July 2019

ClientEarth response to FCA Consultation Paper 19/15 Independent Governance Committees: extension of remit

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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 April 2019, the Financial Conduct Authority (**FCA**) published a consultation paper proposing (amongst other things) a new duty for IGCs to report on their firms' policies on ESG issues, consumer concerns and stewardship, for the products that IGCs oversee (the **Consultation Paper**). This document provides ClientEarth's responses to the questions raised in the Consultation Paper.

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2 Key messages

- While, as the Consultation Paper notes, climate change and the transition to a low carbon economy is a risk – and an opportunity – that providers should think about, it is our experience that many providers are not doing so in practice.
- ClientEarth strongly supports the FCA's proposals to ask IGCs to report on the adequacy, and implementation of firms' policies on ESG issues, member concerns and stewardship, as we believe IGC reporting will go some way to addressing this problem.
- ClientEarth welcomes the guidance proposed by the FCA for the same reasons.
- ClientEarth considers that further regulatory action is required by the FCA in this space. In particular, we would encourage the FCA take further steps to set out its views that firms, and in particular providers of workplace pensions schemes, need to be thinking about the risks and opportunities associated with climate change and the transition to a low carbon when there is not always a strong commercial reason for doing so.

3 Responses to questions

Q1: Do you agree that IGCs should report on the adequacy and quality of their firm's policies on ESG issues, member concerns and stewardship?

Yes, we agree that IGCs should report on the adequacy and quality of their firm's policies on ESG issues, member concerns and stewardship.

As the Consultation Paper notes, climate change and the transition to a low carbon economy is a risk and an opportunity that providers should think about. It is, however, our experience that while pension providers should take the initiative and act on behalf of consumers on these issues, many are not doing so in practice.

ESG issues

There has been considerable confusion in the investment industry in relation to the financially material nature of climate change, and at ClientEarth we believe that it remains a risk that is not properly managed by investment professionals, including in workplace personal pension schemes.

During 2017, ClientEarth wrote to, and met with, a cross-section of providers of contract based pensions to find out how climate risk was being managed on behalf of their customers. The report was provided to the FCA in February 2018, and can be accessed here[1].

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.

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.

[1] ClientEarth, February 2018, Contract-based pensions and climate risk: Report and recommendations to the Financial Conduct Authority, available online at https://www.documents.clientearth.org/wp-content/uploads/library/2017-02-01-contract-based-pensions-and-climate-risk-report-and-recommendations-to-the-financial-conduct-authority-coll-en.pdf

Little appears to have changed since that report was written, in spite of frequent attention in the mainstream media and amongst industry professionals around the catastrophic effects of climate change. Indeed, the experience of individuals who have contacted their contract-based pension schemes in recent months to ask how risks associated with climate change are being managed is that schemes are unable to provide a meaningful response.

Member concerns

While most members of pension schemes will not have the professional investment expertise enjoyed by their pension providers, understanding member views and priorities could help providers design investments to engage members and encourage them to take an interest in their savings.

While "member concerns" has traditionally been an area which finance professionals have regarded with a degree of scepticism, this perhaps stems to a large degree from its framing. In the same way that institutional investors are asked by their investment managers about their investment objectives, members should be asked about their own "investment objectives", including whether they are happy for their money to be invested in high carbon industries. Given widespread societal concern around catastrophic climate change, it is likely that a significant proportion of members of workplace personal pension schemes might want fossil fuel companies to be excluded from their investment universe.

Stewardship

As is clear from the FCA's joint discussion paper on the subject, stewardship activities "*support the functioning of the UK's financial markets by enhancing their quality and integrity, and they contribute to sustainable, long-term value creation for beneficiaries*." As such, stewardship of assets is a key part of the service provided to members by workplace personal pension schemes (whether directly or via intermediaries) and, ultimately, central to the effective discharge of investors' fiduciary duties.

In particular, stewardship and voting has an important function to fulfil in managing systemic and macro-economic risks. As the ICGN highlights, the production of investment returns to meet liability obligations, within a prudent level of risk, is a core obligation of those who invest on behalf of others, and it follows that consideration of systemic risk is embedded in fiduciary, or quasi-fiduciary, duty. Mitigating any potential effects to investments from systemic risk should be considered as part of that duty[2]

Climate change is an example of a systemic, macroeconomic risk that cannot be managed through portfolio construction or asset allocation alone[3]. Because unmitigated climate change will result in losses throughout the economy, across asset classes and sectors, beneficiaries' interests will clearly best be met (and therefore fiduciaries' duties best discharged) through efforts to ensure that warming is kept to a minimum. It follows that it is in beneficiaries' best interests[4] that investment strategies support a swift transition to a low carbon economy that will help limit catastrophic global warming.

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[2] IGCN, 'Guidance on Investor Fiduciary Duties' (2018), p12

[3] See CISL, 'Unhedgeable risk: How climate change sentiment impacts investment' (2015), Mercer, 'Investing in a time of climate change' (2015)

[4] While we focus here on the best financial interests of beneficiaries, it is also important to note that it is obviously also in the best interests of beneficiaries more broadly that investment strategies support a swift transition to a low carbon economy. The difference in quality of life associated with a 1.5°C versus a 3°C, 4°C or 5°C is a very real consideration that we believe fiduciaries' duties permit them to consider. This is particularly the case given the overwhelming public outpouring of concern around catastrophic climate change, exemplified by

This should be seen as nothing more than effective risk management by fiduciaries in which stewardship has a clear role to play exerting pressure both on investee companies and on government and policy makers with the aim that losses associated with the worst excesses of catastrophic climate change do not materialise.

However, given the incentives around “free-riding” on the stewardship activities of others, independent oversight of how far pension providers are acting on behalf of consumers is crucial.

Q2: Do you agree that IGCs should report on how the firm has implemented its policies on ESG issues, member concerns and stewardship?

Yes. For the reasons outlined above, IGC oversight of firms is important in ensuring that providers are acting in the best interests of clients in areas where competition is weak. Reporting on implementation will be key to reducing the likelihood that providers adopt a “box-ticking” approach to their policies, rubber-stamping policies that look good on paper but are not followed in practice.

IGC reporting on implementation of policies will also help scheme members understand how their scheme is putting its policies into practice, and serve to drive best practice in this area.

Q3: Do you agree that IGCs should report on the firm’s policies on these issues for both pathway solutions and workplace personal pensions?

Yes, we agree that requirements should not be different for members invested in pathway solutions and workplace personal solutions.

Q4: Do you agree that firms should make the IGC’s annual report publicly and prominently available, with 2 prior year reports for comparison?

Yes, we agree that firms should make the IGC’s annual report publicly and prominently available, with 2 prior year reports for comparison for the reasons set out in the Consultation Paper.

Q5: Do you agree that the proposed guidance should apply more widely, to all firms that provide pension products and all life insurers that provide investment-based life insurance products?

Yes, we agree that guidance should apply to all firms that provide pension products and all life insurers that provide investment-based life insurance products. It makes sense for outcomes to be comparable between all firms investing money on behalf of others in this way.

It is important that outcomes are comparable across all firms investing on behalf of others. products providing what is essentially the same product.