UK FINANCE

Treasury Committee inquiry into the decarbonisation of the UK economy and green finance

~ Written evidence submitted by UK Finance ~

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Introduction

1. UK Finance is the collective voice for the banking and finance industry. Representing more than 260 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

2. Over the course of the past year addressing climate change has come to be recognised across civil society as a generational challenge meriting urgent attention. This is entirely aligned with policies beginning to be put in place in support of an orderly transition to a low carbon economy in keeping with the Paris Agreement.

3. It remains the case, however, that unless further steps are taken there is no prospect of achieving the internationally agreed target of keeping the increase in global average temperature to below 2°C above pre-industrial levels, let alone limiting the increase to 1.5°C. This said, the issues involved are complicated and the opportunities and costs – whether viewed in purely financial terms or in terms of the potential impact on jobs and communities – of immense scale.

4. Since the announcement of the Treasury Committee inquiry we have seen HM Government make a statutory commitment to achieve net zero carbon emissions in the UK by 2050, the publication on 2 July of the UK's Green Finance Strategy[1] and the launch of the Green Finance Institute (GFI). As the Green Finance Strategy sets out, a long-term and legal policy framework contributes to the long-term certainty investors need and provide the foundation for the financing of clean growth ambitions. This is a prerequisite.

5. The UK's Green Finance Strategy is premised upon aligning private sector financial flows with clean, environmentally sustainable and resilient growth, strengthening the competitiveness of the UK financial services sector by:

    - 'Greening finance', by mainstreaming climate and environmental factors as a financial and strategic imperative
    - 'Financing green', by mobilising private finance for clean and resilient growth
    - 'Capturing the opportunity', by providing leadership to consolidate the UK's position as a global hub for green finance

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[1] HMG Green Finance Strategy, July 2019

6. The UK statutory commitment to achieve net zero carbon emissions by 2050, the Green Finance Strategy and the setting up of the GFI are landmark steps and are welcomed by UK Finance.

7. We are pleased to contribute to the Treasury Committee inquiry. As can be seen from our responses to the individual questions below, we have focused more on issues concerning green finance than those concerning HMT's strategy. We would underline, however, that achieving net zero emissions by 2050 will need a concerted effort all round. We would also make the point that there is considerable developmental work that has been undertaken internationally and in the EU and that the UK should seek to build on and contribute to this.

The economic opportunity

1. What economic costs and benefits does decarbonisation present for the UK?

8. We note that HMT has estimated the cost of the UK achieving net zero carbon emissions by 2050 to be in excess of £1 trillion. While others have commented on this representing only a limited perspective, it serves as a reminder of the need to balance ambition with the economic cost of foregone GDP. We consider the statutory commitment to a 2050 timeline as a strong statement on the part of the UK that it intends to invest in decarbonisation and the greening of the economy. This should bring not only environmental benefit, but economic benefit if it achieves what has been described as 'an orderly transition', through commercial opportunity both at home and overseas.

2. What benefits can a growth of the Green Finance sector deliver for the UK, and does the UK hold a competitive advantage in this space?

9. Delivering green finance requires a blend of skills, depth of market and innovative spirit that is synonymous with UK banking and financial services. It is also dependent, however, on an industrial strategy and approach to regulation – across the field and not just in terms of financial regulation – that provides a stable platform for long-term investment. The corollary of this is that abrupt policy interventions and reversals can have a negative effect. Adopting a forward-looking strategic approach that aims to put the UK at the forefront of technological innovation can only help.

10. We would agree in particular with the assessment of the Committee on Climate Change that government policies to reduce UK emissions need to be business-friendly, with policy providing a clear and stable direction and a simple, investable set of rules and incentives which leave room for businesses to innovate[2]. We consider that the GFI has an instrumental role to play in forming partnerships to mobilise capital in support of the domestic and global transition to a zero-carbon economy and see that they have announced the first three of their mission-led coalitions in support of: the scaling up the energy efficiency of UK buildings; building capacity and financial instruments to finance resilient infrastructure in the UK and overseas; and financing sustainable commodity production across supply chains[3].

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[2] Committee on Climate Change 2019 2019 Progress Report to Parliament, 10 July 2019

[3] Dr.Rhian-Mari Thomas, CEO, Green Finance Institute speech to the City of London Corporation's Green Finance Summit, 3 July 2019

3. **How might HMT deliver a regionally balanced and 'just' transition across the UK?**

11. As the question implies, there is a case for the UK's Green Finance Strategy to include an appraisal of both the threats and opportunities presented regionally by the transition to a low carbon economy. At a minimum this should include an appreciation of the impact on jobs that the transition can have whether in terms e.g. of energy sources or automobile manufacture. A more ambitious approach, and this would be our preference, would be to embrace climate change as an opportunity and to build this into an industrial strategy aimed at delivering regeneration benefits within towns and cities across the UK.

12. UK Finance, for instance, is participating in a 'Banking on a Just Transition' initiative with the Grantham Research Institute at the LSE, the Sustainability Research Institute at the University of Leeds, banks, other financial institutions and key stakeholders[4]. The project aims to identify how banking can support a just transition across the regions of the UK in which people and places are not left behind and transition involves broad social and economic participation and spread of benefits given there should be opportunity as well as risk.

13. Research is currently underway, with issues under consideration including:

    - **Policy frameworks**: What are the key climate and economic policies needed to ensure that banks can support scaled-up action in the real economy with far greater urgency?
    - **Strategic purpose:** How can banks and the banking system respond to the social risks and opportunities that flow from the transition to a net-zero economy in terms of strategic purpose?
    - **Market demand:** How can banks and other finance providers work with households, enterprises and public authorities to design the sustainable financial products that will be needed?
    - **Public and blended finance:** What is the best mix between bank finance, public finance and impact investment, particularly to mitigate risk and ensure inclusion in the transition?
    - **Regional dynamics:** How can banking support place-based climate action, responding to local needs, particularly in a regionally-imbalanced economy such as the UK?
    - **Financial regulation:** What is the role that financial regulators can play in overseeing climate risks and the broader social implications of the transition?

14. The intention is to hold a series of meetings across the UK to better understand the needs of different cities and regions to realise a just transition. This will involve roundtables being held in Belfast, Birmingham, Bristol, Edinburgh, Leeds and Manchester.

HMT's strategy:

4. **What is HMT's current strategy, and approach to, UK decarbonisation, and is it fit for purpose?**
5. **How does HMT work with the Clean Growth Strategy and government departments to support decarbonisation? Is this working well?**

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[4] Banking on a Just Transition research project summary note, July 2019

6. **How should HMT's approach evolve to ensure the Government meets the legally binding carbon budgets (and the net-zero targets, if applicable)**
7. **What role should the 2019 Comprehensive Spending Review play in UK decarbonisation? What projects or measures should receive additional funds through this process?**

15. We note that the Green Finance Strategy announced (p32) that:

    - The Government will consider the financial risk exposures relating to climate change and the low carbon transition as part of the 2020 Managing Fiscal Risks report;
    - HMT will lead a review to understand the costs of achieving net zero carbon emissions by 2050 and to understand where these costs will fall across the economy;
    - Government departments will be asked to incorporate the updates 2018 Green Book focus on climate risks in their policy development, including at the Spending Review; and
    - Reporting under the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) be embedded in publicly funded financial bodies.

16. We further note the intention to use public funds to leverage private capital. The Green Finance Strategy (p.41) includes a number of examples of resources allocated to fund investment in clean energy and natural capital growth – in terms of both substantial allocations and smaller strategic investments to pump prime new markets by funding the development of effective project delivery models.

Green Finance:

8. **What role do UK financial services firms currently play in the decarbonisation of the economy, (for example, through stewardship, capital allocation to green projects, green financial products)? What more can they do?**

17. The question identifies three of the key areas where financial services firms have a significant contribution to make:

- Stewardship, where institutional investors and asset managers are beginning to make known that their investment criteria will increasingly include an assessment of whether companies have sufficient regard for climate risk in their strategy and business planning, including as evidenced by their public reporting under the TCFD.
- Capital allocation, where some larger banking groups have publicly announced ambitious targets for sustainable finance and investment over the medium term.
- Product development, where we would expect to see an increase in offerings that can objectively be labelled 'green', whether e.g. in terms of savings and investment, energy-efficient mortgages or insurance.

18. Climate strategy will in the short to medium term become part of the client dialogue that corporates and other organisations can expect to have with their banks and insurers. We would additionally expect to see increased market demand for information about climate in respect of prospectuses.

19. Firms can also give consideration to their own energy footprint and the question of whether they can make changes to their business practices in support of the transition to a low carbon economy.

20. As mentioned in response to question 2, above, firms could do more if the investment or funding risks were reduced through consistent or mid-term commitments from Government

to a particular approach, for example, many green projects struggle to get proof-of-concept stage funding because of the level or risk uncertainty that the project will become viable, leading to a lack of liquidity in the market for suitable investment projects once necessary licences or permissions have been obtained. If there were a low-cost, sandbox approach for such licencing or permissions (similar to that adopted in our own sector by the FCA), this would enable projects to get to initial stage without the need for such financing, which would result in more green projects for firms to invest in or support. For example, renewable energy projects currently require material funding at the pre-licencing stage in order to obtain the licence, but without the licence they are not a viable project that can then obtain affordable finance because they have no income to repay the funding without the licence.

9. What steps have UK banks, asset managers, and pension funds taken to 'green' their business models, investments strategies and balance sheets, taking into account climate and transition risks?

21. As the 2019 TCFD Status report[5] relates, in the two years since the Taskforce published its recommendations, 785 companies and other organisations globally have committed to working with the TCFD recommendations. This includes 374 financial institutions. The report also confirms that 340 investors with nearly $34 trillion in assets under management are asking companies to report under TCFD.

22. Within a UK context, the six largest banking groups[6] were amongst the early adopters of the TCFD making their opening governance and strategy disclosure statements in their 2017 year-end strategic reports. As an international financial market, the UK is host to a substantial number of non-UK headquartered banking groups that are similarly committed to acting upon the TCFD recommendations. This will extend out to a further cohort of banking and finance firms given the alignment between the climate risk requirements of the supervisory regime announced by the Prudential Regulation Authority (PRA) in April.

23. The TCFD itself, however, in making its recommendations in recognised that further developmental work was needed before firms could be expected to act upon each of its recommendations. This included a lack of common definition and measurement, data gaps and the absence of an agreed framework for modelling and sensitivity analysis. It was for this reason that the TCFD paced a three to five year time horizon on aspects of its recommendations being delivered, while at the same time asking companies to evolve their disclosures over time.

24. Opening disclosures in 2017 year-end strategic reports principally comprised a commitment to the effect of bringing climate-related risks and opportunities into mainstream governance, strategy and risk management. These initial disclosures were built on in 2018 year-end reporting[7], with some being in a position to estimate the proportion of their balance sheet exposures related to carbon-intense industrial sectors, and further progression is expected at this year-end. Developmental work on sensitivity analysis and other aspects has taken place during this time, e.g. within the UNEP Finance Initiative[8] and continues, and over the

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[5] TCFD Status Report, June 2019

[6] Barclays, HSBC, LBG, RBS, Santander UK and Standard Chartered

[7] See e.g. p23-33 Barclays ESG report YE 2018 or Standard Chartered 2018 Climate Change Disclosures

[8] UNEP Finance Initiative Changing Course: a comprehensive investor guide to scenario-based methods for climate risk assessment, in response to the TCFD, July 2018

next two to three years we can look forward to firms building up their sensitivity analyses and the Bank PRA introducing climate-related risks into Biennial Exploratory Stress Test scenarios.

25. The Future of Finance report for the Bank of England[9] prepared by Huw van Steenis highlighted that 'investors, lenders and insurers lack a clear view of how companies will fare as the environment changes, regulations evolve, new technologies emerge and customer behaviour shifts…Without this information, financial markets can't price climate-related risks and opportunities effectively'. While van Steenis urged the Bank to promote the widespread adoption of the TCFD recommendations, Governor Mark Carney in his Mansion House speech adopted a more unequivocal position: "to achieve a carbon neutral economy, disclosure must become mandatory"[10]

26. We note and support the expectation as set out in the Green Finance Strategy (p23) that all listed companies and large asset owners be disclosing in line with the TCFD recommendations by 2022. This is entirely consistent with the timeframe envisaged by the Taskforce at the time of the publication of its recommendations. The supportive actions identified in the strategy, including the planned review of progress on TCFD implementation as part of the 2020 interim report, are welcome (p22 and 25).

10. Are there any barriers (regulatory or otherwise) preventing financial services firms from delivering green finance or investing in 'green' assets?

27. As can be seen from their published annual and related reports, a number of larger, internationally active banking groups have announced that they have targeted achieving in the region of $100 billion of environmental finance in support of customers transitioning to a low-carbon economy[11].

28. It remains the case, however, that there remain significant gaps in the climate risk and green finance framework that need filling in order for firms to put in place a full climate risk management approach and for there to be a clearer understanding of which funding opportunities and assets can unassailably be said to be 'green'. There is also a lack of commonly agreed definitions, metrics and data sources. There is, however, an industry of development taking place across the globe and the open and collaborative spirit in which this is taking place can only accelerate the pace at which market opportunities become available.

29. We are pleased therefore to see the commitment in the Green Finance Strategy (p26) to (at least) match the ambition of the high level objectives within the EU Sustainable Finance Action Plan and the option to onshore specific EU proposals that the UK has been closely involved in developing[12] – on disclosures, benchmarks and a new sustainable finance framework or taxonomy – established by including the files as part of the Brexit-related Financial Services (Implementation of Legislation) Bill.

30. As referred to above in our response to question 2, the Green Finance Strategy (p36) envisages a key objective for the newly launched GFI being the acceleration of the flow of

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[9] Future of Finance report for the Bank of England, Huw van Steenis, 20 June 2019

[10] Mark Carney, Governor, Bank of England Mansion House speech, 20 June 2019

[11] See e.g. p26 HSBC ESG Update, April 2019 or p28 Finance for a Climate-Resilient Future, Citi's TCFD report

[12] See ec.europa.eu for an overview of EU activity on sustainable finance.

finance into the projects and technologies that will help deliver on the strategy's objectives. The strategy (p48) further announces that the institute will launch a series of mission-led coalitions that will convene multi stakeholder groups to address the barriers to greater and more rapid deployment of green capital including, specifically, under the Government Clean Maritime Plan.

31. The degree to which a long-term and reliable industrial strategy contributes also cannot be over-estimated.

32. A question that arises within the dialogue is whether a case can be made for a discount on prudential capital – often referred to as a 'green factor'. While we agree that a case for such a discount can only be made once there is objective evidence in support of 'green' exposures representing less risk than others, and an understanding gained of the way in which green exposures perform within the existing prudential capital regime, we are increasingly persuaded that an adjustment to the capital regime might have a part to play. This includes overcoming the funding barrier presented by the longer-term nature of green infrastructure absent security or collateral. The key is establishing an objective base upon which climate-related factors can be reflected in the prudential capital regime.

33. The corollary to a 'green' factor is that there may be a case for a 'brown' factor in respect of assets embodying climate-related risks. Again, careful thought needs to be given to this if we are not to find ourselves in a position where sectors or geographies become un-bankable in a way that could not be said to be consistent with an orderly transition or mindful of social and community consequence. In any event, consultation is to commence this autumn on conducting a climate stress-test for UK financial institutions in 2021

11. What prudential risks does climate change pose?

34. We agree with the Bank of England and PRA's analysis that prudential risks arising from climate change should be considered in terms of both more immediate physical risks impacting asset values and transition risks arising over a longer timeframe as changing policies, technologies and sentiments have market impact. Also, that climate-related risk should be assessed as part of more traditional credit, market and operational risks.

35. This was illustrated in the Bank PRA's 26 September 2018 report 'Transition in thinking: The impact of climate change on the UK banking sector' as climate-related financial risks comprising both physical and transition risk within more traditional credit, market and operational risk[13].

36. It is worth adding that addressing climate-related risk is an acknowledged priority on the part of an alliance of central banks and supervisors formed under the 'Network for Greening the Financial System' (NGFS) in which the Bank PRA participates. This now comprises 40 member organisations, in addition to multilateral organisations such as the Bank for International Settlements being engaged in an observer capacity, and in April published its first 'comprehensive' report[14]. This underlined the intention on the part of central banks and supervisors to take concerted action in response to the challenge to financial stability posed by climate change.

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[13] Bank PRA report 'Transition in Thinking: The impact of climate change on the UK banking sector', September 2018.

[14] Network for Greening the Financial System first comprehensive report 'A call for action: climate change as a source of financial risk', April 2019

12. **What is the Financial Conduct Authority and the Prudential Regulation Authority doing to support decarbonisation and a 'greening' of the financial system?**

37. The FCA and the PRA both consulted on bringing the management of financial risks from climate change into the scope of their regulatory regimes at the turn of the year, from a prudential supervision perspective and, in the case of the FCA, their statutory responsibility as the listing authority and their role in protecting consumers and market integrity. We have additionally seen the establishment of the joint PRA and FCA Climate Financial Risk Forum (CFRF)[15], with representatives from across the financial sector, with the aim of building capacity and sharing best practice.

38. UK Finance is pleased to be involved in the Forum to help represent a broader range of firms and to ensure the outputs of the CFRF are communicated to members. The forum intends to develop market-based guidance on key aspects of climate risk management. This will offer guidance around developing tools/techniques and, by putting a framework around developing approaches, will be of particular assistance to smaller firms less advanced in considering climate risk.

39. A clear policy direction is needed to support the work of the FCA and PRA in this area, however, as the achievement of a net result across all UK sectors cannot be delivered or driven by the FCA and PRA alone or without a clear understanding of the elements of this net outcome that fall within their purview as opposed to those in other sectors / regulatory oversight, such as manufacturing, energy, telecommunications, automotive and property development.

b) What expectations do (and should) they place on regulated firms about their role in the transition through their policy and supervisory activities?

40. This is an area where consumer-led drivers will have more impact than regulatory supervisory measures. As commercial organisations, firms are by nature demand-led. Fostering an environment where such investments and funding are economically attractive to consumers (for example, through the adoption of incubation 'sandbox' approaches for early-stage green projects or prudential capital requirement reductions to reduce the cost of capital applied to such funding) would be more likely to drive central Government policy outcomes in a fair and consistent manner throughout the sector.

41. There is a risk that, if done solely though supervisory activities, this will have a disproportionate, anti-competitive impact on smaller firms who will have smaller books through which to achieve the same outcomes, particularly on a net basis. It should also be borne in mind here that the existing barriers to new entry into the regulated market presented by the standardised prudential capital model under CRR and CRD have a higher impact in higher risk financing areas, such as green finance, than they do in other areas.

42. The PRA supervisory regime, as set out in Supervisory Statement 3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' is organised around four key tenets:

    - Governance, with the PRA looking for firms to fully embed the consideration of financial risks from climate change into their governance frameworks, including assigned responsibilities within the Senior Managers and Certification Regime (SMCR)

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[15] Bank of England press release 'First meeting of the PRA and FCA's joint Climate Financial Risk Forum, 12 March 2019

- Risk management, with the expectation being that firms address the financial risks from climate change through their existing risk management framework: credit, market and operational
- Scenario analysis, with firms to assess the potential impact that climate change could have on their business strategy and risk management processes, and scenarios to address a range of outcomes on the transition to a lower carbon economy and, importantly, physical impacts if the world does not meet Paris Agreement targets
- Disclosure, with firms expected to develop and maintain an appropriate approach to the disclosure of climate-related financial risks taking into account both the interaction with existing categories of risk and the distinctive elements of the financial risks arising from climate change; the PRA forewarns that firms should recognise the increasing possibility of climate disclosures being mandated in more jurisdictions, raising the prospect of the TCFD recommendations being mandated in the UK under the Government's Green Finance Strategy.

43. When read in conjunction with Policy Statement 11/19[16], which provides feedback on responses to CP23/18, we can see that the expectation is for firms to submit updated Senior Management Function (SMF) forms by 15 October this year and for climate risk to be built into their Internal Capital Adequacy Assessment Processes (ICAAPs) or Own Risk and Solvency Assessment (ORSAs) as and when due updating. Importantly, the PRA has said that it appreciates that expertise will need to be built.

13. What is the consumer demand for 'green' financial products?

44. While it would be fair to say that demand for green products is at a nascent stage, we envisage that as consumer demand grows for environmentally-friendly products, whether in terms of transport, energy and other utilities or the packaging used in their everyday purchases, we could easily envisage demand similarly growing for green financial products, whether mortgages, savings or investments. Cross-sector engagement e.g. between energy and financial services firms utilising the services of the Green Finance Institute and others can help raise.

14. Are there a range of accessible options available to consumers seeking to source 'green' financial products across the product suite (for example, mortgages, bonds, investment products, savings accounts, loans)? Do certain instruments dominate the green finance landscape, and if so, why?

45. Within a UK context, energy efficient mortgages are possibly the most advance in terms of the underlying developmental work needed to bring products to market and will be given a stimulus by the announcement of the £5 million Home Finance Fund to pilot products.

46. We further note, as referenced in the Green Finance Strategy (p40) that under the Clean Growth Strategy HMG set an aspiration to upgrade as many homes as possible to Energy Performance Certificate (EPC) Band C by 2035 and that the total investment needed to improve housing stock to this standard is estimated to be between £35 billion and £65 billion. Actions to build the market for green finance products in support of home energy efficiency include:

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[16] Bank PRA Policy Statement 11/9 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'

- Publishing a consultation paper later this year on the merits of setting requirements for lenders to help households improve energy performance of homes for they lend;
- Publishing and updating EPC data to enable lenders to evaluate the EPC performance of their lending portfolios;
- Exploring further opportunities for simplification and improvement of the Green Deal framework in support of energy efficient measures;
- New technical standards published last month by the British Standards Institution, with the intention that these be embedded in the new TrustMark government endorsed quality scheme.

47. We share the assessment that the TrustMark scheme will improve the investment attractiveness of energy efficiency, enhance the prospect of consumers getting what they were expecting and put in place suitable financial protections.

48. The market in green bonds is relatively under-developed though when these are brought to market they are often over-subscribed. A potential barrier in this regard is the addition costs associated with third party validation of the green credentials of the identified activities funded under the bond. This is something that may warrant consideration.

49. While there are an increasing number of 'ESG-related' investment products, it's fair to say that they remain limited and under-utilised. The same also applies in respect of ethical or environmental savings accounts and loans. We would expect to see this change considerably over time. We further note the increasing number of pension funds announcing that they will only invest in companies signed up to the TCFD. This of itself is expected to be a motivating factor towards companies placing environmental responsibility higher up their order of priorities.

50. We should bear in mind that this should include the need for carbon-intensive industries to transition towards practices that enable them to reduce their carbon footprint and in the process make one of the most significant contributions towards the greening of the economy.

15. Do accompanying documents for 'green' instruments (bonds, funds, etc) articulate why and how the composite holdings within that instrument are 'green'? Are obligations placed upon listed companies, to report their carbon emissions, to inform fund composition?

51. 'Green washing' or the practice of making an unsubstantiated claim about the environmental benefits of the activities associated with a financial instrument is a legitimate concern. It is for this reason that standards and labels for 'green' financial products are needed to give investors certainty. This has been one of the focal points of the EU Sustainable Finance Action Plan complemented by market guidance in the form of green bond principles[17] and green loan principles[18].

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[17] Green Bond Principles published by ICMA and updated June 2018.

[18] Green Loan Principles, published jointly by the LMA, APLMA and LSTA and updated December 2018.

16. Does the current advice and KYC process effectively facilitate a consideration of sustainability preferences?

52. We are not at the stage at which sustainability preferences form part of the dialogue on investment choices. This is not to say that this should not be a medium term ambition. We note, however, the technical advice to the European Commission by the European Securities and Markets Authority (ESMA) in April this year on integrating sustainability risks and factors in MiFID II[19]. This concludes that a high-level principle-based approach should be adopted and that the next step should be for firms to 'take into account' environmental and social considerations relevant for the provision of investment services to clients. This is driven as much as anything else by practical considerations. We would see this more as a matter of firms asking clients about their sustainability preferences than KYC as this tends to be more about consumer protection including vulnerability to financial crime.

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[19] ESMA Final Report technical advice to the European Commission, 30 April 2019