# Written evidence submitted by David Rouch

*This response is made as an individual in a personal capacity.*

1.1 Those familiar with my work have encouraged me to make this response.

1.2 I am an international financial services lawyer, and became a partner in Freshfields Bruckhaus Deringer in 2004. I have advised the full range of finance operators, dealing with all the main UK financial services regulatory bodies. I am especially known for my work on law, finance practice and sustainability. I was recently the lead author of 'A Legal Framework for Impact: Sustainability Impact in Investor Decision-making' (https://www.unpri.org/download?ac=13902), commissioned by the UNEP FI, PRI and The Generation Foundation and published by Freshfields Bruckhaus Deringer in July 2021 ('**A Legal Framework For Impact**'). The report is relevant to the inquiry. Its principal focus is institutional investment, but the framework it provides would also apply to finance operators more broadly. I have been engaging with finance operators and policymakers on the report since publication and it is out of those discussions that I have been encouraged to make this response. I am also the author of 'The Social Licence For Financial Markets: Reaching For The End And Why It Counts' (Palgrave Macmillan 2020) which looks at how to galvanise behaviour change in financial markets and the role of law in that.

1.3 This response focuses on the following aspect of the inquiry:

*The potential effectiveness of the financial sector, including through alliances such as GFANZ, in encouraging the decarbonisation of the economy in time to limit global temperature rises to 1.5°C;*

## 2. Summary

2.1 The potential effectiveness of the financial sector in encouraging decarbonisation can be considered from, broadly, two perspectives: (a) whether finance operators have the inherent capacity to encourage decarbonisation and (b) whether current circumstances facilitate that.

2.2 As to the first, the challenge of decarbonisation is systemic. Finance is integral to the systems that have created that challenge and which now need to change. It therefore seems reasonable to suppose that the finance sector has a role in encouraging decarbonisation. Consequently, this response concentrates on the second issue, particularly its financial legal and regulatory dimension.[1] It suggests that maximising finance sector effectiveness requires greater legal and practical clarity about:

(a) the basis upon which finance operators should be encouraging decarbonisation given the legal goals frameworks they function within; and

(b) the steps they would need to take to do so.

2.3 For the financial sector to be effective in encouraging decarbonisation to meet the 1.5°C target, a significant portion of finance operators (and their support providers) would need to integrate steps to achieve that throughout their business activities. While there has been significant progress, this level of integration has not yet been reached and the UK's regulatory framework is not yet consistently aligned with achieving that.

2.4 There are two core needs.

2.5 The first is to move 'sustainable finance' and 'ESG' practice and regulation:

[1] Among other things, it does not, therefore, consider the role of primary economic and fiscal interventions (such as carbon pricing and public-private initiatives) which could have an important influence on finance sector alignment with decarbonisation goals.

(a) beyond finance operators adjusting their business operations and financial strategies:
- to mitigate and make them more resilient in the face of risks posed to them by climate change; and
- to exploit opportunities to profit from tackling climate change;

(b) further towards finance activity that also:
- recognises:
  - the system-wide or **'systemic' threat** posed by climate change to the health of the economies and markets on which finance operators rely to achieve their goals; and
  - the fact that system-wide challenges require a **collective response** to which finance operators are potentially integral;
- involves finance operators taking **intentional steps** to have an **assessable positive impact** on the root causes of those risks thereby improving the chances of a more beneficial operating environment for those operators and more widely;
- reflects the fact that achieving positive impacts of this sort does not rely solely on **capital allocation** decisions by finance operators, but also involves them **stewarding their relationships with or influencing** (i) the businesses which they finance, invest in or service (thereby affecting capital allocation ***within*** those businesses) and (ii) other third parties whose activities may align with the impacts they are seeking.[2]

2.6 The approach described at (a) above can be thought of as **'outside-in'** since it involves finance operators changing to position themselves as best they can in response to climate change. It is the focus of much current ESG activity, for example. The approach described at (b) is **'inside-out'** since it involves finance operators contributing to collective attempts to head off underlying climate risks themselves. Activities that are essentially 'outside-in' may contribute to addressing these underlying risks in some way, but that is not their main purpose.[3]

2.7 GFANZ is a key attempt to help the finance sector to make this transition since signatories to the constituent alliances commit to take steps to secure behaviour change among economic actors which is intended to tackle the root causes of climate risk. In addition, work on the UK's green finance strategy has also begun to put greater emphasis on inside-out activities, especially its Roadmap to Sustainable Investing.[4]

2.8 The second core need is to reflect consumers' climate aspirations more fully so that the financial products and services they receive are consistent with their climate goals (since there is growing evidence that these align with addressing the decarbonisation challenge – see 3.24 below).

2.9 Since finance is international, cross-border alignment on these matters is essential.

## 3. Response

3.1 The following outlines six key areas where greater conceptual or practical clarity is still needed (a) to enhance financial sector effectiveness in encouraging decarbonisation and (b) for a finance regulatory framework that helps with that. Some might initially appear relatively theoretical. However, all are important in practice. In each area there are implications for how regulatory

[2] Policymakers often emphasise the need for finance operators to allocate capital to business initiatives that address climate change. However, a significant part of the 'private investment' challenge of meeting climate goals does not concern direct investment of this sort, but the ***reallocation of investment within existing business enterprises***. Investment in businesses by finance operators is not necessarily, on its own, the most effective way for finance operators to ensure that private investment is directed towards achieving climate objectives. Their role in stewarding relationships with business enterprises, so influencing the allocation of investment within those enterprises, also needs attention.

[3] For more on this distinction in institutional investment markets see Part A.1 of *A Legal Framework for Impact*.

[4] *Greening Finance: A Roadmap to Sustainable Investing*, HMG, October 2021.

measures are drafted and regulation operates. In some cases, regulation can also be used to support finance operators in generating practical clarity.

**A. Clarity about the different goals of policymakers and finance operators as they concern decarbonisation**

3.2 Goal clarity is key to the success of most endeavours. In the context of decarbonisation, clarity about policymakers' and finance operators' goals, and in what ways the goals of the latter do or should involve steps to secure decarbonisation, is crucial. Currently, policy and industry commentary sometimes seems hazy about this.

3.3 The relationship between two sets of goals needs particular focus:

(a) the decarbonisation outcomes that policymakers want, including the 1.5°C target; and

(b) the goals that finance operators are required or permitted to pursue by law.

3.4 All concerned need to understand in broad terms how far (b) aligns with (a) – see B below. Among other things, that is because finance operators are legal vehicles. The law sets the framework for and limits on their activities: they are only permitted to function in ways consistent with their legal design, and that may affect how far they can pursue decarbonisation goals.

3.5 Often there may be alignment between 3.3(a) and (b) (e.g. see C below). However, where not:

- Policymakers need to decide whether to bring greater alignment by (a) amending the basic duties of finance operators or (b) altering their operating environment to make activities supporting desired policy outcomes more consistent with existing legal duties; and
- Finance operators need to be careful not to exceed what is legally permissible based on the legal structure they operate from.

**B. Clarity about the circumstances in which finance operators' legally defined goals may align with policy goals – pursuing decarbonisation where that is *instrumental* in achieving financial goals and decarbonisation as an end *in itself***

3.6 Having understood the different nature of policy and finance operator goals, it is also important to be clear about the circumstances in which decarbonisation-related goals (and specifically those that concern the 1.5°C target) of finance operators (within the scope of their legal goal frameworks) may align with those of policymakers.

3.7 The precise legal position of different sorts of finance operator varies. However, very broadly, most currently operate under legal frameworks that, essentially, are likely to require them:

(a) to prioritise the goal of generating or maintaining financial or investment value; and

(b) to do so, sometimes, largely to the exclusion of other goals (including climate goals) unless realising those other goals is **instrumental** to achieving (a).[5]

3.8 Consequently, as the legal duties of finance operators stand, if policymakers want finance operators to undertake activities aligned with the 1.5°C target they either need:

[5] As noted, the legal position varies between finance operators. Some have more flexibility in pursuing wider goals. In the case of institutional investors, see Part B.3 of *A Legal Framework for Impact*.

- to ensure that achieving it is **instrumental** to generating or maintaining financial or investment returns, and to help finance operators to understand why that is the case (since it may not always clear at present), or
- to extend the circumstances in which finance operators are required or permitted to undertake activities aligned with policy goals as '**ultimate ends**' in their own right, in parallel with financial goals, so that these include steps to achieve the 1.5°C target.[6]

**C. Clarity about risks posed by failure to decarbonise (and, specifically, meet the 1.5°C target) to financial goals that finance operators are often required to prioritise – especially the threat to the *economic systems* on which finance operators and markets depend to generate returns**

3.9 As noted at 2 above, the focus of much sustainable finance activity and regulation has hitherto been 'outside-in'. While that is changing, especially in response to the decarbonisation challenge, there is a need for greater focus on finance operators taking steps to tackle the root causes of climate risks – 'inside-out' activity.

3.10 The threat from climate change to the performance of the economic systems on which finance operators rely is increasingly clear. So, based on the financial goals those operators are generally legally required to prioritise, many should have an interest in the root causes of that risk being successfully addressed as should regulators with systemic stability, finance operator resilience or consumer outcomes objectives.

3.11 Hitherto, consistent with the outside-in approach, a key means of seeking to mitigate the risks of dealing with or investing in third parties has been to create a diversified portfolio of assets or business model. This reflects modern portfolio theory and can help an asset owner, for example, in mitigating the risks to which a particular investee might be exposed because of how they run their business (i.e. idiosyncratic risks). However, diversification does not protect from the threats posed by declining sustainability to the economic systems that finance operators rely on to generate financial value. That requires action that will have a **positive impact** in reducing the threats themselves, so protecting those systems.

3.12 Finance operators are among those potentially able to achieve or encourage positive impacts of this sort. That is because they finance, invest in and service third parties whose economic and consumption activities contribute to climate change, but are also in a position to influence them. In other words, there is potential for finance operators to change not just their own direct climate impact, but also to have a positive influence on that of others.

**D. Clarity about what positive impacts finance operators can pursue that are consistent with achieving 1.5°C target (where aligned with their duties), and how**

3.13 Legal and regulatory rules generally operate by reference to an intended outcome. However, how far a given outcome is achieved (and, hence, the effectiveness of the rules) depends, in part, on the circumstances in which those subject to the rules seek to comply. For example, a finance operator might conclude that it would be desirable to take a given step to comply with its legal duties but find that the detailed information it needs may not be available or may be too expensive to acquire.

3.14 To help finance operators towards the outcomes contemplated by legal and regulatory rules as far as this concerns the 1.5°C target and decarbonisation, it is therefore necessary to help them resolve, essentially, three sorts of practical pinch points:

- **Clarity about impact goals**: the need for clarity about what practical steps finance operators can realistically pursue to secure change in third party behaviour aligned with the 1.5°C target (where consistent with their legal duties);

[6] For a more on this distinction between 'instrumental' and 'ultimate ends' activity in institutional investment, see Part A.1 of *A Legal Framework for Impact*.

- **Clarity of information relevant to the 1.5°C target and impact assessment**: the need for greater clarity about the climate footprint of those who receive finance, investment and services from finance operators and how their progress towards impact goals relevant to the 1.5°C target can be understood and assessed (i.e. in terms of changed behaviour); and
- **Clarity about finance operator contribution**: the need for finance operators to be able to understand what difference their involvement has made to any behaviour change by third parties.[7]

3.15 There may be greater clarity on some of these in the context of climate change and the 1.5°C target than for other major sustainability challenges. However, it remains a work in progress.

3.16 Regulators cannot resolve this alone since these are principally matters of industry and specialist expertise and consensus, as seen with the development of sustainability reporting regimes (themselves part of the necessary infrastructure in this area). However, regulators can still help including by:

- Encouraging a **rigorous focus** on these areas by finance operators in their business, for example, using various forms of 'process regulation', among other things, reducing inadvertent 'greenwashing' risks and incentivising finance operators to devote attention to developing the necessary expertise;
- Ensuring a good level of **market discipline** concerning finance operators' climate claims, including those relevant to the 1.5°C target for example, using transparency, labelling and performance reporting regimes, going further than the EU's Sustainable Finance Disclosure Regulation to distinguish clearly between:
    - those that involve intentionally pursuing positive climate impacts (an area where current disclosure regimes are weak);
    - those that apply various sorts of screening or selection to include or exclude exposures to commercial activities based on climate criteria (whether for financial or 'ethical' reasons or otherwise); and
    - those that do not do either.[8]
- Facilitating the development of **enabling frameworks** for finance operators to pursue climate impacts, for example: (a) by strengthening corporate disclosure regimes in areas relevant to climate change (already well progressed in the UK), (b) by using convening or funding power to encourage work by industry, specialist and cross-disciplinary groups to articulate good practice standards in defining and assessing progress towards climate impact goals (as seen in the context of GFANZ), and (c) undertaking market studies to provide greater transparency to the market about existing good practice.[9]

**E. Clarity about the need for coordination and collective action**

3.17 Traditionally, there may have been a tendency to approach legal duties on an 'individualistic' basis involving a detached assessment of costs and benefits by the operator that is subject to them. On that basis, if a finance operator cannot simply quantify a benefit it can realise by taking a given step at a cost that is individually acceptable, it might decide not to act.

3.18 However, climate threats for finance operators are system-wide, resulting from collective failures. Individual action, viewed in isolation, is unlikely to be effective in mitigating them. Solutions therefore almost inevitably also need to involve a collective, or at least coordinated, exercise.

3.19 The essence of a collective endeavour is that success can only be achieved collectively and those participating will only enjoy the fruits of success, at some level, collectively. Coordination increases the likelihood of success and the costs are spread, both of which are potentially relevant

[7] For more on this in the context of institutional investment, see Part A.2 of *A Legal Framework for Impact*.
[8] The Financial Conduct Authority is working on sustainability disclosure rules. It is questionable whether the options outlined in its discussion paper on the new regime would have achieved this sort of transparency (*Sustainability Disclosure Requirements (SDR) and investment labels*, FCA Discussion Paper DP21/4, November 2021). However, further work has been undertaken since.
[9] For more on possible policy options, see Part C.2.3 of *A Legal Framework for Impact*.

considerations for a finance operator in deciding whether to pursue positive climate impacts in discharging its legal duties.

3.20 Essentially, the position for finance operators in this area could be thought of as akin to an election. If one person does not participate, it may not make much difference (although it can), but if lots of people take that approach, the system will fail and everyone will suffer. Finance operators may be failing their shareholders, customers and beneficiaries if they do not 'take part'.

3.21 The collective initiatives under the GFANZ umbrella are intended to provide just this sort of coordination. The headline figures for assets represented by signatories are impressive. However, these initiatives remain a work in progress and not all finance operators are members. If they are to achieve their potential, it is therefore important that they continue to receive the focused attention of signatories so that they provide a context in which appropriate impact goals can be developed and effectively pursued – and seen to have been achieved.[10]

3.22 It may therefore be helpful for the UK regulatory framework to do more to highlight the role of industry-led collective action in complying with legal and regulatory rules, as is already the case, for example in the UK Stewardship Code.[11,12]

3.23 It is also important that the use of competition regulation to generate social goods by protecting and enhancing competition does not cut across the need for cooperation of this sort which also supports key policy goals.

**F. Clarity about individuals' climate-related aspirations for the financial products and services they access**

3.24 There is growing evidence that a substantial majority of individual investors, want their financial affairs to be run in ways that support positive sustainability outcomes as well as being financially good for them. Much of the evidence is reviewed in A Legal Framework for Impact and includes a major UK Government study.[13,14]

3.25 It is questionable how effectively the UK regulatory framework currently captures this consumer 'ultimate ends' aspiration. In consequence, consumers may not be getting what they want even where their desired outcomes align with climate policy goals. In principle, this would need to be picked up in regulatory appropriateness and suitability assessments and product and service design processes, in providing financial advice and in reporting.

3.26 Further, in some cases, particularly pension funds and existing mutual funds, the legal duties of those operating the funds may currently make it difficult to act on beneficiary 'ultimate ends' aspirations, even where financial return is prioritised (so that the situation is 'win-win'). Various options for greater flexibility are discussed in A Legal Framework for Impact.[15]

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[10] 'Appropriate' in the sense that they need to align with the legal goals framework finance operators function within.

[11] Principle 10, UK Stewardship Code, Financial Reporting Council, 2020.

[12] See Part C.2.2.2 of *A Legal Framework for Impact* for a discussion of policy options to foster collective action of this sort.

[13] See Part A.4, 52 *et seq*.

[14] *Investing in a Better World: Understanding the British Public's Demand to Invest in Sustainable Development Goals*, UK Department for International Development, 2019.

[15] See Part C.2, 136 *et seq*.