PRI Principles for Responsible Investment

PRI SUBMISSION

INFORMATION FROM PARTIES AND STAKEHOLDERS IN THE FINANCIAL SECTOR REGARDING WAYS TO ACHIEVE ARTICLE 2, PARAGRAPH 1(C), OF THE PARIS AGREEMENT, INCLUDING OPTIONS FOR APPROACHES AND GUIDELINES FOR IMPLEMENTATION

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PRI Association
Registered office: 25 Camperdown Street
London, UK, E1 8DZ Company no. 7207947
T: +44 (0) 20 3714 3220 W: www.unpri.org E:info@unpri.org

ABOUT THE PRI

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

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

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

ABOUT THIS CALL FOR INPUT

Building on the previous work conducted in 2022, the Standing Committee on Finance (SCF) continues its work regarding ways to achieve Article 2, paragraph 1(c), of the Paris Agreement, including options for approaches and guidelines for implementation, and has invited Parties and stakeholders in the financial sector to make further submissions thereon. This call for submission presents the PRI's work across 4 areas on driving a whole-of-finance transition that are relevant for the SCF.

For more information, contact:

Tamsin Ballard

Director of Climate and Environment

tamsin.ballard@unpri.org

Edward Baker

Head of Climate Policy

edward.baker@unpri.org

Eliette Riera

Head of UK Policy

eliette.riera@unpri.org

Jodi-Ann Wang

Senior Climate Policy Analyst

jodi-ann.wang@unpri.org

KEY RECOMMENDATIONS

Making financial flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development requires foundational changes in public policy as a whole. Financial regulations and real economy policies have played an important role in supporting the growth in sustainable investment practices, and in better aligning these practices with national and international objectives. However, despite the progress that has been seen, including the initiatives highlighted by the SCF in their report to the Conference of the Parties in November 2022[1], financial flows are not yet consistent with low greenhouse gas emissions and climate resilient development that work for people and the planet.

Supportive and aligned regulatory and policy environments are needed to enable all actors to contribute towards low greenhouse gas emissions and climate-resilient development in the short, medium and long term. A key reason for the continued misalignment is that, in most jurisdictions, public policy is not always designed to enable a whole-of-economy transition to a more sustainable financial and economic system. Reorienting financial and business models will require **governments to align financial policies, strengthen legal frameworks, and create an enabling real-economy policy environment** (e.g. climate and energy regulation). The PRI's work to date has helped us identify several areas which would benefit from further discussion with investors and policymakers at the local and global level, including e.g. on transition policy, fiduciary duty, and the global financial architecture.

This submission presents the PRI's work across 4 areas on driving a whole-of-finance transition that are relevant for the SCF:

- Aligning financial policies to support the goals of the Paris Agreement.
- Strengthening legal frameworks for the consideration of sustainability impact in investor decision-making.[2]
- Creating an enabling real-economy policy environment that mobilises and aligns financial flows with low greenhouse gas emissions and climate-resilient development.
- Reforming the global financial architecture to help drive the whole-of-finance transition.

Further work from the PRI with relevance to the operationalisation of Article 2, paragraph 1(c) of the Paris Agreement will be available later this year, in particular regarding policy approaches to the economic transition, including short case studies of policy interventions and looking at key building blocks for a whole of government approach to the economic transition.

We look forward to engaging further with the SCF, UNFCCC and other actors to contribute to this important work, and remain available to discuss our findings following the closure of the call for input.

[1] See the Report of the Standing Committee – Addendum, document FCCC/CP/2022/8/Add.3, 28/10/2022

[2] In particular our programme A Legal Framework for Impact, and previous work undertaken on fiduciary duty.

DRIVING A WHOLE-OF-FINANCE TRANSITION

Attracting private capital, creating investable business models, and incentivising the alignment of existing financial flows with Paris Agreement goals will be facilitated by a suite of policies that support the delivery of governments' climate plans and strategies. Governments have a critical role in developing a high-level, overarching polices that integrate transition planning across all government entities, so as to support a whole-of-government economic transition in an effective, ambitious and inclusive way. This includes public policy and investment that are critical for incentivising and scaling sunrise sectors and supporting innovation, given their long-term and risky nature, and in unlocking private investment. Equally, governments have a critical role in addressing market distortions and ineffective or misaligned incentives, such as fossil fuel subsidies, which counteract measures like carbon pricing or nature-based solutions.

Over 550 financial institutions, including PRI signatories, have committed to align capital with the achievement of net zero by 2050 under various net zero alliances.[3] For example, members of the UN-convened Net Zero Asset Owners Alliance set intermediate targets every five years, aimed at ratcheting up their ambition, following the principles underpinning Parties' Nationally Determined Contributions to the Paris Agreement.[4] **These net zero commitments are made in the expectation that governments will deliver on their own commitments to ensure the objectives of the Paris Agreement are met,** including delivering on their Nationally Determined Contributions.[5]

Financial policy

To support a shift in private financial flows and the achievement of the Paris Agreement objectives, a comprehensive series of financial policy reforms are required to align the rules that guide financial institutions and corporations with a just transition to low greenhouse gas emissions and climate resilient development. Sustainable, net zero-aligned financial systems are the lynchpin for the net zero transition.

The role of Finance Ministries in driving climate action is particularly key, as it is inextricably linked to their mandates of ensuring financial stability, economic growth and societal prosperity. In addition to financial policy reform, they play an important role in closing the delivery gap and the finance gap through macroeconomic strategy, fiscal policies and the power of the budget, and market regulation. For further information, please see PRI's response to the Coalition of Finance Ministers for Climate Action Global Consultation.

[3] This includes Net Zero Asset Owners Alliance, Net Zero Asset Managers Initiative, Net Zero Financial Service Providers Alliance, Net Zero Investment Consultants Initiative, Net Zero Banking Alliance, Net Zero Insurance Alliance and Paris Aligned Investment Initiative. The Glasgow Financial Alliance for Net Zero (GFANZ) provides a strategic forum for bringing these alliances together.

[4] The Alliance's 2022 Progress Report can be found here; it serves as a prototype of target-setting and implementation for private financial actors.

[5] For example, see Net Zero Asset Managers Initiative commitments: https://www.netzeroassetmanagers.org/commitment/ and Net Zero Asset Owners Alliance commitments: https://www.unepfi.org/wordpress/wp-content/uploads/2019/09/AOA_FAQ.pdf

Legal Framework *(see Annex A)*

Reforms are essential to establish legal and regulatory frameworks that facilitates investing for sustainability impact and to overcomes barriers to action, while ensuring a level playing field for market participants. Investments are not sufficiently aligned with global sustainability goals, including those set out in international treaties like the Paris Agreement and in the SDGs. Consequently, investment portfolios remain exposed to sustainability risks – including system-level risks. To address this, investors need to take action through asset allocation, company engagement, and policy engagement, in order to increase positive impacts (and decrease or eliminate negative impacts) from their investments. Investors are likely to have a legal obligation to consider pursuing sustainability impact goals where doing so can contribute to achieving their investment objectives. This includes managing investments so as to contribute to the achievement of the Paris Agreement goals. Yet the way investors understand and discharge their duties in practice can discourage them from pursuing positive sustainability impacts or limit their ability to do so in practice.

Real-economy policy

Clear and consistent policy direction galvanises investor confidence in setting clear targets for their own activity and investment, lending and underwriting, and using stewardship and engagement to encourage ambition and delivery from corporates. It also strengthens finance mobilisation in innovation and breakthroughs, which creates more space for public and private sector action and delivery against Paris Agreement goals. Actions in the next five to ten years matter even more than mid-century net zero targets, both for the prospective of limiting future temperature rise, and for financial markets. Not only is near term accountability important to ensure plans are realistic, financeable, and useful for providing inputs into other strategies, it is also key for investors and companies with net zero plans.

The PRI, alongside our partners, have developed two relevant tools for investors to consider, assess, and prepare for policy changes towards a low greenhouse gas emissions and climate resilient development outcome.

- The **Assessing Sovereign Climate-related Opportunities and Risks (ASCOR)** Project has been established to allow investors to assess governments' climate-related commitments, their policy frameworks (including carbon pricing, energy subsidies, the phase-out of combustion vehicles, deforestation and land use policies) and the actions they are taking to ensure that the benefits of the low-carbon transition and of adaptation are shared among their citizens. This framework provides clarity about the public disclosures investors require to play their part in supporting the transition.
- Commissioned by the PRI in 2018, the **Inevitable Policy Response (IPR)** prepares institutional investors for the portfolio risks and opportunities associated with a forecast acceleration of policy responses to climate change on the energy system, food and land use system, and real economy. **IPR contends that governments will be forced to act more decisively than they have thus far, thus creating an enabling environment for investors to address significant transition and physical risks, while aligning capital allocation towards sustainable outcomes.**

International Financial Architecture

The international financial architecture, including Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs), safeguards the effective functioning of global monetary and financial systems. IFIs and DFIs can leverage their financial power, global reach, on-the-ground capacity, and issue knowledge to support the implementation of Article 2.1(c) within the global financial architecture. The role of MDBs should go significantly beyond filling gaps in development financing, as their direct financing (even if augmented with capital stretching), is insufficient to fill the financing gaps. The purpose and performance of MDBs lie not only in the impact of their own disbursement, but the magnitude of resources they mobilise. Together, MDBs hold about $500 billion in shareholder equity, which can be strategically used to leverage additional public and private financing many times over to deliver the requisite finance for the Paris Agreement.

The PRI has been working on a policy paper focussed on reforming the international financial architecture, which will present a diagnosis of the current structure's incompatibility to meet present economic and sustainability challenges and highlight the necessary changes to unlock the potential of private finance. It will present a suite of mutually reinforcing reform priorities to align public and private finance with the goals of the Paris Agreement, and broader sustainability goals.

ANNEX A: LEGAL FRAMEWORK FOR IMPACT

WHAT IS A LEGAL FRAMEWORK FOR IMPACT?

A Legal Framework for Impact, authored by Freshfields Bruckhaus Deringer and commissioned by the PRI, UNEP FI and the Generation Foundation, is a ground-breaking study of **11 jurisdictions around the world**[6] on whether the law permits or even requires investors to tackle some of the world's most urgent sustainability challenges by setting and pursuing sustainability impact goals. Building on the legal findings, the Legal Framework for Impact project is working on policy implementation in five jurisdictions:

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

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

The findings from both the overarching legal analysis presented in the global report and the policy recommendations in individual jurisdictions provide information on common challenges and barriers faced by the investment community. Addressing these issues through the implementation of the Paris Agreement could contribute significantly to achieving the goal of making financial flows consistent with low greenhouse gas, climate-resilient development pathways.

Further information on the details of the project is included below.

WHY DOES INVESTING FOR SUSTAINABILITY IMPACT MATTER?

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

- Investments are not sufficiently aligned with global sustainability goals, including those set out in international treaties like the Paris Agreement and in the SDGs. Consequently, investment portfolios remain exposed to sustainability risks – including system-level risks.

[6] The LFI report analysed the legal frameworks in Australia, Brazil, Canada, China, the European Union, France, Japan, the Netherlands, South Africa, the United Kingdom and the United States of America.

- In some circumstances it is necessary for investors to address sustainability impacts in order to manage ESG risks and opportunities and deliver financial returns for clients and beneficiaries, particularly when sustainability impacts cause system-level risks. But doing so is not currently considered part of mainstream investment practice.
- To address this, investors need to take action to increase positive impacts (and decrease or eliminate negative impacts) from their investments.

WHAT ARE THE KEY LEGAL FRAMEWORK FOR IMPACT FINDINGS?

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

However, the research also found that the way investors understand and discharge their duties in practice may be discouraging them from pursuing positive sustainability impacts or even considering doing so. Furthermore, legal frameworks sometimes limit investors' ability to pursue sustainability impact objectives as an ultimate end, rather than in support of financial objectives.

We have observed that many investors remain hesitant to change their established practices and pursue sustainability impact goals, even when this is required to achieve financial objectives.

Climate change poses significant systemic threats to the stability of the global financial system. Institutional investors, which are required to secure long-term financial returns, have a responsibility to consider whether system-level risks are relevant to their ability to meet their legal obligations and objectives and, if so, how they can mitigate these threats.[7] Reduced system-level risks – which can be referred to as "better beta" – could improve financial outcomes over the long term.[8]

Diversification, a core tenet of the popular modern portfolio theory, does not address such risks to investors' portfolios. A more effective approach investors might take is to work towards improving the sustainability impacts of their investments (or to *invest for sustainability impact* in the terminology of the Legal Framework for Impact report). In the case of climate change this could entail, for example, setting and pursuing goals to reduce the GHG emissions of investee companies in line with the Paris

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[7] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making (p.154-p.192)

[8] Hawley, J., Lukomnik, J. (2019), Modernising modern portfolio theory

Agreement goals. They can take action in pursuit of such goals through investment decisions, stewardship and engagement with policy makers, acting individually or in collaboration with other investors.

Many investors are already taking this approach. One example is more ambitious stewardship driven by sustainability concerns: as highlighted in the *Legal Framework for Impact* report,[9] the investor-led Climate Action 100+ initiative[10] is increasingly focusing on the outcomes of companies' decarbonisation commitments, and a number of its investor members are setting emission reduction targets for their investee companies.

WHY DO WE NEED POLICY REFORMS?

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

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

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

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

RECOMMENDATIONS FOR POLICY MAKERS

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

Overarching policy recommendations

Clarify investors' legal duties

[9] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making (p.38)

[10] Climate Action 100+ currently has 700 investors and 166 companies as members.

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

Ensure sustainable finance policies facilitate investing for sustainability impact

1. Adopt comprehensive corporate sustainability disclosure frameworks which meet the needs of investors seeking to understand material sustainability risks, opportunities and impacts.
2. Ensure that sustainability disclosure and labelling regulations address not only integration of ESG risks, but also how investment entities and products assess sustainability outcomes, set sustainability impact goals, and take steps to contribute to positive sustainability impacts.
3. Implement sustainable taxonomies to help investors understand and promote economic activities that are environmentally and socially sustainable.
4. Strengthen regulatory support for effective and accountable stewardship, including the use of stewardship powers to address sustainability risks and sustainability impacts.
5. Support collaborative action by investors that seeks to improve sustainability outcomes, and provide regulatory guidance and, where required, consider establishing a safe harbour to ensure that sustainability-related collective action by investors does not fall foul of anti-trust rules.
6. Explore ways to enable investors to take client and beneficiary sustainability preferences into account in their asset allocation and stewardship activities.
7. Establish corporate due diligence requirements to ensure that negative sustainability impacts are identified and addressed; ensuring coherence with international standards including the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises