Grantham Research Institute on Climate Change and the Environment

Response to the Consultation on the Financial Regulation Review's Proposals for Reform by HM Treasury

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About this submission

In November 2021 Her Majesty's Treasury of the United Kingdom launched a consultation on the 'Proposals for Reform' under its Financial Regulation Framework Review, which aims to shape the regulatory framework for financial services following the UK's departure from the European Union. The Government has stated its intention to maintain a coherent, agile and internationally respected approach to regulation that is right for the UK. The proposals include changes to the regulators' statutory objectives and enhanced mechanisms for accountability, scrutiny and oversight of the regulators by Parliament, HM Treasury and stakeholders.

More information on the consultation is available at www.gov.uk/government/consultations/future-regulatory-framework-frf-review-proposals-for-reform.

This paper consists of a submission to the inquiry written by Rob Macquarie with Brendan Curran, Swenja Surminski and Bob Ward, on behalf of the Grantham Research Institute on Climate Change and the Environment at the London School of Economics and Political Science. The response was submitted on 9 February 2022. The version presented here has been lightly edited.

Authors' note

The Grantham Research Institute welcomes the opportunity to assist and support the work of HM Treasury to shape the UK's Financial Regulation Framework at this crucial moment for the sustainable transition in the financial sector. In addition to the evidence presented, this submission is based on work from across the Institute, including: coordinating the Financing a Just Transition Alliance, the Investing in a Just Transition Initiative and the Banking on a Just Transition project; contributing to the Place-based Climate Action Network (PCAN); work on net-zero central banking; chairing the Network for Greening the Financial System (NGFS) and International Network of Sustainable Financial Policy Insights, Research and Exchange (INSPIRE) joint Study Group on Biodiversity and Financial Stability; the Transition Pathway Initiative (TPI); the Zurich Flood Resilience Alliance; and participation in the UK's Third Independent Climate Change Risk Assessment (UKCCRA3).

Disclaimer

The views expressed in this paper represent those of the authors and do not necessarily represent those of the host institution or funders. No conflict of interest was reported by the authors.

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Introduction

It is vital that this decade is one of strong action to reduce greenhouse gas emissions and build resilience to reduce the risks posed by a rapidly changing climate. The global financial sector must play a central part by aligning financial flows with the goals of the Paris Agreement: mobilising US$3-5 trillion per year in green investment (BCG & GFMA, 2020) and reducing finance to misaligned activities like new fossil fuel projects and deforestation, to honour commitments made at COP26. This is necessary to decarbonise the global economy in line with the finite carbon budget and to support adaptation to climate change impacts.

The UK financial sector plays a major role both domestically and internationally so should seek to be a global leader on sustainable finance, including regulation. The Chancellor of the Exchequer has set out the ambition to harness the UK's comparative advantage in finance to contribute to this goal and gain wider economic benefits by developing the first 'net-zero financial centre'.

Climate risk and the commitment to net-zero emissions of greenhouse gases and wider environmental goals must be integrated fully into the management of financial stability. Promoting a smooth transition in finance is critical for ensuring the stability and integrity of the UK's financial system and the firms within it, and thus to the achievement of the respective primary objectives of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

Making changes to the financial system and in financial flows to enable a credible transition to net-zero emissions also fits with wider government priorities such as levelling up, as it could provide co-benefits to communities around the country, such as higher living standards and improved health outcomes. Financial institutions can play a critical role in accelerating the pace of transition by including environmental factors in their tools.

Climate resilience and adaptation are important aspects of this transition and will require more investment, as highlighted by the Third UK Climate Change Risk Assessment (CCRA3). While the 2019 Green Finance Strategy mentions physical risks and resilience as important factors for financial stability and future growth in the financial sector, these factors are regrettably not present in the Financial Services Future Regulatory Framework Review.

Responses to proposals for reform

Objectives and principles

Although a principle requiring the regulators to have regard for net-zero would be a positive step (Question 2), preferably the Government would create a new, statutory, secondary objective for each regulator with the same provisions, as a more permanent step to embed responsibility for the transition in their operations. As the FRF Review concedes (in the context of a competitiveness objective), 'the regulators are not required to act to advance their regulatory principles… [a principle] would not provide the regulators with the appropriate statutory basis required to act… in line with the Government's vision for the sector'. Taking into account the Chancellor's vision for a green financial centre and the net-zero target in legislation, this observation suggests sustainability should be rendered in statute for regulators to support this transformation effectively. In addition, the objective should require regard for impacts on climate change resilience as well as on biodiversity, in recognition of the close interdependency between climate and biodiversity and the potential for biodiversity-related financial risks to create instability and harm market integrity (NGFS-INSPIRE, 2021).

By contrast, it is not clear that the Government should proceed with its proposal to create new statutory objectives for the PRA and FCA to facilitate growth and competitiveness of the UK economy, including of the financial services sector (Question 1). If the PRA and FCA adopt the requirement to facilitate the long-term growth and international competitiveness of the UK economy, this must be understood to mean sustainable, inclusive and resilient growth. Growth and competitiveness of the wider economy and the integrity of the transition to net-zero finance are mutually supportive. It is vitally important that the financial services sector takes a broad and long-term view of growth and competitiveness to include both social and environmental factors and is not restricted to, for instance, growth in GDP over a short period. It should be noted that the objective of sustainable, inclusive and resilient growth is entirely consistent with having regard for net zero, climate resilience and biodiversity.

Experience of previous regulatory regimes, especially prior to the 2007–8 financial crisis, highlights the danger to stability of pursuing national competitiveness defined in a narrow sense within the financial services sector (Thiemann, 2014). In addition, evidence suggests that increasing the size of a country's financial sector is not beneficial for wider economic growth beyond a certain threshold (Arcand et al., 2012).[1] What matters instead is the composition of the sector and its effectiveness in directing investment where it is needed.

The Government's objectives, including to achieve the net-zero target and develop a green financial sector, would be best served by prioritising standards that are rigorous in their alignment with the Paris Agreement and the net-zero goal. To the extent that a new duty to facilitate financial sector competitiveness would create guardedness around the industry's ability to meet new, robust standards, it could result in much greater longer-term economic and financial damage, undermining the goals of financial sector stability and protection for consumers more generally.

In finance, as in many other areas of regulation, stability and integrity are best served by setting high standards for exposure to risk and transparency of products and ensuring the sector is effective and efficient in its basic functions, which are consistent with preserving the dynamism of an industry and its international competitiveness. Indeed, this was the broad view of the post-crisis Independent Commission on Banking (2011) and has remained the view of the regulating bodies considered in the FRF Review (Woolard, 2019). Previous research by the Government shows

1 A threshold has been identified at the point when credit to the private sector reaches 100% of GDP, after which point the growth effects of further financial development tend to be negative. The UK's credit to the private non-financial sector was over 160% in 2021 (BIS, 2022).

that robust regulation is often associated with 'effective market mechanisms, through the imposition of shared standards and requirements for transparency on business practices', resulting in better protection, lower costs for consumers and fewer failures. It is not associated with lower innovation (BEIS, 2018).

In the context of the sustainable transition, financial regulators have a strong role to play in guaranteeing not just growth in green finance but its quality. For instance, the FCA may ensure that new financial products serve their purpose while protecting consumers, and that firms make credible claims about environmental performance, where such claims affect market share. Greenwashing was the concern cited most frequently by respondents to the 2021 Schroders Institutional Investor Study. Standardised metrics are needed to ensure that emission reduction targets are disclosed in a consistent manner.[2] Transparent data and internationally comparable classifications (via the UK Green Taxonomy) will be essential to align finance with climate goals and will support the FCA's existing primary objectives.

On the prudential side, the PRA should assess transition plans (which will become mandatory for companies to publish in the UK) submitted by supervised entities, as a key step towards establishing a strategic approach to climate risk management (Robins, Dikau et al., 2021). The intention to make transition plans a mandatory component of the Sustainability Disclosure Requirements is an opportunity for the UK to show international leadership and exhibit best practice among financial regulators and central banks, encouraging other institutions to do the same through the forum provided by the Network for Greening the Financial System.

Ensuring resilience to climate impacts should also be central to the regulators' duties. As stated by CCRA3: 'investment in net zero and climate resilience should go hand in hand and mutually reinforce the ambitions of low-carbon and resilience' (Surminski, 2021). The FRF Review provides an opportunity to ensure that both climate change mitigation and adaptation ambitions are embedded in financial regulation and policy. Resilience offers investment opportunities, but this is currently held back by a lack of standards, unclear resilience metrics and an absence of regulatory guidance on adaptation finance. This has also been demonstrated by the Zurich Flood Resilience Alliance, which works with communities, companies and the public sector to strengthen the business case for resilience: high returns (CCRI, 2019) and net co-benefits (as reflected by the concept of the 'triple resilience dividend') (Surminski and Tanner, 2016; Rözer et al., 2021). Nevertheless, adaptation still faces significant underinvestment (UNDRR, 2019). This is a key risk for the UK, as highlighted by CCRA3: lack of investment in physical risk reduction, underestimating physical damage, and limited understanding of thresholds and interdependencies (particularly in the context of indirect impacts from physical risks) can create lock-in situations for the finance sector and those who depend on it (Surminski, 2021).

Considering social co-benefits and risks within financial regulation

Social factors – the impact of industry activity on standards of living and wellbeing – should be recognised as an under-appreciated risk to the financial and economic system, as well as an essential component in protecting the beneficiaries of financial services, particularly consumers. Within the Grantham Research Institute, we have identified that delivering the transition to net-zero in a manner that is just and reduces inequality is critical to the efficiency of delivery. As a result, the social risks from the net-zero transition as well as inherent social co-benefits should be an emerging consideration for financial regulation in the UK.

A social perspective is integral to the objectives of the FCA, which require the regulator to secure protection for consumers and ensure that competition works in their interests. However, potential

[2] Critical to this are four choices inherent in these targets: which types of greenhouse gas emissions are covered, which of the entity's activities are covered, what is the boundary of the organisation considered by the target, and what is the expected use of offsets? For more information, see TPI (2021).

social co-benefits go further and include the importance of generating place-based investment that supports community wellbeing.

Any new provisions for the FCA and PRA to have regard for the Government's net-zero objective should enable these regulators to consider the importance of co-benefits in facilitating that objective, and the interactions between social factors and types of economic activity in driving risk. To do so, financial institutions should be encouraged to fully integrate the environmental and social dimensions of the transition into policies and decision-making (Robins, Muller et al., 2021).

The Government's recent decisions in other areas of financial and economic policy show that it is possible to include these factors: for instance, in reporting social co-benefits of the green financing programme associated with the Green Gilt and NS&I's Green Savings Bond. Therefore, in designing a future roadmap for emerging trends in financial regulation, a prudent approach would be to build towards embedding a consideration of the social factors of the transition to net-zero.

This approach would also align with other government objectives of levelling up, as set out in the Levelling Up White Paper of February 2022.

Cost-benefit analysis (CBA)

Proposals for greater clarity over the regulators' use of cost-benefit analysis (CBA) are reasonable on their own terms but must not harm the integrity of decision-making with respect to the fundamental climate and social risks outlined above.

While a new statutory panel could helpfully lead the regulators to refine their tools for making policy, there are also pitfalls to avoid. To safeguard accountability and avoid regulatory capture, the panel must have balanced composition (with as many members drawn from civil society and academia as from private firms) and its interventions must be published transparently. Furthermore, since economic analysis historically has failed to take sufficient account of climate and other environmental risks (including thresholds and cascading risks), there is an ongoing shortcoming in the ability of models to account properly for the costs of inaction. This leads to a short-term policy bias that favours limiting the scope of regulations that govern economic activity (Dasgupta, 2021; Dietz et al., 2021; Stern and Stiglitz, 2021). This dynamic could be especially pronounced and result in multiple market failures in the financial sector because the metrics and models required to represent these (material) costs there are still being developed, as is recognised by the Government's approach to greening investment. In the same way, an uneven distribution of social benefits and costs typically results in the under-estimation of systemic benefits and over-estimation of localised costs.

We judge that providing post-publication review of CBA is the more appropriate role for a new panel (Question 8). Pre-publication input could result in these systematic biases and special interests exerting direct influence over new policies, and stakeholders are already able to share views via the existing statutory panels and consultations launched by the FCA and PRA. Post-publication scrutiny would provide an appropriate forum through which stakeholders and experts could contribute to the ongoing refinement of methodologies and their practical application.

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