Written evidence submitted by the UK Sustainable Investment and Finance Association (UKSIF)

Introduction

The UK Sustainable Investment and Finance Association (UKSIF) is the membership organisation for those in financial services committed to the growth of sustainable and responsible finance in the UK.

We seek to actively promote a more sustainable and inclusive financial system that works for the benefit of the environment and wider society. UKSIF represents a diverse range of financial services firms committed to these aims, and our 290+ members, representing over £10trn in assets under management (AUM) include investment managers, pension funds, banks, ESG data and research providers, financial advisers, NGOs, among others.

UKSIF and our members have played a prominent role in helping embed sustainability in the UK's policymaking and regulation over recent years. For example, UKSIF was last year appointed a representative of the UK's Green Technical Advisory Group (GTAG) to advise on the delivery of the UK's 'green taxonomy' and we look forward to helping ensure the taxonomy can set the highest standard possible for green investment for the rest of the world to follow.

We welcome the Environmental Audit Committee's inquiry considering the role of financial institutions in winding down the financing of fossil fuel extraction, and promoting the transition to green energy in pursuit of the Government's climate and environment targets. We hope this inquiry can draw further attention to the vital role that the UK's financial services sector will need to play in the coming years to help ensure greenhouse gas emissions peak as soon as possible and to accelerate the transition. With net-zero the defining mission of our age, each of us must act at the pace and scale that this challenge demands and vitally this must financial services

UKSIF's response to this inquiry draws on a number of perspectives outlined in our recent thought leadership report, published in May this year-*Delivering a net-zero financial centre: Recommendations from UKSIF's 'net-zero inquiry'*.[1] Our report provides a roadmap for how the UK can shift financial flows much more rapidly towards a net-zero pathway. It includes an emphasis on the importance of government and financial services working closely together over the 'winding down' and effective phasing out of the most high-carbon intensive industries in the coming years, which will be most effective in quickly reducing emissions.

Corporate approaches to the financing of existing and planned fossil fuel projects

We believe that real economy corporates, and investors too, should more meaningfully consider how existing fossil fuel projects and assets can be phased down over time to reduce carbon emissions, while ensuring a 'Just Transition' for those communities potentially relying on jobs in those industries. Minimising the possible balance sheet hit for the company, including its shareholders, will be another important consideration that corporates will need to keep in mind.

Further below in our response, we provide our views for how fossil fuel assets could be 'responsibly retired' over time and the challenges we see here, and this will be the most effective way to reduce emissions. We should be attuned to the possibility of these assets being sold off by corporates, and investors too, and picked up by less responsible owners simply seeking to maximise financial returns and not considering their impact on emissions and society more widely. This is a realistic scenario we see in some areas of private markets for example, particularly where less transparent investors may operate and not be undertaking robust stewardship and reporting.

In terms of future planned fossil fuel projects, we would urge corporates to seriously reconsider any new investments, particularly in developed economies, in light of the International Energy Agency's statement that new oil and gas projects should not be funded if the world is to achieve net-zero by the middle of this century.

[1] In May this year, UKSIF published our '*Delivering a net-zero financial centre Recommendations from UKSIF's 'net-zero inquiry*,' outlining a roadmap for how the UK can become the 'world's first net-zero financial centre.'

For developing economies with far more significant economic dependence on fossil fuels, such as coal power, corporate approaches to financing will likely need to be quite different with many of these economies not yet able to shift entirely from reliance on coal and other fossil fuels immediately. ‘Just Transition’ considerations will be greater in these countries where there is a more significant dependence on coal power and other fossil fuels, but above all we must collectively seek to promote a rapid transition to clean energy sources in these markets, and where possible bypassing more harmful ‘transitional’ sources of energy such as unabated gas.

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

The UK and global financial services sector has a hugely prominent part to play in encouraging the decarbonisation of the economy to limit global temperature rises to 1.5°C.

Among investors, stewardship and engagement with companies remains a unique lever to help shift the overwhelming part of the UK’s economy not yet on a pathway to 1.5°C towards this goal. We know that active stewardship with investee companies, particularly those in hard to abate sectors such as manufacturing, steel and cement, can speed up this journey. Exercised robustly, stewardship has led to meaningful results such as companies better disclosing and reporting to investors and stakeholders on the financial impact of climate change.

Investor stewardship will need to be enhanced further in the coming years to ensure the economy’s accelerated alignment to the Paris goals, and this means making sure stewardship is more targeted and delivers real-world change. For example, we want to encourage investors to consider stewardship more holistically, including not only engagement with corporate issuers of equity and credit, but also sovereign issuers, stewardship in respect of real assets, such as infrastructure, and stewardship of the financial system itself. We would like investors to be clearer about the role they are playing in advocating for a more sustainable financial system through policymaker engagement, as well as using stewardship of investee companies to encourage them to undertake advocacy for net-zero aligned policies in their own sectors.

Separately to stewardship, we want all investors and other financial institutions to take steps to far better identify their impacts of their investments on the environment and society. Firms should take greater responsibility for where their investments are going. There should not necessarily be differentiation between the impacts of investments and financial risks we believe, as the former over time will become highly relevant to companies’ long-term value.

The approach signalled by the Taskforce on Nature-Related Financial Disclosures (TNFD) is very welcome therefore by recognising the importance of considering both nature-related dependencies and impacts. Despite challenges, such as data availability and measurement, we continue to support initiatives seeking to embed this concept of ‘double materiality’ into regulation and firms’ decision-making, which can help address the climate crisis alongside a broader range of environmental, social, and governance (ESG) challenges.

The financial sector should continue to set an example by setting ambitious, robust net-zero and climate change targets that are verified and science-based, with both near-term targets to reduce emissions by 2030 and a long-term 2050 target at the very latest. Delivery of these targets must then follow, and the upcoming introduction of mandatory climate transition plans in the UK should help investors, and all stakeholders, assess the extent to which companies are delivering on their net-zero commitments. Once climate transition plans are introduced across the economy, investors will have an important role to play in evaluating the quality of companies’ transition plans, scrutinising how boards’ strategies intend to reduce companies’ carbon footprint in time.

Finally, the work of The Glasgow Financial Alliance for Net Zero (GFANZ) in corralling leading financial institutions, representing more than $130 trillion in assets under management (AUM), to accelerate the transition to a net-zero global economy is promising, and we will need to ensure commitments made by institutions as part of the alliance turn into real-world action and change.

We need to quickly see net-zero pledges turned into actionable, science-based transition plans and effective alignment of companies' business activities to a 1.5°C pathway. Consideration should be given to tightening up the criteria and rules for membership of GFANZ annually, and to that end we welcome the recent announcement from the 'Race to Zero' campaign' to strengthen its criteria. This includes making explicit the requirement for members to phase down and out all unabated fossil fuels as part of a 'Just Transition.' We would like to see GFANZ members more regularly held to account, including from policymakers and civil society, to ensure progress is being made towards delivery of their commitments.[2] There is a scrutiny role for parliamentary select committees in this respect, and we therefore welcome the Committee's plans to write to GFANZ signatories which have their headquarters in the UK, or have significant operations here, to seek clarity on their fossil fuel investment policies.

<u>Pathways to reducing investment in fossil fuel extraction</u>

We strongly believe that government needs to send much stronger signals to the financial services and investment community on the envisaged pathways to quickly reducing investments in fossil fuel activities.

Last year's agreement at COP26 in Glasgow on the phasing out of coal power is an example of the right, positive signals sent by policymakers, with at least 23 countries having made new commitments at COP to phase out coal, including five of the world's top 20 coal power-using countries. Similar global agreements would undoubtedly be very positive, and we support recent calls from the We Mean Business Coalition and others ahead of the G7 Summit, urging governments to provide clearer timelines and signals to help companies decarbonise, including the phase out in the G7 of domestic coal-fired power generation by 2030.[3]

We also want to see commitments made here at home that signal the UK's renewed commitment to meeting its emissions reductions targets. Regrettably, the commitments in the UK's recent 'Energy Security Strategy' on North Sea oil and gas exploration, and more recent announcements on gas exploration, have sent precisely the wrong signals to many sustainable investors. This includes on the credibility and viability of the UK's plans to reduce emissions, particularly in light of the International Energy Agency's statement that new oil and gas projects should not be funded if the world is to achieve net-zero by the middle of this century.

An example of a more recent policy announcement in the UK can be seen in the provision in the government's windfall tax announced in April this year, which will offer 91p of tax savings for every £1 of investment made in new domestic projects by oil and gas companies. Allowing the cost of new investments by oil and gas producers to be offset against profits will be very, very damaging to the UK's decarbonisation ambitions. The government must ensure that the right policy landscape and incentives are in place in the economy for private finance to flow to the right areas, and away from the continued expansion of fossil fuel production.

For example, we would like to see government put in place the following policies: stricter, short-term plans to phase out domestic coal, oil and gas production, the elimination of fossil subsidies as soon as possible, a price on carbon so that goods and services better reflect the true costs of their emissions, among other steps to reduce the risks of locking in future emissions and new stranded assets. The ongoing energy security crisis should not be used to slow down the pace of change needed to shift the UK's economy towards net-zero, and can be addressed very effectively alongside our net-zero mission, should the appropriate policy levers be used.

In terms of specific steps that financial regulators could take, we would like to see consideration from the PRA in the coming months of incentives that can bring down the costs and risk premium of lending to climate solutions, alongside measures that can make lending to fossil fuel activities, in particular coal, unattractive today. An area for further exploration could be to consider the merits of a 'one-for-one' risk management rule whereby for each pound that finances new fossil fuels, banks would have a pound of their funds held liable for possible losses. Given the urgency of the climate

[2]Details of the 'Race to Zero' campaign's update of criteria, announced in June this year, can be found here: https://climatechampions.unfccc.int/criteria-consultation-3-0/
[3]Details of the We Mean Business Coalition's statement ahead of the G7 Summit can be found here: https://www.wemeanbusinesscoalition.org/blog/we-mean-business-coalition-statement-on-the-g7-summit-2022/.

crisis, we believe all policy measures must be put on the table. We know the UK will not achieve its objective of becoming the 'world's first net-zero financial centre' if fossil fuel extraction continues to be financed at the current, unsustainable rate.[4]

For investors, robust stewardship and engagement with those most high-carbon intensive assets in their portfolios must take place with appropriate escalation policies in place, should companies not demonstrate sufficient progress in decarbonising their activities. In line with the IIGCC's net-zero investment framework, investors should be considering 'selective divestment' or exclusion of assets in the following circumstances: as a consequence of climate financial risk assessments; as a consequence of escalation following engagement; and to identify exclusions for companies whose primary activity is no longer considered permissible with a credible pathway towards global net-zero emissions.[5]

The effect (if any) on the pace and scale of disinvestment plans of disruption to supply chains and energy markets arising from the 2022 Russian invasion of Ukraine, and what is being done to mitigate any such effects

The conflict in Ukraine has led many investors and real economy companies to divest, or consider divesting, from Russian-linked assets.

We would like to see investors more seriously consider and evaluate their shareholdings where similar geopolitical risks may lie, which we believe could pose material risks to the long-term value of their portfolios. There is also a question of which investors and other parties are buying up Russian-linked assets once these have been divested, and the extent to which these are being managed in a transparent and responsible way.

Likely pathways to the responsible retirement of fossil fuel assets, in a way which is compatible with the UK's national interest, reducing the risk of stranded assets and meeting the UK's international climate obligations.

We believe the 'responsible retirement' of fossil fuel assets, particularly coal, should be a far greater priority among policymakers in the UK and globally.

As we highlight in our recent net-zero report, all actors collectively need to consider how to promote 'responsible divestment' of fossil fuel assets when divestment does take place. This is to help avoid the scenario of investors with potentially fewer incentives to reduce emissions taking on polluting assets simply to maximise returns and not manage these assets responsibly. We do not want to see emissions passed onto other companies' balance sheets, and ultimately we would prefer to see the 'shutting down' of the most high-polluting activities such as coal.

How 'responsible retirement' and 'shutting down' can be achieved without incurring very significant economic costs, either for companies' balance sheets or communities relying on jobs in those industries, requires further consideration. There are questions around who would be the 'buyer of last resort' for those most high-carbon intensive assets, and whether they can be sufficiently incentivised to reduce emissions once mainstream investors have sold their shareholdings in these assets. Investors will need to consider how divestment can lead to real-world emissions reductions when considering this action, and whether higher emissions could result from the new owners of assets.

Making 'shutting down' more financially viable remains a key unanswered question, and a priority should be to consider national and global mechanisms that can help tackle this. For example, the Energy Transition Mechanism launched at COP26 last year has the objective to retire more quickly coal-fired power plants in Southeast Asia and replace these with clean energy sources, and government should engage in further work internationally to promote similar mechanisms.

Furthermore, when selling fossil fuel assets investors should seek to ensure this can be done as responsibly as possible and seek assurances, where possible, from the new owners on how assets will be managed in a responsible manner. The role of stewardship will be very important, with robust

[4] The 'Banking on Climate Chaos, Fossil Fuel Finance Report 2021', published in March 2021, found that banks have provided a total of $4.6tn towards financing of fossil fuels since the Paris Agreement was signed in 2016.

[5] The Institutional Investors Group on Climate Change (IIGCC), Net Zero Investment Framework Implementation Guide, April 2021.

engagement when exercised encouraging companies to adopt a more sustainable pathway and avoid in the first place the significant risks of stranded assets and the hit to balance sheets ultimately.

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