E3G

RESPONSE TO FCA DISCUSSION PAPER D018/8

This is Third Generation Environmentalism's (E3G) response to the Financial Conduct Authority's discussion paper on opportunities and risks from the UK's transition to a greener economosy together with specific FCA actions, closing 31 January 2019.

Context

The FCA has identified a huge opportunity to protect and enhance the integrity of the UK financial system by addressing climate change risk, while protecting consumers, and we encourage it to take strong action in partnership with other regulators.

Information freely available to financial markets demonstrates the importance of recognising the financial risks of climate change. It is concerning that few firms are so far taking a strategic approach that considers how actions today affect future financial risks, for example the Carbon Trust's October-December 2018 survey of board members from the top 500 companies by turnover and the top 100 by capital employed in the UK shows that less than a quarter of those companies planned to implement the TCFD's recommendations in full in their 2019 reporting[1]. E3G welcomes this discussion paper from the FCA which explores the issue further.

The FCA makes it clear that it seeks to act and provide guidance in relation to its mandate, which is already sufficient to encompass climate-related financial risk. This reflects the 2018 recommendations of the UK Green Finance Taskforce (GFT)[2]. We would like to see the FCA further reflect those recommendations in the future by working in close collaboration with other UK financial regulators to address climate-related financial risk and developing joint guidance.

We note that in parallel with the FCA's discussion paper consultation the Prudential Regulation Authority (PRA) published a consultation on a draft supervisory statement in October 2018[3], *'to set out how effective governance, risk management, scenario analysis and disclosures may be applied by firms to address the financial risks from climate change.'* Taken together these two consultations send an important signal to UK financial sector firms. Furthermore, E3G welcomes the FCA and PRA launch of the Climate Financial Risk Forum in early 2019 to help the financial sector manage the financial risks from climate change and support innovation for financial products and services in Green Finance. We support the inclusion of additional regulators in order to achieve full coverage of UK financial regulation.

[1] **https://www.carbontrust.com/media/677275/ct-uk-business-jan-2019.pdf**

[2] Green Finance Taskforce, Accelerating Green Finance, available at: **http://greenfinanceinitiative.org/workstreams/green-finance-taskforce/**

[3] **https://www.bankofengland.co.uk/news/2018/october/pra-consults-on-its-expectations-for-the-management-of-financial-risks-from-climate-change**

Our response to this discussion paper has been informed by discussions and coordination between E3G, ClientEarth and other groups that have expertise on climate-related financial risk.

Disclosures in capital markets

Q1: What, if any, difficulties do issuers face in determining materiality? We are also interested in exploring how investors consider materiality in this context.

We refer you to the detailed response submitted to this question by the Green Finance Initiative, in which E3G participates. In line with that response we would like to highlight the following key points:

1. Difficulties faced by issuers in determining materiality can be grouped in two categories:
    - difficulties associated with determining the threshold for what information is considered material; and
    - difficulties associated with the specific nature of climate risk and opportunities.
2. Existing regulatory guidance in the United Kingdom helps companies to understand the nature of materiality but leaves to their subjective discretion the materiality threshold to be used for reporting qualitative information. The TCFD recommendations themselves raise a question on materiality. Firms are recommended to conduct scenario analysis where climate change has been deemed material following a firm's internal risk evaluation process. However in the case of climate risk it is unclear how a firm can judge the level of materiality *without* conducting scenario analysis, particularly given the low level of climate risk expertise within many boards.
3. We consider that requiring TCFD disclosures would greatly assist in addressing the problems caused by the misapplication of materiality to the unique financial risks posed by climate change. In addition, the FCA has a clear mandate to implement this requirement. We consider that FCA action on this issue is clearly in accordance with the strategic objective to ensure that relevant markets function well, as well as the operational objectives of protecting consumers, improving market integrity and advancing competition.
4. In relation to scenario analysis in particular, where an organisation is silent, investors can infer that management is not using scenario analysis to plan for potential climate-related impacts, and respond accordingly. **In this context we note the statements reported to have been made by Tim Lane, Deputy Governor of the Bank of Canada, on 23rd January 2019[4]: “"If investors are not receiving satisfactory climate-related disclosures, they should not invest.”**

[4] Remark made at Climate Adaptation Leaders Forum on Finance and Investment, 23rd January, 2019.

Where scenarios analysis is disclosed, investors can use these disclosures to:

> assess the credibility of issuers' transition plans (and their ability to execute them)

> analyse the potential changes in value of assets and liabilities that could result from a transition to a lower carbon economy or to other climate-related events (e.g. physical or legal risks).

Q2: We are interested in understanding whether greater comparability of disclosures would help investors in their decision-making more generally. If so, what framework would be most useful?

Greater consistency and comparability of disclosures would help investors in their decision making. Investors are clearly seeking to have comparable, available information at scale: at the COP24 meeting in Katowice, Poland, a record 415 investors managing over US $32 trillion called on world governments to (among other actions) commit to improve climate-related financial reporting[5]. Specific requests to governments included:

> Publicly support the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) recommendations and the extension of its term;

> Commit to implement the TCFD recommendations in their jurisdictions, no later than 2020;

> Request the Financial Stability Board incorporate the TCFD recommendations into its guidelines;

> Request international standard-setting bodies incorporate the TCFD recommendations into their standards.

In order to achieve greater comparability of disclosures the TCFD's eleven recommended disclosures and underlying principles would be the most useful, universally and internationally accepted framework. Implementing the TCFD recommendations can deliver the quality of climate-related financial information that investors need for decision-making and the exposure to climate risk can be assessed, reduced and managed by companies.

To implement the TCFD recommendations, issuers can use TCFD-aligned practical tools such as the CDSB Framework[6] to elicit material climate-related financial information and embed it in the annual (Director's or Strategic) report. The principles and requirements of the CDSB Framework are directly aligned with those of the TCFD. The annual CDP climate change questionnaire[7] already used for disclosure purposes by many financial firms has also been fully aligned with the TCFD's recommended disclosures and can serve as the process for collecting and structuring the content needed for disclosures.

[5] The Investor Agenda, Policy Advocacy, available at: **https://theinvestoragenda.org/areas-of-impact/policy-advocacy/**

[6] Climate Disclosure Standards Board (2017) CDSB Framework for reporting environmental information, natural capital and associated business impacts. [PDF]. Available from: **https://cdsb.net/Framework**

[7] CDP (2018) Disclosure in 2019. [Online]. Available from: **https://www.cdp.net/en/companies-discloser/disclosure-info**

Clear and consistent guidance from regulators will also be important to promote consistency and comparability of disclosures. In 2018 the UK Green Finance Taskforce recommended that Government and financial regulators should create and publish guidelines by Summer 2019 which clarify certain TCFD recommendations to make them more readily implementable (for example in relation to physical climate scenario analysis and the disclosure of assumptions).[8]

The Green Finance Taskforce recommended that these guidelines should:

- define which preparers are covered by disclosure requirements;
- ensure that information is disclosed on a consistent and transparent basis. The guidelines should make clear that assumptions used for calculations, estimates or projections should also be disclosed by preparers;
- ensure that preparers provide scenario-based disclosures of how their business strategies and financial planning may be affected by climate-related risks and opportunities and the associated time horizons considered;
- ensure that preparers are aware of the requirement and are supported in the reporting of revenues from green business areas; and
- take account of how different jurisdictions are responding to new disclosure needs.

The Green Finance Taskforce also recommended that the Green Finance Institute should be formally tasked by the Government and financial regulators to implement an inclusive process involving key private sector stakeholders to help generate the guidelines. This could significantly reduce the burden on the Government and financial regulators associated with preparing new guidance in a short period of time.

Q3: Would exploring a 'comply or explain' approach, or other avenues to encourage more consistent disclosures, be an effective way of facilitating more effective markets?

Adopting a 'comply or explain' approach to regulated disclosures would be insufficient to meet the urgency of the climate change challenge. The October 2018 Intergovernmental Panel on Climate Change (IPCC) special report[9] stated that there are twelve years left to limit warming to 1.5°C above pre-industrial levels, thus avoiding many dangerous climate change impacts. The TCFD acknowledged in its 2017 Final Report[10] that it will take five years for mainstream adoption of its recommendations. Following the availability of effective disclosures, action must be taken by market participants and regulators, like the FCA, to respond to the information provided in these disclosures – noting that a typical investment cycle in the real

[8] Green Finance Taskforce, Accelerating Green Finance, available at: **http://greenfinanceinitiative.org/workstreams/green-finance-taskforce/**

[9] Intergovernmental Panel on Climate Change (2018) Summary for Policymakers. In: Global Warming of 1.5 °C - an IPCC special report on the impacts of global warming of 1.5 °C above pre-industrial levels and related greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty. [PDF]. Available from: **https://www.ipcc.ch/site/assets/uploads/sites/2/2018/07/SR15_SPM_High_Res.pdf**

[10] **https://www.fsb-tcfd.org/publications/final-recommendations-report/**

economy is seven years. Time is therefore of the essence and it would not obviously be helpful to put in place a 'comply or explain' regime where firms had the option to refrain from disclosing material information to the market.

As a more practical point, if the FCA's aim is to bring more consistent and comparable disclosures to the market, then a comply or explain approach is not the most effective mechanism for achieving this. The most effective mechanism would be mandatory disclosure of climate-related financial information.

In the UK, the 'comply or explain' approach is most notably associated with the UK Corporate Governance Code. 'Comply or explain' is seen as a means by which relevant organisations can have flexibility to make the arrangements that suit their circumstances and then explain to shareholders why those arrangements are appropriate (rather than forcing them to adopt a one size-fits all approach). However - where climate risk is material to an organisation, then many existing legal requirements align closely with the TCFD recommended disclosures. While scenario testing is a "new" requirement, we consider that many organisations are already subject to similar requirements. For example, the background analysis required for a viability statement. In addition, for banks and insurers the PRA considers that the ORSA for insurers, and the ICAAP for banks, are useful frameworks within which to consider the financial risks from climate change. Therefore, any concerns related to the enhanced reporting burden may be less significant than perceived.

Public reporting requirements

Q1: Do you think that a requirement for firms to report on climate risks would be a valuable measure?

Yes, a requirement for firms to report on climate risks would be a valuable measure. The need for this approach is supported in paragraph 3.5 of the Discussion Paper "…the expected transition to a low carbon economy is likely to have a significant impact on our economy, so it is important that the UK's financial markets can both respond to and support the transition in a stable and orderly way", and "…the adequate disclosures of material risks and opportunities, including those which are climate change-related, are essential for a transparent and efficient price formation process".

This new requirement would be most effective if such disclosures were to be made through the vehicle of the mainstream report (e.g. the Annual Report, Prospectus, and/or other mandatory reporting documents), which is also consistent with that advocated by the TCFD.

An important point for any new requirement – which does not always seem to be apparent to financial sector firms judging by the disclosures that they already make both voluntarily and in a regulated context – is that their exposure to climate risk is mostly located in their investments. Existing disclosure requirements do not take this into account and for the most part require firms to report predominantly on their operations only. It is very important that any FCA requirement was crystal clear on this point.

- Furthermore, both asset managers and the asset owners which are regulated by the FCA – namely contract-based pension schemes – should be required to report on climate risks.
- The introduction of automatic enrolment means that millions more people are now saving into pension schemes. Climate risk is particularly relevant to these new savers, many of whom will have investments with 40+ year time horizons over which climate risks will crystallise.
- Such newly enrolled savers are members of defined-contribution schemes which do not have the same guarantees as defined-benefit schemes. These savers shoulder the investment risks and therefore have a legitimate expectation that their savings should be managed robustly.
- New regulations recently introduced by the Department for Work and Pensions require schemes to develop and publish a policy on their approach to consideration of financially material factors including climate change from 1st October 2019. From 1st October 2020 these schemes will also have to publish an annual implementation statement outlining how they have implemented the policies in their SIP.
- This aligns with TCFD the recommendation that asset owners and asset managers use their existing means of reporting to clients and beneficiaries where relevant and feasible.
- When the FCA amends rules for contract-based schemes it should introduce similar provisions to those introduced by DWP and require IGCs to report on pension providers' policies on climate risks and make this information publicly available.

Q2: Do you have any suggestions for what information could be included in a climate risks report?

It is unclear in the Discussion Paper whether the FCA is proposing a separate report or whether this could form part of Annual Report, Prospectus, and/or other existing reporting mechanisms. In general we would support inclusion of climate risk information alongside other material information in mainstream reports for investors.

In terms of substantive content of the climate risks report, it should be guided by the TCFD's recommendations and adhere to the advice in the TCFD Supplemental Guidance for the Financial Sector[11]. Additionally, we note that the EU Technical Expert Group on Sustainable Finance's report on climate-related disclosures[12] was released earlier this month. It outlines the potential benefits of climate-related disclosures to listed companies, banks and insurance

[11] See section D, Task Force on Climate-Related Financial Disclosures (2017) Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures. [PDF]. Available from: **https://www.fsb-tcfd.org/wp-content/uploads/2017/12/FINAL-TCFD-Annex-Amended-121517.pdf**

[12] European Commission (2018) Sustainable Finance TEG Report Climate Relate Disclosures. [PDF]. Available from: **https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-sustainable-finance-teg-report-climate-related-disclosures_en.pdf**

undertakings, and provides specific KPIs for climate disclosure in these sectors. FCA should align its reporting requirements to this work.

Q3: Do you have any views on which regulated firms should be required to compile a climate risks report?

The TCFD recommended that disclosures should apply to the financial services sector: banks, insurance companies, asset managers and asset owners. Asset owners are not included in the FCA's question which is concerning given it regulates the contract-based pension scheme market.

We do not support a sectoral approach to the requirement to compile a climate risks report. Albeit to varying degrees, all firms under the FCA's authority are potentially exposed to climate risks, principally through their investments and should therefore consider these. If the FCA is concerned that immaterial information could be reported, we note that the TCFD's emphasis on materiality would function to filter this out.

The alternative suggested in the Discussion Paper is based on the size of regulated firms. While the largest firms may be systemically important, the aggregate exposure of smaller firms may also be significant. It is also important to take into account the relative capacities of the smaller firms, with perhaps less onerous reporting requirements set out for them.

We would also like to highlight that the financial reporting requirements and practices for financial services firms can vary widely. Some firms do not report publicly, while others make more extensive disclosures if they have public debt or equity. The TCFD states that asset managers and asset owners (for example) should use their existing means of financial reporting to their clients and beneficiaries where relevant and feasible.

Additional questions

Q1: How can authorities, including the FCA, most effectively work with industry to meet investor demand for green investment opportunities and encourage those raising capital and investing in it to pursue sustainable outcomes?

UK financial regulators are now being asked to report under the third round of Defra's adaptation reporting power. The FCA therefore has a strong encouragement from government to take action in this area.

Formal industry research published by a financial regulator can have a transformative effect on certain issues. The Prudential Regulation Authority's work on the insurance and banking sectors has been very important[13]. The FCA has the opportunity to take a similar leadership position in relation to the firms which it regulates.

[13] The impact of climate change on the UK insurance sector (A Climate Change Adaptation Report by the Prudential Regulation Authority) (September 2015) and Transition in thinking: The impact of climate change on the UK banking sector (September 2018)

A public statement by the FCA setting out its approach to regulatory oversight of climate-related financial disclosures would act as a clear signal to industry and markets. This could help support investor demand for green investment opportunities.

The TCFD recommendations state that "the more adoption increases, the more transparent the markets will become, the more secure and stable the economy will be, and the faster we can make progress against the harmful effects of climate change." As a regulator of financial markets, the FCA could do more to promote awareness of the TCFD recommendations to increase adoption and implementation. Research commissioned by HSBC[14] suggests that while ESG investment is now mainstream with 61% of investors and 48% of companies having an ESG strategy in place, only 10% of investors and 8% of companies are aware of the TCFD.

Q2: Do you agree with the extent of the FCA's proposed interventions on climate change-related financial disclosures? Is there a specific need for us to intervene further in the interests of market integrity or consumer interests?

There is currently the appearance in the UK of a transparency gap where action is not taken against firms which fail to disclose relevant climate change-related information. CDSB's 2016 review of environmental disclosures by FTSE 350 companies showed gaps in compliance within the financial sector, and in 2018 ClientEarth wrote to the FCA reporting non-compliance by three insurance firms.

In this context we suggest that the FCA clarifies its approach to regulatory oversight. The Discussion Paper does not cover what enforcement action the FCA will take if its supervisory expectations are not met, so these should be clearly stated in this clarification.

In addition, we consider that the FCA extend its focus to the various sources of information required in relation to the listing process.

Q3: In light of the EU work on taxonomy, what are your views on the form common metrics and standards for measuring and reporting against green financial services products should take?

We note that in line with the recommendations of the UK Green Finance Taskforce the British Standards Institute, sponsored by the Green Finance Institute and the UK government, will be leading a new ISO Technical Committee to develop international standards on Sustainable Finance, informed by the UK-led PAS programme. This has the potential to be useful to financial firms in the UK and internationally. In addition ISO standard 14097 on investment, financing and climate change (ISO 14097) is due to be published in early 2020.

The European Commission's Technical Expert Group on Sustainable Finance is in the process of preparing a classification system for sustainable activities ('taxonomy') and has already issued one consultation on its development. The taxonomy is seen as an important foundational element of the Commission's Sustainable Finance Action Plan, necessary for the creation of

[14] HSBC (2018) News Release - ESG Moves Mainstream. [PDF]. Available from: **https://www.hsbc.com/media/media-releases/2018/esg-moves-mainstream**

financial product standards, prudential rules, sustainability benchmarks and EU labels. It is also seen as potentially useful for private investment purposes, and for public investment and policy.

The EU work on taxonomy is still in progress, with a consultation currently open, and no legislative package foreseen until 2020. Although the United Kingdom is expected to have left the European Union by this date, developments in EU financial regulation are still likely to have a significant impact on firms operating in the UK and on UK market practice. In this context the question being asked should perhaps be how UK and EU financial regulators will engage with each other in the future, and how the UK will seek to influence regulatory developments that may affect its markets.

The content of the taxonomy, and the way in which it will be used, are still in discussion. The direction of travel is clear towards a 'green taxonomy' setting out activities which can be considered sustainable, however important actors including the European Parliament are calling for a 'brown taxonomy' approach which defines unsustainable activities. Meanwhile Canada's Expert Panel on Sustainable Finance has pointed out in its interim report[15] that there is a need to direct substantial investment flows towards the transition from 'brown' to 'green' and that such investments may not be easily captured using a binary approach. The taxonomy itself can be expected to change and develop over time under the oversight of a Platform on Sustainable Finance.

As will be clear from the above, the primary function of the taxonomy at present is to enable a public discussion to take place as to how best to direct financial flows to fund a low-carbon transition. This debate is taking place between firms, sectors and jurisdictions as part of a global economic shift. The UK has the opportunity to participate in this dialogue – and the FCA should make every effort to do so - but may not be able to control the final outcome and its impacts on investment by firms operating in the UK, particularly given the international political context.

Q4: How could regulators and industry best work together as part of the Climate Financial Risk Forum?

We suggest that, given the pre-eminent importance of climate risk to the UK economy as outlined in the Discussion Paper, the Climate Financial Risk Forum could invite the Pensions Regulator and the Financial Reporting Council as members, if it has not done so already. This will ensure a joined-up approach across the four financial regulators for overseeing climate-related financial risks and avoid duplication. A further mechanism to formalise collaboration on climate risk between the four regulators could be through signing of a Memorandum of Understanding, outlining the different roles and responsibilities of each regulator and actions they will take concerning climate-related financial risk.

The Green Finance Initiative, in partnership with CDP, CDSB and PRI convened industry and experts in November 2018 under the UK TCFD Preparers Forum to share experiences on

[15] Canadian Expert Panel on Sustainable Finance, *Interim report of the Expert Panel on Sustainable Finance,* available from: **http://publications.gc.ca/site/eng/9.863536/publication.html**

implementing the TCFD recommendations. The Climate Financial Risk Forum may wish to co-host such events with the GFI.

The FRC Reporting Lab is also undertaking a project on climate risk disclosure. We encourage the FCA to actively engage of this project, including sharing outcomes of this consultation with the project group.

Q5: What are your biggest concerns and commercial priorities regarding climate change?

Our biggest concern is that the market may not move at the pace required to limit dangerous climate change and its impacts on the UK's economy by 2030. In this context the rapid development of the dialogue within and between central banks and financial regulators in relation to the implications of climate change risk is very much to be welcomed. It is encouraging to see this agenda moving forward in the UK, in other jurisdictions including Canada, China and the European Union, and through the work of the Central Banks and Financial Supervisors Network for Greening the Financial System.

Central bank and financial regulator action on this topic is relatively new but logical, taking into account the mandates of these institutions. The rationale for this topic to be considered under the FCA's mandate is amply demonstrated through the arguments made in the FCA's discussion paper. It is unfortunate that this level of clarity and mandate-driven action is not always evident at the political level (in the UK or elsewhere) despite national governments' ratification of the Paris Agreement.

Our key concern, which may also be a concern for commercial firms, is that financial regulators should act in a co-ordinated fashion and avoid any temptation to differentiate their approaches to climate risk. Integrating climate risk considerations at economic level requires a consistent approach across the all types of financial institutions, and this is why the UK Green Finance Taskforce recommended that one set of guidance for companies be created jointly by a number of different UK financial regulators.[16] We strongly encourage the FCA to work with other regulators to act on this recommendation and deliver that guidance by Summer 2019.

Q6: What are the biggest barriers to the growth of green financial services in the UK?

The UK Green Finance Taskforce report highlighted significant barriers to accelerating green finance in the UK, for example:

- "Lack of consistent and comparable data is a barrier to realising more green finance opportunities in the UK and globally. It can prevent investors from managing risks as well as seizing opportunities that climate change presents." (page 22)
- "Without credible comparability of climate related disclosures, which are most reliably based on a level playing field of disclosure requirements, it is difficult for

[16] Green Finance Taskforce, Accelerating Green Finance, available at: **http://greenfinanceinitiative.org/workstreams/green-finance-taskforce/**

financial system users and beneficiaries to trust the information they receive." (page 36)

- "Despite wide acceptance in business and finance of the need to reduce emissions, information failures limit understanding of the financial risks and opportunities and hamper decision making." (ibid)
- Lack of forward-looking analysis (ibid);
- Inadequate consideration of transition risks (ibid); and
- Partial enforcement of existing requirements (ibid).

In addition, research by the Asset Owners Disclosure Project[17] identified a range of barriers to the growth of green financial services. These include areas where FCA action can help the sector overcome such barriers, for example:

Regulation and policy

- Uncertainty around investors' fiduciary duty;
- Uncertainty around climate-related investment approaches;
- A fragmented approach from regulators to climate-related regulation.

Misaligned time horizons

- Varying timelines across the range of climate related risks and opportunities;
- Shorter-term time horizons of fund managers with the expected physical impacts of climate change;
- Contrasting time-horizons between the asset management, investment consultation and pension fund sectors (this can be overcome through more joined up thinking by regulators).

The prevalence of traditional mind sets

- The belief that ESG and financial performance are mutually exclusive;
- The belief that climate-related issues are ethical or political.

Concluding comments

E3G is highly supportive of the FCA's work and its goals for this discussion paper, and we thank the FCA for the opportunity to comment. We will be happy to make ourselves available to discuss any of the content in this submission.

Signed

[17] https://aodproject.net/wp-content/uploads/2018/06/AODP-WinningStrategiesReport.pdf

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About Third Generation Environmentalism (E3G)

Third Generation Environmentalism Ltd. (E3G) is a UK-based not-for-profit think tank working to accelerate the global transition to a low carbon economy. In 2017 E3G delivered "15 Steps to Green Finance" with the City of London Corporation. This led to E3G's invitation to act as the Secretariat for the UK's Green Finance Taskforce (GFT) which made recommendations in March 2018 on how the government and the private sector can work together to make green finance an integral part of UK financial services.