

Time for action: the Devil is in the policy detail

Will financial regulation support a move to a net
zero financial system?

Summary of analysis and recommendations

A report researched and written by the Financial Inclusion Centre
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The Financial Inclusion Centre (FIC) is an independent research and policy innovation think-tank dedicated to promoting financial inclusion and fair, inclusive, efficient, sustainable, and accountable financial markets.

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Summary

As part of its work on the impact of finance on the environment, the Financial Inclusion Centre (FIC) undertook a new project called *The Devil is in the policy detail – will financial regulation support a move to a net zero financial system?* This followed on from *Time for Action – greening the financial system*¹ which made over 40 high-level policy recommendations to overcome the barriers to greening the financial system and markets.

The *Devil in is the policy detail* project takes the analysis to the next level and evaluates, in detail, the main financial policy and regulatory tools available to green the financial system. There is a complex ecosystem of environment-related² financial policymaking and regulation. The project spans regulation aimed at financial institutions such as banks and shadow banks, insurers, asset managers, and pension funds, and reporting and disclosure standards aimed at businesses in the real economy. It also considers the critical role of data, data assurance, and environmental ratings.

This document summarises the key insights and recommendations contained in the full report. The full report: provides a comprehensive description of the complex ecosystem of environment-related financial regulation at UK, EU and international level (Part 1); evaluates, in detail, the potential effectiveness of the main environment-related financial policy and regulatory tools currently being developed in the UK (Part 2); and makes a series of policy and regulatory recommendations to align financial markets with climate and wider environmental goals (Part 3).

As well as providing a much-needed comprehensive assessment of environment-related financial regulation, we hope this report will become a useful resource and reference material for civil society groups who want to understand the complex ecosystem of financial regulation.

We are very grateful to Friends Provident Foundation for supporting this follow up project, and indeed for supporting our first report.

A fork in the road

Post Brexit, there is much to consider and major political decisions to take. The future of specific UK environment-related financial regulation will be influenced by international and EU developments, not just domestic considerations. The UK government intends to make the UK a global green finance centre. Will the UK develop world leading standards on green financial regulation, or instead establish a lighter regime than the EU and other regions and so risk a regulatory race to the bottom?

The UK is at a fork in the road on environment-related financial regulation. Decisions made now won't just have domestic implications, they will have consequences for efforts to establish high standards at a global level.

UK financial services remain one of the most important in the world. The UK can play a positive role in supporting the global transition to a net zero financial system. Even though the UK has left the EU, the EU still matters to the UK financial sector, and vice versa, so the UK can still play an important role in influencing financial regulation for good at EU level. Conversely, if UK policymakers take the

¹ [Time for Action – Greening the Financial System | The Financial Inclusion Centre](#)

² We tend to use the terms climate and environment interchangeably. But, throughout the report whichever term we use we mean climate and wider environmental issues (such as biodiversity)

wrong approach, and embark on a strategy of regulatory arbitrage, this could significantly harm efforts to create universally high standards of environment-related financial regulation.

Within the UK, there are concerns that finance industry lobbies are using the need to fund the green transition and economic recovery as ‘Trojan Horses’ to push for financial deregulation. They argue that current regulations limit their ability to finance green technology/infrastructure. We think this is disingenuous to say the least. Financial deregulation will undermine defences against future financial crises and weaken consumer protection. But, it is unlikely to support a move towards a net zero financial system. As we explain in this report, there are better ways to ensure the financial sector supports net zero goals, without weakening the financial system and undermining the security of people’s pensions.

A reminder of what’s at stake

The UK is failing to meet its ambitious³ climate goals,⁴ and the government’s plans for net zero do not include enough information to allow for proper scrutiny of those plans.⁵ Reforming financial markets is a key part of greening the UK economy and, given the influence of the UK financial markets, the global economy. Much more needs to be done to ensure UK financial institutions take climate responsibilities seriously.⁶ Banks continue to lend to, insurers continue to insure, asset managers and pension funds continue to invest at scale in corporate and sovereign assets⁷ that cause serious harm to the environment.

Even from a ‘selfish’ national interest perspective, financial market reform should be a priority for the UK as its heavily financialised economy is particularly exposed to climate risks.⁸ However, people living in nations with the lowest incomes, poorest health, and weakest infrastructures are most at risk.⁹

Much more needs to be done to ensure financial institutions take climate change seriously. Protecting the environment from finance needs to be given equal status as other regulatory objectives.

Financial services is one of the UK’s leading export sectors. The carbon emissions associated with the UK financial sector were estimated to be nearly twice the emissions produced domestically by other UK economic activities.¹⁰

Financial policy and regulation are not aligned with climate goals

To move towards a net zero financial system, financial policy and regulation must:

- Reduce the **stock** of environment-damaging assets held by financial institutions.
- Direct the **flow** of new money away from environment-damaging economic activities and towards environment-supportive economic activities.

³ The Climate Change Act 2008 was amended to commit the UK government by law to reduce greenhouse gas emissions by at least 100 percent of 1990 levels (in other words, ‘net zero’) by 2050. The previous goal was 80 percent of 1990 levels.

⁴ [Current programmes will not deliver Net Zero - Climate Change Committee \(theccc.org.uk\)](https://www.theccc.org.uk)

⁵ [We’ve won our case against the UK Government’s inadequate net zero strategy | ClientEarth](https://www.clientearth.org)

⁶ See for example: [51% of major global energy companies are still failing to disclose their decarbonisation strategy - Grantham Research Institute on climate change and the environment \(lse.ac.uk\)](https://www.granthamresearchinstitute.com); [Climate Action 100+ Net Zero Company Benchmark shows an increase in company net zero commitments, but much more urgent action is needed to align with a 1.5°C future | Climate Action 100+](https://www.climateaction100.com)

⁷ E.g., bonds issued by national governments and agencies

⁸ See: [People in the US and UK face a huge financial hit if fossil fuels lose value, study shows | Fossil fuels | The Guardian](https://www.theguardian.com)
[Stranded fossil-fuel assets translate to major losses for investors in advanced economies | Nature Climate Change](https://www.nature.com)

⁹ [Climate change and health \(who.int\)](https://www.who.int)

¹⁰ [The-Big-Smoke-the-global-emissions-of-the-UK-financial-sector.pdf \(greenpeace.org.uk\)](https://www.greenpeace.org) Note that the analysts conclude that this is likely to be a significant underestimate due to lack of publicly available data in key areas such as insurance.

- Hold financial institutions to account for harm caused to the environment.

We conclude from our assessment that the UK does not have: the appropriate high-level policy and regulatory framework and architecture; effective regulatory objectives and tools; and regulatory culture to align finance with environmental goals and to hold financial institutions to account.

Financial markets, quite rightly, are regulated to prevent: finance from wrecking the economy as with the 2008 financial crisis; money laundering and insider trading; the financing of terrorism; and consumers being misled and ripped off. Yet, even the most basic assessment of financial regulation shows that preventing finance from harming the environment does not have anywhere near the same status or priority as those other objectives in the work of the Bank of England, Prudential Regulation Authority (PRA), and Financial Conduct Authority (FCA).

The report makes a set of recommendations to help move us towards a net zero financial system. The recommendations may seem radical, but they are not when compared to existing regulations already used to maintain financial stability, ensure market integrity and protect consumers. If adopted, the recommendations would accord the environment equal status in financial regulation. This is not much to ask for. Indeed, there is a strong case to be made that the environment should be given priority status in financial regulation.

The regulatory tools needed will depend on the financial activity, e.g., bank and shadow bank lending/finance, insurance and reinsurance, asset management, pension funds, financial intermediaries, and information providers. The main categories of regulatory intervention that can be used to align market behaviours are prudential; information, reporting and disclosure based; conduct of business regulation; and direct market interventions aimed at changing behaviours of financial institutions. We analysed each category and concluded that moving towards a net zero financial system needs a very different approach in each of those categories.

Prudential Regulation

The main prudential regulators, the Bank of England and PRA, have started to think about the impact of climate change on the financial institutions they regulate, but not the impact of those financial institutions have on the environment - in other words, the *consequences* of climate change not the *causes* of climate change. Prudential tools are not being directly deployed to change the behaviours of banks/shadow banks and insurers that finance climate damaging activities.

Information, reporting and disclosure-based regulation

This has been where most of the regulatory activity has been at UK, EU and global level. The UK lags behind the EU. The FCA should be commended for its attempts to develop a sustainable investment labelling regime to help investors make informed decisions. However, this report concludes that the FCA's proposals are confusing and unlikely to prevent greenwashing and 'impact washing'¹¹.

Generally, the conventional approach to financial regulation based on tackling information asymmetries¹² does not have a great record in preventing market failure in financial services. Our view is that financing climate harm is set to become *the* major market failure if it is not already so. More direct interventions will be needed to change financial institutional behaviours.

¹¹ This report focuses on environment-related finance – the 'E' part of ESG. But this has to be considered alongside corporate responsibility and social impact – the 'S' part of ESG – which considers the impact of corporate behaviours on employees, human rights, and so on.

¹² The theory is that better information allows market participants to make more effective decisions and choices and thereby indirectly improve markets by rewarding good behaviours and penalising bad behaviours. This is different to direct financial regulation where financial regulators use policy tools to directly constrain financial institutions' behaviours.

Meaningful, trustworthy ESG data and ratings of both underlying economic entities and financial institutions is critical to target policy and regulatory interventions. There is significant risk of conflicts of interest in the use of ESG data and ratings and a confusing plethora of methodologies deployed by data providers. It is not possible to judge whether current methodologies provide a meaningful assessment of financial institutions' impact on the environment. There are concerns that ESG ratings

We are far from having comprehensive, usable environmental performance data published in the reports and accounts of major economic entities.

providers primarily focus on the risks financial institutions face from climate change, not the risks these institutions pose to the environment.¹³

A green taxonomy is also important to allow stakeholders to distinguish clearly between those economic activities which harm the environment and those which make a positive contribution.¹⁴

The UK government had committed to legislate for a UK green taxonomy (similar to the EU's sustainable finance taxonomy¹⁵) by January 1st, 2023. Disappointingly, the UK government recently announced that the UK taxonomy would be delayed.¹⁶

The Financial Reporting Council and auditing and accountancy bodies have undertaken welcome work on improving the disclosure of climate risks in company report and accounts. However, disclosures are too reliant on narrative reporting. We are far from having comprehensive, usable environmental performance data published in the reports and accounts of major economic entities.

Cost of business regulation, and direct market behavioural interventions

There has been little active consideration of how to deploy robust conduct of business and direct market behavioural interventions to divert existing pools of assets and the flow of new money away from climate damaging activities. The emphasis has been on encouraging a market-led transition. This light-touch approach towards the continued financing of climate-damaging activities is at odds with the hard line taken against financial institutions that enable practices such as misselling, insider trading, market abuse, money laundering, financing terrorism, or breaking economic sanctions.

The regulatory interventions currently on the table do not reflect the gravity of the challenge. We need a rethink by the main financial regulators on how to deploy prudential, disclosure and reporting, conduct of business, and market behaviour regulation across the key financial sectors and throughout the supply chain (from wholesale through institutional markets to retail financial services and ordinary consumers).

It remains to be seen how the UK will compete as a global centre of green finance. Will it be a beacon of high standards or establish a lighter regime and risk a regulatory race to the bottom?

Avoiding regulatory arbitrage within different sectors of the UK financial system is important, but there are wider potential implications. Post Brexit, the UK financial sector remains hugely influential at EU and international level. The government is developing a Green Finance Strategy with the aim of making the UK a Global Centre of Green Finance (GCGF). It remains to be seen whether the UK intends to make the UK competitive through deregulation or as a beacon of high standards on green finance. The signs are not good.

¹³ [ESG Ratings: A Compass without Direction \(harvard.edu\)](https://www.harvard.edu)

¹⁴ An agreed classification system intended to help stakeholders identify which economic activities which can be considered environmentally sustainable

¹⁵ [EU taxonomy for sustainable activities \(europa.eu\)](https://europa.eu)

¹⁶ [Written statements - Written questions, answers and statements - UK Parliament](https://www.parliament.uk)

Key recommendations

The recommendations apply to UK financial policymakers and regulators. Obviously, given the global nature of the challenge, it would be ideal if there was a consistently robust approach to climate-related financial regulation at international, EU and UK national level. We hope that UK civil society recognises the need to continue to try to influence financial regulation at EU and international level, *and* domestically. What happens at international and EU level will continue to influence domestic regulation; and if we follow a path of lowering UK domestic standards, this could undermine the goal of creating universally high standards of environment-related financial regulation.

High-level policy recommendations

Global Centre for Green Finance - In our view, the government's plans for the GCGF will not make the UK a leading, trustworthy centre of socially useful green finance. Indeed, the government's deregulatory agenda evidenced by the reforms to Solvency II and pension charge caps, and its intention to give financial regulators secondary competitiveness and growth objectives, runs counter to that aim. The GCGF should be built with the following principles and goals in mind. It should: foster genuine green financial innovation; aim to be systemically robust and stable; prize integrity and trustworthiness; and establish a reputation for being well regulated, accountable, and transparent.

The recommendations, below, would help the UK create a GCGF built on high standards and integrity -

A Net Zero funding strategy and plan - The UK government should produce a detailed Net Zero Funding Strategy and Plan which sets out: how the government intends to implement the most sustainable, fairest, and economically efficient means of funding the green transition; and how, where, and when to best deploy available (public and private) funding to different sectors of the economy. We need a funding strategy because the two sources of funding net zero do not operate independently of each other. The scale of private financial resources available for the climate challenge and the terms on which those resources are made available will be affected by the availability of state resources and vice versa. Objectively determining the optimal balance between private and public funding of net zero is critical, yet this has not been analysed in any real depth.

A new status for environmental financial regulation - Environment-related financial regulation should be given at least equal status to financial stability, prudential regulation, financial market integrity, and consumer protection. Therefore, the Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to environmental sustainability. The FCA, PRA, TPR, and FRC should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objective.¹⁷

Financial Conduct Authority high-level responsibility - The FCA should have responsibility for overseeing how financial institutions, listed companies and larger private companies, and employers' pension schemes disclose compliance with environmental goals to investors and other financial users. The FCA should be given responsibility for regulating ESG ratings and ratings providers.

¹⁷ There is a very strong case for establishing a dedicated agency charged with monitoring and reporting on the environmental harm caused by corporates and financial institutions, maintaining an environmental harms register, and regulating ESG ratings providers. But, for now, we recommend that these functions be carried out by existing regulatory authorities.

Financial Reporting Council high-level responsibility - The FRC should retain responsibility for ensuring that the auditing of underlying economic activities meets regulatory requirements. Reporting on ESG compliance should urgently be made a statutory requirement, with tough sanctions for non-compliance with reporting standards.

A new Financial Sustainability Committee - The government and Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate-related risks.

FSC Annual Report - The proposed FSC should publish an annual report on its activities plus a wider triennial review on progress. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

An environmental harm audit of the financial sector - Financial regulators should produce a baseline audit of the environmental harm caused by each of the major financial sectors. This should be done on a preliminary basis using data on emissions generated by underlying economic entities which financial institutions finance/lend to, invest in, and insure.¹⁸ Once better data and a UK Taxonomy is available, a more comprehensive environmental audit should be undertaken.

Sectoral de-risking transition plans - Financial regulators should develop climate de-risking transition plans for each of the main financial sectors. These plans should have clear milestones and timeframes for climate de-risking each sector.

Public register of environment-critical financial institutions/Institutional de-risking plans - Financial regulators should establish a public register of environment-critical financial institutions based on their impact on the climate and wider environment. Regulators should develop environment de-risking plans for each environment-critical financial institution within their remits.

Risk-based approach to climate-related financial regulation - The FCA and PRA already operate a risk-based approach to their existing statutory objectives. They should adopt a similar approach to environment-related financial regulation and produce a list of financial institutions which present the greatest risk to the environment and robustly deploy the appropriate regulatory interventions. The FCA and PRA should incorporate climate risk into their respective board risk committees and report annually on progress made on sectoral and institutional de-risking plans.

Economic and financial supply chains - The FRC and FCA should increase their focus on improving the standards of auditing and reporting on compliance with environmental goals in supply chains.¹⁹

Pre-emptive and precautionary financial regulation - Historically, progress in financial regulation happened in response to financial crises and market failure. With climate risk, we do not have the luxury of relying on markets to 'signal' the true cost of failure so that financial institutions respond properly. We urge the financial regulators to adopt a more robust, pre-emptive, and precautionary approach to environment-related financial regulation.

¹⁸ The EU securities regulator ESMA has already produced an analysis which quantifies the 'greenness' of a large sample of 3,000 European investment funds. UK regulators could adopt and adapt this approach for the UK. See Table 1, p29

¹⁹ The supply chain accounts for more than 90% of most consumer goods companies' environmental impact. For more detail see: [Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre](#)

Prudential Regulation

Change of focus for financial regulators - The Bank of England/PRA focus too much on the *consequences* of climate change not the *causes*. The regulators should reconsider this approach. We urge the Bank of England and other regulators to send a strong, positive signal to Parliament and government that they recognise the need for financial regulation to actively support climate goals.

Solvency II and insurers - The government's intended deregulation of Solvency II to 'encourage' insurers to invest in green assets will reduce consumer protection and undermine the security of people's pensions. It is unlikely to cause insurers to invest in green assets or disinvest from climate-damaging assets. Regulators should require insurers/reinsurers to have credible, demanding climate de-risking transition plans with clear targets and timeframes to both protect insurance policyholders from climate-related risks and reduce the harm caused to the environment by insurance companies.

Specific policy tools for insurers - Specific policy tools will be needed to implement transition plans. Prudential regulators should adopt the 'One for One' Rule. That is, for each £ of funds that finances new climate-damaging activities, insurers should hold a £ of their own-funds against potential losses. If government insists on retaining the use of the Matching Adjustment (MA) technical provision in Solvency II which benefits shareholders at the expense of policyholders (see Annex A of main report), then assets which contribute to climate damage should not be eligible for MA portfolios. To address the stock of climate-damaging assets, insurers should have to hold a proportion of own-funds, ratcheted up over an appropriate time frame to compel insurers to divest these assets in line with the transition plans described above. This should apply to assets already held in MA portfolios.

Banks - Banks (and shadow banks) should be required to have similar credible, demanding climate de-risking transition plans in place. The 'One for One' Rule and treatment of existing climate damaging assets should also apply to banks and shadow banks.

Other Bank of England interventions - We support in principle the proposals, outlined by Positive Money and others, for the Bank of England to establish a Green Term Funding Scheme and Green collateral frameworks to directly influence financial market behaviours.

Defined benefit (DB) pension schemes - The Pensions Regulator (TPR) should require DB schemes to have credible, demanding climate de-risking transition plans. A version of the 'One for One' Rule for banks and insurers outlined above should be developed for DB pension schemes. The value of additional funds needed to comply with the 'One-for-One' rule should be added to the scheme's liabilities and the sponsoring employer required to fund the scheme's climate-risk funding deficit.

Prudential regulation of defined benefit pension schemes - Prudential regulation of DB schemes should be transferred to the Bank of England/PRA. The core principles of prudential regulation are similar for banks, insurers, and DB pension schemes. This would allow for a more consistent approach to prudential regulation, and specifically to environment-related financial regulation.

Conduct of business, reporting and disclosure, and other policy tools

The need for a clear fund rating system and climate health warnings - The FCA is developing a sustainable investment labelling regime to be used by investment funds. The idea behind a sustainable investment label is good. However, the FCA's proposals conflate different ESG goals (environmental, responsible corporate behaviours, and social impact). This will make it difficult for investors to identify funds which meet their preferences. The FCA says that its system does not imply a 'hierarchy' i.e., that some funds are better than others. Nor does the FCA intend to mandate that all funds be subject to a rating. The label is voluntary. So, the FCA's approach is not a proper rating

system which would allow investors to easily identify how well funds comply with stated goals or provide transparency on how much environmental harm is caused by those funds without a label. The FCA should rethink the architecture of its proposals and introduce a labelling system which allows investors to clearly distinguish funds that have a green goal from those that have a social goal (e.g., around fair treatment of workers). To help investors identify how well investment funds meet green goals, there should be a clear rating system based on, say, star ratings. Funds claiming to be 'transitioning' should set clear targets and publish independently verified progress reports. Any fund promoted as sustainable in any form should not be allowed to include fossil fuel assets within its portfolio. Funds with poor ratings should carry a clear environment health warning. We have provided examples of how an alternative green label would work in the report. The approach we set out could work for all types of collective fund/portfolio and indeed for bank loan books.

Other measures - The FCA's label proposals fall well short in a number of areas. Particularly worrying are the weak proposals on oversight and governance; the leeway firms will have to mark their own homework on compliance with green goals; and the lack of consistency on disclosure which will cause investor confusion. Oversight of a fund's objectives could be done by an investment fund governance body, yet FCA rules say only one quarter of the members of this body have to be independent. The FCA should: require independent verification of labels; take the lead on developing a standardised template for disclosure rather than encourage the market to develop one and mandate its use by all funds; and mandate the use of standardised green finance KPIs to allow for meaningful comparison of sustainability performance and progress towards green goals. Rules should be amended to ensure half of fund governance body members are independent. The proposals fall well short of the coverage of products adopted by the EU. The FCA should bring all investment-based products within the label. The proposals should apply to pension scheme trustees, charities, and local government clients not just retail investors. If distributors and intermediaries recommend overseas funds, which claim to be green yet won't be covered by the labelling regime, they should be required to perform due diligence on the green compliance of those funds. If that is not possible, they should not be allowed to recommend those funds.

Investigation into greenwashing in existing ESG funds - There has been a significant growth in the number of funds in the ESG sector. Detriment tends to 'follow the money' in financial services and the ESG fund market has not been directly supervised by the FCA or addressed by the Financial Ombudsman Service (FOS).²⁰ It must be reasonable to assume there is a significant risk that greenwashing²¹ has already occurred. Existing rules require regulated firms to be clear, fair, and not misleading when marketing funds. Therefore, we recommend that the FCA should conduct an investigation into existing funds that claim(ed) to be 'ESG' or 'ESG-aligned'. This will help inform the FCA's preparations for introducing its welcome proposal for a new anti-greenwashing rule.

Recommendations on defined contribution (DC) pension schemes - Sponsoring employers and scheme trustees should be required to submit DC schemes to be green rated by an independent rating agency and compared to an appropriate market benchmark to promote accountability to pension scheme members. Sponsoring employers and trustees should be required to explain poor ratings to scheme members and produce an improvement plan. Scheme trustees should be required to produce climate de-risking transition plans (see above) approved by scheme members.

²⁰ It is interesting that searching the FOS website for 'greenwashing' or 'ESG' at the time of writing turned up no results.

²¹ In the sense that funds have been promoted as being ESG compatible to gain a marketing advantage without fundamental changes being made to the underlying investments

Other measures to ensure financial institutions take environmental harm seriously

The scale of the climate crisis facing us means we need to deploy robust interventions to ensure financial institutions, and their directors and senior managers, are deterred from financing climate and environmental harm and are held to account if they do so.

An Environmental Harm Register - Government should establish an independently operated, publicly accessible Environmental Harm Register.²² The Register would contain details on the level and source of emissions generated by publicly listed and larger private companies and sovereign state agencies. This should be complemented with information on wider environmental harm. The worst performing economic entities on the Register should be included on an Environment Sanctions List.²³ This data should be audited with the auditing overseen by the FRC. The Environmental Harm Register and Sanctions List would be maintained by the FCA. The Register would allow for better targeted regulation and provide the foundational data to build up meaningful sustainability labels. It would also enable progress against transition plans to be monitored thereby allowing government and relevant regulators to consider and require the appropriate remedial action at entity and sector level.

An environmental-harm penalty for funds - In time, allowing for a suitable transition period, penalties should be introduced for financial institutions that continue to fund economic entities which seriously damage the climate and wider environment. Reference would be made to the public Environmental Harm Register and Sanctions List outlined above. For example, if a company, which scored a poor rating on emissions, issued a corporate bond, then any fund which invested in that bond should pay a climate penalty to reduce the net yield received. Gains from equity type investments would also need to be addressed. A global carbon tax on economic entities is desirable. An alternative would be to create a climate harm 'windfall tax' to be applied to investment funds which make above market returns from holding environmental damaging assets.

Direct fines and sanctions - In time, direct fines and sanctions (for example, by removing certain regulatory permissions), should be imposed on financial institutions that continue to finance or provide access to finance for the most harmful environmental activities as designated on the Sanctions List.

Board level/senior management responsibilities and remuneration - There should be professional and financial consequences for the people who run financial institutions that continue to damage the environment. The Senior Managers and Certification Regime (SMCR) should apply to a climate-related financial activities including sanctions for failing to comply with a new climate-related responsibility.²⁴ For individuals covered by the SMCR, a new responsibility should be introduced to consider the impact of a firm's activities on environmental sustainability and to take reasonable steps to reduce that impact.²⁵ It should be mandatory for independent assessment of performance against climate responsibility and climate de-risking plans to be included in the calculation of remuneration for boards and senior management.

²² Ideally, an international register would be created by a relevant international agency

²³ The government maintains a UK Sanctions List under the Sanctions and Anti-Money Laundering Act 2018 [The UK Sanctions List - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/collections/uk-sanctions-list) We argue the same robust approach should be applied to economic entities which cause the worst damage to the environment.

²⁴ [Senior Managers and Certification Regime | FCA](#)

²⁵ This would be seen as being similar in intent to the overall responsibility senior managers have for the *firm's* policies and procedures for countering the risk that the *firm* might be used to further *financial crime* See: [SYSC 4.7 Senior management responsibilities for UK relevant authorised persons: allocation of responsibilities - FCA Handbook](#)

Data, rating and reporting/the role of the FRC

Environment responsibility statements - If stewardship means creating sustainable benefits for the environment, then we need evidence of progress. The FRC should ensure that independent, objective evidence on the degree to which underlying economic entities²⁶ benefit or harm the environment is put into the public domain. Information must be clear and minimise the risk of misinterpretation and obfuscation. Economic entities should produce an environment responsibility statement setting out: independent, audited data on emissions generated by the entity's activities and the degree to which activities align with the definitions in the UK Green Taxonomy (when finalised); and a risk assessment of which activities make the greatest contribution to climate and environmental harm with the actions taken to address those risks.

Qualifying company accounts/environment reporting standards - Auditors should have to say whether statements in a company's report and accounts relating to the environment should be qualified either because they disagree with the conclusions, or there is insufficient independent information to allow for judgment. The FRC and professional bodies for auditors, accountants, and actuaries should urgently develop new standards on identifying, quantifying, and reporting on environment-related risks. These standards should be included in assessing whether enforcement action should be brought for breaching professional standards.

Statutory regulation of ESG ratings and ratings providers - There is an incentive for financial institutions to select a ratings provider that produces inflated ESG ratings. Consumers or pension fund trustees cannot be expected to challenge the different methodologies used by such providers. Nor is it sensible to think that competition will drive up the quality and integrity of ratings. Indeed, if anything the fiercer the competition, the greater the risk of 'ratings inflation' where providers provide more favourable ratings to attract clients. We urge HM Treasury to give the FCA the powers to regulate ESG ratings and ratings providers as quickly as possible.

ESG voluntary Code of Conduct - Until regulation happens, the FCA has created the ESG Data and Ratings Code of Conduct Working Group (DRWG), to develop a voluntary Code of Conduct for ESG data and ratings providers.²⁷ The DRWG objectives should be revised to produce a Code that: ensures the production of trustworthy, meaningful ESG ratings; requires ESG providers operate to the highest standards of integrity; enables investors to make effective decisions on ESG factors; and requires financial institutions/intermediaries to use ESG ratings and the Code responsibly.

Code governance - The governance of the DRWG is very weak and dominated by industry representatives.²⁸ There is a real risk the DRWG will not deliver a meaningful Code of Conduct and could even furnish government with an excuse not to regulate ESG ratings providers. The FCA should chair the DRWG or ensure it has an independent chair. The FCA should appoint DRWG members and ensure half are independent civil society representatives. The FCA must approve ownership of the Code. To build trust in the Code, the workings of the DRWG should be open to public interest representatives to make representations at meetings. The Chatham House Rule should *not* apply except when there are genuine issues of commercial confidentiality being discussed. Minutes of the meetings should be published on the FCA website. The FCA should require institutional users to disclose upfront to investors whether the ESG ratings provider they use complies with the Code. ESG

²⁶ The real economy entities which financial institutions finance in different forms

²⁷ [Code of Conduct for ESG data and ratings providers | FCA](#)

²⁸ Two industry groups will serve as the Secretariat for the DRWG. This Secretariat, co-chaired by industry representatives, will appoint the DRWG members. The DRWG will be composed of between 15-18 members, with only three positions reserved for academics and civil society representatives.

ratings and providers may not yet be regulated. But the FCA already requires financial promotions and communications to be clear, fair, and not misleading. Misuse of ESG data and ratings obviously has the potential to mislead. So, even though this is a voluntary code, the FCA should require the DRWG to consider appropriate deterrents and sanctions for providers and users that abuse the Code. The FCA should issue guidance on the use of ESG data and ratings by regulated firms and intermediaries.

ESG ratings inconsistency - Worryingly, the FCA does not seem to think the low correlation between the ESG ratings provided by different agencies is a problem.²⁹ It is not reasonable to expect end-users to compare and contrast underlying methodologies. The FCA should: investigate and publish urgently an assessment of why there is such a low correlation between ESG ratings; assess the potential for conflicts of interest created by users being able to select favourable ESG ratings methodologies; and promote consistent methodologies for ESG ratings. A fair and functioning system requires direct regulatory intervention.

If you would like to discuss the report or have any questions, please contact:

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²⁹ Where different ESG providers produce different ESG ratings on the same economic entity/financial product



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