The Money Charity Response – Bank of England Discussion Paper on Financial Risks from Climate Change (March 2020)

The Money Charity is a financial capability charity whose vision is to empower people across the UK to build the skills, knowledge, attitudes and behaviours to make the most of their money throughout their lives.[1]

We welcome the opportunity to respond to the Bank of England's Discussion Paper on exploring the financial risks of climate change, which is directly relevant to the constituencies we work with, particularly to young people (Gen Z and Millennial) whose savings and pension horizons stretch to 2065 and beyond, i.e. well beyond the date of the UK's 2050 'net zero' target.

Below we set out our Key Points and Response, focusing mainly on Discussion Paper Question 1: Are there areas of the financial system that should be represented in the 2021 biennial exploratory scenario (BES) that are not captured by the proposed participation?

[1] See box on back page.

Key Points

1. We support the Bank of England's proposal to begin assessing banks' and insurance companies' financial exposures to carbon-based investments inconsistent with the Paris Agreement.[2]

2. We note that media and other reports suggest the aggregate investment and production plans of fossil fuel and related sectors are not consistent with the Paris Agreement. If not corrected, these plans will likely lead to crystallisation of the 'more severe physical risks'[3] of climate change accompanied by financial and economic disruption. It is the proper role of government and regulators to highlight this inconsistency and to bring aggregate private sector decisions into alignment with physical and financial reality.

3. As well as exploring the climate change exposures of banks and insurance companies, **we propose that the scenario exercise be extended to pension funds and retail investment funds (non-money market investment funds)** as these are large scale and most relevant to the savings decisions of retail savers, such as the young people and adults we work with. If these lie beyond the Bank of England's jurisdiction, we recommend that the Bank draws this issue to the attention of the relevant regulators and encourages them to undertake a similar exercise.

4. Related to this, we note that it is currently difficult for retail savers and investors to find genuinely non-carbon investment options. Most funds (pension funds, managed funds and tracker funds) are heavily invested in fossil fuel firms and other firms with high carbon footprints and do not seem to view this as problematic. There is a tendency to greenwashing, i.e. including carbon fuel companies in 'green' funds for spurious reasons. There are relatively few genuinely clean energy options to choose from, a situation that needs to change rapidly to enable ordinary savers and investors to vote with their feet in favour of implementing the Paris Agreement.

5. From the point of view of financial capability and consumer protection, we think it is vital that regulators help ordinary members of the public make financially capable decisions by ensuring that relevant information is available in understandable forms and that the choice architectures people are presented with lead them toward, and not away from, the outcomes they prefer. This Bank of England initiative sits well with this approach, especially if the environmental risk-sizing is extended to pension and retail funds.

[2] The 2015 Agreement to limit global warming to between 1.5 degrees and 'well below' two degrees.
[3] Bank of England Discussion Paper, page 1.

This response mainly addresses Discussion Paper Question 1: Are there areas of the financial system that should be represented in the 2021 biennial exploratory scenario (BES) that are not captured by the proposed participation?

We also comment on the need to make sure that measures of exposure to carbon-based investments are genuine and not affected by “greenwashing.”

Our Response

We agree with the underlying assumptions of the Bank of England’s Discussion Paper, i.e. that there is a mismatch currently between the undertakings made in the Paris Agreement and the carbon-dependence of the world economy which, if nothing changes, will see global warming substantially above two degrees centigrade, with all the physical, economic and financial costs that will flow from this. According to Oil Change International, the International Energy Agency’s 2019 “Stated Policies Scenario” forecasts global warming of 2.7 to 3.2 degrees centigrade.[4] The Bank of England has denoted this as scenario three, the ‘no additional policy action scenario’.[5] We note that if ‘business as usual’ continues the world will have a permanently elevated level of atmospheric CO_2 and global warming will continue for centuries into the future, with large scale changes to life on Earth. This is a scenario that must be avoided.

IEA data show that rather than decreasing, world output of CO_2 continues to increase, reaching 33.2 Gigatonnes in 2018, up from 30 Gt in 2010 and 20.5 Gt in 1990.[6] In 2018, the USA was responsible for the largest increase (principally from gas), followed by China and India. China was responsible for the world’s largest increase in renewables and nuclear energy, but these were outstripped by its growth in gas, oil and coal production.[7] Europe and Japan saw an improvement in sustainability with renewables (Europe) and nuclear (Japan) replacing part of their gas, oil and coal demand.

Given known human biases, particularly present bias and hyperbolic discounting, it is likely that governments will eventually take significant action when the climate crisis reaches a critical scale of intensity, but the longer this is delayed (Bank of England Scenario Two: “Late Policy Action”) the more disruptive it will be to prices, markets and investment values. From a long-term perspective, a substantial part of the world’s fossil fuel reserves and associated investments already have a true value of zero (because they can’t ultimately be used) but this is not yet reflected in market prices. The market currently takes the view that fossil fuel extraction will continue unabated.

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[4] http://priceofoil.org/2019/11/13/iea-2019-weo-working-for-fossil-fuels-not-climate/
[5] Discussion Paper, page 11.
[6] https://www.iea.org/reports/global-energy-and-co2-status-report-2019/emissions#abstract
[7] https://www.iea.org/reports/global-energy-and-co2-status-report-2019#

The risk for investors, savers and pension fund members (the people we work with) is that a significant part of their savings will at some point suddenly be re-rated to zero value, a crisis such as affected investors in the Neil Woodford funds in 2019, but on a much greater scale. The market and the institutions in the market (banks, insurance companies, pension funds, retail platforms etc) are not currently signaling this risk to retail savers and investors.

For example, in late 2019 the writer of this response attended a retail investor conference hosted by one of the major UK retail investor platforms and found that only one of the five fund managers speaking rated climate change as a significant risk worth mentioning. The other fund managers were either silent on climate change or actively promoted investments in fossil fuel companies.

Many investments are packaged and named in such a way that it is not possible for the average saver to know the extent to which they might be invested in potentially stranded carbon fuel assets. This is a grave issue for consumer protection and financial capability.

There are three key points we wish to make in this response:

1. The need to extend climate change testing to pension funds and retail investor platforms.

2. The need for the market to develop more investment options for retail investors and pension fund members to support the transition to a sustainable economy.

3. The need for regulators to intervene to prevent “greenwashing”, i.e. the inclusion of fossil fuel investments in funds that have a “green” or “sustainable” label.

Taking each point in turn:

1. The need to extend climate change testing to pension funds and retail investor platforms.

We agree with the Bank of England’s proposal to climate stress-test banks and insurance companies, as these play central roles in the UK financial system and are essential to financial stability. However, the average person is distanced from the investment decisions made by banks and insurance companies. For most of us, the fungibility of money prevails in our relationship to these institutions. More relevant to the average retail investor and saver are pension funds and retail investments. This is because the latter give a degree of control to the consumer over where their money is invested, either by offering investment in named funds or in profiles such as “low risk”, “medium risk” or “high risk” (low risk referring to bond-type investments and high-risk referring to equities). Pension funds usually operate a default approach that transitions

members from high risk to low risk investments as they approach retirement. However, pension funds also offer members some degree of control over this choice.

At the moment, pension funds and retail investment funds are more-or-less neutral on the issue of climate change, i.e. they regard investment in fossil fuel companies in the same way as they regard investment in retailers, Internet companies or electric car manufacturers – the investment is assessed purely on its potential rate of return.

Little is being done to prepare pension savers and retail investors for the coming radical revaluation of carbon-based investments. This is bad for financial capability because it denies consumers information about the true risks of their investments. It is bad for consumer protection because it exposes consumers to the possibility of radical losses with uncertain mitigation. It is particularly bad for the younger generations (Z and Y) because the horizon for their pension savings and investments lies well into the second half of the twenty-first century: a person beginning work today is unlikely to retire before 2065, which is beyond when most fossil fuel investments will need to be "retired" if we are to achieve the goals of the Paris Agreement. Someone starting work today may live to the year 2100, so their savings will need to be paying out in the decades of the 2070s, 2080s and 2090s.

Just as banks and insurance companies need to re-evaluate their fossil fuel investments and risks, so pension funds and retail investment providers need to do the same. If these lie beyond the Bank of England's jurisdiction, we recommend that the Bank draws this issue to the attention of the relevant regulators and encourages them to undertake a similar exercise.

2. The need for the market to develop more investment options for retail investors and pension fund members to support the transition to a sustainable economy.

Many savers and pension scheme members, particularly those in the younger generations (Z and Y), may wish to invest their savings and investments in a way that is consistent with the Paris Agreement. However, at the present time it is very difficult to do this, as the market has not developed the necessary range of financial products. To take an example, one of the leading investor platforms in the UK is AJ Bell Youinvest.[8] This platform offers investors searching for Exchange Traded Funds the Morningstar category "alternative energy", but on the AJ Bell site this category contains only one fund: the iShares Global Clean Energy UCITS ETF. However, the category "energy" offers 21 ETFs with typically heavy investments in firms producing fossil fuels.

As the Bank of England will be aware, there are thousands of funds in total, some managed, some ETFs, many of which are pitched towards particular regions, markets

[8] https://www.youinvest.co.uk/

or investment styles. However, there is no obvious filtering by environmental sustainability or consistency with the Paris Agreement. This is simply a non-issue in the way that most funds have been designed.

Another leading UK platform is iWeb,[9] which is owned by the Lloyds Banking Group. A search[10] for “clean energy” on the iWeb site produces only three results: one managed fund (Pictet Clean Energy), one ETF (the iShares Global Clean Energy ETF, also listed by AJ Bell) and one equity offer (Clean Energy Fuels Corp). However, a search for “energy” produces 105 equity offers, 4 ETFs, 5 investment trusts and 5 funds.

Searches for “Paris Agreement”, “environmentally sustainable” and “carbon-free” on the iWeb site produce zero results.

This presents a consumer looking for a way to invest in carbon-free energy with a dilemma: do they pile their money into one or two investments (thereby violating the cardinal rule to “spread risks”) or do they spread their risks in the knowledge that they will be investing in fossil fuel and other high carbon footprint companies? Given the UK’s commitments under the Paris Agreement,[11] this is not a choice that consumers should be faced with. There should be a wide range of investments clearly labelled as Paris Agreement consistent for the consumer to choose from.

The same argument applies to pension funds: in their offer to consumers they should include a range of Paris Agreement consistent options and their default strategies should also be Paris Agreement consistent.

3. The need for regulators to intervene to prevent “greenwashing”, i.e. the inclusion of fossil fuel investments in funds that have a “green” or “sustainable” label.

A further hazard facing consumers is that some financial products may be labelled “green” or “environmentally sustainable” (responding to what some in the financial markets see as fashion) but when one looks inside the box, they turn out not to be. This is normally termed “greenwashing”.

A topical recent example is the Climate Transition Index Fund, developed with an index provider by the Church of England and launched on 30 January 2020, which includes investments in the oil and gas sector (Royal Dutch Shell and Repsol) and leaves the

[9] https://www.iweb-sharedealing.co.uk/share-dealing-home.asp
[10] On 31 January 2020.
[11] https://www.theccc.org.uk/tackling-climate-change/reducing-carbon-emissions/how-the-uk-is-progressing/

door open to including other oil and gas companies providing they set targets "judged to be consistent with the Paris Agreement".[12]

According to a report by the Climate Accountability Institute, Royal Dutch Shell is responsible for the seventh largest contribution to greenhouse gas emissions since 1965[13] and has plans for a 37.6% increase in fossil fuel production between 2018 and 2030, including a large new oil and gas fracking facility in western Argentina.[14]

News reports of fracking in Argentina are typically gung-ho, reflecting the disconnect between financial markets, fossil fuel companies and the Paris Agreement. For example, the Financial Times reported:

> "With about 2bn barrels of oil reserves — and some 27bn barrels of potential resources in Vaca Muerta — and confidence that Argentina's shale fields are comparable to formations such as Eagle Ford or Bakken in the US, the government aims to double oil production from 500,000 to 1m bpd and natural gas from 1.4tn cubic ft to 3.5 tcf by 2023…
>
> … investment in Vaca Muerta could go parabolic after the elections, argued David Tawil, president of Maglan Capital, a hedge fund that owns Madalena Energy, which operates in Vaca Muerta…
>
> … Shell and Exxon have announced their intention to ramp up operations in Vaca Muerta…
>
> … IHS Markit forecasts that capital investment in Vaca Muerta will increase by around 10-15 per cent year on year over the next decade, rising from about $1.5bn this year to more than $8bn in 2029."[15]

While the Church of England is reported to have reduced its fossil fuel exposure by setting up its new index fund, the labelling of a fund that includes oil and gas producers as a "climate transition fund" is not helpful to the ordinary saver or retail investor. What is needed is a range of investments that are close to 100% fossil fuel free, so that investors who wish to can clearly contribute to bringing down the average carbon footprint of human economic activity.

The Shell case illustrates a number of the problems around green labelling. The TPI assessment that led to Shell being included in the Climate Transition Index is expressed not in terms of total greenhouse gas emissions, but in terms of CO_2 intensity, i.e. the

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[12] https://www.churchofengland.org/more/media-centre/news/church-england-pension-board-invests-ps600-million-global-new-stock-index
[13] https://www.theguardian.com/environment/2019/oct/09/revealed-20-firms-third-carbon-emissions
[14] https://www.theguardian.com/environment/2019/oct/09/what-we-know-top-20-global-polluters
[15] https://www.ft.com/content/579cf542-afa7-11e9-8030-530adfa879c2

amount of CO_2 emitted per unit of energy produced.[16] Under such a measure, the total carbon footprint can increase even as the intensity measure reduces. Even on the intensity measure, Shell's reported path according to TPI is well above the two degrees centigrade global warming target through the whole reporting period up to 2050. In 2050, according to TPI, Shell's intensity will be over four times higher (35.6 $gmCO_2e/Mj$) than the "below two degrees" climate target (7.9 $gmCO_2e/Mj$).[17] At the same time, Shell's planned investments in fossil fuels (£30 billion per year in the 2020s) dwarf its planned investments in clean energy (£1-2 billion per year).[18]

A second problem with the TPI assessment is that it assesses companies against government pledges in relation to the Paris Agreement, not against compliance with the Paris Agreement. Most governments have not yet made pledges consistent with the Paris Agreement, meaning that the world is presently on course for at least 3-4 degrees of global warming by the end of the twenty-first century rather than the significantly less than two degrees called for by the Paris Agreement.[19]

In due course, all investments without exception will have to pass a "Paris Agreement consistent" test if the world is to avoid severe climate disruption. This will involve very large cuts in greenhouse gas output. If they wish to remain in business, oil and gas companies will need to transition to clean energy and most of the current reserves of oil and gas will need to be left in the ground. An oil and gas company should only be included in a climate transition fund if it has a plan, matched by its investments, to replace its fossil fuel output with clean energy at a rate that is consistent with keeping global warming significantly below two degrees centigrade.

Shell is one example of greenwashing, but there are many others. For example, the website ETF.com (an ETF-finder site) made a study of ETFs labelled as passing an environmental, social and governance (ESG) test and found that of 31 ESG ETFs that screen for fossil fuels, only six were genuinely fossil-fuel free. The ten ESG ETFs with the largest exposure to fossil fuels had fossil fuel investments of between 10% and 24% of invested funds, including investments in Shell, Exxon, Total and Petroleo Brasileiro SA.[20]

To help avoid greenwashing, UK financial regulators can assist retail investors by setting standards for the labelling of environmentally sustainable investments.

[16] https://www.transitionpathwayinitiative.org/tpi/companies/royal-dutch-shell
[17] https://www.transitionpathwayinitiative.org/tpi/companies/royal-dutch-shell. (The measure is "grams of CO_2 emitted per Megajoule of energy")
[18] https://www.theguardian.com/business/2020/jan/03/royal-dutch-shell-may-fail-to-reach-green-energy-targets
[19] https://www.nationalgeographic.com/science/2019/11/nations-miss-paris-targets-climate-driven-weather-events-cost-billions/
[20] https://www.etf.com/sections/features-and-news/fossil-fuel-free-funds-arent?ts=1580738996

Investments should only be able to use key words such as “green”, “clean” or “sustainable” when they genuinely reach a high standard of greenhouse gas minimisation and overall environmental friendliness. Firms that misuse green labelling should be subject to regulatory sanction.

On this point, it should be noted that Ofgem, in its decarbonisation strategy launched on 3 February 2020, specifically refers to greenwashing, saying that “we expect suppliers to be transparent about what constitutes a ‘green tariff’ and we will undertake work to ensure that consumers are not misled.”[21]

In relation to the climate change risk testing exercise, the key point is to ensure that participant firms make a realistic assessment of their fossil fuel exposures, including related party exposures, and do not hide risks behind spurious “green” or “climate transition” labels.

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[21] https://www.current-news.co.uk/news/ofgems-decarbonisation-action-plan-tackling-greenwashing-facilitating-evs-and-flexibility

The Money Charity is the UK's financial capability charity providing education, information, advice and guidance to all.

We believe that everyone achieves financial wellbeing by managing money well. We empower people across the UK to build the skills, knowledge, attitudes and behaviours to make the most of their money throughout their lives, helping them achieve their goals and live a happier, more positive life as a result.

We do this by developing and delivering products and services which provide education, information and advice on money matters for those in the workplace, in our communities, and in education, as well as through influencing and supporting others to promote financial capability and financial wellbeing through consultancy, policy, research and media work.

We have a 'can-do' attitude, finding solutions to meet the needs of our clients, partners, funders and stakeholders.

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