

ClientEarth response to FCA Discussion Paper 18/8: Climate Change and Green Finance

1 Introduction

ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, Madrid, New York and Beijing. ClientEarth's climate finance initiative conducts research and advocacy in relation to the legal implications of climate change-related financial risks for a wide spectrum of market participants, including companies, investors, company directors, their professional advisers and regulators.

In October 2018, the Financial Conduct Authority (**FCA**) published a discussion paper in relation to a number of areas in climate change and green finance that the FCA considers require greater regulatory focus (the **Discussion Paper**). This document provides ClientEarth's responses to the questions raised in the Discussion Paper.

Please do not hesitate to contact Joanne Etherton (jetherton@clientearth.org) for further information on anything contained in this response.

2 Key messages

We are pleased that the FCA recognises that climate change will have a significant impact on the UK's economy and financial services markets and commend the FCA for committing to address this risk. Ensuring that climate change-related risks are properly disclosed to regulators, investors and customers is a crucial way in which the FCA can meet its strategic objective to ensure that markets function well.

ClientEarth's view is that existing disclosure rules (if properly applied and enforced) already require the disclosure of climate-change related risks, which will be material to the majority of issuers and firms. The FCA should adopt the TCFD recommendations, as an internationally agreed and widely endorsed standard, as a means for complying with these existing rules in order to provide markets with consistent and comparable disclosures.

Our regulatory referrals to the FCA and the FRC have identified a divergent approach from companies in the disclosure of climate risk. This inconsistency undermines the utility of the information disclosed and demonstrates a need for clearer regulatory guidance and enforcement actions.

Given that climate risk is relevant to existing mandatory disclosure requirements, we do not believe that 'comply or explain' is an appropriate approach to this issue. Further, we do not believe that a voluntary approach would provide the market-wide disclosures required to address such a systemically important issue in the timescales required to limit the catastrophic effects of climate change.

3 Responses to questions

3.1 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.

1. ClientEarth has extensive experience in reviewing annual reports of UK listed companies (**issuers**) for compliance with disclosure requirements. Over the past ten years we have reported numerous issuers to the FRC and (more recently) the FCA for their failures to disclose material information about environmental and climate change-related trends and risks in their annual reports. This has included the following:

- BP plc (complaint to the FRC Financial Reporting Review Panel – 2010)
- Rio Tinto plc (complaint to the FRC Financial Reporting Review Panel – 2010)
- Cairn Energy plc (complaint to the FRC Conduct Committee – 2016)
- SOCO International plc (complaint to the FRC Conduct Committee – 2016)
- Admiral Group plc (complaint to the FCA – 2018)
- Phoenix Group Holdings (complaint to the FCA – 2018)
- Lancashire Holdings Limited (complaint to the FCA – 2018)
- EasyJet plc (complaint to the FRC Conduct Committee – 2018)
- Balfour Beatty plc (complaint to the FRC Conduct Committee – 2018)
- EnQuest plc (complaint to the FRC Conduct Committee – 2018)
- Bodycote plc (complaint to the FRC Conduct Committee – 2018)

(together, the **Regulatory Complaints**)

2. In addition to these Regulatory Complaints, we have also worked closely with investors who have brought shareholder resolutions at a range of issuers to demand information which they consider useful, and which issuers have otherwise failed to provide, relating to material trends and risks associated with climate change. This has included the following:

- BP plc (2015 – resolution passed with over 95% support)
- Royal Dutch Shell plc (2015 – resolution passed with over 95% support)
- Anglo American plc (2016 – resolution passed with over 95% support)
- Rio Tinto plc (2016 – resolution passed with over 95% support)
- Glencore (2016 - resolution passed with over 95% support)

3. In the course of these activities, we have observed a highly divergent and inconsistent approach taken by issuers in determining materiality, both in the financial accounts themselves and in narrative reporting, including strategic reports and directors' reports. This has clear implications for compliance with requirements under the Companies Act 2006 (**Companies Act**), as well as under the Prospectus Rules (**PRs**) and the Disclosure and Transparency Rules (**DTRs**). In our view, this inconsistency also significantly undermines the

utility of this information and is caused by two key issues: inadequate regulatory guidance; and lack of regulatory enforcement.

Inadequate regulatory guidance

4. As identified in the Discussion Paper, issuers are subject to a wide (and often overlapping) range of disclosure requirements. This includes requirements under the Companies Act, accounting standards, PRs, DTRs and the Listing Rules (**LRs**). A variety of guidance materials provided by standard setters and regulators may also be relevant to the interpretation of these requirements.
5. Although it is not referred to directly in primary legislation, the concept of ‘materiality’ has emerged as a key touchstone for many of these disclosure requirements. In particular, ‘materiality’ is a key concept for IFRS accounting standards. IFRS Practice Statement 2 on Making Materiality Judgments notes that “*the need for materiality judgements is pervasive in the preparation of financial statements*”.¹
6. Similarly, ‘materiality’ is a key concept in the FRC’s Guidance on the Strategic Report, which is intended to serve as a ‘best practice’ statement for issuers preparing strategic reports in accordance with the requirements of the Companies Act. Given the overlapping subject matter, we assume this guidance also applies to the requirements for the preparation of a ‘Management Report’ under DTR 4.1.5R of the FCA Handbook. Clarification from the FCA in relation to this assumption would be welcome.
7. In our view, the IFRS Practice Statement on Making Materiality Judgements provides relatively useful and clear guidance on making materiality judgements for the purposes of IFRS financial statements. In this respect, failures by issuers to adequately address financially material climate change-related factors in their accounts is more likely to be a result of a lack of oversight, accountability and enforcement. This is discussed further below.
8. Unfortunately, the brief section on ‘materiality’ included in the FRC’s Guidance on the Strategic Report is less clear and does not provide adequate clarity to enable shareholders or regulators to hold issuers accountable for failures to disclose material information. In our view, the current guidance is overly permissive in the discretion that it suggests issuers have to determine materiality. In particular, it fails to make clear the need for issuers to carefully consider the needs and demands of shareholders or sector or geographic specific indicators of materiality (see, for example, the SASB materiality map).²
9. The lack of specific FCA guidance on this issue, which is clearly relevant to its regulatory remit, is also a problem.

Lack of Regulatory Enforcement

10. In our view, the single biggest reason why issuers fail to properly disclose financially material information in their annual reports is due to a lack of credible threat of enforcement by regulators. Combined with limited powers for investors to seek information from issuers

¹ IFRS, Practice statement 2, ‘Making Materiality Judgements’ (2017), [8].

² See Sustainability Accounting Standards Board (SASB) Materiality Map <https://www.sasb.org/standards-overview/materiality-map/>

directly, this leads to a significant accountability gap, which leaves investors disempowered and financial markets lacking the information required to operate efficiently.

11. This problem is particularly evident in relation to climate change-related information. As evidenced by our Regulatory Complaints, referred to above, over a period of nearly ten years we have repeatedly brought detailed evidence about failures to comply with disclosure requirements to the attention of the UK's financial regulators. The core issue at the heart of these complaints has been whether or not an issuer has properly disclosed 'material' information. In every case so far, the relevant regulator has failed even to reach a decision about whether or not the report in question complies with the law – let alone to pursue any remedial actions or sanctions.
12. More generally, we note that the FRC, which has in the past taken on primary responsibility for reviewing corporate reporting, has taken an unusually permissive and conciliatory approach to correcting material errors in financial information. In 2016/17, for example, the FRC conducted just 203 reviews of corporate reporting, out of which no corrections were required and just three companies were required to publish details of the FRC's review.³ This approach has been criticised directly by the European Securities and Markets Authority (**ESMA**) in its Peer Review Report on Enforcement of Financial Information, where it concludes that:

“the decisions taken by the FRC with regard to correcting material errors in financial statements are too weighted towards permitting those corrections to be made in future financial statements, rather than ensuring that the issuer makes the correction publicly and much earlier in a corrective note.”⁴
13. This overly permissive approach is also highly anomalous compared to other key jurisdictions. One clear example is the regular corporate reporting review and comment process undertaken by the US Securities and Exchange Commission (**SEC**). By statute, the SEC must review the corporate report of every issuer at least once every three years (though it typically reviews the reports of 50% of all issuers each year). Where it has questions about either the financial or narrative components of the corporate report, it provides issuers with a comment letter, describing its concerns and requesting a written response from the issuer. Issuers must then provide that response and the entire exchange is publically available. If the issuer's response satisfies the SEC's inquiry, the SEC issues a formal letter acknowledging as much. If it does not, the SEC issues a restatement notice, which may require the issuer to amend the report.
14. In 2017, the SEC required 553 reissuance restatements for deficient financial reporting. As noted above, in the 2016/17 year, the FRC required zero corrections. We are also not aware of any action taken by the FCA in this regard to fulfil its own duties to oversee and enforce compliance with disclosure requirements for issuers under the FCA Handbook.
15. While we acknowledge that issuers should be permitted a certain amount of discretion in making materiality judgements at the margins, we believe that transparent and robust regulatory enforcement in relation to clear failures to provide material information is

³ See FRC, 'Annual Review of Corporate Reporting' (2016/17) <https://www.frc.org.uk/getattachment/311af48c-bdfa-4484-8e7d-6de689fd8f4b/Annual-Review-of-Corporate-Reporting-2016-17.PDF>

⁴ ESMA, 'Peer Review on guidelines on Enforcement of Financial Information' (2017) [74] https://www.esma.europa.eu/sites/default/files/library/esma42-111-4138_peer_review_report.pdf

essential. Beyond providing clearer guidance, robust enforcement of existing principles-based requirements would provide much needed clarity for issuers about their duties, and confidence for investors and other stakeholders in the integrity and quality of information they are using.

16. In our view, this problem is especially clear in relation to climate change-related information. For most issuers, whether or not climate change-related information is material is not a marginal question. For many years now, shareholders have overwhelmingly made clear their views that detailed and granular information about the financial implications of climate change and the low carbon transition are highly material to their investment and stewardship decisions.⁵ A SASB Technical Bulletin has found that climate change is likely to have material financial impacts on companies in 72 out of 79 industries.⁶ And the FRC has also issued multiple guidance highlighting its expectations about the relevance of climate change-related factors for compliance with existing disclosure obligations.⁷
17. Despite these clear indicators of materiality, many issuers still fail to disclose any information at all about climate change-related risks or trends facing their business and only a very small handful provide granular detail about scenarios and financial implications, which investors have been demanding. For this reason, investors have been forced to pursue the costly and inefficient route of passing shareholder resolutions (referred to above) to obtain useful information which, given its clear materiality, is arguably already their right to have.
18. In light of these concerns, we welcome the FCA's confirmation that it will consult on guidance to issuers about how the current regulatory regime might be interpreted to apply to climate change-related risks. However, we believe that this will not be sufficient to address the current deficiencies in issuers' disclosures unless it is accompanied by clearer guidance about materiality determinations generally, and, most importantly, robust and transparent enforcement of existing legal requirements.

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?

19. We agree that greater consistency and comparability of disclosures relating to climate change would help investors in their decision-making. As set out in the recent independent report of the Green Finance Taskforce,⁸ the current 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 and the transition to a low carbon economy present.
20. In our view, the starting point for ensuring consistent and comparable climate change-related disclosures should be the requirements under existing legal disclosure frameworks. This includes existing requirements under the Companies Act, accounting standards, PRs, LRs,

⁵ See, e.g., BlackRock, Statement of engagement priorities for 2017-2018 <https://www.blackrock.com/corporate/about-us/investment-stewardship#2018-priorities>; Bill McNabb, 'An open letter to directors of public companies worldwide' 31 August 2017 <https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf>; LGIM, 'Time to act on climate change: engagement with consequences' (2016) <http://www.lgim.com/uk/en/press/2018/legal---general-investment-management-takes-action-on-climate-change-risks.html>.

⁶ SASB, 2018, Climate Risk - Technical Bulletin. [Online] Available at: <https://library.sasb.org/climate-risktechnical-bulletin/>

⁷ FRC, Annual Reviews of Corporate Reporting 2015/2016, p. 50; FRC, Annual Reviews of Corporate Reporting 2016/2017, p. 22; FRC, 'Guidance on the Strategic Report' (July 2018).

⁸ Green Finance Taskforce, 'Accelerating green finance: Green Finance Taskforce report' (2018) Available at <https://www.gov.uk/government/publications/accelerating-green-finance-green-finance-taskforce-report>

and DTRs, relating both to the financial accounts themselves, as well as information relating to trends and risk factors facing a business. If applied properly and appropriately enforced, we believe that these principles-based requirements provide a sound basis for incorporating climate change-related factors and information into existing disclosures in a way which is understandable and useful to investors.

21. As an additional overlay, the TCFD recommendations provide an effective and widely endorsed framework to aid issuers in preparing disclosures with the appropriate level of granularity now demanded by investors.

Existing reporting requirements

22. As noted above, it is our view that disclosure of material climate-related information is already necessary under existing disclosure requirements. Among other things this includes:

- principal risks and uncertainties facing the issuer (Companies Act, s414C, DTR 4.1.8R);
- main trends and/or factors likely to affect the future development, performance and position of the issuer's business (Companies Act, s 414C(7)(a));
- the long term viability of the issuer (C.2.2 Corporate Governance Code; LR 9.8.6);
- numerous requirements under IFRS accounting standards;
- the overarching requirement for financial accounts to provide a 'true and fair view' of an issuer's performance and capital position (Companies Act, s 393); and
- the duty to take all reasonable care to ensure that any regulated information is not misleading, false or deceptive and does not omit anything likely to affect the import of the information (DTR 1A.3.2R).

23. In relation to the first three of these points, further details are contained in our recent complaints to the FRC Conduct Committee in relation to the 2017 annual reports of EasyJet plc, Balfour Beatty plc, EnQuest plc and Bodycote plc.⁹

24. In relation to the application of IFRS accounting standards and the overarching requirement for company accounts to provide a 'true and fair view', numerous commentators have now identified the need for accountants and auditors to consider climate change-related factors in their work. For example, a recent report by asset manager Sarasin & Partners, has highlighted the relevance of decarbonisation to long-term oil and gas price assumptions used by fossil fuel companies in a range of balance sheet items, including impairment testing and assessments of property, plants and equipment, goodwill, deferred tax assets and asset retirement obligations.

25. Additionally, the Australian Accounting Standards Board (**AASB**) and Audit and Assurance Standards Board (**AUASB**) have recently published a detailed practice note providing more detail about the implications of climate change-related factors for existing accounting and audit standards.¹⁰ The Institutional Investor Group on Climate Change (**IIGCC**) has also

⁹ ClientEarth, 'EasyJet among companies reported to regulator by ClientEarth' (2018) <https://www.clientearth.org/easyjet-among-companies-reported-to-regulator-by-clientearth/>

¹⁰ AASB and AUASB, 'Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2', (2018) https://www.aasb.gov.au/admin/file/content102/c3/AASB_AUASB_Joint_Bulletin_13122018_final.pdf

published a paper setting out investors' expectations about the key role of audit committees and auditors in ensuring climate change-related risks are properly reported to investors in annual reports and accounts under existing legal and accounting requirements.¹¹

26. In our view, factoring insights about climate change related-risks into the preparation of company financial accounts (including disclosures about key estimates and assumptions in the notes to the accounts), is a basic necessity for providing a 'true and fair view' as required by the Companies Act. This in turn is critical to ensure that issuers are complying with the UK's capital maintenance regime, which requires that accounts are prepared using prudent assumptions and take into account foreseeable losses or liabilities. Failure to do so could result in capital being overstated and the payment of illegal dividends (distributions paid out of capital), undermining confidence in the UK capital markets for investors and other stakeholders.¹²
27. Where financial accounts or other material included in the annual report provide a misleading view of the financial position of the issuer or 'omit anything likely to affect the import of the information', it may also indicate that the issuer is in breach of DTR 1A.3.2R or other requirements under the FCA Handbook.

TCFD Recommendations

28. While existing disclosure requirements should provide the starting point, we believe that the TCFD recommendations then provide an effective and widely agreed framework which can be overlaid to provide a common and consistent approach to considering and disclosing the more granular detail about climate change-related factors, which investors are demanding.
29. In our view, the TCFD recommendations (including the four key pillars of: governance; strategy; risk management; and metrics and targets) provide an essential starting point for issuers to work through and report the relevant implications for their business. The TCFD's recommendation for issuers to conduct forward-looking scenario analysis is particularly critical to ensuring that that issuers' strategies and disclosures are robust and tested against a range of different scenarios.
30. In this regard, we would also draw attention to the Green Finance Taskforce Report which set out more detailed observations about how to implement the TCFD recommendations in the UK. In particular, the Green Finance Taskforce Report recommends that financial regulators should 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 accounting assumptions).

¹¹ IIGCC, 'Voting for better climate risk reporting: the role of auditors and audit committees' (2018) http://www.iigcc.org/files/publication-files/IIGCC_2018_Voting_and_Climate_Risk_v11.pdf

¹² Part 23 2006 Companies Act s830 sets out that for distributions (e.g. dividends) to be legal, they can only be made out of "profits available for the purpose". This means accumulated realised profits not needed to cover foreseeable losses. In addition, companies must comply with the "net asset restriction" (s831), which prohibits distributions that result in net assets falling below the aggregate called up share capital and undistributable reserves.

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?

31. As outlined above, it is our view that material climate change-related information should already be disclosed under existing laws and regulations. In light of clear statements from investors that information on climate related issues is most effectively provided by using the TCFD framework, we believe that there is also a strong argument that issuers should already be adopting the TCFD recommendations in order to comply with their existing disclosure duties.¹³
32. As noted in the IFRS Practice Note on Making Materiality Judgements, questions of materiality relate not just to *what* information must be disclosed but *in how much detail* it should be disclosed and presented.¹⁴ Given strong investor support and increasingly well-developed industry practice, we therefore consider that for many issuers, failure to provide information included in the TCFD recommendations will amount to a failure to provide material information.
33. That being said, we consider that a clear signal of expectation from the FCA on this point would be of significant benefit in accelerating uptake of the TCFD recommendations. It would also assist with ensuring greater consistency and reliability of the reported information. In our view, the most effective means of doing so would be for the FCA to provide guidance for listed entities setting out its expectation that all issuers adopt the TCFD recommendations as a framework for preparing and disclosing climate change-related information under their existing disclosure obligations.
34. This would have the effect of explicitly confirming that, in light of investor demand and market practice, compliance with the TCFD recommendations is now effectively mandatory, without requiring the passing of new legislation or update of the FCA Handbook. Given the widespread uptake and use of the TCFD recommendations and investors' clearly expressed expectations that it be adopted, we believe that clarifying this position is now appropriate.
35. However, should this approach fail to deliver the requisite improvement in quantity and quality of climate change-related information provided by issuers in a rapid timeframe then we believe that the FCA should take steps to introduce an additional, explicitly mandatory, obligation to disclose climate change-related information in line with the TCFD recommendations in legislation or the FCA Handbook.
36. If the FCA does not feel comfortable setting such expectation in its guidance then, at the very least, issuers should be required to state whether or not they have adopted the TCFD recommendations (including conducting scenario analysis) in preparing their disclosures.

¹³ See further, CCLI, 'Concerns misplaced: Will compliance with the TCFD recommendations really expose companies and directors to liability risk?' (2017) <https://ccli.ouce.ox.ac.uk/wp-content/uploads/2017/10/CCLI-TCFD-Concerns-Misplaced-Report-Final-Briefing.pdf>

¹⁴ IFRS, Practice statement 2, 'Making Materiality Judgements' (2017), [43].

3.2 Public reporting requirements

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

Why there should be a requirement

37. As set out above in relation to issuers, ClientEarth considers that firms should already be reporting on climate risk where such risks are material and therefore caught by existing (mandatory) disclosure requirements. However, it remains the case that existing requirements are, in many cases, not being effectively met by firms in relation to climate risk. An explicit statement that firms are required to report on climate risks would therefore be a valuable measure, assisting firms in developing effective mechanisms for understanding these risks and (where relevant) reporting them as part of their existing obligations.
38. Such reporting would, as the FCA suggests, help firms manage the transition to a low-carbon economy and encourage the financial services industry to consider the impact of climate change. However, climate risk reporting would also be of great value to other users of climate-related financial disclosures:
- **Regulators:** Applied to all FCA regulated firms, such a requirement would ensure that the FCA has adequate information to fulfil its own statutory and strategic objectives. From a prudential perspective, requiring firms to report on climate risk will enable the FCA to assess whether those firms have adequate controls in place for considering and managing climate risk. The availability of comprehensive and comparable information relating to climate change is itself crucial to investor decision-making and the proper functioning of markets.
 - **Investors:** Climate risk reporting by asset managers would enable investors to make informed decisions about which firm they want to invest with. Comparable and consistent reports could also provide the basis to assess the effectiveness of managers' stewardship and engagement activities, likewise the robustness of their climate risk management. Scenario analysis would also make it possible for investors to align their own portfolios with the transition to a low carbon economy, and avoid investments that they felt were not supporting that transition. Comprehensive disclosure of risk reporting could thus help channel financial flows towards green finance.
 - **Customers:** Given the prominence and systemic nature of climate risk, public reporting would enable customers to understand the ways in which firms are assessing and managing these risks. Climate risks reports could provide customers with information that would enable them to make better informed decisions about which firms they buy services and products from. Additional transparency on a systemically important issue could also help to build trust between consumers and financial services providers.

Reporting should be mandatory

39. In our view, there is a clear need for this expectation to report on climate risk to be understood as mandatory (and to apply to all regulated firms, as to which see further below). This reflects both the widely-acknowledged importance of adequate climate disclosures in facilitating effective investor decision-making and - as discussed in our responses above - the ongoing failure of many regulated entities to incorporate climate risk into their existing mandatory requirements to consider risks, in spite of the FCA's stated expectation that they will do so. We discuss this failure further in the context of contract-based pension schemes at paragraphs 45-48 below.
40. The Environmental Audit Committee (**EAC**)'s report on 'Greening Finance' emphasised the UK's existing framework of financial laws as a means of implementing climate risk reporting but also stated that "*only if reporting is mandatory are we likely to see comprehensive and comparable climate risk disclosures.*"¹⁵
41. In 2016, France introduced a climate risk reporting requirement on a 'comply or explain' basis.¹⁶ While the new rule has been credited with substantially increasing awareness of climate risk reporting among companies and institutional investors, it has also been criticised as failing to achieve the original policy intent. The PRI has called for France to make the law mandatory for asset owners by 2020.¹⁷ The FCA can benefit from this example and begin by setting a mandatory standard to ensure that the identified risks to the market are effectively addressed without undue delay.
42. Mandating new requirements for climate risk reporting will also ensure continuity with the existing reporting landscape, which provides for mandatory climate risk reporting for corporates where those risks are material (as, according to the SASB, they will be for companies in 72 out of 79 industries, equating to 93% of the equity market in the U.S.¹⁸).
43. Some might argue against a mandatory reporting requirement on the basis that it is impossible for firms to report on climate risk while reporting by investee companies is inadequate. We disagree that firms' reporting has to lag behind that of corporates. In some respects (such as perhaps reporting against metrics and targets), climate risk reporting by investors will only be as good as the disclosures from their investee companies allow. However, many aspects of climate risk reporting, including in respect of governance, strategy and risk management) can be implemented based on the existing dataset. The FCA could accommodate the improving state of corporate disclosures in initial reporting rounds by ensuring that its enforcement approach recognises these obstacles and facilitates sharing of best practice, while still ensuring that firms remain focussed on high standards of disclosure. The resulting pressure from investors on their investee companies will, in turn, necessitate better disclosure from those entities, driving better climate risk reporting across the board.

¹⁵ Environmental Audit Committee (2018) Greening Finance: embedding sustainability in financial decision making – Seventh Report of Session 2017-19 <https://publications.parliament.uk/pa/cm201719/cmselect/cmenvaud/1063/1063.pdf> at paragraph 53 (para. 86)

¹⁶ Article 173, Energy Transition for Green Growth Law

¹⁷ <https://www.unpri.org/fiduciary-duty-in-the-21st-century-france-roadmap/3843.article>

¹⁸ SASB (2018) *Climate Risk – Technical Bulletin* (<https://library.sasb.org/climate-risk-technical-bulletin/>)

The broader regulatory context

44. If reporting requirements are not mandatory, investors are unlikely to see climate risk reporting as a priority for the firm or the regulator. A clear example of the current treatment of climate risk reporting by investors is that only eight of the 25 largest pension funds in the UK questioned by the EAC as part of its Green Finance inquiry had committed to report in line with the TCFD recommendations, compared to ten funds that had no plans to report.¹⁹ While these pension funds are not regulated by the FCA, the EAC's research highlights the difficulties of a voluntary approach to reporting, even for the largest and best-resourced investors (all those questioned by the EAC have over £11.4bn Assets Under Management). It also demonstrates that the FCA will need to collaborate with other regulators, such as the Pensions Regulator, to try to ensure equivalence of climate risk reporting across the market. The Climate Risk Forum would be an obvious forum for such collaboration.

What firms are doing to manage the effects and risks from climate change: Contract-based pension schemes

45. The FCA has expressed an interest in what firms are doing to manage the effects and risks from climate change and the transition to a low-carbon economy for their customers, and ClientEarth's work on climate risk in contract-based pension funds is instructive in this respect.
46. During 2017, ClientEarth wrote to, and met with, a cross-section of providers of contract-based pensions to find out how those providers were managing climate risk on behalf of their customers. The report was provided to the FCA in February 2018, and can be accessed [here](#).
47. The report highlighted a number of findings in relation to contract-based pension providers' management of risks to their customers, including that:
- a) Many providers were not able to tell us how they were dealing with climate risk in respect of their contract-based pension schemes and had not considered the effects of climate risk for strategic asset allocation in their product design and offering.
 - b) In many cases there was a disconnect between a pension provider's group stance on climate risk (publishing strong policies and external strategies on investment of the provider's assets) and its consideration in the provision of pensions for its customers. This was the case even where contract-based pensions are provided by insurance companies, whose catastrophe and/or general insurance arm has already developed a view on the wide-ranging risks and opportunities associated with climate risk. This disconnect and, for some firms, complete failure to consider climate risk in respect of the provision of contract-based pensions was acknowledged in a number of face-to-face meetings.

¹⁹ Environmental Audit Committee (2018) *Greening Finance: embedding sustainability in financial decision making – Seventh Report of Session 2017-19* <https://publications.parliament.uk/pa/cm201719/cmselect/cmenvaud/1063/1063.pdf> at paragraph 53

- c) Where default funds are passive index tracker funds, providers had not always considered whether the fund was vulnerable to climate risk, sometimes citing an inability to make investment/disinvestment choices in relation to passive funds.

48. This failure to manage climate risk in respect of contract-based pension schemes was ongoing in spite of the FCA's view (expressed to ClientEarth in a letter in April 2017) that its 2013 guidance on the Responsibilities of Providers and Distributors for the Fair Treatment of Customers (**RPPD**) placed an expectation on firms to consider climate risk. Explicit references to climate risk in guidance or rules produced by the FCA, including the RPPD, would send a much clearer signal to firms that they are expected to properly consider and report on these risks. However, even if such guidance were to set a clear expectation on firms to assess and manage climate risk, we do not think that this alone would be sufficient to enable firms to manage risks posed to their customers or operations by climate change. The RPPD and similar guidance is explicitly non-binding and a failure to follow it does not indicate a breach of the FCA's rules.²⁰ It is therefore critical that the FCA consider the relevance of climate risk across all existing reporting requirements and take action against firms where there are ongoing failures to acknowledge and report on such risks.

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

49. As set out in our response to Question 1 above, reporting in line with the TCFD recommendations would be an appropriate way to require firms to produce public disclosures on climate risk. In deciding what information should be disclosed, we would support the consideration of all information related to the four key pillars of the TCFD recommendations, which are:

- **Governance:** The organisation's governance around climate-related risks and opportunities.
- **Strategy:** The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.
- **Risk Management:** The processes used by the organisation to identify, assess, and manage climate-related risks.
- **Metrics and Targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

50. The TCFD supplemental guidance also provides a framework for appropriate sectoral disclosures by banks, insurance companies, asset owners and asset managers.²¹ This supplemental guidance corresponds with the major categories of financial market participants and provides additional context for these sectors when determining how to structure disclosures on climate risk.

²⁰ See FCA 1.3 in the 'Responsibilities of Providers and Distributors for the Fair Treatment of Customers'

²¹ TCFD, 2017. Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures [Online] Available at: <https://www.fsb-tcfd.org/wp-content/uploads/2017/12/FINAL-TCFD-Annex-Amended-121517.pdf>

51. In order to ensure consistency across financial and corporate sectors and to support the development of market standards in the extent and quality of disclosures it would be beneficial to formally endorse the use of the TCFD reporting framework for FCA-regulated firms. This approach would build upon the current use of the TCFD by some investors and allow the examples set during the current 'best practice' phase of adoption to inform a next phase of international standard setting.

A global standard

52. A clear benefit of the TCFD framework is that it is becoming increasingly familiar to firms across global markets. Taking a leading stance on the development of an international standard in climate risk reporting will put the UK at the forefront of consumer protection in this regard, while also creating certainty for firms and a reporting process that will provide accessible and decision-useful information beyond the UK-market.

53. It is likely that regulators in other jurisdictions will consider mandatory climate risk reporting using the TCFD recommendations. Action 9 in the EU's Sustainable Finance Action Plan commits to using the TCFD recommendations to strengthen sustainability disclosure standards. The European Commission's technical expert group, appointed to consider this issue, recommended in January 2019 that reporting requirements under the Non-Financial Reporting Directive be aligned with the TCFD.²²

Scenario analysis

54. Some of the firms regulated by the FCA may currently be less affected by climate change and uncertain as to how climate risk will impact their business in the future. Given the long-term nature of many of the risks resulting from climate change and the range of scenarios which may occur, it would be prudent for firms to conduct scenario analysis in order to effectively plan for and mitigate future risks. As part of this process, firms should consider planning against a scenario that is consistent with the Paris Agreement goal of limiting global temperature increase to well below two degrees and preferably in line with 1.5 degrees, as recommended by the IPCC's 2018 special report.²³

55. The TCFD recommendations include guidance on the use of scenario analysis which could help to inform the development of these practices for firms. We consider that conducting scenario analysis will assist firms with business planning and also provide the FCA with data on how emerging categories of risk are expected to affect a particular sector. Endorsing the use of scenario analysis as part of a new climate risk reporting requirement would therefore provide both commercial and prudential benefits for firms.

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

56. We think that it would be appropriate to ask all regulated firms to report on climate risks. This approach would ensure consistency across the market and assist the FCA in meeting its regulatory objective to ensure that the market functions well.

²² https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en

²³ <https://www.ipcc.ch/sr15/>

57. If certain sectors or firms were to be exempted from a new requirement to produce a climate risks report it could create a misleading impression that these sectors or firms were not exposed to climate-related risks, and that other firms were. As the FCA acknowledges, climate change is a developing risk and it would be beneficial to all market participants to conduct assessments of how their activities are affected. Although some firms may not currently be materially exposed to climate risk, it would be good practice for these firms to put in place the appropriate systems and processes for assessing climate risks to their business now in case such risks should increase in the future. As discussed above, one way of doing this would be through the use of scenario analysis.
58. The systemic nature of climate risk means that it will have a degree of impact upon all regulated firms and it is therefore appropriate that reporting requirements should apply to all firms.
59. We also note that the information reported by firms on climate risk will assist the FCA with producing a report under the third round of the Adaptation Reporting Power, as it has now confirmed it will do.²⁴ Better climate risk reporting would support the FCA in its assessment of existing and developing risks to the market as a whole and enable a more holistic view of how the FCA should adapt its rules and enforcement practices to better fulfil its operational objectives in respect of climate risk.

3.3 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?

60. We are aware of several areas in which the FCA could help to support investors, both institutional and retail, to invest sustainably.
61. For institutional investors, an important way in which the long-term sustainability of investments can be achieved is by effective stewardship of existing investments. This could involve engaging with companies to ensure that they are equipped to transition their business to a low-carbon economy, and to ensure that any risks arising from climate change are identified and appropriately acted upon. One barrier to conducting effective stewardship that we have identified is the inconsistent approach taken by asset managers to providing dis-aggregated voting rights for investors in pooled funds. While we do not propose to go into this topic in detail in this response, we feel that this issue could merit regulatory attention as a potentially anti-competitive practice and may present a significant opportunity to dismantle one of the roadblocks to the mainstreaming of sustainable investing.
62. For retail investors, a clearer understanding of how investment advisors are required to incorporate investment objectives relating to sustainability into their recommendations would be beneficial. The current rules on suitability assessments in COBS 9A require advisors to consider any information provided by the client in relation to their investment objectives but research suggests that suitability assessments do not routinely include questions on

²⁴<https://www.gov.uk/government/publications/climate-change-adaptation-reporting-third-round/list-of-organisations-reporting-under-adaptation-reporting-power-third-round>

investors' sustainability objectives.²⁵ The FCA could take steps to ensure that both retail investors and firms providing investment advice are aware of the correct application of the rules in this respect.

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?

63. We support the FCA's proposals to consult on new guidance to issuers on how climate risk might apply to their existing regulatory obligations. We also support the proposals to consult upon guidance for contract-based pension providers, particularly the suggestion to clarify how financial and non-financial factors should be considered.
64. We further support the suggestion that a new requirement could be introduced for all FCA-regulated firms to emphasise the existing obligations relevant to climate risk.
65. However, we would like to reiterate the importance of effective regulatory oversight of existing rules. This is a means by which the FCA can clarify its approach and provide certainty to firms as to what the regulator expects of them.
66. We also suggest that, beyond the outcomes of this Discussion Paper, the FCA takes an iterative approach to its consideration of climate risk, building on the PRA's work in this area and using the process of reporting under the third round of the Adaptation Reporting Power to help shape intervention strategies.
67. In addition to our comments above in relation to disclosure, we also strongly believe that the FCA should adopt a consistent approach to the PRA in providing explicit guidance on the need for relevant regulated firms to fully embed the consideration of financial risks from climate change in their governance and risk management frameworks. As recommended in the PRA's recent consultation on its proposed supervisory statement (Consultation Paper 23/18), this should include a requirement for relevant firms to allocate responsibility for identifying and managing financial risks from climate change to the relevant existing Senior Management Function(s) (SMF(s)) most appropriate within the firm's organisational structure (subject to the forthcoming implementation of these rules for all FCA solo-regulated firms). The FCA should also set out clear expectations for firms to undertake scenario analysis and stress testing of climate change-related factors to inform their risk identification and management processes, as well as their disclosure obligations.²⁶

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?

68. We do not propose to answer this question.

²⁵ <https://2degrees-investing.org/non-financial-message/>

²⁶ See PRA, Consultation Paper 23/18 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' (October 2018).

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

69. We support the FCA and PRA's proposal to convene a Climate Financial Risk Forum. As referenced above, we see this as an opportunity for ongoing collaboration with the other key UK regulators (including the Pensions Regulator). In relation to the participation of industry, it is important that those responsible for assessing and reporting compliance with mainstream disclosure requirements are included and that the issue of climate risk reporting is not siloed within responsible investment/ ESG business teams.

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

70. As referred to above, the IPCC special report presented a stark message on the importance of limiting global temperature rises to 1.5 degrees. The significance and scale of this challenge will require decisive action by both the public and the private sector. One of the greatest concerns must therefore be the timescale for implementing such changes. It is for this reason that we think it is critical that firms' ability to assess and manage climate risk be driven forward as quickly as possible. Clear, rigorously enforced reporting standards, which provide decision-useful information across financial markets, will be an effective way of achieving this.

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

71. The lack of consistent and comparable data available to investors and consumers is one significant barrier. Despite widespread acceptance in business and finance of the need to reduce GHG emissions, information failures can restrict understanding of the financial risks and opportunities associated with climate change and negatively impact upon decision making.

31 January 2019