

PRI RESPONSE TO THE FCA'S DISCUSSION PAPER ON CLIMATE CHANGE AND GREEN FINANCE

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. Originally set up by the UN in 2005, the PRI is now a non-for-profit company with over 2250 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles globally with approximately US \$83 trillion in assets under management.

339 of these signatories, representing \$7 trillion, are based in the United Kingdom. The PRI was a member and a part of the secretariat for the UK Green Finance Task Force and is leading the development of the sustainable finance taxonomy on behalf of the European Commission. The PRI's chair, Martin Skancke, is a member of the Task Force on Climate-related Financial Disclosures (TCFD).

In January 2018, the PRI introduced climate risk indicators to its reporting framework¹. These were based on the TCFD recommendations and officially approved by the Task Force secretariat. Despite being a voluntary module for signatories to respond to, over 480 investors representing \$42 trillion, did complete the indicators and submitted responses to the PRI. The indicators have been revised for 2019, including the incorporation of questions from the Bank of England's climate change survey, and provide a window on how UK and international investors are responding to TCFD and starting to address climate-related risks.

¹ Signatories to the PRI are required to report to PRI on their responsible investment activities annually. The climate risk indicators are currently a voluntary and non-assessed module of this reporting framework.

SUMMARY OF THE PRI'S POSITION

The PRI welcomes the FCA's discussion paper on climate risk and green finance. This paper represents an opportunity for the FCA to address market information failures with respect to climate-related risks and opportunities.

Institutional investors should consider the likelihood and impact of an inevitable policy response² to climate change. The longer the current and growing gap between the objectives of the Paris Agreement and G20 government policies continues, the greater the risk of a policy mis-read by the private sector, leading to heightened market volatility, an abrupt repricing of assets³ and what Bank of England Governor Mark Carney has called a "climate 'Minsky' moment"⁴.

As such, climate change and the realities of current G20 energy policy has implications for financial system stability and are within the mandate of the FCA's market integrity objective.

Recommendations for the FCA

Financial regulators can play an important role in raising awareness and helping to address market information failures. In response to the discussion paper, the PRI has three key recommendations.

1) A two-step approach to implementing the TCFD recommendations

In the UK Green Finance Task Force's final report⁵, representatives from the UK financial sector, including the PRI, provided a two-step approach on how these recommendations should be implemented.

- I. Official guidance from UK financial regulators, including the FCA, that climate change is a material financial risk and thereby publicly reporting against it is mandatory under existing UK law.
- II. The FCA, together with other UK financial regulators, should integrate the TCFD recommendations throughout the existing corporate governance and stewardship reporting frameworks.

2) A comply or explain approach is avoided. The heightened global risks of a disorderly low carbon transition means that firmer action by governments and financial regulators is now needed to address market information failures and help ensure investors and companies incorporate climate-related risk systematically in their view of the future.

3) Seek to reduce the costs and burden for issuers of these extensions to existing UK law by implementing them over a two year period, leveraging the FCA and PRA Climate Risk Forum to build capacity through annual conferences and facilitating a leading group of users and preparers to accelerate the maturity and standardisation of the reporting and TCFD implementation process.

² Further details on the Inevitable Policy Response (IPR) are available here <https://www.unpri.org/climate-change/the-inevitable-policy-response-to-climate-change/3578.article>

³ An International Energy Agency (2016) study of business as usual vis-à-vis the goals of the Paris Agreement identified a possible \$26 trillion in capital misallocation by 2040. Available here: <https://www.iea.org/topics/climatechange/climate-energy-policies-for-low-carbon-transitions/>

⁴ Mark Carney "Breaking the tragedy of the horizon – climate change and financial stability" 29th September 2015.

⁵ The UK Green Finance Task Force report 2017, pages 37 – 39. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/703816/green-finance-taskforce-accelerating-green-finance-report.pdf

Further to this submission, the PRI would be happy to present evidence in person and / or elaborate on responses provided below.

Q1. What, if any, difficulties do issuers face in determining materiality? We are also interested in exploring how investors consider materiality in this context.

The difficulties faced by issuers in determining materiality can be grouped into two categories:

- I. those associated with determining the threshold for what information is considered material; and
- II. those associated with the specific nature of climate risk and opportunities.

Definition of materiality

Auditors set the materiality for the financial statements as a whole at the planning stage. This is expressed as a level of the probability of impact or the probability of default arising from a particular risk factor. The principal reason for setting the materiality at this stage is that this informs the design of an appropriate audit procedure and identifying a clearly trivial threshold for accumulating misstatements.

This approach (i.e. setting a level of an appropriate benchmark) is extremely difficult in the context of qualitative information such as that included in the strategic report or non-financial statement (as required by the Companies Act 2006 (CA 2006), management report (as required by various provisions of the Listing Rules and Disclosure Guidance and Transparency Rules), listing particulars (as required by the Prospectus Rules) etc. This qualitative information is financially material, but is not expressed in numerical form.

Nevertheless, the *concept* of materiality is used in regulatory guidance about how to determine what information should be included in any of these reports.

For example, the FRC's *Guidance on the Strategic Report*⁶ states:

'Information is material if its omission or misrepresentation could reasonably be expected to influence the economic decisions shareholders take on the basis of the annual report as a whole. Only information that is material in the context of the strategic report should be included within it.' (Paragraph 5.1)

Further information on the concept of materiality is as follows:

'Materiality is entity-specific 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.' (Paragraph 5.3)

'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. However, due to the nature of the information contained in the strategic report, and the purpose it serves: (a) qualitative factors will often have a greater influence on the determination of materiality in the context of the strategic report, particularly in relation to non-financial information; and (b) the materiality of an item in the financial statements may be based on its magnitude relative to

⁶ FRC, 2018. *Guidance on the Strategic Report*. [Online] Available at: <https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf>

other items included in the financial statements in the year under review but may also be based on the potential effect over the longer term. The potential magnitude of future effects of a matter on the entity's development, performance, position or future prospects should also be considered when determining the materiality of a matter in the context of the strategic report.' (Paragraph 5.4)

The PRI considers that, while this guidance assists with understanding the *concept of materiality*, it is less effective in *identifying a threshold to determine what information must be included in the strategic report* (and what information may legitimately be left out of the strategic report).

Specific nature of climate risk

Issuers face other difficulties which relate to the specific nature of climate risk and opportunities. These difficulties include:

- limited knowledge of climate-related issues within organisations;
- preconceptions about the nature of climate change which lead to an initial bias in the assessment of climate risk;
- the tendency to focus mainly on near-term risks without paying adequate attention to risks that may arise in the longer term. The time horizon over which financial risks from climate change may be realised are uncertain, and their full impact may occur outside of many business planning horizons;
- difficulties in translating climate risk into other categories of risk (such as underwriting, reserving, credit or market risk);

However, there is a growing body of evidence that points to a way forward. Notably:

- the advancement of climate attribution science which assigns probability of the influence by climate change to extreme weather events⁷ as well as analysis by credit rating and financial service companies.
- Moody's, for example, has identified 11 sectors with \$2 trillion of rated debt that have immediate or emerging climate-related risk⁸.
- Research by the IEA has identifies \$26 trillion in capital re-allocation needed by 2040 to deliver the objective of the Paris Agreement of limiting warming well below two degrees.
- Schroders has a "climate progress dashboard"⁹, which monitors progress on 12 indicators (including six industry sectors) to show the progress being made towards decarbonizing the global economy.
- The 2015 Mercer study "Investing in a time of climate change" concluded that climate change will have an impact regardless of the climate scenario used, over the next 10

⁷ See for example the World Weather Attribution report on the summer of 2018 heatwave in northern Europe. The full report is available here <https://www.worldweatherattribution.org/attribution-of-the-2018-heat-in-northern-europe/>

⁸ Moody's Environmental risk – Climate risk heat map, November 2015

⁹ An overview of Schroder's climate dashboard is available here: <https://www.schroders.com/en/lu/professional-investor/featured/climate-change-dashboard/>

years to 2025 the potential sector impacts are the most meaningful. Asset class impacts are also material and vary by climate scenario¹⁰.

- Off-the-shelf and free-to-use tools such as PACTA (www.transitionmonitor.com), which analyses climate transition risk in a portfolio. The tool shows the alignment of an investment portfolio to climate scenarios. It has global data coverage of several high emitting sectors, adjustable parameters and the analysis is kept confidential to the user.
- Research by HSBC ranked 67 countries by their vulnerability to the physical impacts of climate change¹¹. Analysis by Moody's¹² found that the credit profiles of some developing countries as well as those of sub-national public finance institutions (cities) are susceptible to climate-related risk.

This provides a practical reference point for investors to identify sectors, regions and cities at risk as well as indicators of change which they can track over the time horizon of their investment strategy. This information can be used as a basis of a materiality assessment of climate-related risks to the organization. Examples of UK companies and investors that have done this include:

- Unilever¹³.
- The UK Environment Agency Pension Fund¹⁴
- AVIVA Investors¹⁵

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?

Yes. In order to make informed voting and investment decisions and to direct engagement activities, investors require decision-useful information on a firm's operating performance and financial prospects, including on climate-related risks and opportunities. Information should be made available in a format which allows investors to take action, and in this context greater consistency in how issuers report on climate-related risks would improve the ability of investors to take action on these risks.

The PRI believes the TCFD recommendations, as an internationally-accepted framework through which exposure to climate risk can be assessed and managed, would be the most useful framework for these purposes. The UK government has already endorsed the TCFD recommendations, leaving the question of how it should implement them.

¹⁰ Mercer (2015) Investing in a time of climate change. Report summary is available here: <https://www.mercer.com/our-thinking/wealth/investing-in-a-time-of-climate-change.html>

¹¹ HSBC "Fragile Planet: scoring climate change risk around the world", by Ashim Paun, Lucy Acton and Wai-shin Chan. March 2018

¹² Moody's Environmental risk – sovereigns, How Moody's Assesses The Physical Effects Of Climate Change On Sovereign Issuers May 15th 2018

¹³ Highlighted on page 48 of the TCFD's September 2018 status report. Available online here: <https://www.fsb-tcdf.org/wp-content/uploads/2018/08/FINAL-2018-TCFD-Status-Report-092518.pdf>

¹⁴ EAPF climate policy is available here <https://www.eapf.org.uk/investments/climate-change/climate-disclosure>. Their TCFD reports and bespoke report from the Mercer study are also available online

¹⁵ AVIVA's 2018 TCFD report is available here <https://www.aviva.com/social-purpose/climate-related-financial-disclosure/>

The PRI contributed to and supports the recommendations of the Green Finance Task Force's report¹⁶ which sets out a detailed path to implementing the TCFD recommendations in the UK. This report recommends a two-step approach to implementing the recommendations:

- I. Official guidance from UK financial regulators, including the FCA, that climate change is a material financial risk and thereby publicly reporting against it is mandatory under existing UK law.
- II. The FCA, together with other UK financial regulators, should integrate the TCFD recommendations throughout the existing corporate governance and stewardship reporting frameworks.

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?

A "comply or explain" approach is not recommended in this case. Such an approach would risk undermining the comparability of disclosures sought by investors and the FCA. This would lead to a variety of disclosures which in turn would hamper efforts to address market information failures.

Instead, the PRI recommends the two-step approach set out above.

The discussion paper notes how climate risk is relevant to the FCA's statutory objectives, a point the PRI agrees with, and as such having a stronger approach than comply or explain is recommended. The PRI draws your attention to the different requirements which relate to the viability statement. For listed companies incorporated in the UK there is a mandatory requirement to provide a viability statement over a specific period¹⁷. Thus, a key aspect of the TCFD recommendations, the need for forward-looking analysis, is mandated for material financial risks for premium listed companies under existing UK law.

The discussion paper notes that the TCFD is a voluntary framework. However, the PRI would argue that times have changed since the Task Force was first conceived. Global emissions are rising, the impacts of even 1.5°C of warming are now better understood and the IPCC reports that the world is on track to miss the targets of the Paris Agreement by a wide margin¹⁸. Firmer action is now needed by financial regulators to address market information failures and avoid the financial instability of a disorderly or abrupt transition.

The burden for issuers of the extension to existing UK law set out above can be reduced by phasing in implementation over a two-year period, utilising the PRA – FCA climate risk forum to build capacity and accelerate the maturity and standardisation of TCFD reporting.

PUBLIC REPORTING REQUIREMENTS

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

Yes. The TCFD recommends that asset managers and asset owners (including contract-based pension providers) should implement its recommendations so that their clients and beneficiaries

¹⁶ See pages 37 ~39 of the UK Green Finance Task Force report: <http://greenfinanceinitiative.org/workstreams/green-finance-taskforce/>

¹⁷ LR 9.8.6 R (3)

¹⁸ IPCC Special Report on Global Warming of 1.5°C <https://www.ipcc.ch/sr15/>

may better understand the performance of their assets, consider the risks of their investments, and make more informed investment choices.¹⁹

The PRI considers that the financial reporting requirements and practices for firms can vary widely. Some firms have no public reporting, while others provide extensive public reporting if they have public debt or equity.

The TCFD states that asset managers and asset owners should use their existing means of financial reporting to their clients and beneficiaries where relevant and feasible.²⁰ However, in the UK context, the PRI does not consider that these existing channels of reporting are adequate. Therefore, the PRI supports a clarification through regulatory guidance that climate change is a material financial risk and thereby under existing UK law there is a requirement to report against it.

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

As set out in the response to Question 1 above, certain firms may have public debt or equity, in which case it makes sense for any new requirement on firms to report climate risks should take account of what measures are introduced in relation to issuers.

Otherwise, referencing the supplemental guidance issued by the Task Force which should inform what information could be included in a climate risks report is recommended.

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

If the approach is based on the size of the regulated firm, the PRI considers that demarcation is required of what proportion of the largest firms across the UK financial services industry will be required to compile a climate risks report.

While the very largest firms may be systemically important, the aggregate number of customers for smaller firms may also be significant.

¹⁹ TCFD, 2017. Final Report, p.17.

²⁰ TCFD, 2017. Final Report, p.18.

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?

Formal industry research published by a financial regulator can have a transformative effect on certain issues. In this regard, papers on the subject of climate change released by the PRA include:

- I. The impact of climate change on the UK insurance sector (A Climate Change Adaptation Report by the Prudential Regulation Authority) (September 2015)²¹
- II. Transition in thinking: The impact of climate change on the UK banking sector (September 2018)²²
- III. Formal response to DEFRA's adaptation reporting power

The PRI considers that analogous research of market areas where the FCA has oversight, or relevant firms over which the FCA has oversight, could have a similarly transformative effect. In addition, there is no reason why a line of enquiry could not be defined which is focussed on emerging green investment opportunities and pursuing sustainable outcomes.

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?

Yes, as stated above the clarifications on the materiality of climate-related risk and full integration with relevant codes and reporting standards is both useful and needed.

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?

Institutional investors and asset managers are currently identifying sustainable economic activities and sustainable investable assets in-house and on a voluntary basis. This can be time consuming and costly, and consequently, for some investors, too burdensome.

The PRI recommends the introduction of a sustainable taxonomy to define sustainable economic activity, possibly developing work underway by the European Commission . The proposed European regulation establishes the conditions and the framework to create, over time, a unified classification system (or taxonomy) on what can be considered environmentally sustainable economic activities. This is widely seen as an important enabling step in the overall effort to allocate investments to sustainable economic activities. The PRI's experience is that it is important to distinguish between those activities which contribute only partially or in a transitional way to environmental objectives with those that contribute in a substantial and sustainable way, which may influence the FCA's approach to existing Taxonomies.

²¹ Available at: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf>

²² Available at: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.pdf?la=en&hash=A0C99529978C94AC8E1C6B4CE1EECD8C05CBF40D>

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

As climate change is a cross-cutting issue, the establishment of the PRA and FCA Climate Risk Forum is a welcome development. The PRI recommends that the Forum:

- I. Build capacity. Bring together preparers and users of climate-related disclosures in annual conference before the start of a new reporting cycle to identify barriers and potential solutions and serve as a platform for peer exchange. The PRI, CDP and the City of London previously hosted the UK's first [TCFD Preparers Forum](#). Whilst there are plans for follow-up events, we would like to coordinate this with the Climate Risk Forum.
- II. Accelerate the maturity and standardisation of TCFD reporting. This could be done by establishing or leveraging an existing pilot group of leading financial institutions and companies to pilot the TCFD recommendations. Participants would be invited to develop a multi-year action plan, which would be published, and then report progress annually against this plan, with the intention that each year would build on the last. The above mentioned annual conference could be used to identify key issues that the pilot would address and as a dissemination platform.

An example of this approach is the UK – China climate and environmental information disclosure pilot²³. This involves ten financial institutions (four from the UK: HSBC, AVIVA, Hermes, and Brunel), as well as representatives from the Bank of England and the PBoC. The PRI together with ICBC coordinates this group.

PRI would be happy to provide technical support to the Forum as it looks to raise awareness of climate-related risk and enhance reporting practice in the UK.

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

[N/A]

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

Scaling up green finance faces a number of challenges

- **The enabling environment.** The absence of a (sufficient) price on carbon, fossil fuel subsidies and uneven enforcement or the absence of environmental regulation means that the market economy can provide barriers rather than incentives for greening financial flows. It is notable, for instance, that investor demand is greatest in countries (Western and Northern Europe) which have climate and environmental policies in place. A positive enabling environment is vital to significantly increasing the demand for green investing.
- **Upstream bottleneck: a shortage of bankable green projects.** With interest rates at a historic low, the investment gap in green infrastructure is not due to a lack of capital. Rather, a key blockage is the shortage of bankable, credit worthy projects with

²³ Further information on this pilot is available here: <http://greenfinanceinitiative.org/uk-china-climate-environmental-information-disclosure-1st-year-progress-report/>

transparent procurement procedures to invest in. McKinsey²⁴ notes that even in the G20 only half the countries publish infrastructure pipelines. Supporting and building capacity at the project preparation stage is one of the key challenges to bringing more investible green projects to market.

- **Short-termism and a lack of investor demand for longer-term financial analysis.** In the financial markets, the market for analysis is driven by short-term traders. As a result, analysis is calibrated to one- to three-year time horizons and non-linear long-term risks can get missed²⁵. Whilst methodological difficulties for longer-term scenario analysis exist, Mercer and 2^o Investing Initiative argues more fundamentally there is a lack of demand from investors for longer-term (10-year plus) analysis.
- **Path dependency.** Asset owners and asset managers tend to be comfortable with sectors that have delivered for them in the past. There needs to be a compelling reason (e.g. reputational / price benefits) for them to change.
- **Connecting with the real economy.** In theory, tools like green bonds are meant to increase the velocity at which capital to qualifying projects is recycled. However, in practice there is only currently anecdotal evidence that this is happening and even some of green bonds' foremost advocates see it more as a marketing and financial industry engagement tool. Greening finance could arguably benefit from being more grounded in the real economy and more formally tied to measurable targets in climate & environmental policy.
- **Avoiding a green bubble.** The rapid growth of any new self-regulated financial market is not without risks; avoiding a major mis-selling scandal will be vital to maintaining market credibility and sustaining growth. Designing a governance framework that doesn't throttle an emerging market with transaction costs and yet is still robust enough to guard against fraud is a key challenge.
- **Higher transaction costs.** As a new market with additional transparency requirements, green finance can have higher costs for the issuer. Bloomberg notes that the global green bond market has tended to grow by expanding into new geographies, where an initial market boom in year one then plateaus out due to the slightly higher transaction costs from year two.
- **Just transition.** The energy transition creates the risk of "stranded communities" as well as "stranded assets". The 2016 US election highlights the importance of including this social dimension of the transition in the dialogue with policy makers and investors.

To address this a number of **solutions** could be considered:

- **Carbon reduction plans to address policy and information failures.** Based on commitments under the Paris agreement & domestic targets, countries should set amid- (to 2030) and near-term (3-5 year) carbon budget. Through Carbon Reduction Plans they

²⁴ McKinsey & Co "Financing change: how to mobilise private sector financing for sustainable infrastructure" January 2016

²⁵ 2 Degrees Investing "All swans are black in the dark"

should then design and roll out policy measures, including use of carbon pricing and incentives to deliver on this objective, thereby creating a more positive enabling environment for greening finance.

- **National infrastructure capital raising plans.** As part of the above, encourage governments to focus investment on project-preparation facilities and technical assistance to increase the “bankability” of green infrastructure plans. These national infrastructure plans would then become a primary mechanism through which countries reduce carbon and meet their NDCs.
- **Develop regulator and investor demand for monitoring long-term risks.** Promoting the adoption of TCFD recommendations, particularly on scenario analysis, and / or the development of alternative longer-term (5-10 year) credit ratings.
- **Standards.** Arguably, there is a need, particularly among OECD countries, to take a more top-down approach to what qualifies as green and a governance structure to trace the use of funds and maintain the credibility of this growing market. Definitions should be aligned with climate and environmental policy objectives. Once this framework is in place, it would then provide a stronger foundation for the potential introduction of incentives and to define low carbon benchmarks.
- **Increase syndication of loans that finance sustainable-infrastructure projects.** Encourage financial institutions to expand loan syndication and create a larger secondary market for sustainable-infrastructure-related securities.
- **Clarifying investor roles and responsibilities.** The ways these are framed, viewed and understood helps set the assumption for appropriate investment behaviour. As such, strengthening fiduciary duty provisions on climate risk and ESG to encourage long-term investing and provide an alternative means of monitoring performance in the investment chain. Specific interventions in the UK include:
 - The Financial Reporting Council should extend the stewardship code to include explicit reference to ESG risk factors (including climate change) as part of its biennial review process.
 - The Financial Conduct Authority should strengthen Conduct of Business Rule 2.2.3 from requiring an investor to state the nature of its commitment to the Stewardship Code to a report or explain requirement against the Code.
 - Monitor developments in European law on duties of investors and align UK regulation in order to make it explicit that incorporating ESG into long-term investment practices is part of fiduciary duty.
- **Develop a plan for when things go wrong.** An arbitration panel for where the use of green finance was disputed. This could be part of a green certification governance structure whereby the regulator or standards body monitors and reviews a select number of verifiers third party reports (e.g. the first three and at random there-after).