Complaint to the FCA

Phoenix Group Holdings

Contents

1 Executive Summary

1. Phoenix Group Holdings ("**Phoenix**") is a closed life assurance fund consolidator that manages and acquires closed life and pension funds via its subsidiaries. It operates primarily in the United Kingdom and has a premium listing on the London Stock Exchange. It is a member of the FTSE 250 index.

2. The purpose of this complaint (the "**Complaint**") is to bring two breaches of Phoenix's legal duties to the attention of the Financial Conduct Authority ("**FCA**").

3. Climate change is a principal risk affecting the life insurance sector. Furthermore, Phoenix's business model may be particularly vulnerable to climate change risks. An analysis of both the general and specific risks posed by climate change is presented in section (3) of this Complaint.

4. Phoenix is legally obliged to disclose the principal risks and uncertainties affecting its business in its annual report. A detailed discussion of the relevant provisions is given in section (4) of this Complaint.

5. Notwithstanding the above, Phoenix has failed to mention climate change in its annual report at all. As a result, it is in breach of its legal duties under DTR 1A.3.2 R and DTR 4.1.8 R of the Disclosure Guidance and Transparency Rules ("**DTRs**"). Further details are given in section (5) of this Complaint.

6. The FCA is responsible for enforcing the provisions of the DTRs. Accordingly, ClientEarth requests that the FCA i) imposes a financial penalty in an amount it considers appropriate, and ii) requires Phoenix to publish information so as to rectify the deficiencies in its annual report.

7. In the alternative, ClientEarth requests that the FCA publicly censure Phoenix for its failure to meet its legal duties. These submissions are detailed in section (6) of this Complaint.

2 Factual Background

2.1 ClientEarth

8. ClientEarth is a non-profit environmental law organisation based in London, Brussels, Warsaw and Beijing. ClientEarth's Climate Finance initiative analyses the legal implications of climate change-related risk for a wide spectrum of market participants, including insurance companies and regulators. We also engage and conduct advocacy with these stakeholders in relation to the specific and systemic risks of climate change.

2.2 Phoenix Group Holdings

9. Phoenix is incorporated in the Cayman Islands (Registered Company No. 202172). It is a closed life assurance fund consolidator that primarily manages and acquires closed life and pension funds.

10. Phoenix's core business segment is Phoenix Life, which consists of four operating life companies and its distribution business, Sunlife. It has over 5.6 million policyholders and £74 billion of assets under management.

11. Phoenix has had a premium listing on the main market of the London Stock Exchange since 5 July 2010. Their shares are included in the FTSE 250 index.

12. This Complaint relates to the annual report produced by Phoenix for the year ending 31 December 2017.

3 The Materiality of Climate Change

13. In order to understand whether Phoenix has a legal duty to report on climate change-related financial risks, it is first necessary to understand the nature and extent of those risks. This section therefore considers how climate change-related risks are material to i) the life insurance sector generally, and ii) Phoenix specifically.

3.1 The Materiality of Climate-Related Financial Risks to the Life Insurance Sector

14. Over the last few years, there has been a growing awareness of the risks which climate change pose to the life insurance sector.

15. The Prudential Regulatory Authority's ("**PRA**") seminal paper, "*The Impact of Climate Change on the UK Insurance Sector*"[1] published in September 2015 provided an overview of some of these risks. Notably, its analysis suggested that "*there is potential for climate change to present a substantial challenge to the business model of insurers.*"[2]

16. The paper categorised the challenges posed by climate change into physical, transition, and liability risks. This Complaint shall adopt the same terminology. It includes a short summary of how physical risks and transition risks affect life insurers, plus an additional discussion of reputational risk.

17. Following these summaries, the recognition of these risks by financial regulators and the insurance sector shall be addressed.

3.1.1 Physical Risks

18. The Intergovernmental Panel on Climate Change ("**IPCC**") is the pre-eminent global scientific authority on climate change. The IPCC anticipates that the impacts of climate change will include:

    a. extreme precipitation events intensifying and becoming more frequent;

    b. a continued rise in global sea levels and increased coastal flooding; and

    c. more frequent heat waves which persist over longer durations, and increased prevalence of drought and wildfires.[3]

19. The broad scientific consensus is that increasing global temperatures will have a significant impact on weather-related natural catastrophes, and will account for an increasing proportion of natural catastrophe losses.[4]

20. The IPCC has identified key climate-related risks that span sectors and regions. An example is systemic risks arising from extreme weather events which lead to a breakdown of infrastructure networks and critical services.[5]

21. All these risks are likely to cause direct damage to property, as well as business disruption. Analysis by Swiss Re has shown that total economic losses from natural catastrophes in 2017

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[1] *Bank of England (2015). "The impact of climate change on the UK insurance sector: A Climate Change Adaptation Report by the Prudential Regulation Authority" September 2015.*
[2] *Ibid, pg. 5.*
[3] *IPCC (2014) "Climate Change 2014: Synthesis Report. Contribution of Working Groups I, II and III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change [Core Writing Team, R.K. Pachauri and L.A. Meyer (eds.)]." IPCC, Geneva, Switzerland.*
[4] *Ibid.*
[5] *Ibid pg. 65*

were around $330 billion (£250 billion)[6]. According to a 10-year rolling average, economic losses due to catastrophes has grown by 5.9%. [7]

22. Relevantly, assets are becoming highly concentrated in urban areas.[8] For these areas in particular, the IPCC states that:

> "*climate change is projected to increase risks for people, assets, economies and ecosystems, including risks from heat stress, storms and extreme precipitation, inland and coastal flooding, landslides, air pollution, drought, water scarcity, sea level rise and storm surges.*"[9]

23. On this point, the Lloyds' City Risk Index discusses the economic consequences of climate change for the cities in its index. It anticipates that climate events will cost those cities $122.98 billion (£93.91 billion) every year, and that this sum will grow as extreme weather events become more frequent and severe.[10]

24. This vulnerability is expected to result in credit downgrades for municipalities that do not engage in addressing climate change threats. Local governments are more likely to default where they suffer direct financial losses due to climate change and sea level rise, combined with a decreasing tax base resulting from water hazards.[11]

25. In the same vein, the Union of Concerned Scientists ("**UCS**") recently published a report which found that sea level rise will put billions of dollars of property at risk. Their analysis concludes that more than 300,000 of today's homes and commercial properties in the coastal United States are at risk of chronic disruptive flooding within the next thirty years.

26. Accordingly, the value of real estate is expected to fall in flood-prone areas. The UCS concluded that "*the cliff's edge of a real estate market deflation due to flooding and sea level rise is already visible for many communities*".[12]

27. However, climate change is not only likely to result in increased property damage. Climate change will also impact supply chains, distribution networks, customers, and markets.[13]

28. Accordingly, the indirect effects of climate change could also affect the value of investment portfolios, e.g. business interruption due to extreme weather events could lead to bond

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[6] All GBP £ figures in this Complaint are approximate based on an exchange rate of 1 USD = 0.763487 GBP.
[7] Swiss Re Institute (2018), sigma No 1/2018. "Natural Catastrophes and Man-Made Disasters in 2017: A Year of Record-Breaking Losses".
[8] ClimateWise (2017). "Insurable Cities: ClimateWise Principles Independent Review 2017" University of Cambridge Institute for Sustainability Leadership and PwC.
[9] IPCC (2014), pg 69.
[10] Lloyd's of London (2018). "Lloyd's City Risk Index: Executive Summary".
[11] Miller, John A., (2018). "Credit Downgrade Threat as a Non-regulatory Driver for Flood Risk Mitigation and Sea Level Rise Adaptation" Master of Environmental Studies Capstone Projects. 73.
[12] Union of Concerned Scientists (2018). "Underwater: Rising Seas, Chronic Floods, and the Implications for US Coastal Real Estate". pg 25.
[13] European Bank for Reconstruction and Development (2018). "Advancing TCFD guidance on physical climate risks and opportunities."

defaults or share price reductions.[14] Given the global nature of the supply chain in many sectors, the impact could be profound.

29. In many cases, companies have a poor understanding of the exposure that their supply chains have to extreme weather events. Nick Wildgoose, the Global Supply Chain Product Leader of Zurich Insurance Group, states that:

> "*Most companies in our interconnected world depend fundamentally on their supply chain. There's hardly anybody running industry now that doesn't. And I'm afraid to say that many of these companies still fail to understand where their critical suppliers are, from an extreme-weather point of view.*"[15]

30. A recent example is the catastrophic flooding in Thailand during 2011. The floods resulted in extensive damage to commercial properties and business interruption losses. The high losses were ascribed to a combination of the following factors:

    a. Thailand's role in the global manufacturing supply chain;

    b. the scale of the affected areas;

    c. a high concentration of property values;

    d. high insurance penetration; and

    e. insufficient pre-disaster preparedness.[16]

31. These risks are highly relevant to life insurers as they may detrimentally impact on the value of their investment portfolios. Such impacts could result from downgrades to national bonds, municipal bonds and corporate bonds due to an increased likelihood of default. There may also be sharp reductions in the value of climate-vulnerable companies and real estate. Finally, climate change may significantly increase the risk of investments which are secured against real estate.

32. In addition, climate change may affect life insurers' liabilities. Increasing climate change is expected to adversely affect mortality and morbidity due to increases in heat-related human deaths, and the spread of vector-borne and water-borne diseases.[17] According to the Lancet Commission, a growing and ageing human population combined with coastal migration could

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[14] *Bank of England, 2015.*
[15] *"Interconnected Risks Put Global Businesses in Path of Extreme Weather Events" Bloomberg 6 June 2018. Accessed via https://www.bloomberg.com/news/sponsors/zurich/interconnected-risks-put-global-businesses-in-path-of-extreme-weather-events/?adv=6712&prx_t=1LgDAAAAAAFEANA on 10 July 2018.*
[16] *Swiss Re Institute (2012), sigma no 2/2012. "Natural catastrophes and man-made disasters in 2011: historic losses surface from record earthquakes and floods".*
[17] *IPCC, (2017).*

also exacerbate vulnerability to climate risks.[18] Life insurers could therefore suffer higher than expected losses.

33. It should be noted that the risks discussed in this section are all driven by the same underlying driver, climate change. With that in mind, the potential correlation between these risks should be evaluated and reflected in decision-making processes.

34. The physical risks of climate change therefore present a material business risk to life insurers.

3.1.2 Transition Risks

35. The Paris Agreement entered into force in 2016 and set out a global action plan to curb dangerous climate change by holding increases in global average temperature to well below 2°C, and to pursue efforts to limit the temperature increase to 1.5°C.

36. If the world is to achieve the objectives of the Paris Agreement, a significant shift in the trajectory of carbon emissions will be required.[19] This transition to a low carbon economy could have a significant impact on the value of financial assets and their capital returns. These could result from policy changes, legal actions, technological changes, market responses, and reputational considerations.[20]

37. Such a transition would result in a wealth of business opportunities for many sectors.[21] However, it also poses serious challenges to certain sectors who do not or cannot adapt.

38. In particular, the fossil fuel industry faces significant stranded asset risks as a result of the transition to a low-carbon economy. Stranded assets can be defined as assets which become obsolete or non-performing, leading to premature write-downs, devaluation or conversion to liabilities.[22]

39. To put this into context, a study from University College London concluded that to have a 50% chance of limiting warming to 2°C, 33% of oil reserves, 50% of gas reserves, and 80% of coal reserves should remain unused.[23] [24] Such assets are therefore especially vulnerable to being written off and becoming stranded assets.

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[18] *Lancet Commissions (2015). "Health and climate change: policy responses to protect public health". June 2015.*
[19] *International Energy Agency (2017). "Energy Technology Perspective 2017: Catalysing Energy Technology Transformations, Executive Summary".*
[20] *Kepler Cheuvreux Transition Research (2018). "Investor Primer to Transition Risk Analysis: Summary". Climate Scenario Compass: Climate Change & Natural Capital. 31 January 2018.*
[21] *Task Force on Climate-related Financial Disclosures (2017). "Recommendations of the Task Force on Climate-related Financial Disclosures". June 2017.*
[22] *Caldecott, B. (2017). "Introduction to special issue: stranded assets and the environment" Journal of Sustainable Finance & Investment Volume 7, 2017 – Issue 1: Stranded Assets and the Environment.*
[23] *McGlade, C. & Ekins, P. (2015). "The geographical distribution of fossil fuels unused when limiting global warming to 2°C" Nature volume 517, 187–190. 08 January 2015.*
[24] *Indeed, this assessment may be conservative in light of the fact that the Paris Agreement in fact aims to keep global temperature increases "well below" 2°C, rather than simply limiting them to 2°C.*

40. The most striking example is that of coal. In recent years, US coal has been in drastic decline. Between 2008 and 2016, coal production fell by 38%. As a result, its share of energy generation in the US fell from 50% to 30% within the same period.[25]

41. Financial analysts do not expect this picture to change, despite the actions of the Trump Administration, due to competitive pressure from natural gas and renewables.[26] Carbon Tracker estimates that the total stranded asset value for US coal owners is $104 billion (£79 billion) for the period to 2035 under the International Energy Agency's "Beyond 2°C Scenario".[27]

42. These issues are not unique to the US. Carbon Tracker has also found that 54% of operating coal capacity in Europe is cash flow negative today, increasing to 97% by 2030. This makes units reliant on lobbying to secure capacity market payments and avoid air pollution regulations.[28]

43. However, the fossil fuel sector is not the only sector which is exposed to transition risks. Many other sectors may also be significantly affected.

44. For instance, it is anticipated that the world's biggest meat and dairy companies could surpass major fossil fuel companies as the largest climate polluters in the world within the next few decades. The top five meat and dairy corporations are already responsible for more annual greenhouse gas emissions than ExxonMobil, Shell or BP.[29] This footprint exposes the sector to potential changes in policy, technology, and consumer preferences in much the same way as the fossil fuel industry.

45. Overall, research suggests that the combined exposure to sectors that could be affected by the climate and energy transition is about 45 – 47% of equity portfolios. However, the same research also concludes that climate-related risks tend not to be fully captured or priced in by current financial models, analyses, or recommendations.[30]

46. As a result, the Bank of England has warned that "*a wholesale reassessment of prospects, as climate-related risks are re-evaluated, could destabilise markets, spark a pro-cyclical crystallisation of losses and lead to a persistent tightening of financial conditions: a climate Minsky moment.*"[31]

47. It is often assumed that these risks are contingent on governments adopting Paris-compliant policies. However, a recent study concludes that this risk exists as a result of our current

[25] David, *Schlissel, IEEFA (2018). "Can the US coal industry come back", Forum, Issue 111, The Oxford Institute for Energy Studies*
[26] *Ibid.*
[27] *Carbon Tracker Initiative (2017). "No country for coal gen: Below 2°C and regulatory risk for US coal power owners". September 2017.*
[28] *Carbon* Tracker Initiative (2017). "*Lignite of the living dead: Below 2°C scenario and strategy analysis for EU coal power investors*". December 2017.
[29] *Institute for Agriculture & Trade Policy and GRAIN (2018). "Emissions impossible: How big meat and dairy are heating up the planet".*
[30] *Kepler Cheuvreux Transition Research (2018).*
[31] *Speech by Mark Carney, Governor of the Bank of England. "A Transition in Thinking and Action" 6 April 2018.*

technological trajectory, regardless of whether new climate policies are adopted. Nevertheless, new climate policies may amplify the impact.[32]

48. Consequently, it is estimated that losses from stranded fossil fuel assets alone could amount to a discounted global wealth loss of $1 - 4 trillion (£0.8 - £3 trillion), with some regions being disproportionately affected.[33]

49. The timeframe for these risks to crystallise is inherently uncertain and could be unexpectedly abrupt. A recent survey found that the fund management sector agreed that transition risk will significantly affect oil company valuations in the next five years, while 90% expected at least one risk to significantly impact valuation within two years.[34] Climate change therefore presents a short, medium and long-term risk which could detrimentally impact the value of life insurers' investment portfolios.

50. Partly as a response to concerns raised by the Bank of England, Lloyd's of London released a report on how stranded asset risk may affect the assets and liabilities of the (re)insurance sector. Their view was that "*physical environmental change and societal response to these changes could potentially strand entire regions and global industries within a very short timeframe, with direct and indirect impacts on international insurance markets*."[35]

51. The report identifies a number of key actions that insurers could take to identify and mitigate such risks including stress-testing, screening, hedging, hiring expertise, divestment and enhanced engagement.[36]

52. A recent analysis was also conducted by the California Department of Insurance with regard to insurers' investments.

53. This analysis revealed that Californian insurers were heavily exposed to the stranded asset risks associated with coal as their portfolios were consistent with a trajectory of six degrees of warming.[37] This over exposure is unlikely to be confined to Californian insurers, and insurers globally should be assessing and managing their exposure to high-risk sectors such as coal.

54. Transition risks are therefore a material business risk for life insurance companies which must be identified, managed and disclosed to investors.

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[32] *J.-F. Mercure et al. (2018) "Macroeconomic Impact of Stranded Fossil Fuel Assets." Nature Climate Change, Volume 8, pgs. 588–593.*
[33] *Ibid.*
[34] *UKSIF and the Climate Change Collaboration (2018). "Not long now: Survey of fund managers' responses to climate-related risks facing fossil fuel companies" April 2018.*
[35] *Lloyd's of London (2017). "Stranded Assets: the transition to a low carbon economy. Overview for the insurance industry." Emerging Risk Report 2017, Innovation Series: Society and Security.*
[36] *Ibid pg 28.*
[37] *California Department of Insurance. Analysis available at https://interactive.web.insurance.ca.gov/apex_extprd/f?p=250:70*

3.1.3 Reputational Risk

55. The role that the insurance industry plays in financing the fossil fuel sector is coming under increased public scrutiny. Prominent civil society movements, such as the Unfriend Coal campaign, are insisting that insurance and reinsurance companies cease facilitating projects that fuel climate change. To date, this mounting pressure has led to a tide of new restrictions on their investment activities.[38]

56. Unfriend Coal estimates that nearly half of the global reinsurance market has now divested from coal. Reinsurers such as Hannover Re, Swiss Re, Munich Re, SCOR, and Lloyd's have all introduced divestment policies within the last year or two.[39]

57. In total, seventeen (re)insurers are reported to have adopted divestment policies in respect of joint assets over $6 trillion (£4.5 trillion). Unfriend Coal estimates that $30 billion (£23 billion) has been withdrawn from the coal sector as a result.[40]

58. These developments are notable for two main reasons:

    a. First, insurers who remain engaged in such activities are likely to become targeted by campaigners which could result in direct reputational damage. As increasingly ambitious policies are adopted, laggards may find it challenging to justify their inaction.

    b. Second, they are indicative of a growing movement away from activities and investments that are contrary to the aims of the Paris Agreement. For a large part, this can be seen as a response to reputational risk. As such, reputational pressure may be a key driver of the transition risks discussed in section 3.1.2 above.

3.1.4 Regulatory Recognition of the Risks posed by Climate Change

59. Given the substantial challenges detailed above, climate change is a rising priority on the regulatory agenda. The risks associated with climate change and their impacts have been noted by three of the major financial regulators in the United Kingdom: the Prudential Regulatory Authority, the Financial Conduct Authority, and the Financial Reporting Council. These are discussed in turn below.

3.1.4.1 The Prudential Regulatory Authority (PRA)

60. The PRA is responsible for the prudential regulation of financial institutions including insurance companies. Over the last few years, the PRA has been increasingly vocal about the financial risks posed by climate change.

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[38] *"The beginning of the end for coal investment and underwriting". Published by Insurance ERM on 19 April 2018.*
[39] *Unfriend Coal (2018). "Close to half global reinsurance market divests from coal" 19 June 2018. Accessible via https://unfriendcoal.com/2018/06/19/close-to-half-global-reinsurance-market-divests-from-coal/*
[40] *Ibid.*

61. Paul Fisher, then the Executive Director of Insurance Supervision at the PRA, identified some of the financial risks associated with climate change in a speech in early 2015. He commented that:

> *"insurers, as long term investors, are also exposed to changes in public policy as this affects the investment side. One live risk right now is of insurers investing in assets that could be left 'stranded' by policy changes which limit the use of fossil fuels. As the world increasingly limits carbon emissions, and moves to alternative energy sources, investments in fossil fuels and related technologies – a growing financial market in recent decades – may take a huge hit. There are already a few specific examples of this having happened*."[41]

62. The governor of the Bank of England, Mark Carney, expanded on the financial stability risks associated with climate change in a speech at Lloyd's of London in 2015.[42] In this speech he discussed physical, transition and liability risks facing the insurance sector. Carney remarked that:

> "*Insurers are therefore amongst those with the greatest incentives to understand and tackle climate change in the short term. Your motives are sharpened by commercial concern as capitalists and by moral considerations as global citizens."*

63. At the same time, the PRA published its report on climate change and the insurance sector as discussed above. In that report, the PRA concludes that "*the impact of physical risks arising from climate change on investment portfolios and policyholders is likely to be of particular relevance to life insurance firms, given relatively long-term investment horizons, as well as to the PRA's objective for policyholder protection.*"[43]

64. The PRA further noted that transition risk may be particularly relevant to life insurers given the relatively long-term horizon of their investments.[44]

65. This was followed by a quarterly bulletin published by the Bank of England in 2017 which further discussed climate-related financial risks and its relevance to financial regulators.[45]

66. Accordingly, the PRA is clearly aware of the systemic financial risks that climate change poses, and the particular vulnerabilities of the life insurance sector. Notably, it has alluded to further regulatory scrutiny of climate change risks in the future with a focus on disclosure.[46]

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[41] *Speech by Paul Fisher (2015), 'Confronting the challenges of tomorrow's world', 3 March 2015.*
[42] *Speech by Mark Carney (2016), "Breaking the Tragedy of the Horizon – climate change and financial stability" 29 September 2015.*
[43] *Bank of England (2015), pg. 45.*
[44] *Bank of England (2015), pg. 54.*
[45] *Bank of England (2017). "Quarterly Bulletin 2017 Q2 – Topical article: The Bank of England's response to climate change".*
[46] *See https://uk.reuters.com/article/us-boe-insurance-regulations/bank-of-england-to-intensify-climate-change-scrutiny-of-insurers-idUKKCN1J30UO*

3.1.4.2 The Financial Conduct Authority (FCA)

67. The FCA has recently discussed climate change risks as part of its response to a Law Commission report on pension funds and social investment.[47]

68. In its response, it confirmed that "*the FCA consider that financially material ESG risks, including climate change risks, should be incorporated into investment decision making*".[48]

69. While the comments are made in the context of pension funds, the investment challenges they face largely mirror those facing life insurers. Both pension funds and life insurers are vulnerable to the physical and transition risks discussed above. Against that backdrop, the FCA's comments are equally relevant to the present Complaint.

70. Furthermore, the FCA recently responded to the Environmental Audit Committee's Green Finance report. They listed a number of proactive steps which they are taking with regard to climate change-related disclosures.

71. As part of this, the FCA stated it will "*highlight to issuers the need to make adequate disclosures regarding materially important information, including information that allows investors to understand how ESG matters affect the valuation of a listed company's securities and how these matters are managed by the company*."[49]

72. It is ClientEarth's submission that this Complaint represents an opportunity for the FCA to take action in line with its recent statement.

3.1.4.3 The Financial Reporting Council (FRC)

73. The FRC is responsible for reviewing annual reports to monitor compliance with accounting requirements and reporting frameworks.[50] Climate change has been a strong theme identified in the FRC's Annual Reviews of Corporate Reporting for both 2015/2016 and 2016/2017.

74. In the 2015/2016 Review, the FRC states that: "*We encourage companies to consider a broad range of factors when determining the principal risks and uncertainties facing the business, for example cyber-crime and climate change*."[51]

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[47] *Law Commission (2017). "Pension Funds and Social Investment " Law Comm No. 374 printed 22 June 2017.*
[48] *Department for Work & Pensions (2018). "Pension funds and social investment: the Government's final response" June 2018.*
[49] *Letter from David Geale, Director of Policy at the FCA, to Mary Creagh MP, Chair of the Environmental Audit Committee, dated 6 July 2018.*
[50] *Financial Reporting Council (2017). "FRC Roles and Responsibilities: Schedule of Functions and Powers" June 2017.*
[51] *Financial Reporting Council (2016). "Annual Review of Corporate Reporting 2015/2016". October 2016.*

75. In the 2016/2017 Review, the FRC stated that "*we expect reference to be made to the impact of climate change where relevant for an understanding of the company's activities*." [52]

76. In 2017, the FRC also published a draft of proposed amendments to their Guidance on the Strategic Report, which specifically highlights climate change as an example of the type of risk that entities should be considering.

77. This echoes the increasing importance that investors are placing on climate-related disclosures. Stephen Haddrill, CEO of the FRC, has written that investors have "*expressed surprise that risks relating to data protection in IT system / cyber risks and risks from climate change are not reported more often as principal risks*."[53]

3.1.5 Sectoral Recognition of the Risks Posed by Climate Change

78. The Sustainable Insurance Forum ("**SIF**") has recognised that "*climate change is one of the most serious long-term threats to the financial system. Insurance is one of the financial sub-sectors most exposed to climate-related risks, being potentially exposed on both sides of its balance sheet."*[54] This has been echoed in research with LeBlanc and Linkin identifying insurance as the "*canary in the coal mine*" for climate-related financial risks.[55]

79. Importantly, SIF also warns insurance companies against *"prematurely concluding that climate-related risks are not material based on a certain perception of their longer-term nature."*[56]

80. As a result of the significance of climate change risks, SIF has been working with the International Association of Insurance Supervisors ("**IAIS**") to produce an *"Issues Paper on Climate Change Risks to the Insurance Sector".* The paper states that "*physical and transition risks may pose different strategic, operational, and reputational risks to insurers across underwriting and investment business. While certain climate-related risk factors are long-term in nature, some are already having material impacts*".[57]

81. Some insurance companies have already made significant progress in recognising the material risks posed by climate change. This can be seen in the annual reports produced by other leading insurers.

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[52] *Financial Reporting Council (2017). "Annual Review of Corporate Reporting 2016/2017". October 2017.*
[53] *Letter from Stephen Haddrill to the Audit Committee Chairman dated 15 December 2015.*
[54] *Sustainable Insurance Forum (2017). "Leading Insurance Supervisors Support Adoption of Climate Disclosure Recommendations" Response to FSB TCFD Recommendations Report public consultation.*
[55] *LeBlanc, A. and Linkin, M. (2010). "Insurance industry". InClimate Change Adaptation in New York City: Building a Risk Management Response: New York City Panel on Climate Change 2010 Report, pp. 113, New York, NY: Annals of the New York Academy of Sciences.*
[56] *Sustainable Insurance Forum (2017).*
[57] *International Association of Insurance Supervisors and Sustainable Insurance Forum (2018). "Issues Paper on Climate Change Risks to the Insurance Sector." pg. 17.*

82. For instance, AXA recognises in its annual report that "*the consequences of climate change are expected to significantly impact the insurance industry, including with respect to risk perception, pricing and modelling assumptions, and the need for new insurance products, all of which may create unforeseen risks not currently known to us*".[58]

83. A further example is provided in the annual report of Aviva. In describing their principal risks, they include "*Climate change - potentially resulting in higher than expected weather-related claims (including business continuity claims) and inaccurate pricing of general insurance risk, as well as adversely impacting economic growth and investments markets. Trend - increasing. Risks impacted: General insurance risk, credit risk, market risk.*"[59]

84. Additionally, Prudential's annual report describes how climate change is creating a number of potential near term risks. It specifically discusses investment risk, liability risk, and reputational risks.[60]

85. In light of the above, it is clear that climate change poses challenges beyond the traditional risks often identified by insurance companies. It is therefore imperative that insurance companies disclose these risks to their shareholders and explain how they are being managed. Indeed, SIF has recognised the "*critical importance*" of adequate climate disclosure.[61]

86. A framework for disclosing climate-related financial risks was published by the Task Force on Climate-related Financial Disclosures in June 2017.[62] This recommended framework was accompanied by sector-specific supplemental guidance on implementation for the insurance industry.[63] Accordingly, there are existing sources of advice on how material climate-related risks should be disclosed.

3.2 Additional Material Climate-risk Factors Applicable to Phoenix

87. As the UK's leading consolidator of closed life funds with £74 billion of assets under management, Phoenix faces significant challenges from climate change.

88. Life insurers are particularly susceptible to risks which affect their investments. Investment returns are critical to fulfilling longer-term obligations on their saving, pension and annuity

[58] *AXA Annual Report 2017.*
[59] *Aviva plc Annual Report 2017.*
[60] *Prudential Annual Report 2017.*
[61] *Sustainable Insurance Forum (2017).*
[62] *Task Force on Climate-related Financial Disclosures (2017). "Recommendations of the Task Force on Climate-related Financial Disclosures". June 2017.*
[63] Task-Force on Climate-related Financial Disclosures (2017). "Annex: Implementing the Recommendations of the TCFD" June 2017.

liabilities.[64] Indeed, Phoenix's operating profit is based on expected long-term investment returns.[65]

89. Phoenix' sensitivity to fluctuation in those returns therefore gives rise to market risk. Many of the funds held by Phoenix expose the company to such risks. In particular:

    a. With-profit funds exposes shareholder capital to economic movements. This type of product comprises 40% of Phoenix's key products.[66]

    b. Protection policies and annuities also expose shareholders to investment risks. These comprise 17% of Phoenix's key products.[67]

    c. Phoenix is exposed to the mismatch between liability portfolios and asset investment portfolios.[68]

90. Market risk is considered the most material risk for life insurers by the PRA, and Phoenix itself classifies market risk in their highest risk universe category. With that in mind, the systemic financial risks posed by climate change should logically be of paramount concern to Phoenix.

91. Climate change risks affects a multitude of different asset classes and acts over a range of temporal and geographical scales. Phoenix's assets may therefore be highly vulnerable to the physical and transition risks discussed above. Furthermore, the correlation between these risks due to the underlying driver of climate change may further amplify their impact.

92. Phoenix is also likely to be particularly vulnerable to the long-term aspects of climate change-related risk. Life insurers typically hold assets to match their liabilities towards policyholders. These policies are long-term in nature and can span several decades. The assets matching these long-term liabilities are often held until maturity. The PRA has recognised that "*on these timescales, the challenges of climate change become very real and significant*".[69]

93. The PRA estimates that life insurers' exposure to the energy sector alone is 5% of total life assets. However, as discussed above, it is not only the energy sector which is potentially affected. Accordingly, life insurers' overall exposure to climate risks is likely to be far greater than 5% of total life assets. As a life insurer, Phoenix may therefore be particularly exposed.

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[64] Bank of England (2015).
[65] See Phoenix's Annual Report 2017.
[66] See Phoenix's Annual Report 2017, pg. 13.
[67] Ibid.
[68] See Phoenix's Annual Report 2017, pg. 141.
[69] Bank of England (2015), pg. 3.

94. Accordingly, for all the reasons given in this section (3) climate change constitutes a material business risk for Phoenix.

4 The Law

95. The Transparency Directive[70] was issued on 15 December 2004 and revised in 2013. Its purpose is to increase transparency and promote the flow of information to market participants in order to enhance investor protection and market efficiency.

96. According to the preamble, "*the disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance assets*."[71]

97. The section of the FCA Handbook which relates to the implementation of the Transparency Directive in the United Kingdom is the Disclosure Guidance and Transparency Rules ("**DTRs**"). The three provisions of the DTRs which are relevant to this Complaint are set out below.

    a. DTR 1A.3.2 R states that "*an issuer must take all reasonable care to ensure that any information it notifies to a [Regulatory Information Service] is not misleading, false or deceptive and does not omit anything likely to affect the import of the information."*

    b. DTR 4.1.5 R states that "*an issuer's financial report must include:… (2) a management report....*"

    c. In turn, DTR 4.1.8 R states that "*the management report must contain: … (2) a description of the* ***principal risks and uncertainties facing the issuer***" (emphasis added).

98. The DTRs do not provide a definition of the term "*principal risks and uncertainties*". However, these requirements appear to be synonymous with section 414C(2)(b) of the Companies Act 2006 which requires companies to disclose "*a description of the principal risks and uncertainties facing the company*" in the "*strategic report*".

99. On that basis, we can look to secondary sources for guidance on the term "*principal risks and uncertainties*". In 2014, the FRC published its Guidance on the Strategic Report ("**FRC Guidance**").

100. This guidance is described by the FRC as being persuasive although not mandatory. As such, the following paragraphs of the FRC Guidance provide an authoritative indication as to what constitutes a principal risk or uncertainty.

[70] *Directive 2004/109/EC*
[71] *Paragraph (1) of Directive 2004/109/EC*

a. Paragraph 5.1 states that "*Information is material if its omission or misrepresentation could influence the economic decisions shareholders take on the basis of the annual report as a whole."*

b. Paragraph 5.3 states that "*Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the actual or potential effect of the matter to which the information relates in the context of an entity's annual report. It requires directors to apply judgement based on their assessment of the relative importance of the matter to the entity's development, performance, position or future prospects*."

c. Paragraph 5.4 states that: "*Materiality in the context of the strategic report will depend on the nature of the matter and magnitude of its effect, judged in the particular circumstances of the case*."

d. Paragraph 5.7 states that "*the terms 'key' … and 'principal' … refer to facts or circumstances that are (or should be) considered material to a shareholder's understanding of the development, performance, position or future prospects of the business.*"

e. Paragraph 7.24 states that "*The risks and uncertainties included in the strategic report should be limited to those considered by the entity's management to be material to the development, performance, position or future prospects of the entity*."

f. Paragraph 7.25 states that "*Directors should consider the full range of business risks, including both those that are financial in nature and those that are non-financial. Principal risks should be disclosed and described irrespective of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control.*"

101. In light of this guidance, it is ClientEarth's submission that:

a. in order to satisfy DTR 4.1.8 R, the management report must include a description of all the principal risks and uncertainties facing the company;

b. for the purpose of DTR 4.1.8 R, '*principal risks and uncertainties facing the company'* means facts or circumstances that are (or should be) considered material to a shareholder's understanding of the development, performance, position or future prospects of the business;

c. for the purpose of DTR 4.1.8 R, '*material*' facts or circumstances are facts or circumstances which a reasonable director in the position of Phoenix's directors would identify and consider could influence the economic decisions shareholders take on the basis of the annual report as a whole.

102. It was shown in section (3) above that climate change-related risks are material to Phoenix. Furthermore, a reasonable director of a FTSE 250 life insurance company should be aware of

these risks given that UK financial regulators have repeatedly flagged climate change-related risks since 2015. Accordingly, Phoenix must disclose material climate change-related risks in their annual report.

5 Phoenix's Breach of its Legal Duties

103. The discussion in section (3) of this Complaint made it clear that climate change poses a material risk to the life insurance sector. In addition, Phoenix's business model comprises numerous elements which are particularly susceptible to climate risks.

104. In accordance with the laws set out in section (4) of this Complaint, Phoenix has a legal duty to disclose the principal risks and uncertainties facing its business.

105. Despite this, Phoenix makes no reference to climate change in its annual report.

106. Phoenix is therefore in breach of DTR 4.1.8 R as it has failed to disclose a principal risk and uncertainty affecting its business. (**Breach 1**)

107. Consequently, Phoenix is also in breach of DTR 1A.3.2 R for omitting information which is likely to affect the import of the annual report. (**Breach 2**)

6 Request to the FCA

108. The annual report is a key resource which enables investors to assess the nature and value of a particular business. Phoenix’s failure to adequately disclose principal climate risks may therefore hamper their investors' ability to make an informed assessment.

109. The FCA has the following powers under section 91(1ZA) of the Financial Services and Markets Act 2000 (“**FSMA**”):

“*If the FCA considers that -*

(a) an issuer who has requested or approved the admission of a financial instrument to trading on a regulated market,

(b) a person discharging managerial responsibilities within such an issuer, or

(c) a person connected with such a person discharging managerial responsibilities,

has contravened any provision of disclosure rules, it may impose on him a penalty of such amount as it considers appropriate.”

110. Furthermore, the FCA may take the following measures under LR 1.3.2 R of the Listing Rules:

(1) *"The FCA may, at any time, require an issuer to publish such information in such form and within such time limits as it considers appropriate to protect investors or to ensure the smooth operation of the market. [Note: Article 16.2 CARD]*

(2) *If an issuer fails to comply with a requirement under paragraph (1) the FCA may itself publish the information (after giving the issuer an opportunity to make representations as to why it should not be published). [Note: Article 16.2 CARD*]"

111. In light of the legal breaches detailed above, ClientEarth requests that the FCA:

   a. *imposes a financial penalty on Phoenix in an amount it considers appropriate; and*

   b. *requires Phoenix to publish information so as to rectify the above-referenced deficiencies in its annual report.*

112. These steps are vital to ensure that investors have adequate information on Phoenix's exposure to climate change-related risks. For the reasons given above, it is important that the information in the public domain is both accurate, and legally compliant.

113. In the alternative, ClientEarth requests that the FCA publishes a statement censuring Phoenix in accordance with section 91(3) of FSMA.

114. Again, a public statement of this nature would put investors on notice that the information in Phoenix's annual report does not adhere to the standards required by law.

115. Please do not hesitate to contact us if we can be of any further assistance in relation to this complaint.

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ClientEarth is a non-profit environmental law organisation based in London, Brussels, Beijing and Warsaw. We are activist lawyers working at the interface of law, science and policy. Using the power of the law, we develop legal strategies and tools to address major environmental issues.

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