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Shamamah Deen
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Financial Conduct Authority
12 Endeavour Square
London E20 1JN
(Sent via the FCA online portal)

31st January 2019

Dear Ms Deen,

I am writing to respond to the FCA discussion paper DP18/8, *Climate Change and Green Finance,* on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. In preparing this response we have engaged with representatives from UK asset owners, fund management houses, legal firms and retail investment experts. This response also builds upon research undertaken by the Asset Owner Disclosure Project, which published four reports last year on the approach of the financial services sector to climate risks.

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.

One of the key challenges for issuers in determining materiality is a misconception around the nature of climate risk. This is particularly the case where there may be a limited knowledge of climate-related issues within an organisation. Linked to this are incorrect existing preconceptions about the nature of climate change. These can lead to biases in climate risk assessment.

There may also be a tendency by both issuers and investors to misconstrue appropriate time horizons over which climate-related risks may crystallise. For example focusing mainly on shorter-term risks without paying adequate attention to risks that may arise over the longer-term. Equally, however, the incorrect assumption that climate-change is solely a long-term issue. According to research 90% of fund managers expect climate change to significantly impact the valuation of oil companies within two years.[1]

The Taskforce on Climate-related Financial Disclosures (TCFD)[2] was asked to develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders, and insurance underwriters in understanding material risks.[3] Disclosures focused on

[1] UKSIF, *Not Long Now: Survey of fund managers' responses to climate-related risks facing fossil fuel companies*, 2018 available at http://uksif.org/wp-content/uploads/2018/04/UPDATED-UKSIF-Not-Long-Now-Survey-report-2018-ilovepdf-compressed.pdf
[2] https://www.fsb-tcfd.org/
[3] TCFD, *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures*, June 2017 available at https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf

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the resilience of an organisation's strategy, including taking into consideration different climate-related scenarios, particularly a 2^{o}C or lower scenario, was one of the TCFD's key recommendations. The TCFD notes that an 'organisation's disclosure of how its strategies might change to address potential climate-related risks and opportunities is a key step to better understanding the potential implications of climate change on the organisation'. This information not only allows investors to assess the credibility of issuers' transition plans (and their ability to execute them) but also to analyse the potential changes in value of assets and liabilities that could result from a transition to a lower carbon economy.

The FCA's statutory objectives consist of its strategic and operational objectives:

- The strategic objective of ensuring that the relevant markets function well; and
- Its operational objectives, to advance its strategic objective:
  - To secure an appropriate degree of protection for consumers;
  - To protect and enhance the integrity of the UK financial system;
  - To promote effective competition in the interests of consumers.[4]

The TCFD recommendations are well-aligned with these objectives and the FCA should consider implementing them on a comply-or-explain basis in the first instance, ahead of mandatory disclosures in the medium-term.

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 data is essential to enable investors to fully understand their exposure the risks stemming from climate change. We note that at COP24 last month 415 investors managing assets of over US $32tn called on world governments to commit to improve climate-relating financial reporting. Specifically, governments were asked to publicly support the TCFD recommendations and the extension of the TCFD's term and to commit to implementing the recommendations no later than 2020. The UK Government has already endorsed the TCFD recommendations and we await its response to the Green Finance Taskforce. The FCA should show leadership and, working with the investment community, implement the recommendations within the next few years.

It is worth noting that the UK has legally binding frameworks for climate risk reporting which are intended to promote consistency and comparability, for example, the Companies Act 2006 and the FCA's Disclosure and Transparency Rules. These both already provide strong disclosure frameworks for both companies and insurance firms under which a significant amount of climate change-related information should be disclosed. Any failures to disclose such information therefore represent a failure of enforcement and accountability by the Government and appropriate regulators.

The recommendations of the TCFD represent the most useful framework to achieve such consistency and transparency. It is an internationally agreed framework through which investors can assess, manage and reduce their exposure to climate risks. There are

[4] https://www.handbook.fca.org.uk/handbook/glossary/G2976.html

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significant gaps between the TCFD and the requirements under the Companies Act and the DTR, particularly around scenario analysis. To address this the FCA should endorse the TCFD, as BEIS has done, draw attention to scenario analysis requirements, and publish guidance on how firms should disclose such information.

The Green Finance Taskforce recommended that the Government and financial regulators should integrate the TCFD recommendations throughout existing UK corporate governance and stewardship reporting framework. To aid this it recommended that by summer 2019 regulators publish guidance around the recommendations to make them more readily implementable.[5] It proposed that the Green Finance Initiative should initiate an inclusive process involving key private sector stakeholders to help develop the guidelines. This would significantly ease the burden on Government and regulators to prepare the guidance over this short time frame.

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?

Financial markets need consistent and complete information in order to operate and allocate capital efficiently. As we have already stated, we are of the view that comply or explain should therefore be adopted as a minimum to allow investors time to better understand, apply and make disclosures aligned with the TCFD recommendations. However, mandatory TCFD-aligned reporting requirements will help to drive the development of stronger climate responses from the largest pension funds. In AODP's recent survey of investors' approach to climate-related risks, French insurers and pension funds performed particularly well thanks in part to Article 173 of the French Energy Transition Law. We accept that in the short-term a comply or explain approach may be desirable to allow investors to develop their disclosure methodologies, but this should become a mandatory system in the medium-term to enable them to properly take account of climate-risks.

Public reporting requirements

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

Yes. However, it is crucial the FCA is not too narrow in its focus and examines the role of other links in the investment chain, namely asset owners. The FCA regulates asset owners in the form of contract pension schemes, provided by insurance companies, and it has the power to require such schemes to report on climate risks.

The introduction of automatic enrolment means that around 10 million people are newly saving or saving more 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. The schemes the FCA regulates are contract-based defined-contribution schemes and the legal set up of these schemes is such that the pension scheme members have none of the guarantees seen in defined-benefit schemes. These

[5] Details on what such guidance should include are available in Recommendation 6 at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/703816/green-finance-taskforce-accelerating-green-finance-report.pdf

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savers shoulder all the investment risks and therefore have a legitimate expectation that their savings are being managed robustly and that the scheme into which they are enrolled is taking such risks seriously.

Following new rules introduced by DWP in November, trust-based pension schemes will now be required to develop and publish a policy in their Statement of Investment Principles (SIP) on their approach to consideration of financially material factors including climate change from 1st October this year. They will also be required to publish an implementation report on an annual basis stating how schemes have implemented the policies in their SIP. There is clear alignment with the TCFD recommendation that asset owners and asset managers use their existing means of reporting to clients and beneficiaries where relevant and feasible.

The FCA has stated it will consult in the first quarter of 2019 on new rules for contract-based pension schemes. When it does so it should introduce provisions which mirror the new Investment Regulations laid by DWP by requiring IGCs to report on pension providers' policies on ESG including climate risk as well as stewardship. This information should be made publicly available.

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

The TCFD published supplemental guidance for the financial services sector on what information should be included in a climate risk report:[6]

- In relation to identifying and assessing climate related risks, organizations should describe:
    - Their risk management processes for identifying and assessing climate-related risks. An important aspect of this description is how organizations determine the relative significance of climate-related risks in relation to other risks.
    - Whether they consider existing and emerging regulatory requirements related to climate change (e.g., limits on emissions) as well as other relevant factors considered.
    - Organizations should also consider disclosing processes for assessing the potential size and scope of identified climate related risks and definitions of risk terminology used or references to existing risk classification frameworks used.
- In relation to identifying and assessing climate related risks, organizations should describe:
    - Their processes for managing climate-related risks, including how they make decisions to mitigate, transfer, accept, or control those risks.
    - Their processes for prioritizing climate-related risks, including how materiality determinations are made within their organizations.
- In relation to integrating climate related risks into the organisation's overall risk management, organisations should describe how their processes for identifying,

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

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assessing, and managing climate-related risks are integrated into their overall risk management.

The FCA states, '*We are particularly interested in what firms are doing to manage the effects and risks from climate change and the transition to a low-carbon economy*'. A recent report by the Asset Owners Disclosure Project (AODP)[7] explored best practice amongst leading asset owners in developing climate strategies. Its analysis showed that reporting against TCFD is already widespread amonst leading pension schemes. In particular this is being done through:

- Integration with annual or sustainable reporting;
- Via standalone TCFD-aligned reports;
- Piloting the recently TCFD-aligned PRI report framework;
- Via AODP survey responses (TCFD-compliant);
- Via an internal TCFD update to members.

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 banks, insurance companies, asset managers and asset owners. We are concerned that asset owners are not covered in the FCA's consultation paper and, while we appreciate it intends to consult on new rules for contract-based schemes which it regulates in spring, are keen to ensure this is not a missed opportunity. Research by AODP found that only 20% of funds are performing forward-looking climate scenario analysis in their portfolios as recommended by the TCFD.[8]

The FCA should work to ensure there is clear alignment in disclosures between the entities it regulates and the recommendations of the TCFD. Members of contract-based pension schemes have a legitimate expectation that their savings are managed responsibly with account taken for all financially material factors. A situation where members' savings are managed more or less prudently based on the legal set up of the scheme – about which the members have no say – would be extremely undesirable. Over 60% of pension funds publish little or no information on their climate responses, placing them at risk of breaching their legal duties to their beneficiaries.[9]

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?

One of the most effective ways to collaborate with the sector to boost demand for green products is through formal industry research. This should be published by the FCA. Two recent examples of where this has been successful are papers published by the FCA on the impact of climate change on the insurance sector in 2015 and the banking sector in 2018. Linked to this, financial regulators have been invited to report under the third round of the

[7] https://aodproject.net/
[8] AODP, *Pensions in a Changing Climate,* 2018 available at https://aodproject.net/wp-content/uploads/2019/01/AODP-PensionsChangingClimate.pdf
[9] Ibid.

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adaptation reporting power and have all accepted.[10] This is welcome news and will contribute to helping meet the FCA's stated objectives on green finance.

Last year AODP conducted a series of interviews with 22 leading asset owners to explore best practice in developing climate strategies. The research found mixed views amongst asset owners around the availability of low-carbon investment opportunities. Some reported facing difficulties in finding enough investable opportunities, while others noted they had faced no issues. Some respondents also reported liquidity constraints as an issue where opportunities existed, in non-equity asset classes. This confusion around available opportunities and structural barriers to investment are clear obstacles to investors pursuing sustainable outcomes. The FCA should consider this in future research and we would welcome a meeting with FCA representatives to discuss the findings of the report in more detail.[11]

Finally, following the results of this review, the FCA should draft and disseminate '*Dear CEO*' letters to its regulated firms. This should include information about the context of the review, the focus of the review, the results of the review and next steps. Such letters would promote the work being undertaken in this area by the FCA, highlight the urgent need to take climate-risks into account and remove 'ignorance' as an excuse for firms not properly taking account of the risks relating to climate change.

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?

The FCA needs should extend its focus to the various sources of information required in relation to the listing process. There is an emerging accountability gap where action is not taken against firms which fail to disclose relevant climate change-related information.

The FCA has oversight capacity on the provision of prospectus documentation during either secondary or primary equity or/and debt issuance. We believe many prospectus's and listing documentation for primary and secondary equity and debt raising do not fully satisfy existing mandatory disclosure requirements by failing adequately to report on climate risk. Increasingly volatile weather patterns, regulatory responses to climate change and the energy transition present material risks for existing business models, corporate & asset valuations. These implications are important across a range of asset classes but few companies or issuers adequately address these risks in their statutory corporate reports. There is also a lack of consistency in the type and quality of information presented within prospectus's in relation to the risk presented by climate change.

This information should be included in the Risk Section of both debt and equity prospectuses in selected sectors. Investors should expect that risk sections in debt prospectuses for these

[10] List of organisations reporting under adaptation reporting power: Third round, published 21st December 2018 https://www.gov.uk/government/publications/climate-change-adaptation-reporting-third-round/list-of-organisations-reporting-under-adaptation-reporting-power-third-round#financial-regulators

[11] AODP, *Winning Climate Strategies,* 2018 available at https://aodproject.net/wp-content/uploads/2018/06/AODP-WinningStrategiesReport.pdf

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sectors should include coverage of climate risk. Improving the ability of investors to make properly informed decisions is a key role played by the FCA and the UKLA through the oversight and monitoring of prospectuses for both primary and secondary equity and debt issuance in the London Market.

As a result, UKLA should:

- Undertake a thorough review of the industrials sectors where climate risk is most material to identify prospectuses where climate risk should receive extensive coverage;
- Write, in the form of an open letter, to the leading investment and corporate legal advisers to request they carefully review, where material, the information incorporated in the prospectus documentation;
- Not approve prospectus documentation where climate risk information is missing;

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

We note work by the British Standards Institute on a standard for green finance which has the potential to be useful for investors.

The EU's work on a sustainable finance taxonomy is not expected to be completed until after the UK's exit from the European Union. We do, however, anticipate it will have a significant impact on financial services firms operating in the UK and selling into the EU and on market practice more generally. The precise content of the taxonomy remains unclear, and despite a direction of travel towards a "green" taxonomy, Members of the European Parliament have been calling for a "brown" taxonomy which would incorporate unsustainable activities. We note that the intention is for this to become a sustainable finance taxonomy rather than a climate taxonomy, and the Commission will need take steps to develop social side of this agenda. The scope of the taxonomy is vast and we see a risk of mission-creep. The FCA must therefore carefully consider how it will engage with European financial regulators post-Brexit to ensure the regulatory developments taking place in Brussels complement UK market practice and how it will seek to influence policy makers where it does not.

AODP research found that almost all respondents to its survey highlighted quality of climate-related data as a key concern.[12] Scenario analysis was raised in particular due to concerns around a lack of clarity and expectations for asset owners, and the investment-relevance of currently available scenarios. Other common data-related barriers faced by asset owners include:

- Data quality (especially around scope 3 emissions and coal data)
- Data availability (i.e. available data out of date)
- Data comparability

[12] AODP, *Winning Climate Strategies,* 2018 available at https://aodproject.net/wp-content/uploads/2018/06/AODP-WinningStrategiesReport.pdf

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- Most data still voluntary and not verified
- Lack of forward-looking climate-risk methodologies
- Lack of data around the physical impacts of climate-change
- Lack of data around sustainable development
- Challenges of applying carbon foot-printing across asset classes
- Expectations and available methodologies around scenario analysis
- Lack of robust impact metrics
- ESG ratings from service providers not correlated
- Difficulties in translating ESG data into financial metrics

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

A coherent approach to climate risk across the financial services sector is crucial and this is an opportunity for the UK to show leadership. We welcome the setting up of the Climate Financial Risk Forum, although we are concerned to learn that the Pensions Regulator and the Financial Reporting Council have not been invited to join the forum. All appropriate regulators with standard-setting functions should be involved in the forum and an MoU should be publicly disclosed.

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

N/A

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

AODP's *Winning Climate Strategies* research identified a range of barriers to the growth of green financial services.[13] These include areas where FCA action, including more joined up thinking with other financial regulators through the risk forum, can help the sector overcome such barriers, these include:

- 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;

[13] AODP, *Winning Climate Strategies,* 2018 available at https://aodproject.net/wp-content/uploads/2018/06/AODP-WinningStrategiesReport.pdf

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- 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.

One obstacle to climate risk mitigation by investors is the misconception that engagement with companies on sustainability issues is only relevant to equity investors. Engaging on climate issues should be the responsibility of debt as well as equity holders. Fiduciary duties are a universal responsibility – where engagement with companies is a successful tool it makes no sense to limit that engagement to a single asset class.

ShareAction recently published its latest report on bond holder engagement on climate risk. The report shows that ESG risks are relevant to bond investment and that many engagement teams already straddle bond and equity portfolios but also that complexity and poor data are key barriers to climate action. Further, the report outlines that refusal to refinance/roll over bonds and issuer specific divestment are effective escalation tools. The report makes one recommendation which is specifically geared towards the FCA:

> '*Bond investors were concerned about concert party issues surrounding collaboration and joint engagement. We do not believe stifling engagement among institutional investors on systematic challenges such as climate change is in the interest of financial stability… Financial supervisors including the FCA should provide clear guidance on how bond investors can engage collectively*.'[14]

We would welcome the opportunity to meet to discuss the findings of this report and how the FCA can support the sector with such guidance.

I hope our views are clear, but please let me know if we can provide any clarifications. We would be interested in meeting to discuss this response, the work of the FCA in this area and our research into the approach by some of the world's biggest investors to taking account of climate-risk. If this is of interest please let me know at fergus.moffatt@shareaction.org.

Yours sincerely,

Fergus Moffatt
Head of UK Policy

[14] ShareAction, Sleeping Giants: Are bond investors ready to act on climate change?, 2019 https://shareaction.org/wp-content/uploads/2019/01/Sleeping-Giants.pdf