CENTRE FOR CLIMATE ENGAGEMENT
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Tackling sustainability in the finance sector: paradigm change

An expert briefing with David Rouch*

Briefing Highlights:

- A resilient financial system is crucial for well-being, aligning with the aspirations of society and finance staff. However, sustainability challenges pose a threat, necessitating substantial behavioural changes to bridge the gap between aspirations and reality.
- Finance behavior and legal rules are influenced by a complex social dimension, including powerful incentives. However, laws are also created and applied by reference to common mental frameworks, narratives or paradigms.
- Such frameworks significantly shape individuals' self-perception and behavior. Finance frameworks, adapting to include 'ESG' factors alongside financial returns, still inadequately capture the extensive interdependencies between finance and its natural and social surroundings.
- Attention to alternative frameworks is growing – especially those concerning 'sustainable finance' in tackling sustainability threats to economic systemic resilience and the idea that finance operators have a social license to carry on business. A paradigm change is underway.
- From that perspective, even where finance operators' legal duties prioritise financial returns, activity supporting progress towards core positive sustainability outcomes may well be permissible, or even necessary. That said, legal rules often do not limit sustainability-related activity to financial goals.
- Promoting sustainability in finance requires collaboration among stakeholders, including policymakers and civil society. Emphasising economic systemic resilience is crucial to drive action within the finance sector, with more progress required.

CCE Expert briefings

Providing summaries from academic and industry experts on key climate issues, presenting recommendations to inform ongoing industry and policy debates. Drawing on the Centre for Climate Engagement's expertise, these briefings summarise key research findings or the state of knowledge about a particular issue.

*This expert briefing is based on a discussion with David Rouch, a Partner at Freshfields Bruckhaus Deringer LLP and author of *The Social Licence for Financial Markets* (Palgrave Macmillan 2020).

Accompanying resources

More information is available at:

A Legal Framework for Impact report: https://www.freshfields.com/en-gb/our-thinking/campaigns/a-legal-framework-for-impact/

David Rouch's website: https://www.davidrouch.com/

Centre for Climate Engagement website: climatehughes.org

Tackling sustainability in the finance sector

David Rouch is an expert in financial services law and regulation with a longstanding interest in the intersection between finance and positive human outcomes. Environmental and social sustainability have emerged as key themes in his work, especially as issues such as climate change have ushered in broad debates about the role of finance in addressing global problems. The basis on which finance operators engage with core sustainability challenges like global warming is undergoing a paradigm change.

Having co-authored a major Freshfields report, A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making (2021), Rouch has been working with organisations in finance and beyond as they grapple with the relationship between law and practice in this area, for example how far investors are permitted, or even required, to account for sustainability in their decision-making. These specific legal issues capture aspects of broader questions which are explored in David's 2020 book *The Social Licence for Financial Markets* – what aspirations does society have for the role of finance within it, and how can the finance sector become more focused on global challenges so that this purpose is better realised?

Wider purpose of finance

Society's most basic expectations of the finance sector are that it provides reliable and effective products and services, and it is crucial that it remains resilient to do that. There is also an aspiration that it operates to enhance, and not detract from, human wellbeing more widely. These aspirations can seem in tension with common perceptions of financial actors as driven only by financial gain, but Rouch offers a more nuanced perspective: 'Contrary to the public view represented by the 'Wolf of Wall Street' genre of narratives, individuals in the finance sector *do* share overarching aspirations to benefit society.' However, these aspirations are not always especially visible, partly because of the strength of prevailing narratives. Consequently, narrow financial goals often win out, even where legal duties might prompt a broader approach, more aligned with wider aspirations.

Legal structures can also sometimes exacerbate the potential for this divergence. David explains that multidimensional social aspirations for finance can end up being narrowed down when 'mediated through legal structures and rules,' designed to tackle specific societal goals, such as the provision of pensions to retirees. As a result, legal duties can end up prioritising financial goals, so 'editing out' wider goals in way that an individual might not. The operation of rules like this can then feed off, but also reinforce, a perception that near-term profit is the sole aim of financial actors. However, even with legal duties that prioritise financial goals, that may often be a misperception. As David points out, 'there can frequently be significant overlap between the goal of financial value creation and protection and, for example, tackling climate change. Properly understood, legal duties may often be prompting finance operators to consider how sustainability factors threaten the very economic systems they rely on to achieve even financial goals.'

A growing body of climate-related regulation, both in the UK and internationally, has aimed to highlight the connection between climate risks and financial performance. However, it is only just beginning to address the reliance of finance actors on the continuing resilience of economic systems to perform their most basic functions, and what that might mean for their activities today.

Understanding the interdependence of financial institutions and economic systems

Organisations now broadly understand that they may need to adapt their business and investment models to shield themselves and reap potential benefits from climate risks and other 'ESG' issues. However, many may not yet have taken the second important step of unpacking the bigger-picture implications for them of sustainability threats to the economic systems on which they depend. This is an important theme in Rouch's work. Insufficient attention to these interdependencies and collective efforts to achieve core sustainability goals could have severe consequences: 'The economy falls apart, banks fall apart, insurers have uninsurable risks, and pension funds can't generate the sort of finance that they need to pay pensions.'

Rouch continues, 'there is a high level of dependency among financial actors on systems that they themselves are a part of and, because they are a part of them, they also influence the outcomes those systems produce.' Hence the significant legal implications of the connection between environmental, social and economic resilience. The legal duties of finance operators tend to centre on financial performance, though not exclusively so. However, interdependencies such as these make climate change and core sustainability challenges more broadly a relevant factor in discharging those duties in a way that goes beyond the kind of 'ESG' integration mentioned previously. 'People are only just beginning to realise that legal duties may require them at least to consider the wider impact of risks on economic systems,' Rouch explains.

The 'conceptual haze' that surrounds issues related to legal duties and climate change has been hindering progress: 'When you talk about sustainability and climate change people often still think you mean 'ethics' – i.e. sustainability goals as ends in themselves, distinct from financial goals. The apparent assumption that the financial goals of legal vehicles such as pension funds do not have a moral purpose is questionable. However, putting that to one side, it also results in a belief that legal duties prioritising financial goals prevent finance operators from tackling climate change and other sustainability challenges. Rather, they may need to consider whether, for example, unabated climate change is going to damage the systems they rely on for financial outcomes they are required to pursue and, if so, how they may be able to contribute to efforts to address it.'

Addressing climate change through regulation

From high-profile investments into green technologies such as President Biden's Inflation Reduction Act, to technical standards promulgated by groups such as the International Sustainability Standards Board, Rouch says 'there is no question at all' that policy measures impact behaviour in financial markets. Some of the most important interventions are those that set the incentive structures for financial activity, the most obvious example in this context being carbon pricing. However, other forms of regulation target the activities of finance actors more specifically.

Pointing to the Bank of England's work in stress-testing banks' and insurers' exposure to climate risk, Rouch adds that 'much regulator power isn't in their black letter rules but in the supervisory relationship they have with the firms they regulate.'

Although Bank of England surveys and other regulatory communications like 'Dear CEO' letters indicate that many institutions could be doing more to integrate climate risks in their decision-making, in Rouch's view, 'partly prompted by regulation and improved levels of information through such things as the TCFD (Task Force on Climate-Related Financial Disclosures),[1] there has been a reasonable level of attention by many major financial institutions to their vulnerabilities to sustainability risks.'

[1] https://www.fsb-tcfd.org.

A large body of regulation concerns the risk that climate change poses to individual financial institutions, but there is also a growing focus on the impact of institutions on the systemic resilience they require to be resilient themselves. That includes, for example, looking not only at how climate change impacts institutions, but also how these institutions, and those they have financial relationships with, contribute to climate change.

According to Rouch, tackling climate risk 'is now a critical question, especially for institutional investors and pension funds, as some have to generate a return over the next 20, 30 or 40 years and beyond.'

Financial services regulation – driving, or driven by, cultural change?

As to the effectiveness of law in bringing about change, Rouch highlights the symbiotic relationship between law and culture. Although regulation can influence culture, it can't run too far ahead and will not work without societal support. He contrasts UK rules making customers pay for plastic bags in supermarkets, which led to reduced plastic usage because of a preexisting cultural shift supporting the law's goal, to London's Ultra Low Emissions Zone which has seen significant opposition. Rouch emphasises that 'it is important to understand that there are limits to what regulation can do.'

A clear example of regulation changing behaviour in finance firms is the Senior Managers Regime, implemented by the UK's FCA (Financial Conduct Authority) and PRA (Prudential Regulation Authority) in the aftermath of the Global Financial Crisis. This regime defines what each member of senior management in a bank, insurer or asset manager is responsible for doing, and makes it easier for the regulator to hold them to account if something goes wrong. Regulatory reviews suggest that the regime has had a positive impact.

Coordinating approaches to sustainable finance activity and regulation – what's the story?

Government or regulatory intervention can, then, create change in financial activity. However, the relationship between law and wider culture means that it is also important to look at other coordinating mechanisms bearing on, and within, the market. This is particularly important given the international nature of financial markets. While governments appreciate the need for international policy harmonisation, in practice it can be challenging. This adds to the need to harness more fundamental coordinating mechanisms.

Rouch believes that much of the challenge of moving behaviour towards a greater focus on achieving positive sustainability outcomes is in navigating the balance between shorter-term financial goals and the sort of steps needed to achieve longer-term goals, which have both a financial and a wider social dimension. In doing so, he sees a need to 'reorientate perspectives so that finance operators are more aware of how they inhabit and impact the economies and societies they depend on.'

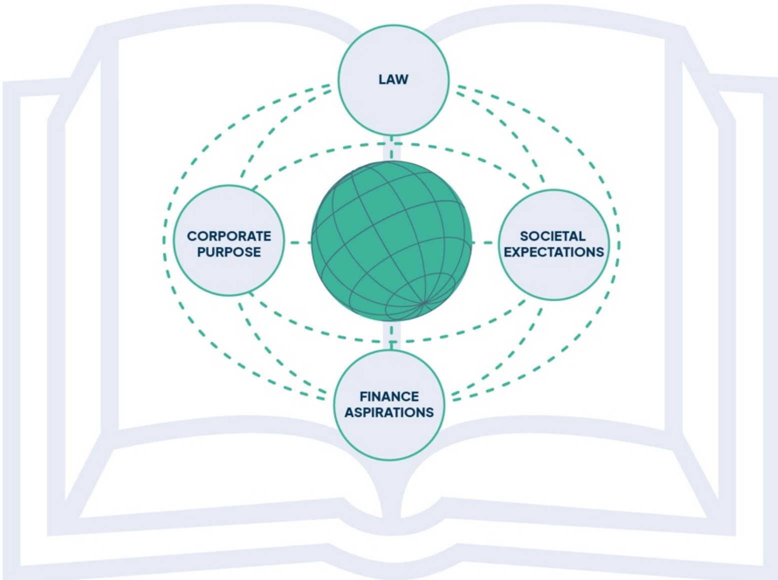
Core to this, Rouch believes, are the mental frameworks, paradigms or 'social narratives' that people bring to bear in making sense of the world around them and navigating through it. 'Mental frameworks have a massive impact on behaviour. In this case, the crucial framework is the switch to understanding financial actors as dependent on economic, environmental and social systems; the health of which is impacted by the financial actors' own activities and those of their clients, counterparties and investees. This way of looking at financial activity is still at quite an early stage but gaining ground. A paradigm change is underway.'

Rouch continues, 'We understand our place in the world and how we should act through stories. Narratives focus people's desires for what they are trying to achieve, their aspirations; they also provide a framework for decision-making in pursuing those desires.' The business world is a highly narrated, highly storied environment. However, he says, 'we need to give greater salience to (not make up) stories that give a better account of the embeddedness of business in healthy social structures and natural environments and the associated values-based aspirations that people have.'

This involves a major re-evaluation, but Rouch sees it in progress: 'When engaging within the markets, I've noticed a clear change in vocabulary, with more discussion than two years ago of "positive sustainability outcomes," meaning "are we doing things that are resulting in real-world positive impacts on the challenge of addressing climate threats?".' Rouch continues, 'This indicates a recognition that ESG integration is not necessarily addressing the underlying risks.' There are signs of a similar change of perspective among policymakers.

Society's role in catalysing a change in mental frameworks

Paradigm change of this sort is a society-wide exercise, recognising that finance staff are themselves part of those societies. Rouch highlights two of the most basic requirements for this kind of change to happen. First, a better understanding of the shortcomings of existing frameworks and narratives that get applied to finance activity. Popular 'Wolf of Wall Street' finance narratives are paralleled in assumptions often made in financial markets, such as the idea of *homo economicus* (humans as completely rational agents only pursuing material self-interest), and similar approaches associated with, for example, the Chicago School of economic thought. While these frameworks can be useful, like any attempt to model reality, they only go so far. Rouch thinks wider society, including NGOs and multi-disciplinary academic communities, can help in highlighting shortcomings: 'Economists, scientists and social scientists have a really important role in casting light on the socially contingent nature of finance, the impact of climate change and similar sustainability threats on finance, and also how existing frameworks don't adequately take account of these.'



Second, there is the process of giving greater prominence to alternative mental frameworks that can usefully supplement existing models. The Legal Framework for Impact report is one such example. It examines whether the law in 11 jurisdictions, including the major investment hubs, requires or permits institutional investors to tackle sustainability challenges: does it allow them to do this where that supports their financial goals and does it allow it as an end in itself? However, in doing so, the report provides a way of working through the interaction between the goals that finance actors are required to pursue by law and their dependence on economic systemic resilience which is threatened by climate change and other sustainability factors.

Another framework is examined by Rouch in his book *The Social Licence for Financial Markets: Reaching for the End and Why It Counts* (Palgrave Macmillan, 2020), building on something that Mark Carney highlighted during his tenure as the Governor of the Bank of England. A licence is a freedom. So, talk of a social licence for financial markets highlights 'how finance actors are given *freedom* to pursue their own interests, but in ways that benefit not just the people carrying on the activity, but also have a positive impact on wider society and serve human wellbeing, with the two needing to be kept in balance.' It draws both on self-interest and wider human aspirations towards people and planet that are common among all people, including finance staff.

Increasing focus on positive sustainability outcomes

In the two years since publication of 'A Legal Framework for Impact, Rouch has observed positive changes, as well as some barriers to change. As noted, for example, there is now a growing emphasis on the contribution of investors to achieving positive sustainability outcomes. There has also been greater attention to the use of corporate and policy engagement in achieving that, going beyond the preexisting focus on integrating ESG factors in investment.

In terms of barriers to further change, he sees a need for greater assurance that courts will understand the higher levels of uncertainty that finance actors work with when tackling sustainability challenges, compared with the more traditional numbers-based financial models that have underpinned much financial activity hitherto. Scenario analysis and theories of change have an important part in this. Rouch also cites the failure to scale up carbon pricing at a sufficient pace and the lack of concrete policy to follow through on 1.5° commitments as key barriers delaying climate action globally.

There are political barriers too. He highlights the activities of a number of US state attorneys general who have written to various financial actors and their advisors alleging potential unlawful coordination and other breaches of legal duty in the context of sustainability activity. 'While there is some scepticism about the validity of some of their arguments, the fact that they could launch investigations, as well as the possibility of a Republican win in next year's elections, is clearly having a chilling effect on behaviour.' By contrast, UK and EU competition authorities have moved to address concerns that collaboration in support of bona fide sustainability goals could breach competition law regimes, for example, the UK Competition and Market Authority's Green Agreements Guidance, which provides clarity on the legal possibilities for businesses working together towards environmental sustainability goals. However, Rouch points out that, 'many companies and finance actors are international institutions, so the fact that they have a market in America has implications for their behaviour elsewhere.'

Beyond these, there is also a need for attention to the 'enabling environment' for action by finance actors to address core sustainability challenges. They need help in answering questions like: 'What levers should we be pulling now to tackle climate change? How can we know that those levers are going to contribute to the real-world outcomes we need? How do we establish whether what we are doing is having any impact?'. Many financial actors are working to answer questions like these, but they also need insights from wider society, including academics, NGOs and policymakers.

In this context, Rouch cites the Transition Pathway Initiative (TPI) as a good example of cooperation between industry, academia and the public sector. The TPI, a global asset owner led initiative based at the London School of Economics, analyses data to assess companies' progress towards addressing and adapting to climate change.

Lawyers can contribute to these processes in multiple ways. Among other things, they, 'can help policymakers because their training leads them to ask different sorts of questions and to analyse things differently.' Rouch explains, 'they can then apply the law accurately and cast new light on the kind of measures that might be most useful in tackling policy problems.'

Conclusion

As sustainability challenges intensify, finance operators increasingly find themselves participating in, and relying on, the economic systems that have helped to create, and which are threatened by, those challenges, but which can also help to resolve them.

Many, if not most, finance operators have a financial interest in a successful resolution. As a minimum, legal duties prompt finance operators who are likely to be impacted to consider how they could contribute to societal attempts to achieve sustainability goals consistent with their continuing financial success. Doing so is also likely to chime with social aspirations for finance to serve human wellbeing more broadly.

But black letter law is far from sufficient to create system-wide change. Laws operate in a broader social context. The incentives societies create are enormously important. However, so are the mental frameworks, social narratives or paradigms that develop to help societies make sense of and navigate the reality confronting them.

There are signs of an ongoing reframing of finance activity that gives greater visibility to these interdependencies. Shifting mental frameworks across the world to permeate complex economic and social structures is no small feat. However, greater attention to the need for economic systemic resilience and its connection with environmental and social resilience is now crucial in galvanising finance sector action on sustainability, helping to protect its own future and aligning with wider aspirations for finance.