# PRI RESPONSE

## CALL FOR EVIDENCE

## THE FINANCIAL SECTOR AND THE UK'S NET ZERO TRANSITION

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PRI Association

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An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Environmental Audit Committee's call for evidence on the financial sector and the UK's net zero transition.

# ABOUT THIS CONSULTATION

The UK government has made a number of domestic and international commitments with regards to climate change, including legally binding targets to reach net zero carbon emissions by 2050 underpinned by successive carbon budgets, and a Nationally Determined Contribution to the Paris Agreement to reduce greenhouse gas emissions by 68% by 2030. In 2021, the Chancellor of the Exchequer Rishi Sunak announced his intention for the UK to be the world's first net zero financial centre. The government also published a Green Finance Strategy in 2019, and a Greening Finance Roadmap in 2021.

The Environmental Audit Committee (EAC) is conducting an enquiry into the financial sector and the UK's net zero transition. The EAC notes that the reach of industry initiatives, such as the Glasgow Financial Alliance for Net Zero (GFANZ), the UN Race to Zero campaign, and the prevalence of net zero statements sends a strong signal. However, these commitments must be followed through in order to effectively achieve the UK's net zero targets. The EAC is therefore enquiring into the impact of these initiatives in winding down the financing of fossil fuel extraction and facilitating the transition to a sustainable financial system.

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# KEY RECOMMENDATIONS

Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development, and creating "net zero financial centres" in the UK and globally requires foundational changes in public policy as a whole. Financial policies and regulations have played an important role in supporting the growth in sustainable investment practices, and in better aligning these practices with national and international objectives. Despite the progress that has been seen, including the private sector led initiatives highlighted by the Environmental Audit Committee (EAC) in their call for evidence, financial flows are not yet consistent with zero carbon, climate resilient development pathways that work for people and the planet.

A key reason is that, in most jurisdictions, public policy is not always designed to support a whole-of-economy transition to a more sustainable financial and economic system. Reorienting financial and business models will require governments to go beyond stand-alone issue specific policies (e.g. climate and energy regulation) and sustainable finance policies. To realise the UK ambition of becoming a net zero financial centre, the UK government should set out a clear delivery plan for the transition of the real economy and financial services, including credible sectoral roadmaps underpinned by the near-term policies, actions and milestones.[1]

Following the UK's ambition to becoming the world's first net zero financial centre, and this call for evidence, the PRI has produced a number of analysis and recommendations which can be found on our PRI UK Policy webpage. In particular, we highlight the following documents as initial input into this call for evidence:

- the PRI's mapping of our key recommendations to date against the proposals included in Chris Skidmore's Review, intended to signal areas for the UK Government to prioritise to transition the economy to net zero; and
- the work done under the joint project led by the PRI, Generation Foundation and UNEP FI "A Legal Framework for Impact", including our specific report "UK: integrating sustainability goals across the investment industry" exploring how UK policymakers can support investors' abilities to invest for sustainability impact.

We remain available to discuss our findings and provide further information as needed.

[1] Key recommendation in the PRI's response to the Call for Evidence, as part of Chris Skidmore's independent Net Zero Review. The PRI is conducting further work on the topic of whole-of-government approach to the transition, and we remain available to discuss our ongoing findings.

# NET ZERO REVIEW ANALYSIS

Chris Skidmore's Independent Review of Net Zero underscores that policymakers taking ambitious commitments and decisive action will help to deliver a net zero economy by 2050. Scaling up clean energy solutions today will pave the way towards a more affordable, stable, and resilient energy system in the UK.

The PRI conducted an analysis of Chris Skidmore's Net Zero Review. The Review accurately captures the transition to a net zero economy as a major pro-business and pro-investment opportunity. As well as this, the correlation between economic growth and climate objectives is undeniable, and this further highlights the need for an urgent shift on UK policies towards net zero.

Our analysis maps the Review's recommendation against PRI's existing advice, to signal areas for the UK government to prioritise. From an overarching perspective, our recommendations centre around a whole of economy policy framework, clear climate policies, and supportive financial policies. With this in mind, the PRI strongly supports the Review's emphasis on reducing energy demand, powering net zero, and ISSB-alignment. However, the UK government must now focus on:

- clarifying when sustainability goals must or can be considered as part of investor fiduciary duties;
- considering a fair and equitable transition, utilising the opportunity of net zero to redistribute economic activity through attracting investment and skilled jobs;
- continuing, without delay, the development of a UK green taxonomy that supports net zero objectives, and for the taxonomy to be anchored in regulation with mandatory disclosures:
- providing a necessary action plan to support the UK's ambition to become the first global net zero aligned financial centre; and
- providing greater detail on incentives for investment in decarbonisation and extending credible sectoral roadmaps beyond solar, onshore wind, and nuclear projects.

# LEGAL FRAMEWORK FOR IMPACT

## WHAT IS A LEGAL FRAMEWORK FOR IMPACT?

A Legal Framework for Impact, authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, UNEP FI and the Generation Foundation, is a ground-breaking study of 11 jurisdictions around the world on whether the law permits or even requires investors to tackle some of the world's most urgent sustainability challenges by setting and pursuing sustainability impact goals. Building on the legal findings, the Legal Framework for Impact project is working on policy implementation in five jurisdictions:

- European Union: empowering investors to pursue sustainability goals;
- Australia: integrating sustainability goals across the investment industry;
- UK: integrating sustainability goals across the investment industry;
- Canada; and
- Japan [forthcoming, May 2023].

The Legal Framework for Impact supports a shift from "how do investors manage the effect of ESG risks/opportunities on their portfolios?" to also address "how can investors ensure portfolios have positive impacts in the world?"

## WHY DOES INVESTING FOR SUSTAINABILITY IMPACT MATTER?

Financial investments drive real world outcomes on issues including climate change, sustainable development and human rights. This is true whether the sustainability impacts of investments are intended or not. Investors increasingly recognise that financial returns depend on the stability of social and environmental systems, especially in the long term. This fact is driving investors to be increasingly focused on what they can do to improve sustainability outcomes and contribute to sustainability goals.

- Investments are not sufficiently aligned with global sustainability goals, including those set out in international treaties like the Paris Agreement and in the SDGs. Consequently, investment portfolios remain exposed to sustainability risks – including system-level risks.
- In some circumstances it is necessary for investors to address sustainability impacts in order to manage ESG risks and opportunities and deliver financial returns for clients and beneficiaries, particularly when sustainability impacts cause system-level risks. But doing so is not currently considered part of mainstream investment practice.
- To address this, investors need to take action to increase positive impacts (and decrease or eliminate negative impacts) from their investments.

## WHAT ARE THE KEY LEGAL FRAMEWORK FOR IMPACT FINDINGS?

- While financial return is generally regarded as the primary purpose and goal of investors, investors are likely to have a legal obligation to consider pursuing sustainability impact goals where doing so can contribute to achieving their investment objectives.
- In some circumstances, investors can pursue sustainability goals for reasons other than achieving financial return goals - i.e. in parallel to them. Investors are legally required to pursue sustainability impacts if the objectives of the financial product commit them to do so.
- Pursuing sustainability impact goals does not entail a departure from prioritising an investor's financial purpose and objectives. On the contrary, in some cases investors need to address sustainability impacts in order to protect or enhance financial returns.
- Stewardship - alongside asset allocation - is a vital tool for investors seeking to improve sustainability impacts, and collaboration between investors is likely to make pursuing sustainability impact goals both more efficient and more likely to succeed.

## WHY DO WE NEED POLICY REFORMS?

Investors are increasingly seeking to understand and improve sustainability impacts, but they cannot do so without support from policymakers. Mitigating system-level risks and delivering on sustainability goals committed to by governments, such as Paris Agreement goals on climate change and the Sustainable Development Goals, relies on improving the sustainability outcomes of investments.

Investors face a range of impediments to accelerated action on sustainability goals:

- investors are discouraged by uncertainty about what the law requires or permits. They need greater clarity, consistency, and guidance;
- backward-looking interpretations of legal standards exacerbate inertia, are out of step with trends in leading investment practice and impede innovative approaches to investing for sustainability impact; and
- sustainable finance policy regimes (including disclosure rules, product standards, sustainable taxonomies, and stewardship codes) need to facilitate investing for sustainability impact, but in most cases do not do so sufficiently at present.

Policy reforms are essential to facilitate investing for sustainability impact and to overcome barriers to action, while ensuring a level playing field for market participants.

## RECOMMENDATIONS FOR POLICY MAKERS

The solutions proposed by the Legal Framework for Impact project provide the required robust foundations for investors and policy makers to facilitate investing for sustainability impact as a core part of mainstream investment activity. Policy reforms should address both the legal duties investors are subject to and the circumstances in which those duties are applied, which includes sustainable finance policy frameworks and standards.

### Policy recommendations for the UK

1. Clarify when sustainability impact goals must or can be considered as part of the duties of loyalty, care and prudence.
2. Clarify that purpose-related requirements (sometimes described as a duty to act in clients'/beneficiaries' "best interests") entail consideration of sustainability impact goals.
3. Ensure stewardship powers are used to achieve sustainability impact goals.

### Policy areas for further consideration in the UK

1. Sustainability-related disclosures and labelling/classification of sustainable investment products
2. Competition law
3. Options to enable consideration of certain sustainability impact goals and of individual investors' views on sustainability
4. Guidance for pension schemes on assessing relevance of social and environmental goals

### Overarching policy recommendations – global

**Clarify investors' legal duties**

1. Update standards and guidance to clarify when investors' legal duties enable or require them to considering pursuing sustainability impact goals.
2. Update standards and guidance to clarify that purpose-related requirements (sometimes described as a duty to act in the "best interests" of clients or beneficiaries) may entail consideration of sustainability impact goals.

**Ensure sustainable finance policies facilitate investing for sustainability impact**

3. Adopt comprehensive corporate sustainability disclosure frameworks which meet the needs of investors seeking to understand material sustainability risks, opportunities and impacts.
4. Ensure that sustainability disclosure and labelling regulations address not only integration of ESG risks, but also how investment entities and products assess sustainability outcomes, set sustainability impact goals, and take steps to contribute to positive sustainability impacts.
5. Implement sustainable taxonomies to help investors understand and promote economic activities that are environmentally and socially sustainable.
6. Strengthen regulatory support for effective and accountable stewardship, including the use of stewardship powers to address sustainability risks and sustainability impacts.

7. Support collaborative action by investors that seeks to improve sustainability outcomes, and provide regulatory guidance and, where required, consider establishing a safe harbour to ensure that sustainability-related collective action by investors does not fall foul of anti-trust rules.
8. Explore ways to enable investors to take client and beneficiary sustainability preferences into account in their asset allocation and stewardship activities.
9. Establish corporate due diligence requirements to ensure that negative sustainability impacts are identified and addressed; ensuring coherence with international standards including the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises

*The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the Environmental Audit Committee further.*

*Please send any questions or comments to policy@unpri.org.*

*More information on www.unpri.org*