



Towards a Royal Bank of Sustainability: protecting taxpayers' interests; cutting carbon risk

By Nick Silver ¹

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Foreword

It is widely accepted that the global economy is not on a sustainable long-term path. World leaders will shortly meet in Copenhagen to secure a deal to change course. Whatever is agreed, without the active involvement of the world's leading companies, we will fail. We need companies to create essential new low carbon technologies; to transform the way we all do business (e.g. tele-presence rather than business travel); and we need them to build a new low carbon energy and transportation infrastructure. Banks, like RBS, also have a fundamentally important role to play – we need them to channel much of the capital required to pay for these transitions. This is no small task. The International Energy Agency estimates that, globally, we need to spend some \$10 trillion on transport, energy efficiency and power generation by 2030 (IEA World Energy Outlook, 2009).

Enabling companies to play this role is partly about governments creating incentives through carbon pricing and other regulations. But it is also a matter of leadership. To achieve the huge transition ahead we need company leaders to understand the risks and opportunities they face and to develop bold and imaginative strategies for long-term success. Board directors cannot formulate and execute these strategies without the active support and engagement of their largest shareholders.

As initiatives like the UN Principles for Responsible Investment and the Carbon Disclosure Project demonstrate, many of the world's largest investment institutions understand this role and are committing themselves to become more active and engaged owners – scrutinising the companies in which they invest, not just on conventional governance issues but also on wider questions such as climate change strategy; challenging poor transparency and weak risk management; and supporting and encouraging vision and leadership.

If banks are to return to full health, and play their role in sustainable wealth creation, their boards must benefit from the active scrutiny, challenge and support of their owners; not just on short-term financial issues, but on the full range of long-term leadership and governance issues that fall within

the purview of their boards. This report raises important and timely questions about the role of UK Financial Investments, the majority owner of RBS, in fulfilling this role. There is no doubt a debate to be had about exactly what RBS's long-term strategic position should be on the many controversial issues raised by the report, but this debate is one in which its owners, government or otherwise, should be fully and intelligently engaged. The roots of the financial crisis lie partly in a failure of owners to play a sufficiently engaged part in the governance process of banks; it would be ironic if the solution to the current crisis were to create a governance vacuum that contributes to the next one.

Dr. Craig Mackenzie, Director, Centre for Business and Climate Change, University of Edinburgh Business School².

Executive Summary

In October 2008, the UK government purchased shares in a number of troubled banks. It manages these shareholdings at arms-length, through UK Financial Investments (UKFI), a government-owned company specially set up for the purpose. This report argues that the government – now the principal shareholder in Royal Bank of Scotland (RBS) - should behave as an active owner to initiate a transformation of RBS into a sustainable bank.

Active engagement is not just good investor practice, it is government policy: it is the government's view that the financial crisis was at least in part a consequence of the lack of active investor engagement. By failing to take such an approach, UKFI is failing to monitor, assess or manage environmental, social and corporate governance risks which are considered significant by mainstream investors.

Active engagement is clearly a legitimate approach for UKFI, but this report argues that the unusual circumstances of UKFI's investments create not only an opportunity, but an imperative for it to take such an active investor stance.

The reasons for this include the major economic externalities inherent in RBS' fossil fuel rich portfolio of loans and investments. These will impact on UKFI's stakeholders (the general taxpayer) more severely and consistently than on RBS or other financial institutions. Also, in line with the expectations of the Companies Act 2006, the government should set goals and objectives for the companies that it owns through UKFI to provide long-term incentives for responsible investment that will protect shareholder value (where the shareholders and taxpayers are the same).

The environmental and economic risks of climate change are severe, yet they are largely externalised by financial institutions and their client companies. Moreover, the potential failure of government policy is seen as a significant risk to investments in clean technologies. As a result RBS over-invests in fossil fuels and under-invests in renewables and other clean technologies. This in

turn damages the wider credibility of government climate policy, and threatens its delivery.

On the other hand, if regulatory or fiscal policies adequate to deliver climate change policies are delivered by the UK and other governments there is a significant risk that RBS' investments in fossil fuel companies could go bad. UKFI, as an active owner, should therefore seek to transform RBS' lending and investment strategy.

Recommendations

Immediate recommendations to put UKFI in step with industry good practice:

As a minimum, UKFI should follow standard good practice for institutional investors, which involves:

Becoming a signatory to the Carbon Disclosure Project (CDP) enabling UKFI to assess the climate risks of its investments.

Being fully transparent by stating clearly guidelines on Environmental, Social and Governance (ESG) considerations and undertaking a periodic independent audit that takes into account ESG considerations.

Seeking expert advice on how best to incorporate ESG considerations into investment analysis and decision-making processes.

Behaving as an active owner and incorporating ESG issues into its ownership policies and practices; as well as seeking appropriate disclosure on ESG issues by the entities in which it invests.

Recommendations that would provide leadership by UKFI:

UKFI must also go beyond current industry good practice because of the government's social and environmental policies and obligations. Recommendations to achieve leadership include:

Providing incentives for long-term, sustainable behaviour by linking executive pay to the companies' long-term performance and to the bank's environmental and social performance.

Ensuring bank lending is screened on environmental and social criteria. The bank's commercial customers should be subject to independent audit on

environmental and social criteria.

Appointing a board member with specific ESG responsibilities.

Commissioning an independent review to investigate a “sustainable” bank model, with recommendations and lessons learned that could be applied to RBS.

Introduction

Recommendations to ensure coherence with the UK government’s policies:

RBS, in consultation with UKFI, should adopt a strategy to reduce exposure to high carbon investments, using the government’s estimate of the ‘social cost’ of carbon to assess the risk/reward profile of potential funding decisions. It should:

Set targets for reducing emissions from its lending portfolio, and monitor and audit those reductions.

Allocate responsibility for climate change policy to the board and senior management.

Develop a revised investment mandate drawing on expertise and guidance from independent sources and best practices in the financial sector to identify which activities should not be funded in future.

Conclusions

UKFI should engage actively with the Board and management of RBS to ensure effective consideration and analysis of environmental, social and corporate governance issues. UKFI should pursue higher standards than industry good practice because it is representing the wider interests of taxpayers, and defending the credibility of the government’s policy and its UK Low Carbon Transition Plan.

A credible low carbon strategy for the UK would require the substantial economic risks of the fossil fuel sectors in which RBS is heavily involved to be internalised. This would represent a serious financial risk to companies in these sectors. To manage these risks and protect the shareholder/taxpayer, RBS should, in consultation with UKFI, adopt a strategy to reduce exposure to such investments.

There is a sound business case for RBS to initiate a transformation into a sustainable bank. For RBS’ owners - the government and taxpayers – this becomes an imperative to assess the risks and opportunities involved and to act as responsible, engaged owners in driving such a transition.

This report has been commissioned by People & Planet, World Development Movement, PLATFORM, Friends of the Earth Scotland, and BankTrack to investigate whether and how the government should align its recent investment in the Royal Bank of Scotland (RBS) with social and environmental objectives, in particular to combat climate change. Although many of its recommendations can be applied to other government-rescued banks, this report focuses specifically on RBS.

The report examines investment good practice with respect to environmental and social factors and focuses in particular on how the government, through UK Financial Investments Ltd (UKFI), might apply a risk management perspective to RBS’s lending to companies involved in fossil fuel extraction and high carbon industries. It argues that such an analysis should form the basis of the government’s policy towards its investment in RBS. The report does not suggest that government should be involved in the day-to-day management of RBS; but argues that the government, through UKFI, should be acting as an active owner, for example by setting goals, incentives and boundaries under which RBS operates, in the way that is considered good practice by investors.

The government had to take majority ownership of RBS because the bank failed; which strongly suggests that its risk management was less than optimal. This has also led to widespread public anger at the use of public funds for the bail-out, along with concerns over executive remuneration at the failed bank. RBS’ reputation is currently at a low ebb, and the banking industry and RBS in particular are facing the widespread public perception that they are unconcerned and disconnected with the society in which their activities are embedded. Dealing with environmental and social issues should be a major priority for the banks, if for nothing else than to help restore their tattered reputation. However this report argues that with regards to RBS, there is a strong business case for UKFI to intervene, as an active owner, to reorientate the investment strategy of the bank.

The 2008 bank bail-out

In October 2008, the British government proposed a bank rescue package totalling £500 billion. This was made up of 3 parts:

A special liquidity scheme: made up of £200 billion of short term loans

The Bank Recapitalisation Fund: the government would purchase shares of up to £50 billion in troubled banks

A credit guarantee scheme: the government underwrites up to £250 billion in lending between banks

This report concentrates on the recapitalisation, the purpose of which was described as: “supporting stability in the financial system, [protecting] depositors, [safeguarding] the interests of the taxpayer.”³ Through this Recapitalisation Fund, the government has invested £37 billion into RBS, HBOS and Lloyds TSB (the latter two now merged as Lloyds Banking Group).

In November 2008, the government set up (UKFI) to manage the government’s shareholdings. UKFI also has responsibility for management of the government’s investments in Bradford and Bingley plc and will shortly take over this responsibility from Northern Rock plc.

In January 2009, another package was announced, consisting of £50 billion to purchase corporate debt, and the Asset Protection Scheme, which insures future credit losses. RBS has assets worth £325 billion in the scheme.

The government stated that “[the government] is not a permanent investor in UK banks. Its intention, over time, is to dispose of all investments it is making as part of this scheme in an orderly way.”⁴

This report is divided into 2 sections; the first looks at how the government should act as an investor in the banks with respect to climate change. The second section examines the risk represented by banks’ lending to fossil fuel companies and how they might manage that risk to ensure the long-term sustainable value of RBS.

Section 1

government as an institutional investor

Through UKFI, the government is a majority shareholder in RBS and other banks. This section investigates the environmental and social investment criteria UKFI could reasonably be expected to adopt given current institutional shareholder good practice and the government’s own guidance, policies and views.

UKFI’s objectives

UKFI is effectively an institutional investor as it manages the investments of a large fund on behalf of a beneficiary, in this case the taxpayer. The government and UKFI acknowledge this in its Framework Document⁵ which sets out an Overarching Objective that:

“The Company [UKFI] should, in compliance with the Investment Mandate described in Section 4, develop and execute an investment strategy for disposing of the Investments in an orderly and active way through sale, redemption, buy-back or other means within the context of an overarching objective of protecting and creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. This objective includes:

- A. consistent with HM Treasury’s stated aim that it should not be a permanent investor in UK financial institutions, maximising sustainable value for the taxpayer, taking account of risk;
- B. maintaining financial stability by having due regard to the impact of its value realisation decisions; and
- C. promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions.”

To achieve this aim:

“For these financial institutions, the Company [UKFI] will engage actively with the Investee Company in accordance with best institutional shareholder practice. The Company will (subject to the other provisions of this Framework Document) exercise the rights attaching to HM Treasury’s Investments in these companies, including voting rights.”⁶

The government has also said that it “is not a permanent investor in UK banks. Its intention over time, is to dispose of all the investments it is making as part of the scheme in an orderly way.”⁷ The implication is that the government is just invested for the short-term, and therefore does not have to consider long-term impacts such as climate change. There is a wide divergence of opinion amongst experts as to the outcome of the financial crisis. However, it is clear that there is a great deal of uncertainty over how severe and long-lasting the downturn will be, what the limits of the banks’ losses are, and when or if the government will be in a position to “dispose” of its investments in the banks.⁸ When the investments in the banks are sold, there is no guarantee that they will not fail again.

The government has set a clear precedent and expectation that it will intervene again. Therefore the government’s relationship with the banks as owners or potential owners is effectively indefinite. Even if the relationship does prove relatively short-term, there are sound reasons - set out below - why the government as investor cannot ignore long-term social or environmental implications.

Setting best practice as an institutional investor

As an institutional investor, UKFI has fiduciary responsibilities – it must act in the best interest of its beneficiaries who are the UK taxpayers. This is defined in its Overarching Objective, which specifically refers to “maximising sustainable value for the taxpayer, taking account of risk.”⁹ It is widely recognised that “integrating ESG [environmental, social and corporate governance] considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.”¹⁰

Best institutional shareholder practice is generally considered to include active engagement with management to address strategic risks. The Institutional Shareholder’s Committee Statement of Principles suggests that “instances when institutional shareholders and/or agents might want to intervene include when they have concerns about ... the company’s approach to corporate social responsibility.”¹¹

In the UK, pension funds, the major category of institutional investor, are legally required to report on their policy with respect to CSR issues. Lord McKenzie, the Parliamentary Under-Secretary of State for the Department of Work and Pensions has stated that “It is an obligation on pension fund trustees, not simply a right or option, to state in their Statement of Investment Principles what the fund’s guidelines are on responsible investment and to what extent social, environmental or ethical considerations are taken into account”.¹²

With respect to ESG issues, good practice for institutional investors is defined by the United Nations Principles of Responsible Investment (UNPRI), which has 582 signatories with total assets under management in excess of \$14trillion.¹³ The Principles state that “As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.”

So, at best, by having no environmental or social policy, UKFI is not even following the minimum standards that could reasonably be expected of an institutional investor, and is not properly fulfilling its stated obligation of “taking account of risk”.

Recommendation 1

The minimum standard that UKFI should adopt is in line with standard good practice for institutional investors. It should become a signatory to the UNPRI, and follow guidance as set out in a recent United Nations Environmental Programme Financial Initiative (UNEPFI) report. This would involve the following:

- UKFI should become a signatory to the Carbon Disclosure Project (CDP) enabling UKFI to begin assessing the climate risks of its investments.
- UKFI should be fully transparent about investment strategies pursued, including to what extent such strategies incorporate ESG considerations; it should also clearly state its guidelines on ESG considerations and undertake a periodic independent audit that takes into account ESG considerations. UKFI should seek expert advice on how best to incorporate ESG considerations into investment analysis and decision-making processes.

UKFI should behave as an active owner, incorporate ESG issues into its ownership policies and practices; and seek appropriate disclosure on ESG issues by the entities in which it invests.

By failing to take any of these actions, UKFI is failing to monitor, assess or manage ESG risks which are considered significant risks by mainstream investors. A recent UNEPFI report concluded that:

“it would be expected that the investment consultant or asset manager would raise ESG considerations as an issue to be taken into account and discussed with the client even if the pension fund had not specified ESG considerations as material to the tender. If the investment consultant or asset manager fails to do so, there is a very real risk that they will be sued for negligence on the ground that they failed to discharge their professional duty of care to the client by failing to raise and take into account ESG considerations.”¹⁴

However, UKFI, representing the taxpayer’s investment, should go much further than standard good practice for a number of reasons.

Firstly UKFI is not a standard institutional investor: UKFI invests on behalf of the taxpayer to “maximise sustainable value for the taxpayer, taking account of risk.” The theory of the Universal Investor is well established, namely that a large institutional investor, such as a pension fund, is invested long-term in a wide diversity of assets, so that any externality caused by one company will impact the economy as a whole, and hence the investor’s other assets.¹⁵ This argument is much stronger in the case of UKFI which has to maintain sustainable value for the taxpayer. It has been shown, most comprehensively by HM Treasury’s Stern Review ¹⁶, that the damage to the economy caused by unmitigated climate change will be considerable. In financing a company which contributes to climate change, UKFI is causing damage to society and the economy, the cost of which is borne by the taxpayer. The implications of this are elaborated on further in section 2 below.

Secondly the government’s own spending criteria, set out in the Green Book¹⁷, states that “All new policies, programmes and projects, whether revenue, capital or regulatory, should be subject to comprehensive but proportionate assessment, wherever it is practicable, so as best to promote the public interest.” It goes on to say that “There is a wide range of

generic issues that may need to be considered as part of any assessment ... [including] Environmental impacts – The effects on the environment should be considered, including air and water quality, land use, noise pollution, and waste production, recycling and disposal.” The Green Book also includes a number of social criteria on its spending decisions, such as equality, health and safety. It can be argued that these criteria apply to significant decisions by UKFI, as well as to the initial establishment of the company.

Beyond the specific confines of the Green Book, the government is bound by a range of social and environmental obligations, policies and commitments. These include limiting global warming below 2°C, promoting human rights and realising the UN Millennium Development Goals. If a company in which the government is by far the largest shareholder is engaging in activities that undermine these aims (see Box 1 for an example), the government has a duty to intervene. This is very much the approach taken by the Norwegian government Pension Fund (see Table 1).

Lundin Petroleum

*Box 1
RBS client
activity
contrary to
the UK Gov-
ernment’s
policies*

In October 2007, RBS underwrote loans of \$1 billion for Lundin Petroleum. The Sudan Divestment Task Force (SDTF) has classified Lundin in its Top 5 “Highest Offenders”, for its direct support for the Sudanese government during the continued ethnic cleansing in Darfur. Lundin was exploring for oil in Block 5B in south Sudan, together with Sudapet, the Sudanese national oil company, which is part of the regime. Human Rights Watch and Christian Aid asserted that, if not complicit, the company enabled Sudanese military operations against local civilians, including the clearing of villages and widespread rape. 83 MPs signed EDM 1338 in support of Sudan Divestment UK, while MEPs managed to divest the European Parliament’s pension holdings from Petrochina (also active in Sudan).

Thirdly, the government has itself introduced measures designed to better enable company directors to take account of social and environmental performance in delivering long-term benefit to shareholders in the 2006 Companies Act. The traditional view – that companies must only act in the interests of achieving profits – was rejected as out-dated and unethical by the Act. Instead, the government put in statute an approach to corporate

governance based on what they termed “enlightened shareholder value”. Margaret Hodge, the Minister in charge of shuttling the legislation through Parliament, explained that:

“...There was a time when business success in the interests of shareholders was thought to be in conflict with society’s aspirations for people who work in the company or in supply chain companies, for the long-term well-being of the community and for the protection of the environment. The law is now based on a new approach. Pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones.”

Specifically, the 2006 Companies Act spelled out in statute for the first time that in discharging their duties to shareholders, company directors must consider the impacts of their decisions on employees, the community and the environment, and that their decisions should look to the long-term impacts on the company and its reputation (see Box 2). In fact, Alistair Darling, now the Chancellor, noted at the time that:

“For the first time, the Bill includes a statutory statement of directors’ general duties. It provides a code of conduct that sets out how directors are expected to behave. That enshrines in statute what the law review called “enlightened shareholder value”. It recognises that directors will be more likely to achieve long-term sustainable success for the benefit of their shareholders if their companies pay attention to a wider range of matters... Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so they will have to have regard to a wider range of factors, including the interests of employees and the environment”.

Box 2: 2006 Companies Act, Part 10, Chapter 2, Clause 172 “Duty to promote the success of the company” “A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to – the likely consequences of any decision in the long term,

the interests of the company’s employees, the need to foster the company’s business relationships with suppliers, customers and others, the impact of the company’s operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of the company.”

In essence, while the underlying duty of Directors remains the same as it has been – to act in the interests of its members – the way in which companies discharge this duty is fundamentally different. This Act tells us that the duty is fulfilled only when companies consider the wider impact they have on society and the environment. The Act requires larger companies to report on these matters where they constitute potential material risks. With taxpayers as the primary shareholder in RBS, the directors have a particular need to consider these issues in how the company’s actions create ‘benefit’ for its members. And as the company responsible for managing the taxpayers’ shareholding in RBS, UKFI bears a unique responsibility for driving behaviour and decision-making within the bank that lies in accordance with the long-term interests of the taxpayer.

Finally, the government’s own view on institutional investors has been clear and critical. In 2001, HM Treasury published a review which was broadly critical of the governance practices of most institutional investors. Recently its author, Paul Myners, now the government’s Financial Services Secretary, reiterated its conclusions:

“As you are only too well aware, market pressures and the structure of corporate share ownership present major challenges for shareholder engagement...The focus of an “owner”, with an emphasis on creating long-term value, does not sit comfortably with the commercial pressures on an “investor” obliged to produce short-term returns... Institutional investors are expected to exert the influence and exhibit the values of “owners” but are incentivised to behave as “investors”, with performance scrutinised on a quarterly, monthly or even a daily basis...

“The picture I paint is one that has led us in the direction of what I have characterised as “the ownerless

corporation”, reflected in fragmented share registers and inconsistent investor engagement... Any change that will lead to fund managers behaving more like “owners” and less like “investors” will have to come from the end client... Short-termism, as practised by pension funds, is self-defeating for those charged with delivering pensions over many decades in to the future, and yet it remains a predominant form of behaviour...

“A focus on “shareholder value”, as measured by relative share price performance over quite short time periods lies at the heart of a number of behaviours which have delivered less than ideal outcomes, such as... A failure to take account of the longer-term consequences of investment activity, including impact on the broader economy and society.”¹⁸

In summary, the government should set goals and objectives for the companies that it owns through UKFI to provide long-term incentives for responsible investment that will protect shareholder value (where the shareholders and taxpayers are the same). On 22 June RBS announced its £9.6 million pay package for Stephen Hester, the Chief Executive of RBS, with the backing of UKFI, much of it linked to “long-term” share price targets over a 3 year time period.¹⁹ But UKFI has not, to our knowledge, asked for any information or incentives relating to long-term value (unless a 3 year time frame can be considered long-term) or “impact on the broader economy and society.”

So what standards could we reasonably expect of UKFI’s management of the recapitalised bank shares? Best practice in this field has been established by a number of large institutional investors, a selection of which are summarised in Table 1.

The pension funds listed in Table 1 are all large institutional investors with a track record of many years, and are often seen as leaders amongst their peers. None of these investors believe that ESG considerations are detrimental to the funds’ performance, and instead see them as core to the long-term financial performance of the companies in which they invest. Responsible Investment practices do not involve interference in the day-to-day running of investee companies, but involve setting the correct incentives, time-frames and boundaries in which the company operates. Examples of responsible engagement by one of these pension funds are described in Box 2.

[Universities Superannuation Scheme \(assets under management £29 billion\)](#)

The Scheme’s approach to responsible investing is one of engagement, not exclusion and USS aims to work with companies and managers to encourage responsible corporate behaviour based upon the belief that: Management of such issues is good for long-term corporate performance and Better management of these issues protects and enhances the value of the fund’s investments.

[Environment Agency Pension Fund \(assets under management £1 billion\)](#)

The increasing popularity of responsible investment stems from a growing recognition by investors that good ESG practices can benefit the financial performance of companies, particularly over the long-term. This may be because investors who are aware of all these factors are better placed to manage risk – and thus to seize opportunities to increase financial returns.

[APG Group \(assets under management £1.205 billion\)](#)

APG believes that systematically taking environmental, social and corporate governance considerations into account can contribute to better investment decisions. As we explain below, it is clear that these issues impact the financial performance of many of the companies we invest in. By embedding responsible investment in its investment policy, APG helps pension funds not only to fulfil their ambitions in relation to social responsibility, but also to meet their long-term financial targets.

[Norway Government Pension Fund \(assets under management 87 billion Kroner\)](#)

Folketrygdfondet [the pension fund manager] has defined ethical principles as an integrated part of the management effort, in order to promote long-term value creation. As a major investor in the Norwegian stock market, Folketrygdfondet attaches considerable weight to acting as a responsible and predictable owner. It has therefore prepared a set of fundamental ownership principles.

Table 1 A selection of investors’ Responsible Investment Policies

Box 2

Examples of active engagement by APG²⁰

Measures against child labour at CVS Caremark
“We investigated accusations of involvement in child labour aimed at companies including the US multinational CVS Caremark. The company, which had already been convicted in 2007 in connection with child labour, informed us that it had an arrangement with the US Labour Secretary, in which managers and young people receive training on what work the latter may and may not do. Parents were also informed, and measures were taken to avoid irregularities in the future. The steps taken give us confidence that the company will not overstep the rules again.”

Child labour in cocoa production

“In 2008, APG launched an investigation into companies that use cocoa from Ghana and Ivory Coast in their products. We want to encourage companies to take joint action to fight child labour. Although this has been a hot topic for years, companies are by no means making the most of the opportunities to prevent children from becoming recruited into cocoa farming. For these companies, reports in the media of involvement in child labour pose a real risk to their reputation. Collaborating with a Scandinavian investor, we entered into talks with the key players in the sector to find a structural solution.”

UKFI is not a typical institutional investor as it is a very large shareholder in only two companies as opposed to being a small shareholder in many companies. It therefore cannot actively manage its portfolio, by investment and disinvestment. However, much of the focus of the pension funds described in Table 1 refers to engagement with companies and not to (dis)investment, and is therefore applicable to UKFI. It also follows that as UKFI is a significant shareholder in its investee companies, its engagement will carry much more weight than a normal institutional investor.

Recommendation 2

As an active owner, UKFI must engage effectively with RBS management. RBS is predominantly a retail bank with a large public-facing presence which places great importance on brand and reputation. These have been significantly tarnished by the bank's collapse and public anger over executive pay. The bank's ethical performance may be affecting its long-term value, and

this is likely to continue without active ownership, as there is no other impetus for the company's culture to change. At the very least UKFI should request that the board of RBS commission an external advisor to report on the company's ESG performance and how this could be improved. UKFI should also engage actively with RBS on the following issues:

Providing incentives for long-term, sustainable behaviour. Executive pay should be linked to the companies' long-term performance, for example through company bonds and equity held in escrow accounts for directors and released after 10-20 years. It could also be linked to the bank's environmental and social performance. This would contrast significantly to the Executive pay that has actually been awarded.

All lending over a certain level should be screened on environmental and social criteria. Companies that the bank lends to must be subject to an independent audit on environmental and social criteria so that they meet basic government environmental and human rights criteria.

A board member should be appointed with specific ESG responsibilities. This would help place ESG decision-making at the centre of company policy.

UKFI should request reports both from the RBS Board and an independent consultant investigating “sustainable” banking models. A number of banks are considered to be “sustainable” banks (see box 3). The larger banks such as HSBC and Standard Chartered that survived the financial crisis have started to adopt sustainable practices. RBS should aim to be a leader in applying such practices, where appropriate, to a high-street bank.

Box 3
 “Sustainable” Banks

Triodos Bank

“Triodos Bank can claim to be the world’s most sustainable bank. Winner of the Financial Times Sustainable Bank of the Year Award in 2009, Triodos offers a pioneering banking model and the inspiration for a genuinely sustainable financial future. Crisis-resistant, genuinely transparent and only lending to and investing in organisations that benefit people and the environment, Triodos is unlike any other commercial bank.

“Established in 1980 in The Netherlands, with a UK office following in 1995, Triodos Bank enables money to work for positive social, environmental and cultural change.

“Triodos offers a comprehensive range of banking services for social businesses, charities and groups along with a variety of savings accounts for individuals. It is a public bank with thousands of customers and shareholders. Our principles and independence are guaranteed through a special share-holding trust which protects the social and environmental aims of the bank. We have offices in the UK, Belgium, Spain and The Netherlands as well as an International Development Investment Unit which finances fair trade and microfinance in developing countries.”

The Co-operative Bank

“The Co-operative Bank’s Ethical Policy is based on extensive consultation with customers and reflects their ethical concerns surrounding how their money should and should not be invested. It also informs The Co-operative Bank’s choice of partners and suppliers. The policy covers the following issues: Human Rights, The Arms Trade, Corporate Responsibility and Global Trade, Genetic Modification, Social Enterprise, Ecological Impact and Animal Welfare.

“During 2005, The Co-operative Bank turned away some 30 businesses whose activities were in conflict with their customers’ ethical concerns. As a result, income worth some £10 million was denied to the Bank. At the same time, significant monies were directed to businesses whose activities were supportive of the Bank’s customer’s ethical priorities.”

The lending risks of climate change

Section 1 identified the need for UKFI to take an active ownership approach to its investments with respect to environmental, social and governance issues. This would be in the interests of the taxpayer and be consistent with best practice which has been developed over a number of years by institutional investors. Active ownership will both improve the long-term sustainable value of RBS and enhance its positive contribution to society as a whole. These are symbiotic, not mutually exclusive, objectives.

This section concentrates on lending risks with respect to climate change, as it is the major environmental threat identified by the government. It is also an issue on which RBS has been specifically and heavily criticised. The fossil fuel-related activities of RBS’ clients represent a risk to the long-term value of the company, and will potentially impact the taxpayer-shareholder.

RBS is currently a leading financier of the fossil fuel and carbon intensive industries which contribute to climate change. In practice, much of the risk associated with these industries is borne by society and hence the taxpayer. However UKFI’s objective is to “maximising sustainable value for the taxpayer, taking account of risk”. From the taxpayers’ viewpoint, risk would be reduced if fossil fuel investments were phased out in a managed way based on carbon intensity, while investment supporting the low carbon economy should be increased. This is not only true of environmental risk, but also of economic risk, as described in HM Treasury’s Stern Review.

Background on climate change

The evidence, cause and consequences of climate change have been well documented elsewhere. The reader is referred to, for example, the latest Intergovernmental Panel on Climate Change Assessment Reports.²¹ Of particular relevance to this report, are the following:

It has generally been agreed that an increase in global temperatures of more than 2°C is “dangerous”, and that emissions should be reduced to avoid this level of warming. This can only be achieved if global emissions peak by 2015.

The government’s own emissions targets are 34% reductions by 2020 and 80% by 2050²². A recent letter from the Committee on Climate Change, the body that advises the government on setting carbon budgets, concluded that because of aviation emissions, the cut of greenhouse gas emissions from other sectors would have to be 90% by 2050²³.

A recent paper²⁴ estimates that to have just a 25% probability of limiting temperatures below 2°C will require total emissions in the fifty years between 2000 and 2050 to be constrained to no more than 1,000 Gigatonnes of CO₂, of which the world has already burnt a third (in less than 10 years). To achieve this target would mean limiting future emissions to, at most, a further 667 Gigatonnes. This has been estimated as equivalent to burning just 22% of current fossil fuel reserves.²⁵

A recent report from PLATFORM²⁶ found that embedded emissions from project finance attributable to RBS was 44 M tonnes of CO₂ in 2006, greater than Scotland’s national emissions. However, most of these projects were in collaboration with other lenders and the total annual emissions from these projects was 825 M tonnes of CO₂²⁷, significantly more than the UK’s total direct emissions and 3% of global emissions. So, through its ownership of RBS, the government potentially has a larger influence on global carbon emissions than it does through all domestic activities.

The Stern Report made it crystal clear that a ‘business-as-usual’ model of managing the economy would lead to the imposition of additional economic costs or to the loss of economic value.

Those findings have been reinforced by the World

Bank’s World Development Report 2010 in which a key message is that “Economic growth alone is unlikely to be fast or equitable enough to counter threats from climate change, *particularly if it remains carbon intensive and accelerates global warming*. So climate policy cannot be framed as a choice between growth and climate change. In fact, climate-smart policies are those that enhance development, reduce vulnerability, and finance the transition to low-carbon growth paths. A climate-smart world is within our reach if we act now, act together, and act differently”

The report goes on to say, “Acting now is essential, or else options disappear and costs increase as the world commits itself to high-carbon pathways and largely irreversible warming trajectories. Acting differently is required to enable a sustainable future in a changing world. In the next few decades, the world’s energy systems must be transformed so that global emissions drop 50 to 80 percent.”

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The social cost of climate change

UKFI's objective is to "maximising sustainable value for the taxpayer, taking account of risk". Climate change represents a significant risk to the taxpayer and the economy as a whole. HM Treasury's Stern Review, one of the most influential reports on the economic impacts of climate change concludes that "In summary, analyses that take into account the full ranges of both impacts and possible outcomes - that is, that employ the basic economics of risk - suggest that 'business-as-usual' policies will reduce welfare by an amount equivalent to a reduction in consumption per head of between 5 and 20%."²⁹

Since initial publication of the Stern Review, new research has concluded that "Since the late 1990s, greenhouse gas emissions have increased at close to the most extreme IPCC scenarios, meaning that rates of warming will be faster than most people expect."³⁰ This conclusion is supported by a recent report from the Hadley Centre which found that warming of more than 4 degrees centigrade could happen within the lifetime of many taxpayers. Such a high level of warming could have extreme consequences, such as the Arctic warming by 15°C³¹. Stern himself has acknowledged that his report was based on the 'understated' conclusions of the IPCC³². The cumulative message of recent research is that the accelerating pace of climate change is likely to mean that the negative impact on consumption will be more, not less, significant.

In assessing the economic costs the Stern Report goes on to make it clear that "Much (but not all) of the risk can be reduced through a strong mitigation policy, and we argue that this can be achieved at a far lower cost than those calculated for the impacts. In this sense, *mitigation is a highly productive investment.*"

A business model that is based on unfettered investment in and support for fossil fuels needs to be recognised for what it is - a model that will increase the risks of reduced economic activities and one that chooses not to maximise the benefits of investing in mitigation.

The reason that financing the exploitation of fossil fuels is currently profitable and low risk for a bank is that the risks of climate change are currently externalised. Neither the bank nor the fossil fuel company has to pay the full costs of the damage (current or future), or directly face the risks caused by burning fossil fuels. The costs of adapting to the impact of climate change are borne by the taxpayer – for example, through increases in the cost of flood defences or extra storm damage. The transfer of ownership of RBS to the taxpayer effectively means that, in the case of RBS, these 'external' costs from lending activity into the oil, gas and coal sectors are no longer carried by a third party. Shareholders/taxpayers will have to face the cost and risk from climate-damaging investments unless steps are taken to factor them into RBS' decision making process.

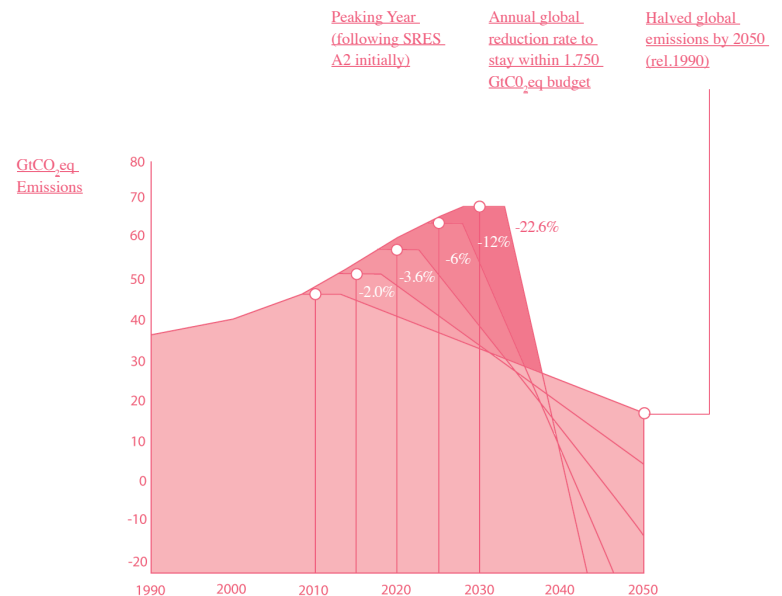


Figure 1 Annual global emissions reduction rate to stay within 2°C³³

The risk and cost caused by burning fossil fuels is socialised since the cost falls on society and ultimately the taxpayer. This social cost of carbon has been estimated by, for example Stern (2006)³⁴, to be \$85 per tonne of CO₂, compared to the current price in the Emissions Trading Scheme (ETS) of \$19³⁵. The fossil fuel company pays the first \$19 of the damage caused by emissions, whereas the taxpayer ultimately faces the cost of the remaining \$66.

From the taxpayer-owner's point of view, investment or lending decisions for both fossil fuel projects and renewable energy projects should be based upon the social cost of carbon, as the taxpayer is effectively bearing the extra cost. Needless to say, this would make fossil fuel lending much less attractive and lending decisions to renewable and clean technology projects much more attractive. As part of its UK Low Carbon Transition Plan, the government has recently adopted new guidance on the valuation of carbon which suggests a shadow price of £70 per tonne of CO₂ by 2030 and £200 by 2050³⁶. It is inconsistent, and not in the interests of taxpayers as shareholders, for UKFI and RBS to use a lower carbon price in assessing risk than that set in the government's guidance.

Risk from climate change to taxpayer as RBS shareholder

To significantly reduce the risk from climate change, drastic action is required. Figure 1 shows that global emissions need to peak before 2015, otherwise it will become virtually impossible to avoid warming of 2°C. Even if global emissions peak by 2015, in 6 years, annual reductions thereafter of 3.6% will be required. This compares to the UK's emissions (including embedded emissions) increasing by 19% since 1990³⁷. The scale of the challenge is daunting – we will have to achieve a low carbon re-industrialisation three times as great as the industrial revolution³⁸. To achieve this revolution the government will, without delay, have to make effective use all of the tools available.

Whilst it is growing, current investment in low-carbon industries is much lower than required to meet the government's carbon reduction targets. A report by Ernst and Young concludes that £234 billion of new investment by 2025 is required to meet the UK's energy goals. Of this, approximately £169.8 billion³⁹ will need to be invested in clean energy (Table 3). The government estimate that £100 billion will need to be invested in renewable energy⁴⁰. This compares with the current asset base in the *entire* energy supply industry of £62 billion⁴¹. Venture capital investment in renewable energy in the UK was only £74 million in 2008 (£240 million in 2007)⁴².

Renewable generation capacity	112.5
Transmission and distribution	28.2
Smart metering	13.4
Carbon emission reduction target/Supplier Obligation	15.7
Total	169.8

Table 3 Required investment in clean energy to 2025⁴³

Annual investment will have to increase by an order of magnitude to achieve the UK's clean energy targets. The global picture is similar – investment in renewable energy was \$155 billion in 2008⁴⁴, compared with estimates of required investment ranging from \$500 billion⁴⁵ to \$1 trillion per annum⁴⁶. So both in the UK and globally there is a considerable funding gap to fulfil the required scale up of clean energy technologies and infrastructure.

The government is legally obliged to oversee a massive growth in renewables and clean technology. For example, in 2007, renewables accounted for approximately 5% of the UK's energy supply⁴⁷ whereas the government's target is for this to grow to around 30% by 2020⁴⁸. Similar growth could be expected in low-carbon transport and energy efficiency to meet the government's targets.

Why does a funding gap exist when the government has set legally-binding targets for emissions reductions which could be expected to lead to spectacular growth in these sectors?

For a project to be investible, a financier will consider the risk/return profile of an investment; if the risk is perceived to be high, then the cost of finance will increase, making the project uneconomical. On this basis, renewable energy and clean technology investments can appear high risk as they are often relatively new technology and rely on specific policy intervention to make them profitable. For example, offshore wind requires appropriate power purchase agreements, timely access to the national grid and sufficiently-priced renewable obligation certificates.⁴⁹

This policy uncertainty is perceived as an extra risk. However, from RBS' perspective, this risk is in the control of RBS' majority shareholder and could be promptly reduced by engaging in a dialogue with its owner.

In contrast to renewable and clean tech investments, the financing of fossil fuel companies arguably represents a higher risk to RBS. If the government's ambitions for averting dangerous climate change are credible, then RBS' heavy exposure to the fossil fuel sector will represent a significant credit risk to the company.

As an active owner of RBS the Treasury, or UKFI acting on taxpayer's behalf, has a duty to intervene on this issue to protect the long-term sustainable value of RBS. By taking no action to manage the risks associated with fossil fuel lending, RBS is acting as if the government's climate policy is not credible, which is clearly inconsistent with the government's controlling interest in the bank through UKFI. Furthermore it encourages other business interests to draw similar conclusions about the credibility of climate change and low carbon policies, which in turn undermines the government's ability to deliver them.

Reputational risk

RBS is highly exposed in the fossil fuel sector, and this represents both a reputational and a regulatory risk to the long-term value of the business. RBS has described itself as "The Oil and Gas Bank" and is considered a leader in the field. Between May 2006 and April 2008, it was involved in loans to the coal industry worth \$95.83 billion (of which RBS's share was estimated to be \$15.93 billion)⁵⁰, and between 2001 and 2006, RBS lent over \$10 billion in loans to the oil and gas sector, along with structuring loans on over \$30 billion of projects⁵¹. Whilst investments in renewable energies are much smaller than those in non-renewable energies it is worth noting that RBS is a relatively large investor in this sector, claiming to have invested £2 billion in renewable energy projects in 2006⁵². The existence of significant in-house capacity in assessing and supporting the renewables sector is an asset which should not be overlooked.

RBS is predominantly a retail bank with a large public-facing presence which relies on brand and reputation. RBS' public reputation has already been highly damaged by its collapse and subsequent bail-out with public funds, along with widespread publicity over the pay of the board members who oversaw the collapse⁵³. It is therefore not well placed to face a high profile public campaign over its lending to fossil fuel companies, highlighting concerns over the global impact that its lending has

on climate change, or the poor human rights, environmental and governance records of many of the companies it lends to (see Box 4).

*Box 4.
Questionable
practices of
fossil fuel
companies
financed by
RBS*

Arch Coal

In October 2006 RBS participated in an \$800 million revolving credit facility for Arch Coal. Arch Coal is the second largest coal producer in the US, and owns a number of mountain top mines in the Appalachia region. Its use of Mountain Top Removal (MTR) has attracted high levels of controversy and criticism. Arch Coal has been accused of responsibility for the disappearance of 300,800 acres of biologically diverse hardwood forest through MTR. In the US, the Bank of America has adopted a policy to end finance for mining companies engaging in MTR.

Tullow Oil

In March 2009, RBS was part of a consortium of 14 banks that lent \$1,890 million to the Irish company Tullow Oil - providing in the region of \$100 million itself. The bank had already helped raise £402 million by placing shares for Tullow in January. Tullow Oil's operations on the border between the Democratic Republic of Congo and Uganda are taking place in a region where resource-driven conflict recently displaced 30,000 people, adding to the existing 1.4 million internally displaced people in the region.

<u>Company:</u>	<u>Proved oil/NGL reserves (millions of barrels)</u>	<u>Proved Natural Gas reserves (billions of cubic feet)</u>	<u>Proved and Probable coal reserves (millions of tonnes)</u>	<u>CO₂ emissions from burning reserves (millions of tonnes)</u>
PDVSA	77,500	150,000		42,535
Gazprom	19,959	1,051,708		71,908
Qatar Petroleum	15,200	900,000		60,723
Rosneft	14,448			6,247
Shell	10,903			4,714
Exxon	10,135	65,879		8,346
Chevron	7,350	23,075		4,566
Conoco Phillips	5,817	29,948		4,317
Total	5,695	26,218		4,040
OXY	2,979			1,288
BG	2,459			1,063
Repsol	2,404			1,039
Cairn Energy	240			104
Arch Coal			2,540	24,982

Table 2⁵⁵ Reserves of largest companies that RBS has lent to:

Regulatory Risk

RBS is a major lender to the fossil fuel sector and this could potentially represent a credit risk to RBS if either regulatory or fiscal measures are widely used (following global agreement to pursue emissions reduction) to reduce the use of fossil fuels, or if the activities of the companies that RBS finances are directly curtailed to such an extent that they can no longer service their debt to RBS.

RBS has itself identified credit risk as of major importance in its response to the Carbon Disclosure Project:

“In our view the impact of climate change on credit risk - either directly or indirectly - is potentially the most serious financial risk for our business arising from climate change. Material risks to the business models of customers arising from climate change include regulatory risks, physical risks, changes to purchasing patterns and consumer rejection of less efficient products and services. Our ability to assess the impact of climate change on credit risk for corporate and commercial loans will become increasingly important in the future.”⁵⁴

Fiscal and regulatory policies to reduce fossil fuel consumption, as well as technical efficiency regulations, would be a credible response by governments to the adoption of more stringent greenhouse gases emissions targets. Insofar as such measures reduce fossil fuel usage or make it more expensive through taxation, they will reduce the profitability of many businesses in the fossil fuel industries. In turn this could impair such businesses’ capacity to service loans from RBS. It is also possible that measures to directly curtail the exploitation of fossil fuel reserves may be adopted. Insofar as such measures do not result in proportionate price increases in fossil fuels, they may have a similar effect on the future value of fossil fuel companies.

Table 2 shows the proven reserves of a few of the fossil fuel companies that RBS has lent to.

Proven reserves represent the reserves that these companies are certain to be able to extract. In fact, the expected reserves of these companies may be many times greater than proven reserves and these play a key role in the valuation of fossil fuel companies. The ability of these companies to repay debt partly depends upon them being able to extract and sell their reserves, unless they can switch out of these industries into other industries.

The importance of reserves was illustrated in January 2004 when Royal Dutch Shell announced that it had over-reported its proven reserves by approximately 25%. This has been described as ‘the worst crisis’ in the company’s hundred year history⁵⁶ - its share price plunged 8%, wiping £3 billion off Shell’s value within an hour of trading on the London Stock Exchange⁵⁷.

And herein lies the contradiction; the UK government is committed to limiting temperature increases to below 2°C and to achieve this aim the world must emit no more than a further 667 giga tonnes of CO₂ by 2050. Yet if only those companies in Table 2 burnt of all their proven reserves, that alone would represent 35% of the world’s remaining carbon budget.

To put it bluntly, the world can burn no more than 22% of total proven fossil fuel reserves by 2050⁵⁸, and little if any more thereafter. It is therefore true that most of the world’s reserves, and those of the companies above, will have to stay in the ground in order to keep global warming below 2°C⁵⁹. How this is achieved is a matter of policy, but the most credible tools will inevitably reduce the long-term value - and therefore the ability to service debts - of these fossil fuel companies.

It is unlikely that the value of these fossil fuel companies could be maintained by simply raising the price of their reduced reserves. Oil prices are affected by numerous factors, but crucially it is demand for oil that is shifting and will be affected by policy. British Petroleum chief executive Tony Hayward commented in early June 2009 that as the oil price went over \$90 consumers “began to change their behaviour”⁶⁰. Recent research by Peter Hughes, who spent much of his career with BP and British Gas and is now Director of Global Energy for leading management consultant Arthur D Little, shows that “we may be closer than most people currently believe to a ‘tipping point’ which would see long-term downward pressure on the demand for oil and oil products”⁶¹. Driving this change are the coalescing policy incentives to avoid volatile prices, ensure security of supply, and avert the worst affects of climate change. As previously noted, policy measures to significantly curb carbon emissions will be accompanied by policies supporting alternative energy growth, which will simultaneously curtail demand for fossil fuels.

The risk from RBS’ perspective is that its clients will face falling demand for their products, and/or not be able to utilise the vast majority of their reserves or continue with their carbon intensive activities which increases the risk that they will be unable to service their loans.

Recommendation 3

The cost of damage caused by climate change is only partially borne by fossil fuel companies through the carbon price, the vast majority will ultimately have to be paid by the taxpayer who is also the owner of RBS. Therefore, RBS should use the government’s estimate of the ‘social cost’ of carbon to assess the risk/reward profile of potential funding decisions. This would result in reduced lending to fossil fuel companies and projects and increased lending to renewable energy and into the low-carbon economy. Additionally, much of the perceived risk of investing in renewable energy projects is caused by uncertainty over policy, which is lessened for RBS as this policy is controlled by RBS’ major shareholder. RBS, in consultation with UKFI, should:

1. Set targets for reducing emissions from its lending portfolio, and monitor and audit those reductions.
2. Allocate responsibility for climate change policy to the board and senior management.
3. Develop a revised investment mandate drawing on expertise and guidance from independent sources and best practices in the financial sector to identify which activities should not be funded in future.

Conclusions

There is a clear case for UKFI to engage actively with the Board and management of RBS to ensure effective consideration and analysis of environmental, social and corporate governance issues. UKFI should pursue higher standards than industry good practice because it is representing the wider interests of taxpayers, and defending the credibility of government policy and its own UK Low Carbon Transition Plan.

A credible low carbon strategy for the UK would require the substantial economic risks of the fossil fuels sectors in which RBS is heavily involved to be internalised. This would represent a serious financial risk to companies in these sectors. To manage these risks and protect the shareholder/taxpayer, RBS should, in consultation with UKFI, adopt a strategy to reduce exposure to such investments.

There is a sound business case for RBS to initiate a transformation into a sustainable bank. For RBS’ owners - the government and taxpayers - there is an imperative to assess the risks and opportunities involved and to act as responsible, engaged owners in driving such a transition.

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