Joint Submission to the Economy, Energy and Tourism Committee Banking Inquiry

Friends of the Earth Scotland, Banktrack, People and Planet and the World Development Movement welcome the opportunity to make a joint formal submission to the Economy Energy and Tourism Committee's Banking Inquiry.

1. What is your view on the cause, nature and impact of the recent difficulties in the financial sector in Scotland?

We believe the fundamental causes of the banking crisis are twofold. First, a systematic failure of risk assessment and management in the financial sector. Second, the failure of the shareholders of financial institutions to exercise effective and strong governance as active owners, allowing the concealment of risk through repackaging in financial derivatives.

It is therefore of grave concern that at present there remains a systematic failure of risk assessment and management with respect to social and environmental risks – notably those associated with climate change, which have the potential to be transformed into highly significant financial risks much sooner than widely understood. There is also a continuing failure of governance, even amongst the largely public-owned banks where one would expect to see tax-payers' interests represented effectively by UK Financial Investments (UKFI).

It must be noted that active engagement is not just good investor practice, it is Government policy. 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. Moreover, 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 – and in this case shareholders and taxpayers are the same.

3. What changes can be expected as part of the ongoing and future restructuring plans in the financial services sector within Scotland?

We do not expect the restructuring plans to address the emerging risks associated with environmental factors such as climate change. For instance we are not aware of any plans to improve the procedures of project appraisal which might lead to a welcome shift in the availability of project finance away from environmentally damaging projects such as coal-fired power stations or tar-sands exploitation, and towards renewable power and energy efficiency. The UK Government arrangement with EIB, RBS, Lloyds and BNP to increase the availability of loans to on-shore wind development is an example of what needs to happen at a much larger scale, and without the financial leadership of the EIB.

4. How might these changes affect the business and retail banking market in Scotland, access to project finance, a reduction in competition on the 'high street' for lending, the plans for the retention of functions and 'headquartering' etc and what can the public sector in Scotland do to ensure the best possible result for Scotland?

As noted above, access to project finance for renewable and decarbonisation projects in Scotland will remain constrained and challenging. The main tools to affect this issue are in the hands of the Treasury and UKFI, but the Scottish Government should be taking a much more proactive stance on the matter.

7. What are your views on the current efforts across the public sector in Scotland to respond to the recent difficulties in the financial sector in Scotland and what, if anything, needs to change in the future as the situation develops?

Public agencies based in Scotland and London have been too quick to endorse bail-out packages designed simply to restart lending without any analysis of whether that lending will be in the broader public interest. As with the 'cash for clunkers' scheme to stimulate car purchase, a focus on quantity rather than quality has failed to reap long-term benefits. Worse, in the financial sector it has largely failed to restart lending to SMEs and householders.

The Scottish Government should be taking a much more proactive stance to seek the transformation of parts of RBS into a 'green investment bank' to finance the transition to a low carbon economy in Scotland and elsewhere through increased lending on energy efficiency, home improvement and renewables development amongst others.

Scotland needs a financial sector which matches up to its ambitions for a low carbon economy, one that can support the just transition of carbon-intensive business, as well as delivering finance to support low-carbon innovation.

To deliver this requires the Government and UKFI, as an active owner, to seek to transform RBS' lending and investment strategy. At 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 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.

Due to the Government's social and environmental policies and obligations, UKFI must go beyond current industry good practice. To achieve leadership and coherence with Government policy requires the following:

- 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.
- 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.

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.

9. How should Scotland differentiate itself and promote itself as a financial services centre in the future and what steps are being taken by our competitors in this respect?

The opportunity to host a low-carbon finance centre should not be missed. The partial transformation of RBS into a green investment bank could provide the anchor for such a cluster. In the medium term the oil and gas sector cannot provide a specialism for Scottish finance, and a replacement is needed.

Financial institutions are in a unique position to influence greenhouse gas emissions through investment; however current carbon reporting fails to capture this opportunity. Banks and other financial institutions occupy a uniquely powerful position among private companies to influence the course of future global climate change. The financial sector in the UK handles trillions of pounds of finance and investment every year and affects the activities of millions of corporate clients. With this influence, the financial sector has the potential to bring about extremely significant greenhouse gas emission reductions in the economy as a whole. However, this potential influence and impact on emission reductions is not currently captured by banks' environmental management strategies, conventional carbon assessments, or the Government's climate change strategy.

With Scottish leadership on climate change targets, and massive opportunities for investment in renewable energy, cleaner vehicle technologies and improved buildings, this is an opportunity that should be grasped by the Scottish financial sector, with the chance to take a global lead in accountability for influenced emissions. But so far the opportunity is being squandered.

10. How can we ensure that the Scottish financial sector continues to retain a global perspective and does not retreat into a purely localised lending regime?

Given the global need to cut emissions and the expected high growth rates of low-carbon technology, adopting a focus on low-carbon finance would, once again, move the Scottish financial sector into a leading global role.

Attached

We've attached two other reports – the 'Royal Bank of Sustainability' and 'Banking on carbon accountability' for further information and analysis.

For further information contact:
Francis Stuart
Parliamentary Officer
fstuart@foe-scotland.org.uk
0131 243 2701