK's financial sector with the goals of the Paris Climate Agreement. Robust transition plan reporting would help fix the net zero pledge

accountability gap; it is crucial that this reporting is mandatory, rather than on a ‘comply or explain’ basis.
The Transition Plan Taskforce (TPT) has made significant progress with a wide range of stakeholders to define what transition plans should look like. We believe publication of these plans should be strictly mandatory from the start. They should outline how companies and financial institutions plan to decarbonise their investments and operations in line with 1.5C global warming in the short, medium, and longer term.

Enact the Green Taxonomy as soon as possible

We are disappointed to see minimal progress on the green taxonomy, which is needed to help investors identify sustainable investment opportunities and bring about the allocation of capital to companies driving the green transition. As set out by the Green Technical Advisory Group (GTAG), the key aims of a green taxonomy are to[xxxiii]:

- Help tackle ‘greenwashing’, improve understanding of environmental impacts to help companies and investors make informed green choices, support investment in sustainable projects and boost efforts to tackle climate change.
- Clearly set out the criteria which specific economic activities must meet to be considered environmentally sustainable.
- Enable better data to help companies, investors and consumers make informed green choices, support investment in sustainable projects and boost efforts to tackle climate change.

It is now commonplace for financial institutions and companies to have net zero targets. But research conducted by Accenture finds that 93% of companies are on track to miss their net zero target[xxxiv], raising questions of greenwashing and the lack of accountability when firms self-proclaim sustainability. Furthermore, the UK risks losing its competitiveness against global financial markets if it does not keep pace with green finance[xxxv].

A Green Taxonomy is a science-based framework to determine genuinely sustainable activities and companies that substantially contribute to one of six environmental objectives: climate change adaptation, climate change mitigation, sustainable use and protection of water and marine resources, pollution prevention and control, protection and restoration of biodiversity, and transition to a circular economy. In addition, a ‘do no significant harm’ principle is applied to the other five environmental objectives, as well as the requirement to meet minimum social safeguards.

We recommend the Government works to enact the green taxonomy as soon as possible, one which is science-based, accessible and harmonised with the EU taxonomy and others around the world. The GTAG’s recent paper on international interoperability of green taxonomies lays out how this can happen[xxxvi].

We recommend the Government details a timeline for when the taxonomy consultation, delayed from March 2022, will happen, and when the SDR, which will make taxonomy reporting mandatory in the UK, will be implemented.

Publish plans to extend the new Sustainable Disclosure Requirements (SDR) labelling regime to institutional funds

ShareAction has been a vocal supporter of the FCA's proposals on Sustainability Disclosure Requirements and investment labels. The new labelling regime represents a key way of tackling greenwashing by providing confidence to investors that the products they invest in live up to their sustainability credentials. The new regime is also a critical piece in the Government's broader efforts to become the world's first net-zero financial centre, as announced by the Prime Minister at COP26. However, in contrast to the approach taken in the Sustainable Finance Disclosure Regulation in the EU and proposals by the Securities and Exchange Commission in the US, the UK is introducing a consumer-focussed labelling regime which will only apply to retail funds.

The new regime introduces various labels to distinguish between investment products based on their sustainability-related objectives and features. The stated aim of the proposals is to provide greater transparency, consistency and trust in the market for sustainable investment products. We support this aim but consider that these considerations should apply to all investments.

Clearly it is important consumer interest in sustainable finance is not undermined by the mis-selling of retail investment products. There is strong interest amongst UK consumers for sustainable investment products and assets under management grew to £62.5bn in 2022 showing that people want to make money without harming the environment[xxxvii]. But if the UK is serious about becoming the world's first net-zero financial centre then it must extend the scope of the new regime to cover institutional funds in addition to retail funds: retail assets under management are dwarfed by the UK's institutional fund market, which stood at £4.7tn in 2021, up from £4.5tn the previous year.

Despite these net inflows, ShareAction research has found that voting performance on sustainability resolutions has stagnated in the UK compared to 2021, while European asset managers have shown a large improvement[xxxviii]. We agree with the Prime Minister that, "climate and environmental considerations should be central to the decision-making process of [...] every investor's risk and return calculations" but are extremely concerned that institutional funds have so far been excluded from SDR proposals[xxxix].

The Government has the opportunity remain a global leader in green finance and take another step towards becoming the world's first net zero financial centre. Publishing plans to extend the scope of the new labelling regime to institutional funds would put the UK's finance sector on the right track.

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ShareAction is a registered charity working globally to define the highest standards for responsible investment and to drive change until these standards are adopted worldwide. Our vision is a world where the financial system serves our planet and its people.

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ShareAction»

ShareAction is a registered charity working globally to define the highest standards for responsible investment and to drive change until these standards are adopted worldwide. Our vision is a world where the financial system serves our planet and its people.