Reforming the Investment System to Secure a Low-Carbon Future

The investment system has the potential to greatly influence the transition to a low-carbon economy. This briefing outlines how regulatory change and specific policy developments in the UK will nurture that potential.

The 2015 Paris climate agreement set a goal to limit global temperature rises to below 2°C. We are not yet on track to achieve this. More UK businesses need to seize the opportunity of leading in new areas and creating a low-carbon economy. Otherwise, rising global temperatures will affect not just our environment, but the health of the wider economy – climate change is a material financial risk. The UK investment system is uniquely placed to turn this situation around. This briefing outlines the reforms needed to bring this about.

How will climate change affect UK business?

The low-carbon transition has started. Under the Climate Change Act 2008, the UK must ensure its CO2 emissions are 80% lower by 2050 than they were in 1990.[1] By signing the Paris accord, we've made international commitments to fight global warming. As a result, green technology is growing, and polluting industries are being restricted by new legislation.[2] With oil demand expected to peak by 2020,[3] companies are having to adjust - as Ben van Beurden, CEO of Shell, states "We are in the middle of an energy transition that is unstoppable."[4] Despite this, many haven't adapted their business models, still operating on the assumption we'll be able to live with an unregulated, high-carbon economy for decades to come. This is unsustainable – for our environment, and for business.

How can reforming the investment system tackle climate change?

With the right reforms, the investment system could become a vehicle for creating a low-carbon economy.

Reform could encourage companies to acknowledge that climate change, and policy action to counter it, will affect their performance. If temperatures rise to 6°C, it could lead to a value loss of USD 13.8 trillion of manageable financial assets, roughly 10% of the global total.[5] A warming planet, environmental regulations, and the growth of green technology all have long-term implications for companies. Forward-thinking investors want to know how their investee companies will deal with these.

Reform of pension schemes can also speed up the low-carbon transition. Pension savers have an interest in investing their money in companies that will pursue a low-carbon future. However, savers have little say on where their money ends up. Many pension schemes pass on their money to asset management firms with short-term incentives,

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who invest in companies on their behalf. We need to create a more transparent and accountable investment system. This will enable pension savers to engage about climate-related issues with those handling their money.

How are people responding to climate-related financial risk?

Policymakers are responding

The Task Force on Climate-related Financial Disclosures (TCFD), chaired by Mike Bloomberg, has made a series of recommendations.[6] They specify how companies should make clear, to investors, lenders, insurers and other stakeholders, how climate change will affect their business. The UK Government has encouraged all listed companies to implement them.[7] In France, they have gone even further. In 2015 the French Energy Transition Law was passed; Article 173 of this legislation makes climate-related disclosures mandatory for companies and financial institutions.[8] The UK has also established the Green Finance Initiative,[9] a partnership between investors and the Government, to look at how to accelerate the growth of the UK's green finance sector.

Companies are responding

100 companies support the TCFD – they have a total market capitalisation of USD 25 trillion, including big names from the oil and gas, mining and banking sectors.[10] In France, the disclosure regime created by Article 173 is is having a positive effect on their banking sector. Société Générale have disclosed they will commit €100 billion to the financing of the energy transition between 2016 and 2020,[11] while ING announced they would accelerate the reduction of their financing of coal power generation, reducing their exposure to close to zero by 2025.[12]

Investors are responding

Aviva and BlackRock, two of the world's largest asset management firms, support the TCFD.[13] 50 investors, with USD 1 trillion in assets under management (AUM), are asking companies to switch to using 100% renewable electricity.[14] 64 investors, also with 1 trillion AUM, are demanding banks disclose their exposure to climate-related financial risk.[15] Individual savers are organising to open a dialogue on climate risk with their pension schemes.[16]

What is preventing further action on climate risk?

The investment system is presently structured around short-term thinking, maximising investor returns in the short-term at the expense of climate-proof business planning in the long-term. Furthermore, a lack of legislative clarity has caused confusion among pension trustees. Many of them still think their fiduciary duties mean they must maximise short-term profitability. The law is also unclear whether asset managers are obliged, as trustees are, to act in the best interests of pension scheme members.

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Recommendations for policymakers

Developing the right policy framework can shift capital away from business-as-usual investing and towards the low-carbon solutions we need to tackle climate change. The following reforms would help change the aims of the investment system, enabling it to facilitate the low-carbon transition.

1. The DWP, the FCA and The Pensions Regulator should accept the Law Commission's recommendations[17] to amend the rules governing pension schemes. They should clarify that when making investment decisions, scheme managers should consider potential financial implications of environmental factors, which could affect savers' returns.

2. The UK Stewardship Code should be refined. Asset managers have a duty to sustain investment returns and guard against financial

risk for their pension scheme clients. This includes climate-related financial risk – the Code should reflect this. Asset managers should also disclose how they manage risk.

3. MPs should propose or amend legislation to strengthen mandatory disclosure requirements for listed companies, and carbon reporting for institutional investors. The introduction of Article 173 in France has pioneered this approach; having similar provisions in the UK would help ensure our companies and financial institutions up their game in their response to climate change. ShareAction conducted a survey of European banks in 2017, [18] assessing how effectively they were planning for the low-carbon transition, and how much information on this they made publicly available. French banks were the best performers - as these disclosures were mandatory under Article 173, it meant they produced much more comprehensive data on how they were adjusting for the low-carbon transition. By comparison British banks, which are under no such obligation, fared poorly - in fact most of them fell towards the bottom end of the ranking.

4. The Government should exercise its reserve powers to make voting disclosure mandatory for institutional investors. This would allow pension savers to know which way these investors vote on climate-related shareholder resolutions at company AGMs.

5. The FCA should regulate investment consultants. The FCA could then issue guidance to consultants, to ensure that when they advise pension schemes, they account for environmental factors.

6. The Government should secure a legal right for savers to know where their money is invested. This will guarantee savers can find out if their pension scheme's investment portfolio is packed with high-carbon assets, and how their scheme plans to manage climate risk.

7. The Pensions Regulator should amend the Master Trust Assurance Framework. It should recommend 1/3 of trustees of master trust pension schemes are Member-Nominated Trustees (MNTs). This diversifies the governance structure of the scheme, and when decisions on investment strategy are taken, there is scope for factoring in climate issues.

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About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes Responsible Investment practices by pension providers and fund managers. ShareAction believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

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