

Sir Mervyn King
Chairman, Financial Policy Committee
Bank of England
Threadneedle Street
London EC2R 8AH
United Kingdom

Dear Sir Mervyn King,

The Financial Policy Committee (FPC), which you chair, was recently created to, “contribute to the Bank’s financial stability objective by identifying, monitoring, and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.”

As the FPC develops its forward work programme, we urge it to investigate how the UK’s exposure to high carbon investments might pose a systemic risk to our financial system and what the options might be for managing this potential threat to our economic security.

The depth and breadth of our collective financial exposure to high carbon, extractive and environmentally unsustainable investments could become a major problem as we transition to a low carbon economy. Five of the top ten FTSE 100 companies are almost exclusively high carbon and alone account for 25% of the index’s entire market capitalization¹. This exposure is likely to be replicated in other indices, by companies, in bank loan books and in the strategic asset allocation decisions taken by institutional investors. At present regulators are not monitoring the concentration of high carbon investments in the financial system and have no view on what level would be too high.

As policy and technology work consistently over time to reduce returns in high carbon areas while supporting low carbon ones, investing in high carbon sectors, say as an institutional investor looking to generate good returns over a 20 to 30 year period to successfully cover future pension liabilities, could result in stranded assets and poor returns. Counter intuitively, institutional investors, as well as banks, companies, mutual funds and retail investors, continue to risk exactly that by deploying significant amounts of capital into high carbon sectors, or in companies with significant exposure to them. This contradiction was observed in recent *Financial Times* and *Guardian* opinion pieces, one of which was written by the leading economist Lord Stern². This could be another example of our capital markets

¹ FTSE 100, 11th July 2011.

² Caldecott, B.L. (2011) Why high carbon investment could be the next sub-prime crisis. *The Guardian*, 12th July 2011. See: <http://www.guardian.co.uk/environment/2011/jul/12/high-carbon-investment>; Stern, N. (2011) A profound contradiction at the heart of climate change policy. *The*

fundamentally mispricing assets and, as a result, building up a systemic risk that threatens long term growth.

For many investors an exposure to high carbon and environmentally unsustainable assets is not an active or an informed decision. Instead it is frequently driven by the fact that a large proportion of capital must flow into funds that aim to track the main indices. Many investors have little choice but to do this due to liquidity requirements and the desire to track average market performance. Moreover, new regulatory requirements, such as Basel III and Solvency II, can make it more difficult for investors to deploy capital into longer term assets, such as low carbon infrastructure, and simpler to invest in the status quo, even though there might be significant appetite to do the opposite. In such situations we believe that regulators have a role to play in protecting investors from systemic risk.

To understand the extent of the potential problem we need to assess global, and particularly UK and European, financial exposure to high carbon, extractive and environmentally unsustainable investments. While the exposure of listed companies is beginning to be understood³, that of non-listed companies, bank loan books and institutional investor portfolios is significantly less appreciated.

We then need to look at how exposure and relative values, between high carbon and low carbon investments, could change over time and how this might affect different parts of the financial system and the system as a whole. For example, how might a sudden change in relative values be different from a longer period of transition? The purpose of this work should be to evaluate the health, soundness and vulnerabilities of the financial system as we proceed with a low carbon transition.

After these studies are completed, we need to develop a strategy that could manage the challenges that might arise as a result of an over-exposure. If this is indeed akin to a systemic risk in our financial system, what macroprudential instruments might be designed and deployed to help to restrain the build-up of risk? Could we change the risk-weightings used to calculate capital requirements? Could we use different discount factors for high carbon investments? What steps can be taken in each part of the financial system? What is the role of regulators – nationally and internationally? What might we do to create sustainable, low carbon alternatives for investors with the right risk-reward profiles? And how could we predict and manage the risks associated with sudden changes in exposures and relative values?

Given its significance over the long term, we hope that the FPC can incorporate this work into its forward programme, with the appropriate expertise and personnel. There

Financial Times, 8th December 2011. See: <http://www.ft.com/cms/s/0/52f2709c-20f0-11e1-8a43-00144feabdc0.html#ixzz1g1WNryuV>.

³ See: Carbon Tracker Initiative (www.carbontracker.org); Carbon Disclosure Project (www.cdproject.net)

are also a variety of organisations, such as the Carbon Tracker Initiative, Oxford University's Smith School of Enterprise and the Environment, Climate Change Capital, the London School of Economics and Anglia Ruskin University's Global Sustainability Institute, that are working in this area and they would be able to develop collaborative partnerships with the FPC to help enhance resilient low-carbon economic development, as well as reduce systemic risk in the UK financial system.

We look forward to hearing from you and the Committee in due course.

Yours sincerely,

Paul Abberley

Chief Executive

Aviva Investors London and Global Investment Solutions

Peter Ainsworth

Chairman, Conservative Environment Network

Ben Caldecott

Head of Policy, Advisory

Climate Change Capital

Catherine Cameron

Director

Agulhas: Applied Knowledge

James Cameron

Founder and Vice-Chairman

Climate Change Capital

Paul Ekins

Professor of Energy and Environment Policy

UCL Energy Institute, University College London

Zac Goldsmith MP

Member of Parliament for Richmond Park & North Kingston

The Rt Hon. John Gummer, Lord Deben

Former Secretary of State for the Environment

Catherine Howarth

Chief Executive

FairPensions

Dr Aled Jones

Director, Global Sustainability Institute

Anglia Ruskin University

Mark Kenber
Chief Executive
The Climate Group

Sir David King
Director, Smith School of Enterprise and the Environment
University of Oxford

Bernice Lee
Research Director, Energy, Environment and Resource Governance
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Jeremy Leggett
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Solar Century and Carbon Tracker Initiative

Nick Mabey
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Penny Shepherd
Chief Executive
UK Sustainable Investment and Finance Association

Paul Simpson
Chief Executive Officer
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Matthew Spencer
Director
Green Alliance

Dimitri Zenghelis
Senior Fellow, Grantham Research Institute
London School of Economics & Political Science

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