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Financial Regulators and Climate Risk

How financial regulators can assess the impacts of climate change under the Adaptation Reporting Power

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1 Executive summary

1. The next round of reporting under the Adaptation Reporting Power (**ARP**) will take place from 2018. If financial regulators are not asked to report in this round, it will be a further five years before the next reporting round takes place.

2. The Committee on Climate Change (**CCC**) – the official body which supports the Department for Energy, Food and Rural Affairs (**Defra**) in its exercise of the ARP – recommended in March 2017 that the third round of reporting (**ARP3**) be **extended to cover all areas of the finance sector** and made **mandatory**[1].

3. A consultation on the government's strategy for the exercise of the ARP will be taking place in the second half of 2017. We believe it is crucial that Defra implements the CCC's recommendations by including UK financial regulators in that strategy.

4. There is precedent for financial sector reporting; in 2015, as part of the second round of adaption reporting, the Prudential Regulation Authority (**PRA**) prepared a report into the impact of climate change on the UK insurance sector in (the **PRA Report**)[2]. The PRA Report identified three primary channels through which climate-related risks relevant to the financial sector might arise: physical risks; transition risks and liability risks (together **climate risk**), dealt with in further detail below.

5. Concerns about the impact of climate change on financial markets have since been gathering momentum[3]. Yet overwhelming evidence remains that many investors are not equipped to deal with climate risk[4]. The ARP could be a key tool to help financial regulators

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[1] Committee on Climate Change (2017) "Adaptation Reporting Power: second round review" available at https://www.theccc.org.uk/publication/adaptation-reporting-power-second-round-review/

[2] Bank of England Prudential Regulation Authority (2015) "The impact of climate change on the UK insurance sector: A Climate Change Adaptation Report by the Prudential Regulation Authority" Available at http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf

[3] See for example the work by the Financial Stability Board's Task Force on Climate-related Financial Disclosures, available at https://www.fsb-tcfd.org/publications/recommendations-report/; Institute and Faculty of Actuaries (2017) "Intergenerational Fairness Bulletin: Climate Change" available at https://www.actuaries.org.uk/documents/intergenerational-fairness-bulletin-issue-1-climate-change; Pensions and Lifetime Savings Association (2017) "ESG in default funds: analysis of the UK's DC pension market" available at: http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/0619-ESG-risk-in-default-funds-analysis-of-the-UKs-DC-pension-market.aspx

[4] See for example Elizabeth Hartnett's (2017) "The state of climate change knowledge among UK and Australian institutional investors", in which Ms Hartnett finds that only one third of survey participants are comfortable with the idea of a '2 degree target' and only 30% are aware of 'stranded asset

fully assess the impact of climate change on their organisation and the firms they regulate. Under the ARP, reporting authorities prepare an assessment of the impact of climate change on the organisation's functions and its proposals and policies for adapting.

2 What is the Adaptation Reporting Power?

6. The ARP is a process for organisations to report on the progress they are making in adapting to climate change. It was established by the Climate Change Act 2008 and operates on a five yearly cycle. Two rounds of ARP reporting have taken place to date.

7. Under the ARP, the Secretary of State for Environment, Food and Rural Affairs has a power to direct bodies with public functions (as well as the PRA, this would include the Pensions Regulator (**tPR**), Pension Protection Fund (**PPF**), Financial Conduct Authority (**FCA**) and Financial Reporting Council (**FRC**)) to prepare a report containing:

   a) an assessment of the current and predicted impact of climate change in relation to the authority's functions;
   b) a statement of the authority's proposals and policies for adapting to climate change in the exercise of its functions and the time-scales for introducing those proposals and policies; and/or
   c) (not relevant in this round to regulators other than the PRA) an assessment of the progress made by the authority towards implementing the proposals and policies set out in its previous reports.

8. These reports provide an opportunity for organisations to identify and examine their risks associated with climate change: risks to their assets, buildings, staff, services and operations, supply lines, stakeholders and - crucially - regulatory functions. Reporting also helps organisations make timely, cost effective decisions about how to adapt, contributing to the organisation's sustainability[5].

3 Why should UK financial regulators prepare an adaptation report?

9. In 2015, the PRA Report identified three primary channels through which climate-related risks relevant to the financial sector might arise. These were:

   a. **physical risks** to assets and operations (including supply chains) from extreme weather events, sea level rise and loss of natural capital;

   b. **transition risks** to business and markets, resulting from the transition to a low carbon economy and the potential re-pricing of carbon-intensive financial assets; and

risk'. The paper is available at http://www.smithschool.ox.ac.uk/research-programmes/stranded-assets/Revolution-not-evolution-SFP-Discussion-Paper-February-2017.pdf

[5] HM Government (2013) "2013 Strategy for exercising the Adaptation Reporting Power and list of priority reporting authorities" at paragraph 2.3

c. **liability risks** arising where parties that have suffered loss and damage from climate change seek to recover losses from others that they believe may have been responsible (directors, professional advisers, insurers etc).

10. The PRA Report highlighted the importance of climate change adaptation for the insurance sector, catalysing mainstream industry focus on the financial materiality of climate risk for insurers.

11. However, while the PRA Report is an excellent in-depth analysis of the risks associated with climate change, its stated objective was to provide a framework for considering those risks (and opportunities) through the lens of the PRA's statutory objectives in relation to insurers. It did not consider the risks of climate change in any other area of the financial sector or, indeed, the other market segments the PRA itself oversees.

12. It is widely acknowledged that climate change poses potentially systemic risks to the finance sector, including by the CCC in its June 2015 report to Parliament[6]. As the Governor of the Bank of England, Mark Carney, said in September 2015, risks to financial stability will be minimised if the transition to a (well below) 2°C world begins early and follows a predictable path, thereby helping the market anticipate the transition[7].

13. Regulators around the world are already engaging with climate change[8], including in Switzerland where voluntary analysis of key performance indicators by investors and meta-analysis for regulators is being explored[9]. As the FSB's Taskforce on Climate-Related Financial Disclosures (**TCFD**) and Article 173 of the French Energy Transition Law[10] make clear, disclosure of climate-related risks is crucial for successful engagement with climate change.

14. To ensure that the UK financial system remains resilient and efficient in the face of these challenges, the PRA should extend its work to look at the adaptation of the other firms and market sectors it regulates. The UK's other key financial regulators, the FCA, FRC and tPR (together with the PPF) should also carefully consider the implications of climate risk for their operations, including their regulatory functions. Preparing reports under the adaptation reporting power would be an effective way of doing so.

15. The CCC's recommendations to Defra, published at the end of March 2017, reflect this view, recommending that:

> *"the Bank of England should undertake research to understand better the potential systemic risks from climate change to the finance sector, building on the Prudential Regulatory Authority's ARP2 report. The risks to the financial sector from climate change are currently not well understood and there is little evidence that financial service*

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[6] Committee on Climate Change (2015) "Progress in preparing for Climate Change" available at https://www.theccc.org.uk/wp-content/uploads/2015/06/6.736_CCC_ASC_Adaptation-Progress-Report_2015_FINAL_WEB_070715_RFS.pdf
[7] Mark Carney, "Breaking the Tragedy of the Horizon – climate change and financial stability", speech to Lloyds of London on 29 September 2015. Available at http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx
[8] Including the Australian Prudential Regulation Authority, Deputy Governor of the Bank of Canada, Financial Stability Board, French Treasury central bank and prudential regulator, European Systemic Risk Board, Dutch Central Bank and Swedish Financial Supervisory Authority
[9] See 2 Degrees Investing Initiative (2016) "Trails for Climate Disclosure: A Regulatory Review" available at http://2degrees-investing.org/#!/page_Resources
[10] See TCFD, 'Recommendations of the Taskforce on Climate-Related Financial Disclosures', https://www.fsb-tcfd.org/publications/recommendations-report/ and French Treasury, in collaboration with the Banque de France, and the Autorité de Contrôle Prudentiel et de Résolution 'Assessing climate change-related risks in the banking sector' available at http://www.tresor.economie.gouv.fr/File/433465

companies have assessed the risks from climate change to their investments. The Prudential Regulatory Authority's ARP report focused mainly on the insurance sector. ***Expanding the scope of ARP reporting to include other parts of the finance sector, as recommended in ASC's 2015 progress report, would help to improve the evidence on actions being taken by financial institutions and where further guidance may be needed***.*"*[11]

3.1 The Prudential Regulation Authority

16. The PRA is responsible for the prudential regulation and supervision of banks, building societies, credit unions, and major investment firms (as well as insurers). The PRA's first statutory objective is to promote the safety and soundness of the firms it regulates. While the PRA is likely to be invited to report on progress since the PRA Report, its reporting should be expanded.

17. Banks have been identified as being particularly exposed to climate risk.[12] Their balance sheets risk exposure to real estate impacted by climate change and to re-pricing (or even 'stranding') of carbon-intensive assets in other parts of their loan books, as Geoff Summerhayes' speech on behalf of the Australian Prudential Regulation Authority pointed out[13].

18. Other jurisdictions are already exploring "stress tests" of the vulnerability of financial institutions' balance sheets to climate risk, and such modelling does not need to be expensive[14]. Expanded reporting under ARP3 would provide a framework for consideration of similar stress-testing across market sectors regulated by the PRA, as well as wider adaptation to climate risk.

3.2 The Pensions Regulator and Pension Protection Fund

19. The adaptation of the pensions industry to climate change is critical to ensuring the successful provision of UK pensions as exposure to the risks associated with the transition to a low carbon economy is potentially huge[15].

20. Adaptation to climate change goes to the heart of tPR's statutory objectives. Most importantly, the effects of climate change on financial markets could affect tPR's objectives to protect the benefits of members of occupational (and some personal) pension schemes, and to reduce the risk of situations arising which may lead to compensation being payable from the PPF. Likewise, the PPF's adaptation to climate change is vital to the provision of compensation for members.

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[11] Committee on Climate Change (2017) "Adaptation Reporting Power: second round review" available at https://www.theccc.org.uk/publication/adaptation-reporting-power-second-round-review/
[12] See Boston Common Asset Management (2015) 'Are Banks Prepared for Climate Change'?
[13] Australian Prudential Regulation Authority (2017) Speech: "Australia's new horizon: Climate change challenges and prudential risk" Available at http://www.apra.gov.au/Speeches/Pages/Australias-new-horizon.aspx
[14] See 2 Degrees Investing Initiative (2016) "Trails for Climate Disclosure: A Regulatory Review" available at http://2degrees-investing.org/#!/page_Resources
[15] As Mark Carney has pointed out, 19% of FTSE 100 companies are in natural resource and extraction sectors; and a further 11% by value are in power utilities, chemicals, construction and industrial goods sectors. Globally, these two tiers of companies between them account for around one third of equity and fixed income asset, meaning that investors face significant exposure to "stranded" oil, gas and coal reserves.

21. While tPR has acknowledged the potential impact of climate risk on pension fund portfolios in its recent guidance[16], reporting under the ARP would enable a comprehensive risk assessment for the industry as a whole.

3.3 The Financial Conduct Authority

22. Climate change should be a key consideration for the FCA in two of its three operational objectives: securing an appropriate degree of protection for consumers; and protecting and enhancing the integrity of the UK financial system.

23. One key example of this is the regulation of contract-based pension schemes. Asset owners in the pensions sector face particular challenges as a result of their extended investment horizons[17]. And recent research commissioned by the Pensions and Lifetime Savings Association has highlighted that default funds (which 90% of defined contribution savers subscribe to) are vulnerable to a number of ESG risks, with those associated with carbon regulation, energy price increases and fuel switching the most systematically important[18]. This is clearly relevant to contract-based schemes, which will always be structured as defined contribution schemes.

24. Preparing an adaptation report would provide a framework for the FCA to engage with stakeholders on climate change risk assessment, and review the resilience of the firms it regulates to climate change.

3.4 The Financial Reporting Council

25. Without clear, consistent and reliable information about climate risk at company level, the rest of the financial sector has no basis for assessing its own exposure. The FRC has the publicly stated objective of promoting high quality corporate governance and reporting to foster investment, and has primary responsibility for ensuring that UK companies' annual reports are prepared accurately and robustly and disclose all material financial risks to their business. It is also responsible for ensuring that auditors provide assurance about the quality of that information to a standard that gives investors the confidence they need to rely on it.

26. To the extent that climate risk represents a material financial risk for a business, it **should** already be reported to the market. Currently, however, companies are taking an inconsistent approach. The FRC has so far provided minimal direct guidance and has been slow to respond to complaints where companies have failed to disclose these risks[19]. In light of the recent recommendations issued by the TCFD[20], the FRC should be showing leadership on this matter, to ensure that the rest of the market has the information it needs to price these risks properly. The ARP provides a tried and tested mechanism for doing so.

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[16] See most recently The Pensions Regulator (2017) "DB Investment" available at http://www.thepensionsregulator.gov.uk/guidance/db-investment-two-strategy.aspx
[17] See for example the expanding body of work by investment consultant Mercer: Mercer (2016) "Climate Change Investment Risk Management for US Public Defined Benefit Plan Trustees"; Mercer (2015) "Investing in a time of climate change"; Mercer (2010) "Climate change scenarios - Implications for strategic asset allocation"; and Mercer (2005) "A climate for change: A trustee's guide to understanding and addressing climate risk"
[18] Pensions and Lifetime Savings Association (2017) "ESG risk in default funds: analysis of the UK's DC pension market" http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0619-ESG-risk-in-default-funds-analysis-of-the-UKs-DC-pension-market.pdf
[19] See ClientEarth, ' Climate risk and regulators: an investor's guide' (5 September 2016).
[20] TCFD, 'Recommendations of the Taskforce on Climate-Related Financial Disclosures', https://www.fsb-tcfd.org/publications/recommendations-report/

4 Benefits of preparing adaptation reports

27. The preparation of adaptation reports into their respective sectors would have numerous benefits for financial regulators. Adaptation reporting would give regulators the opportunity to:

- elevate climate change adaptation strategy and the impacts of climate risk on financial markets to board level;
- engage with stakeholders on climate change risk assessment, and review sector readiness for climate change, including in respect of climate risk;
- consider appropriate regulatory responses to climate change, including in respect of climate risk;
- carry out an in-depth assessment of the impacts of climate change on their organisation;
- understand whether they need assistance from central government to ensure that the financial sector is resilient to climate change and to ensure that they are in a position to fulfill their statutory and operational objectives;
- send a clear message that the financial sector is resilient to the transition to a well below 2^{o}C world; and
- inform government policy on adaptation to climate change.

5 Why does this matter now?

28. The cycle for implementation of the third round of reporting is already in motion:

- The CCC has recommended that ARP3 reporting should be mandatory.
- Defra is currently preparing the government's strategy for the exercise of ARP3, including the authorities that will be called on to report.
- The strategy will be published during the **second half of 2017** to allow for a consultation to take place ahead of the final strategy being laid before Parliament in summer 2018.
- If financial services regulators are not invited to report in the third round, it will be a further **five years** before the next round of adaptation reporting will take place, raising real concerns that the UK financial sector will be vulnerable to the effects of climate change.

29. There is unlikely to be resource available from government to meet the costs of ARP3. However, reports have previously been resourced with the assistance of academic visitors and secondees. Early consideration of practical arrangements for reporting will be an important part of planning for reporting under ARP3.

30. While it is Defra that has the power to require reporting authorities to prepare a report, regulators could begin preparations for ARP3 by opening dialogue with the Bank of England team responsible for the PRA Report or even engaging directly with Defra to express their interest in adaptation reporting.

31. Likewise, Defra should itself ensure that the CCC's recommendations are followed and effective, mandatory ARP reporting is extended across the financial sector.

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