UKSIF
UK Sustainable Investment and Finance Association

Delivering a net-zero financial centre

Recommendations from UKSIF's 'net-zero inquiry'

MAY 2022

CONTENTS

ABOUT UKSIF

The UK Sustainable Investment and Finance Association (UKSIF) is the membership organisation for those in financial services committed to promoting a more sustainable and resilient financial system that works for the benefit of the environment, society, and us all.

UKSIF represents a diverse range of financial services firms committed to these aims. Our 290+ members, managing over £10trn in assets under management (AUM), include investment managers, pension funds, banks, financial advisers, research providers and NGOs, among others. Historically, UKSIF and our members have been active in, and hugely supportive of, efforts to promote the sustainable finance agenda and worked closely with policymakers and others to find new ways to overcome the barriers to the growth of sustainability and deliver progress towards decarbonisation of the economy.

More information can be viewed on our website at uksif.org

FOREWORD

Since our founding in 1991, the UK Sustainable Investment and Finance Association (UKSIF), with strong support from our members, has looked to drive forward at pace the growth of sustainable finance in the UK and a more rapid transition to a sustainable future. We have worked closely with policymakers and others to deliver on these objectives and are proud of the progress the UK has achieved in recent years.

In many respects the UK has often led the way, encouraging other countries to follow in our path. In 2019, we became the first major industrialised economy to legislate to reduce greenhouse gas emissions to net-zero by 2050. We were also the first country in the G20 to enshrine in law mandatory Taskforce on Climate-related Financial Disclosures (TCFD) aligned requirements for the largest businesses to report on their climate-related risks and opportunities.

The pledge by the government at the COP26 Summit in Glasgow – committing the UK to becoming the 'world's first net-zero aligned financial centre' – is the latest positive signal that the UK will continue to strive to be a global leader on sustainable finance. We see this very bold ambition as a crucial and natural step for the UK to adopt in its climate leadership journey, and one which UKSIF and our members fully support.

Clearly, the financial services sector has a significant responsibility to drive this forward and demonstrate a renewed commitment to move financial flows more quickly towards a net-zero pathway. We believe input from the finance industry will be invaluable as the UK progresses towards its world-leading ambition, particularly since our collective understanding of how we define a net-zero financial centre in practice remains very nascent.

Successive reports from the Intergovernmental Panel on Climate Change (IPCC), as well as other mounting evidence, stress with growing alarm the need to ensure greenhouse gas emissions peak as soon as possible and to accelerate the transition to net-zero. It is clear we are far beyond the point of urgency in tackling the climate crisis. As the defining mission of our age, each of us must now act at the pace and scale that this challenge demands and vitally this includes financial services.

Over recent months, UKSIF has carried out our 'net-zero inquiry' which has seen us extensively consult and engage our membership to identify some of the key areas that policymakers should consider to drive the systems change necessary to move the finance sector – alongside the wider economy – towards net-zero. While we do not seek to provide all the answers, we hope this final report produced as part of our inquiry can provide some effective solutions for government, regulators and others to adopt in the coming years to achieve the UK's world-leading objective.

This report identifies a number of critical actions across various areas that we believe can help move the UK's financial sector towards net-zero, including:

- Transforming the real economy to drive net-zero aligned investing and lending, particularly with the UK and global economies not yet aligned to a 1.5°C trajectory
- Creating a world-leading 'green taxonomy' and sustainability disclosures framework
- Strengthening investors' stewardship role in the economy
- Supporting communities, clients, and savers on the journey to net-zero
- Shifting the whole financial sector and economy to net-zero, including parts of the system that have not yet been prioritised in rulemaking

Our report draws heavily on the views expressed by over 200 representatives from across UKSIF's diverse membership at a series of extensive roundtable discussions we have hosted in recent months, alongside numerous individual conversations with our members. It represents the largest consultation exercise we have undertaken with our membership to date, and reflects the growing interest our members have in contributing to constructive public policy solutions.

The emergence of a serious 'cost of living crisis', record global energy prices, and severe geo-political unrest in Europe undoubtedly present additional challenges that policymakers need to consider in achieving the UK's latest globally-leading objective. In our view, this challenging environment has drawn the net-zero mission into even sharper focus. We must collectively continue to drive forward momentum and rapid action, ultimately seeking solutions that can address these multiple challenges whilst urgently achieving our ambitious emissions reduction targets.

The wide range of far-reaching recommendations presented in this report shows the scale of work for all of us to undertake over the years ahead. We are committed to working with government, regulators, our members, companies, and others to actively contribute to creating the world's first net-zero financial centre, and demonstrate once again the UK's commitment to bringing about a more sustainable world.

JAMES ALEXANDER
CHIEF EXECUTIVE

1 TRANSFORMING THE REAL ECONOMY AND PROMOTING NET-ZERO INVESTMENT OPPORTUNITIES

CONTEXT

Last year's 'Net-Zero Strategy' published by government represented a positive step forward for the finance sector and investors, by providing some clarity on the envisaged net-zero pathways for different sectors of the economy and potential net-zero aligned investment opportunities available.

However, we remain some way off from having clarity over the detailed policy frameworks and policy incentives for various industries that will be required across the board for the UK's economy to reach net-zero. Many investors remain unsure of the future support that will be provided to a number of key sectors that is necessary to encourage higher investment. Furthermore, government will need to demonstrate delivery of its ambitions as outlined in the 'Net-Zero Strategy.'

The UK's objective to become the world's first net-zero financial centre will not be achieved without the real economy taking far greater strides towards net-zero. Measures from government to transform the real economy are urgently needed, and this should include a mix of fiscal and regulatory measures, such as carbon pricing.

POLICY RECOMMENDATIONS

- **Government should rapidly prioritise action on a specific set of sectors of the economy** to drive forward their decarbonisation at a faster pace and promote greater private investment. This could take the form of **'clean investment roadmaps' for several sectors,** developed by convening dialogues between government, investors, and corporates over: a long-term financing framework to lower the cost of capital; a cross-party based policy framework to tackle the risks of future changes to regulation; facilitating a strong pipeline of projects including through effective project preparation; binding decarbonisation pathways, among other areas. This sectoral approach, drawing on the hugely positive experience of the UK's offshore wind sector deal, would promote greater certainty among investors.[1] The priority sectors could be those where investors currently see less clarity provided in the UK such as heat and buildings or food and agriculture, and harder to abate sectors such as steel and cement.[2]

1 RenewableUK's latest EnergyPulse report published this year, tracking the total offshore wind pipeline globally, highlights the UK's continued success as a frontrunner on offshore wind power.

2 We recognise there are a wide variety of sectors that could be prioritised in the 'clean investment roadmaps'. Small and medium sized enterprises (SMEs) are another area where a stronger focus is needed with incentives necessary for this group to prioritise decarbonisation, such as business rates relief linked to investments in climate solutions.

- To incentivise changes across all sectors of the wider economy, the UK will need to consider how to integrate carbon pricing more explicitly into the tax system. With two-thirds of emissions currently unpriced in the economy, many goods and services fail to reflect the true costs of their emissions, and there are a lack of incentives for companies to develop lower-emissions alternatives. **We would like to see the UK's Emissions Trading System expanded to cover more of the economy,** including agriculture, a broader range of manufacturers, heating and transport. In the longer-term, **the UK will need to adopt a comprehensive carbon pricing system** to effectively price emissions across the economy. This will need to be designed in a way that does not penalise low-income households and SMEs, particularly vital in light of the ongoing 'cost of living crisis'.[3]

- In terms of financing the net-zero transition, **the UK should publicly track progress towards funding the identified investment needs for economic sectors to achieve decarbonisation.** A key missing piece from the UK's 'Net-Zero Strategy' is how the substantial public and private investment required to reach our emissions targets will be met. This is critical to monitor and deliver the Strategy in practice, and to encourage the flow of private finance towards sustainable investments. This tracking function could be carried out by an independent body, such as the Office for Budget Responsibility, and in time help address the over-reliance we see on private finance in delivering the additional investment for sectors.[4]

- On current day-to-day public spending, the focus should be on delivering meaningful behavioural changes while tackling the climate change and 'cost of living' crises that we face. In relation to consumers, the one-off rebates announced by Treasury on all households' energy bills, while offering immediate relief, will not deliver a lasting impact. **A far more effective measure addressing the twin crises would be a fresh commitment to boost energy efficiency in all homes.** We support bringing forward the government's existing energy efficiency targets for homes, including its target to have fuel poor homes upgraded to Energy Performance Certificate (EPC) Band C by 2030, and for all homes by 2035. The financial industry should play a prominent role in helping bring forward these dual objectives.[5] This would represent a massive step forward given that energy use in homes accounts for around 14% of the UK's total greenhouse gas emissions.[6]

3 Redistributing the proceeds of a carbon tax could be one solution, with Canada's carbon tax a possible model for the UK. This has seen carbon tax revenues distributed to households through their annual income tax rebates.

4 An example is in the UK's 'Heat and Buildings Strategy', where the CCC has judged increased levels of public funding could be needed if costs of heat pumps do not fall as quickly as anticipated, or if market-based mechanisms stall.

5 The UK's energy efficiency targets are currently relatively vague commitments and could instead be requirements incorporated into law.

6 Climate Change Committee, UK housing: Fit for the future?, 2019.

- UKSIF and our members continue to strongly believe that sustainability must be at the core of policymaking across government, which will be critical to change the real economy and shift our sector towards net-zero. **We reiterate our call for government to commit to a 'net-zero test' to ensure policy decisions are consistent with net-zero,** with many groups such as the Climate Change Committee making similar calls in recent months. One way to deliver this would be for Treasury to introduce a dedicated 'net-zero section' at every Budget, outlining in a statement how the tax and spending decisions announced bring the UK closer towards this objective.[7] For financial regulators, the time has come for **Treasury to enact a formal operational objective for regulators on climate change and sustainability,** building on last year's announcement for their mandates to have regard to the UK's 2050 target.[8]

- In terms of the role of the banking sector in promoting net-zero aligned lending, the UK will not achieve its objective of becoming the first net-zero financial centre if fossil fuel extraction continues to be financed at the current, unsustainable rate. **In its upcoming review, the PRA must consider incentives that can bring down the costs and risk premium of lending to climate solutions, as well as measures that can make lending to fossil fuel activities, in particular coal, unattractive today.**[9] Separately to this, 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. We would like to see investors too be more robust in holding banks to account, making greater use of their voting rights to drive commitments from banks on their lending practices.

FURTHER CONSIDERATIONS TO DELIVER A NET-ZERO FINANCIAL CENTRE

Our sector is increasingly taking an active interest in public policy debates, seeking to shape government's actions in the real economy that will be critical to achieve a net-zero financial centre. There is increasing recognition among our members that regular engagement with policymakers on climate change policies is necessary to decarbonise their portfolios, with existing engagement with investee companies alone not sufficient to achieve this.

Having the right policies and incentives in place first in the economy will be vital with finance flowing to the right areas once investors have regulatory certainty and can be more confident of their future profitability. A recent example is electric vehicles, which have seen significant investment globally in light of a number of countries' planned phase-outs of internal combustion engine vehicles.

By contrast, the commitments in the Energy Security Strategy on North Sea oil and gas exploration send the wrong signals to sustainable investors, including on the credibility 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. Long-term political support is crucial too, with the previous short-lived 'Green Homes Grant' for instance sparking concerns from our members as to whether the political support needed to decarbonise individual sectors will be consistent in the long term.

7 Whitehall departments may have insight into the extent to which sectors' activities are sustainable today, and this could inform an approach to embedding a 'net-zero test' across all of government. A 'net-zero' test in time should be extended to nature.

8 The new objective could form part of other financial regulators' remits, including the Financial Reporting Council and The Pensions Regulator. The objective would, for example, recognise the huge level of risks posed by a disorderly transition to regulators' existing objectives, such as financial stability and consumer protection.

9 In terms of positive incentives, these could include favourable capital treatment for green assets, such as renewable energy projects, meeting certain strict eligibility criteria.

WE CONTINUE TO STRONGLY BELIEVE THAT SUSTAINABILITY MUST BE AT THE CORE OF POLICYMAKING ACROSS GOVERNMENT TO CHANGE THE REAL ECONOMY.

2 CREATING A WORLD-LEADING 'GREEN TAXONOMY' AND SUSTAINABILITY DISCLOSURES FRAMEWORK

CONTEXT

A 'green taxonomy' and sustainability disclosures framework in the UK that are seen as truly world-leading by global investors, businesses and others across different jurisdictions can help drive the systems change necessary to move the finance sector towards net-zero.

We are heartened by government and regulators' work so far, and have actively contributed to both these initiatives through our membership of the Green Technical Advisory Group (GTAG) advising Treasury on the UK's taxonomy, and the Disclosures and Labels Advisory Group (DLAG) advising the FCA on the design of the 'Sustainability Disclosure Requirements' (SDR) regime and investment labelling system.

There is more that can be done to enhance their effectiveness for the sector and consumers ahead of their implementation in the coming years. The upcoming refresh later this year by government of the UK's 'Green Finance Strategy' is an opportune moment for further reflection to take place in regards to both the taxonomy and SDR, and to consider too how we address wider sustainability issues, such as biodiversity and social risks.

POLICY RECOMMENDATIONS

- **It is critical for the UK to learn the right lessons from the EU's recent experience with its 'green taxonomy'.** In our view, this means the UK must not follow the EU's lead in incorporating certain natural gas activities within its taxonomy, which would be in direct conflict with our decarbonisation ambitions. This is particularly crucial in light of the need for the world to rapidly reduce its dependence on oil and gas imports, particularly from regions with considerable geopolitical risks.[10] Inclusion of gas in the UK's taxonomy would change its purpose as a tool to define what is 'green' today and fuel the prospect of 'greenwashing', and we share the serious concerns expressed by the EU Platform on Sustainable Finance and others. We maintain that the taxonomy should not be a political instrument driving the UK's energy policy and energy security considerations.[11] **Instead, creating a credible taxonomy based purely on science will present a strong leadership opportunity for the UK,** with investors and companies consequently more likely to see the UK taxonomy as leading the world.
- In the upcoming 'Green Finance Strategy' from government, **we would like to see a roadmap for the creation of a 'social taxonomy'.** This could drive a positive focus among investors and businesses in addressing the pressing social challenges we face that are key to achieving net-zero.[12] We would also like to see consideration of a separate 'transitional environmental taxonomy', once work on the 'green taxonomy' is complete, to encourage the substantial part of the economy that is not 'green' today towards more sustainable practices. It could ensure transitional activities are time-bound with clear 'phase-out dates' to guide investors.[13]

11 Conflating the 'green taxonomy' with energy security considerations could have negative consequences with investments in the unsustainable use of natural gas possibly 'locked in', and putting at risk the Energy Security Strategy's objective to reduce gas consumption by "over 40%" by 2030.

12 We support the GTAG, or another independent advisory body, being tasked in future with considering a 'social taxonomy' and how we overcome challenges such as a lack of metrics.

13 A transitional taxonomy in future could have the benefit as well of avoiding the dilution of the criteria for the 'green taxonomy' that has happened in Europe, and would recognise that investing in 'green activities' alone will not create the real-world change we need to see.

- We are heartened that the UK has drawn on the EU's experience in regards to its approach to sustainability disclosures, by addressing disclosures directly alongside investment labels in its work on the SDR regime. **It will be important for policymakers to consider the close links between the taxonomy and SDR,** particularly should the taxonomy form the primary environmental criteria for the investment labels system.[14] A category focusing on transitional investments, which the FCA has proposed and we support, will be particularly critical to get right in the UK's labelling system to ensure savers understand why certain companies on a transitioning pathway may be in their portfolios and to minimise the risks of 'greenwashing'.[15] Across the 'sustainable' labelling categories, minimum environmental and social safeguards could also be considered to avoid inadvertent harm from a sole focus on one aspect of ESG.

- At the global level, **we want the UK to continue to play a proactive leadership role in encouraging the harmonisation of sustainability standards.** This includes contributing to, and helping accelerate, the work of the International Sustainability Standards Board (ISSB), whilst highlighting our work internationally to drive adoption of 'best in class' standards. We see a role for the UK to encourage the implementation of the ISSB's final standards by countries when these are published this year, particularly for those nations that are further behind in their sustainability journey.[16] Another important development to harmonise sustainability standards globally would be **mandatory TCFD-aligned disclosures across a much wider group of countries and the UK can play a leadership role in promoting this trend.**[17]

- On biodiversity, **we know the UK's objective of achieving a net-zero financial centre will not be possible without a nature-positive economy.** More meaningful disclosure of nature risks is an important initial step, and clarity on how these disclosures will be integrated in the UK's upcoming SDR regime is needed. Consideration could be given to incorporating, within SDR, disclosures against the Task Force on Nature-related Financial Disclosures (TNFD) framework following its launch in 2023, with an open consultation taking place with industry at this point.[18]

- More broadly, we are very disappointed that government has not yet undertaken a wide-ranging response to the Dasgupta Review on biodiversity, with further action needed to take forward the Review's seminal work.[19] For example, investors, regulators, civil society, and other groups could be convened to consider the implementation of some of the Review's findings into policymaking. Finally, **the UK should lead efforts to deliver a truly ambitious Post-2020 Global Biodiversity Framework at COP15** in China later this year, including the goal for financial flows to align with global biodiversity goals and targets.

FURTHER CONSIDERATIONS TO DELIVER A NET-ZERO FINANCIAL CENTRE

An important, outstanding issue in the area of sustainability disclosures continues to be how we effectively measure investors' and companies' impacts on the environment and wider society, with common metrics and more precise disclosure frameworks still needed.

All companies and investors must take steps to far better identify their impacts and take greater responsibility for where their investments are going. Firms should not differentiate necessarily between impacts of investments and financial risks, as the former over time will become highly relevant to companies' long-term value. The approach signalled by the TNFD is very welcome by recognising the importance of considering both nature-related dependencies and impacts. Despite challenges, UKSIF continues to strongly support initiatives seeking to embed this concept of 'double materiality' into regulation and firms' decision-making.

14 The inclusion of natural gas in the UK's taxonomy could lead savers to raise questions over their funds' commitment to sustainability, should the labelling system rely heavily on the taxonomy.

15 More details on the issues to be considered in a 'transitioning' labelling category can be seen in our response to the FCA's Discussion Paper. For example, evidence of active stewardship will be vital to avoid some funds indefinitely claiming a 'transitioning' status.

16 In the UK, we will always need to aim higher in our reporting standards, recognising ISSB's standards are intended as a minimum 'baseline' for jurisdictions to pursue.

17 This step would help build on the G7's endorsement of mandatory climate reporting and the U.S Securities and Exchange Commission's recent steps in this direction.

18 We would like to see investors in their engagement with companies pose direct questions on their approach to TNFD, and how policies are managing nature risks and looking to measure their impacts.

19 Other recommendations for how the UK could progress the Dasgupta Review's work are in a letter that UKSIF wrote to the Chancellor in September 2021.

3 STRENGTHENING INVESTORS' STEWARDSHIP ROLE IN THE ECONOMY

CONTEXT

The role of investor stewardship, where the UK continues to be recognised as a prominent leader, remains absolutely critical to drive the transition. It is a unique lever for investors to use, particularly with an overwhelming part of the UK's economy not yet on a pathway to 1.5°C. We know that active stewardship with companies, particularly those in hard to abate sectors such as manufacturing, steel and cement, can speed up this journey.

Exercised robustly, stewardship can lead to meaningful results such as companies better reporting on the financial impact of climate change. The UK has led the way in recent years with reforms such as the revised Stewardship Code and most recently the introduction of mandatory climate transition plans. Investor stewardship must now be enhanced further 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.

POLICY RECOMMENDATIONS

- **In the coming years, the UK should build on the success of its Stewardship Code which has been a positive driver in integrating stewardship within the sector.** This includes considering ways to strengthen the readability of stewardship reports for clients and others, helping ensure reports are read by a wider audience. Introducing a 'tiering system,' once we have seen wider adoption of the Code, could drive up standards by helping firms learn from one another when producing their reports and this assessment could help the Code remain relevant in the longer term.[20] We support the Financial Reporting Council's 'Effective Stewardship Reporting' guidance, noting areas for improvement for firms to make. We would welcome further guidance to help smaller firms, particularly asset owners, improve their reports; this is for both existing Code signatories and those applying. This would be an important step with larger, better-resourced investors having a clearer advantage in applying to the Code at present.
- We very strongly support the government's intention, outlined at COP26, to introduce mandatory climate transition plans across the economy. We hope to see much greater consistency of transitions plans once a 'gold standard' has been defined by the government's Transition Plans Taskforce. This consistency would help investors, and others, far more effectively scrutinise boards' strategies to reduce their carbon footprint. **Greater standardisation of climate transition plans would importantly help make the case for a 'Say on Climate' advisory vote for shareholders, which UKSIF supports in principle and would like to see implemented.**
- **We believe the government's independent Transition Plans Taskforce should consider the following areas in its work on a 'gold-standard' plan:** companies' policies on carbon offsets with appropriate restrictions in place on their use, particularly within short-term targets; details on the governance structures to deliver the transition plan; capital allocation plans to finance the transition; the strategy to maximise opportunities afforded by the transition; consideration of real world impacts; how financial statements reflect transition plan commitments; and the approach to policy advocacy and lobbying.[21] We would also like to see transition plans outline how companies intend to: manage biodiversity risks (including their approach to disclosing against TNFD), address the 'Just Transition', and how executive remuneration is linked to net-zero targets.[22] A link to remuneration would ensure clear executive responsibility for delivering on plans, and be a valuable indication of which companies are taking the transition seriously.

20 One way to improve readability for clients could be to allow more up-front emphasis on 'stewardship success stories' in reports, which are of particular interest to clients.

21 Collectively, we need to be wary of companies potentially disguising their emissions through carbon offsets, which we think should only be used as a last resort where absolutely necessary.

22 Investors need to see how companies' governance structures ensure proper implementation of transition plans (e.g. how sustainability committees contribute to board-level decisions), and details of boards' climate capabilities to manage the transition.

- Broadly speaking, **a 'gold-standard' transition plan will need to present a holistic view of how a company will decarbonise as the world transitions towards a low-carbon future,** rather than a predominant focus on net-zero targets alone, as vital as these are. Assessing the quality of companies' transition plans in each sector will be challenging, given their different transition pathways, and independent verification will be needed through a credible body such as the Science Based Targets initiative (SBTi).[23]
- In light of the upcoming implementation of mandatory climate transition plans, **some groups have reiterated calls for mandatory net-zero targets which we continue to oppose.** This step would likely lead firms to adopt wholesale divestment in the short term to meet a government-mandated target, not contributing to meaningful decarbonisation of the economy, and potentially fuel 'green asset bubbles'. To drive momentum on net-zero target setting in financial services, **consideration could be given to a 'comply or explain approach', compelling firms to justify why they have not set a target.** This approach could form, in time, part of reporting against the upcoming 'Sustainability Disclosure Requirements' regime. This would allow financial firms with assets, like government bonds, whose value is driven primarily by governments' policies to provide a valid explanation to clients, while furthering momentum within the sector.
- Finally, **government, regulators and the industry should consider ways to build public understanding and trust in stewardship,** aiming to demonstrate that when exercised robustly, it can be highly effective and outcomes focused. For example, by ensuring that different sectors take greater steps to align with targets set out in prominent frameworks such as the Science Based Targets initiative. Separate to this, we think the role of bondholders has been given relatively less attention to date compared to equity investors. **We would encourage investors to be more active stewards across all asset classes,** not just listed equities, including on fixed income, infrastructure, and sovereign debt. When companies return to the debt markets to raise finance, bondholders could use this opportunity as a pressure point in engagement with companies.[24]

FURTHER CONSIDERATIONS TO DELIVER A NET-ZERO FINANCIAL CENTRE

Debates have often focused on the reduction of emissions at the investment portfolio level rather than companies in the economy.

For investors, it can be quite easy to meet a net-zero target by adopting a sector-bias approach; for example by overweighting low-carbon technology and pharmaceutical shares and divesting entirely from utilities and other high-carbon contributors. However, this approach does not drive change in the economy and tough stewardship of individual companies will be more effective in promoting economy-wide alignment to a more sustainable pathway.

Together, policymakers and the financial sector need to further consider the consequences of carbon intensive assets being passed from public markets to actors in private markets, including some parts of the private equity sector, where less robust engagement may be taking place.

23 An expert industry forum based on the model of Climate Action 100+ could also have a role to play to undertake this evaluation. As with their approach, 'lead investors' could be responsible for evaluating certain sectors' transition plans.

24 Some investors could consider 'denial of debt' as a tool to encourage fossil fuel companies to align with a net-zero pathway. This would involve no longer channelling new funding to these companies seeking to raise funds through new bond issuances, though this will not be open to firms invested in passive fixed-income investments.

4 SUPPORTING COMMUNITIES, CLIENTS, AND SAVERS ON THE JOURNEY TO NET-ZERO

CONTEXT

To deliver the world's first net-zero financial centre, the clients and savers of financial services firms will need to be brought along on this journey and comprehend the implications of net-zero for their financial decisions. For example, both groups will need to understand why a particular investment strategy has been adopted and have much greater confidence to meaningfully engage with their financial services provider.

More broadly, communities across the UK most likely to be adversely impacted by the transition must be properly supported. This is because we know net-zero will bring seismic change to the lives of people across many regions and sectors of the economy. We strongly believe that if we do not have a 'Just Transition', politically it will be impossible to deliver a transition at all and this must be a key focus of government's decision-making.

Collectively, we all have a role to play to support clients, savers and communities at large, improving their understanding of what net-zero will mean for them in the coming years.

POLICY RECOMMENDATIONS

- **UKSIF continues to back the creation of a UK-wide 'Just Transition Commission',** based on Scotland's experience, to identify areas for long-term policy action on the 'Just Transition'. Among its considerations could be the publication of 'Just Transition roadmaps' for each sector of the economy, analysing those sectors where jobs are most at risk and of the reskilling interventions that are needed. Given the urgency of promoting a 'Just Transition', there is a case for swifter measures to be adopted. This could include immediate application of some of Scotland's Commission's recent recommendations.
- We also **warmly endorse the recommendations made last year by the Grantham Research Institute's 'Financing a Just Transition Alliance',** including using the UK Infrastructure Bank as a direct catalyst for action in this area. We believe that the Bank can deliver on both the 'levelling-up' and net-zero elements of its investment mandate in parallel if used as a lever for action on the 'Just Transition'.[25] As the Alliance's report last year concluded, the 'Just Transition' can be the 'policy glue' directly connecting the government's net-zero and levelling-up agendas.
- **Among investors, there should be greater recognition that the 'Just Transition' is a core component of their commitments on net-zero and a material ESG concern.** In engagement for example, questions need to be regularly asked of investee companies' management of: the re-training policies in place for employees, the broader treatment of their workforce, and how a 'Just Transition' is reflected in their climate transition plans. Investors must adopt a wider focus in holding sectors to account over the impact of the transition. This goes beyond the energy sector, and includes other areas of the economy where a 'Just Transition' will be urgently required such as agriculture (for example by supporting the mitigation of the impacts of an increasing shift to organic and plant-based production).[26] **More robust action from financial services on the 'Just Transition' needs to be a priority,** and would be an effective way to demonstrate the sector's commitment to address the pressing social issues critical for net-zero success.

25 UKSIF contributed to the 'Financing a Just Transition Alliance's' work as a member representative of the group, including to its final report launched at COP26. We would like government to engage more actively with the report's findings.

26 'Just Transition' considerations should also be more explicitly incorporated in firms' stewardship and sustainability reports.

- **We continue to see a common lack of understanding within financial services on the extent to which ESG factors form part of investors' fiduciary duties. This area needs urgent clarification for finance to reach net-zero.** There are a number of avenues for this clarification to take place, including guidance and public statements from the Department for Work and Pensions and financial regulators that ESG issues (both risks and impacts) should be considered a core, existing component part of fiduciary duties.[27] We want investors to have clearer expectations from policymakers on the extent to which they can take account of ESG considerations, which could promote more sustainable investment decisions and clarify the present confusion we see throughout the investment chain, including among pension scheme trustees and investment consultants. Following this clarification, the focus could turn to how fiduciary duties are applied in practice and improving firms' understanding of this area.[28]

- For financial services firms' clients and savers, the transition to net-zero will carry significant implications and these groups must be carefully brought along on this journey. Firms need to continue to consider ways to strengthen their relationship with savers, and this should encompass discussions on voting on climate change issues. **We would like to see investment managers implement the 'expression of wish' measure recommended by the Taskforce on Pension Scheme Voting Implementation,** particularly with a regulatory approach likely to be adopted in the UK should progress not be made.[29] Managers should seek to quickly put in place the appropriate technological solutions to implement an 'expression of wish', with smaller managers potentially provided a longer window. More generally, firms can be proactively asking consumers which ESG issues they most value to boost their engagement.

- **Greater priority needs to be given across the financial sector, and companies more widely, to address the ongoing skills and knowledge gaps across sustainability issues.** Internally, ESG training needs to filter down from the executive level to management teams to boost comprehension of these issues, while more diverse backgrounds should be more actively encouraged. We see a real 'skills deficit' in the finance sector, from pension schemes' trustee boards to financial advisers and many other groups, in terms of individuals with strong knowledge of both sustainability issues and financial services. Addressing this pressing capability gap will help the industry boost clients and savers' understanding and drive positive behavioural changes. There is a need for finance to lead the way in this area, by for example exploring innovative solutions such as mobile phone apps displaying the sustainability credentials of savers' investments alongside their financial returns.

FURTHER CONSIDERATIONS TO DELIVER A NET-ZERO FINANCIAL CENTRE

There is a careful balance to be struck on the one hand between addressing the concerns of communities across the UK as we transition to net-zero, which must be a core consideration, and on the other ensuring this does not delay ambitious action towards our 2050 target.

Concerns over the adverse impacts of the transition will need to be addressed at the same time as delivering progress, rather than be allowed to prevent action taking place with the required urgency. The sector must continue to play a prominent role in re-stating the absolute imperative of undertaking the transition in the short time we have to act.

27 Major reforms, as opposed to clarification, to fiduciary duties carries risks, including legal complexities for pension scheme trustees. The main issue has been the incorrect interpretation of fiduciary duties as opposed to issues with the definition.

28 The last report from the Law Commission in 2017 had a positive impact, leading DWP to clarify that pension scheme trustees should consider material ESG factors in their policies. If considered necessary, government could request the Law Commission to again explore fiduciary duties to clarify.

29 The 'expression of wish' could in time broadly improve the relationship between managers and clients, encouraging managers to more regularly engage when initially creating their voting policies and other climate policies, while reflecting clients' views across their policies.

5 SHIFTING THE WHOLE FINANCIAL SECTOR AND ECONOMY TOWARDS NET-ZERO

CONTEXT

The whole breadth of the UK's financial services industry will need to be actively considered by policymakers as we shift towards a net-zero financial centre in the coming years, particularly as the role played by private equity and 'shadow banks' becomes more prominent.

Measures can be taken to more comprehensively address their impacts on sustainability, and this should encompass other groups that have not been prioritised in regulation over recent years. This includes ESG data and research providers, unlisted companies, investment consultants, and auditors, among others.

In the real economy, fresh measures are also needed for unlisted companies to boost transparency over their practices. This is especially important as investors are increasingly seeking to allocate capital to opportunities in private markets to generate good returns for their clients and savers.

POLICY RECOMMENDATIONS

- **We strongly support the FCA's work exploring new measures for ESG data and ratings providers, and believe this group should be brought within the UK's regulatory perimeter.** This is particularly important as ESG data becomes more embedded in firms' investment and lending decisions and the demand for reliable data grows further. The regulator could consider: developing 'best practice' standards for data providers, with a particular focus on addressing conflicts of interest and boosting transparency over methodologies and assurance processes used, and guidance for investors and others on their use of third-party ESG data.
- **In order to markedly improve the quality of data provided by ESG data providers, policymakers need to continue to strengthen corporate disclosures among both listed and unlisted companies.** This is because data providers rely heavily on companies' disclosures to undertake their data analyses. Better disclosure is needed in the UK and globally, especially with financial services firms investing and lending across many different jurisdictions. This development will be important to help firms meet upcoming requirements, such as SDR and reporting against the 'green taxonomy'.
- Unlisted companies form a growing part of investment portfolios and policymakers must ensure regulation is sufficiently targeted for this group; in particular, ensuring effective corporate disclosures. This means **there should be a broad objective from government that unlisted corporates, particularly large, now begin to disclose to the same extent as comparable publicly listed companies on sustainability issues,** which would help reduce regulatory arbitrage.

- For example, **we want to see mandatory climate transition plans extended to large unlisted companies.** Transition plans should not only apply to asset owners, asset managers and listed companies from 2023 onwards as currently planned by government. There is a good case for this extension with mandatory climate disclosures now being rolled out for unlisted companies. Another measure to help level the playing field between public and unlisted companies is in relation to the UK's upcoming investment labels system and how it will apply to private market funds; there is a need for clear explanations for consumers should these funds be invested in illiquid assets, such as infrastructure, and be harder to redeem.

- This focus to have more aligned disclosure rules between listed and unlisted companies is particularly needed with many businesses increasingly choosing not to list on public markets. Progress in addressing this discrepancy could incentivise more businesses to list in the UK's public markets. **In the UK's markets, we want high sustainability standards in place for companies seeking to list,** in particular for those on the premium listing segment, and we would challenge the presumption that lowering standards is necessary to encourage a thriving listings environment.

- Finally, we need to be attuned to instances when divestment may take place in relation to the sale of fossil fuel assets to actors in unlisted markets. **Collectively, we need to consider how we promote 'responsible divestment'** to 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 far prefer to see the shutting down of the most high-polluting activities such as coal. How 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. Making this more financially viable remains a key unanswered question to address.[30]

FURTHER CONSIDERATIONS TO DELIVER A NET-ZERO FINANCIAL CENTRE

There is a specific issue of more data being needed on asset classes beyond listed equities, such as private debt, which can be challenging for investors and corporates to obtain. More accurate disclosures across various asset classes would lessen firms' current reliance on data estimates for certain companies in their portfolios, which is a particular issue for unlisted and smaller companies in portfolios.

Government, regulators and industry should look to work together in this area to address these data availability issues and more broadly widen their focus to assess the specific contribution that each asset class, beyond listed equities, can play in the transition to net-zero.

30 At the global level, the Energy Transition Mechanism launched at COP26 has the objective to retire more quickly coal-fired power plants in Southeast Asia and replace these with clean energy sources, and government could engage in further work internationally to promote similar promising mechanisms.

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