HOW IS CLIMATE CHANGE IMPACTING ON THE FINANCIAL SERVICES SECTOR?

GOWLING WLG

The 2015 United Nations climate-change summit in Paris (COP21) saw the first ever agreement under which virtually every country, including the UK, pledged to constrain their greenhouse gas emissions, with the aim of keeping average temperature increases well below two degrees Celsius above pre-industrial levels. In 2018, the UK Government issued its 25 Year Environment Plan and in June 2019 it laid down legislation to reach net-zero carbon emissions by 2050. It followed this up with its Green Finance Strategy in July 2019, which recognised the crucial role of the financial services sector in delivering global climate and environmental objectives.

In the same month, the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA), The Pensions Regulator (TPR) and Financial Reporting Council (FRC) published a Joint Declaration welcoming the Government's Green Finance Strategy and setting out their shared understanding of the financial risks and opportunities of climate change. Since then, they have each have taken a number of significant actions in respect of climate change.

In this insight, Sushil Kuner from Gowling WLG's Financial Services Regulatory team explains why climate change is an important issue for regulators, financial services firms and the consumers they serve and explores the key developments in this area.

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WHY IS CLIMATE CHANGE IMPORTANT FOR FINANCIAL SERVICES?

Climate change presents financial risks to various participants in the financial sector. The Bank of England (BoE) and PRA reported in September 2018 that financial risks from climate change arise from two primary channels or 'risk factors': physical and transition.[i]

According to the report, physical risks can arise from climate and weather-related events, such as heatwaves, droughts, floods, storms and sea level rise. For banks, they can potentially result in large financial losses, impairing asset values and the creditworthiness of borrowers. Insurers may face a higher number of more costly claims due to an increased frequency and severity of major weather events and for the asset management sector, climate change may materially reduce investment values, a particular concern in the pensions sector.

Transition risks, on the other hand, can arise from the process of adjustment towards a low-carbon economy. Changes in policy, technology and sentiment could prompt a reassessment of the value of a large range of assets and create credit exposures for banks and other lenders as costs and opportunities become apparent. A sharp repricing of assets could also harm investors if the transition to a low-carbon economy is not smooth. Insurers are responsible for investing billions of pounds of assets which need to grow to fund people's retirements and to cover future claims and therefore this presents a significant risk to insurers too.

Given the financial risks which climate change can pose, regulators are taking action now to ensure companies are considering the likely consequences of climate change on their business decisions and are meeting corporate responsibilities by considering their own impact on the environment. The ultimate aim is to ensure that there is an orderly transition to a carbon-neutral economy. Financial services firms should also be mindful about increasing consumer demand for 'green' financial services products. As this demand grows, the FCA has made clear that questions of green taxonomy, in other words, how green products and markets are classified, green disclosure, green performance measurement, and ultimately fairness and consumer protection, will become more important.[ii]

Each of the FCA, PRA/BoE, TPR and FRC have been busy developing their approaches to climate change related risks and set out below is a summary of the key initiatives being deployed by each.

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[i] BoE and PRA report: "Transition in thinking: The impact of climate change on the UK banking sector", September 2018

[ii] FCA Discussion Paper : Climate Change and Green Finance (DP18/8), October 2018

PRA FOCUS

FINANCIAL RESILIENCE AND MARKET STABILITY FOR THE BANKING AND INSURANCE SECTORS

In April 2019, the PRA published a policy statement (PS11/19) and a supervisory statement (SS3/19) setting out its expectations for how banks and insurers address the financial risks from climate change. These include:

- **Governance:** a firm's board should understand and assess the financial risks from climate change that affect the firm, and be able to address and oversee those longer-term risks within the firm's overall business strategy and risk appetite. In particular, the PRA has made clear that it will expect to see evidence of how firms monitor and manage the financial risks from climate change in line with firms' risk statements, which should include the risk exposure limits and thresholds for the financial risks that firms are willing to bear. These should take into account factors such as:
    - long-term financial interests of the firm, and how decisions today affect future financial risks;
    - results of stress and scenario-testing, for shorter and longer term horizons;
    - uncertainty around the timing and the channels through which the financial risks from climate change may materialise; and
    - sensitivity of the balance sheet to changes in key drivers and external conditions.

  There should be clear roles and responsibilities for the board and its relevant sub-committees in managing the financial risks from climate change. In particular, responsibility for identifying and managing financial risks from climate change should be allocated to the relevant Senior Management Function (under the Senior Managers Regime) most appropriate within the firm's organisational structure and risk profile, and the board should be able to evidence effective oversight of risk management and controls.

- **Risk Management:** in a manner proportionate to their business, firms should identify, measure, monitor, manage and report on their exposure to financial risks from climate change and build these in to their existing risk management frameworks:
    - risk identification and measurement – firms should use scenario analysis and stress testing to inform the risk

identification process and understand the long-term financial risks to their business model from climate change (e.g. through catastrophe modelling). As part of the Internal Capital Adequacy Assessment Process or Own Risk and Solvency Assessment, firms should include at a minimum, all material exposures relating to the financial risks from climate change and an assessment of how firms have determined the material exposures in the context of their business;

- risk monitoring - firms should consider a range of quantitative and qualitative tools and metrics to monitor their exposure to financial risks from climate change, for example, these could be used to monitor exposures to climate-related risk factors which could result from changes in the concentration of firms' investments or lending portfolios or to the potential impact of physical risk factors on outsourcing agreements and supply chains;
- risk management and mitigation – where the potential impacts of the financial risks from climate change are assessed to be material, the PRA expects firms to evidence how they will mitigate these financial risks and to have credible policies in place for managing exposures. For Solvency II insurers, under the Prudent Person Principle, an undertaking should only invest in assets for which risks can be identified, measured, monitored, managed, controlled and reported. Where insurers bear the investment risk, they must diversify their assets to avoid excessive accumulation of risk in the investment portfolio. Solvency II insurers should therefore pay close attention to whether there is an excessive accumulation of financial risks from climate change and to mitigate accordingly; and
- risk reporting and management information (MI)– firms should provide the board and relevant sub-committees with MI on their exposure to the financial risks from climate change, which should enable the board to discuss, challenge and take decisions relating to the firm's management of the financial risks from climate change.

- **Scenario Analysis:** where appropriate, firms should conduct both short and long-term scenario analysis to inform their strategic planning and determine the impact of the financial risks from climate change on their own risk profile and business strategy. This should also be used to explore the resilience and vulnerabilities of a firm's business model to a range of outcomes. Scenario testing will inform firms about the potential impact of the financial risks on their solvency, liquidity and, for insurers, their ability to pay policyholders.
- **Disclosure:** banks and insurers have existing requirements to disclose information on material risks within their Pillar 3 disclosures and on principal risks and uncertainties in their Strategic Report (as required under the UK Companies Act). In addition to meeting these existing requirements, firms should consider whether further disclosures are necessary to enhance transparency on their approach to managing the financial risk from climate change. In particular, the PRA has made clear its expectations of firms to disclose how climate-related financial risks are integrated into governance and risk management processes, including the process by which a firm has assessed whether these risks are considered material or principal risks.

It should be noted that on 27 March 2020, the European Central Bank (ECB) published its final and amended 'Guide on climate-related and environmental risks' for banks in the single supervisory mechanism following a public consultation. In the guide, the ECB sets out its understanding of the safe and prudent management of climate-related risks under the Capital Requirements Directive (CRD IV), the Capital Requirements Regulation and related EBA guidelines. The ECB also sets out specific supervisory expectations relating to:

- business models and strategy;
- governance and risk appetite;
- risk management; and
- disclosures.

Although the guide is not binding, the ECB expects banks to assess whether their current practices are safe and prudent in light of the expectations in the guide and, if necessary, to start adapting them.

FCA FOCUS

CLIMATE CHANGE RISK DISCLOSURES, IMPACT ON PENSION PROVIDERS AND ENHANCING COMPETITION AND MARKET GROWTH FOR GREEN FINANCE

In its 2018 Discussion Paper on Climate Change and Green Finance (DP18/8), the FCA highlighted the increasing demand for green financial services and green finance products, with the asset/ investment management and retail banking sectors leading on the capitalisation of changing consumer needs. At the time, it reported that there were over 70 green bonds listed on the London Stock Exchange in seven currencies, 38 companies had raised $10 billion in London (including 14 renewable investment funds) and the retail banking sector had seen the introduction of green mortgages with home owners who want to buy an energy efficient new-build property being offered lower rates on some mortgages.

However, while it welcomed innovation and the development of green finance, it recognised the significant risks posed by climate change, again comprising both physical risks and those resulting from the transition to a low carbon economy. In particular, its immediate concerns centred around:

- **pensions:** given the long-term nature of pension investments, where the potential impact of climate change related risks is much more likely given the time periods products are held for, the FCA wanted to ensure that those making investment decisions take account of all financially material risks, including climate change. This was viewed to be particularly important for the investment strategies of workplace personal pension schemes where consumers are generally 'defaulted' into investments and rely on the investment decisions made for them;
- **innovation:** as part of its competition objective, the FCA has an important role to play in boosting innovation in specialist green products, ensuring these markets work well and delivering good outcomes for all consumers; and
- **disclosures by issuers of securities admitted on regulated markets:** the FCA wanted to explore whether greater encouragement is needed to ensure issuers give investors appropriate information and whether issuers require further clarity over what is expected of them.

It also recognised a risk of so called 'greenwashing' where products are misleadingly marketed as producing positive environmental outcomes, when this is not the case.

In its Feedback statement to DP18/8 (FS 19/6), the FCA made clear that its focus would be on the following three outcomes:

1. issuers provide markets with readily available, reliable and consistent information on their exposure to material climate risks and opportunities;
2. regulated financial services firms integrate consideration of material climate change risks and opportunities into their business, risk and investment decisions; and
3. consumers have access to green finance products and services, which meet their needs and preferences and receive appropriate information and advice to support their investment decisions.

To achieve these outcomes, the FCA has taken the following key actions:

A. Proposed new rules for climate-related financial disclosures:

Increasingly, investors want to commit their money to companies and projects that will support the transition to a low carbon-economy. In 2017, the Financial Stability Board's (FSB) on Climate-related Financial Disclosures (TCFD) published recommendations to help businesses disclose risks and opportunities arising from climate change. The aim was to help investors understand which companies are most at risk, which ones are best prepared, and which are taking action. Greater transparency about how issuers of listed securities may be impacted by climate-related risks and opportunities will help to ensure that securities are more accurately priced and help markets work well. In turn, the FCA believes that this should allow investors to allocate capital more effectively to accelerate the transition and therefore aims to increase transparency in this area. After a period of consultation, on 21 December 2020, the FCA therefore published a Policy Statement (PS20/17) which introduced:

I. new climate-related disclosure rules within the FCA's Listing Rules to promote adoption of the TCFD's recommendations and recommended disclosures. The rules require commercial companies with a UK premium listing (including sovereign controlled commercial companies) to include a statement in their annual financial reports setting out:

a. whether they have made disclosures consistent with the TCFD's recommendations and recommended disclosures in their annual financial reports;

b. where they have:

   i. not made disclosures consistent with some or all of the TCFD's recommendations and/or recommended disclosures, or

   ii. included some or all of the disclosures in a document other than their annual financial report,

   an explanation why; and

c. where in their annual financial reports (or other relevant documents) the various disclosures can be found.

The new disclosure rules apply for accounting periods beginning on or after 1 January 2021; and

II. a new Technical Note clarifying existing disclosure obligations for a wider scope of issuers. Issuers may already be required to make disclosures on climate change and other environmental, social and governance (ESG) matters under existing rules in various parts of the FCA Handbook..

B. Building a regulatory framework for effective stewardship:

In January 2019, the FCA and FRC launched a joint discussion paper (DP19/1) on improving stewardship within the existing structure of UK capital markets. Stewardship by asset owners and asset managers involves making informed decisions about where to invest, and proactive oversight of assets once invested. DP19/1 examined what effective stewardship should look like, what the minimum expectations should be for financial services firms that invest for clients and beneficiaries, the standards the UK should aspire to, and how to achieve them. The FRC has used the feedback in its work to revise the UK Stewardship Code (see below) and the FCA separately issued its Feedback statement (FS19/7) identifying certain actions which it will be taking to address some remaining barriers to effective stewardship. These include:

I. examining how asset owners set and communicate their stewardship objectives and taking actions to promote arrangements between asset owners, asset managers and service providers that support these objectives;

II. helping to address regulatory, informational and structural barriers to effective stewardship practices, including by consulting on rule changes to enhance issuers' climate change disclosures (as discussed earlier);

III. considering further the role of firms' culture, governance and leadership in both the management of climate risks and the exercise of stewardship; and

IV. pursuing a number of actions to promote better disclosure of firms' stewardship practices and outcomes.

Through effective stewardship, the FCA hopes that:

- market integrity will be supported by improving the quality of markets and the effectiveness of capital allocation;
- it will help to deliver good outcomes for consumers by encouraging firms to actively seek value that meets consumers' preferences; and
- good disclosure or stewardship outcomes by firms will encourage them to compete on the quality of their stewardship in the interests of consumers.

C. Extending the remit of Independent Governance Committees (IGCs) on ESG and ethical issues:

In December 2015, the FCA published a policy statement on the extension to the remit of IGCs (PS19/30) which confirmed final rules and guidance requiring IGCs to oversee and report on firms' ESG and stewardship policies. IGCs provide independent oversight of workplace personal pension schemes and the final rules extend the remit of IGCs with:

I. a new duty for IGCs to consider and report on their firm's policies on ESG issues, member concerns, and stewardship, for the products that IGCs oversee; and

II. a new duty for IGCs to oversee the value for money of investment pathway solutions for pension drawdown (pathway solutions),

These changes came into force on 6 April 2020 and are aimed at protecting consumers from investments that may be unsuitable because of insufficient consideration of ESG risks, including climate change. They provide an important layer of governance to oversee how consumers' concerns are taken into account and encourage good stewardship of investments. In June 2020 the FCA published findings from its Thematic Review (TR20/1) on the 'Effectiveness of IGCs and Governance Advisory Arrangements' which focused on how IGCs have improved value for money for workplace pension scheme members.

D. Challenging 'Greenwashing':

The FCA noted in FS19/6 that there were a lack of common benchmarks, standards and metrics for sustainable products and activities. If available, these could help consumers understand the products and services they are offered and assess whether they are genuinely green. If consumers find it difficult to validate firms' claims there will be a risk of greenwashing which could undermine confidence in the green finance sector, leading to unsatisfied demand, reduced participation and competition and insufficient investment in the transition to net zero emissions. The FCA therefore:

I. issued a Policy Statement (PS19/4) in February 2019, including non-handbook guidance that a fund should set out clearly in its Key Information Document if it pursues ESG or other non-financial objectives, and how it does so. This should be done in a manner which is fair, clear and not misleading with ongoing information about performance against these objectives being given to investors on an ongoing basis. Going forward, the FCA has made clear that this will remain an active area of focus in its supervisory and policy work and will challenge firms where it sees potential greenwashing and take appropriate action to prevent consumers from being misled;

II. is engaging with the European Commission's Sustainable Finance Action Plan (SFAP). As part of the SFAP, the EU Regulation on sustainability-related disclosures in the financial services sector was published on 9 December 2019 (SFDR) and will apply from March 2021. The purpose of the SFDR is to achieve more transparency on how financial market participants and advisers consider sustainability risks in their investment decisions and insurance or investment advice. A sustainability risk is defined as an ESG event or condition that may adversely impact on the value of an investment. The SFDR will require firms both to make certain product disclosures and to disclose how they integrate sustainability considerations into their investment decisions and will apply to all financial market participants, including AIFMs, UCITs management companies, investment firms, insurance and credit institutions providing portfolio management, as well as to financial advisers providing investment/insurance advice. The FCA is considering how this and other EU initiatives will impact the UK market, including how they may affect product design and innovation and will consider what actions it needs to be taking in order to match the ambition of the objectives of the SFAP; and

III. is monitoring work underway at EU level proposing amendments to delegated acts under key pieces of EU financial regulation. These include proposals related to investment advice which would mandate insurance companies, pension fund providers and investment advisors to include questions about their clients' ESG preferences in questionnaires and suitability, to act in accordance with those preferences and to disclose to their clients how those preferences will be fulfilled.

E. Innovation:

The FCA has stated that positive innovation will have a key role in enabling financial services to overcome barriers to supporting the transition to a net zero emissions economy and meet changing consumer needs. It is a powerful driver of effective competition and can generate better outcomes for customers by delivering products and services that are better suited to their needs, more accessible or better value. In an attempt to encourage innovation in the green finance space, the FCA launched its first Green FinTech Challenge in October 2018 focussing on green finance. Nine firms were accepted as part of the FCA's first Green Cohort in April 2019 and included investing platforms aimed at helping institutional investors better factor in ESG considerations to investment decisions and consumer focused innovations, such as a tokenised rewards platform which incentivises consumers to adopt greener lifestyle changes.

FRC FOCUS

STEWARDSHIP AND CLIMATE CHANGE REPORTING

The FRC is the UK's independent regulator for accountants, actuaries and auditors, responsible for promoting the transparency and integrity in business. It also sets the UK Corporate Governance Code and Stewardship Code. As mentioned earlier, the FRC used the feedback from DP19/1 to revise the UK Stewardship Code, which took effect from 1 January 2020.

The new code sets high expectations of those investing money on behalf of UK savers and pensioners. In particular, the new Code establishes a clear benchmark for stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society. There is a strong focus on the activities and outcomes of stewardship, not just policy statements.

The Code asks investors to explain how they have exercised stewardship across asset classes. For example, for listed equity, fixed income, private equity, infrastructure investments and in investments outside the UK. These investments have different terms, investment periods, rights and responsibilities and signatories will need to consider how to exercise stewardship effectively in these circumstances. ESG factors have become material issues for investors to consider when making investment decisions and undertaking stewardship. The Code also recognises that asset owners and asset managers play an important role as guardians of market integrity and in working to minimise systemic risks as well as being stewards of the investments in their portfolios.

Principle 7 of the Code now specifically requires signatories to systematically integrate stewardship and investment, including material ESG issues and climate change, to fulfil their responsibilities. There are specific reporting obligations such that signatories should explain:

- how integration of stewardship and investment has differed for funds, asset classes and geographies;
- how they have ensured:
    - tenders have included a requirement to integrate stewardship and investment, including material ESG issues; and
    - the design and award of mandates include requirements to integrate stewardship and investment to align with the investment time horizons of clients and beneficiaries;

OR

- the processes they have used to:
    - integrate stewardship and investment, including material ESG issues, to align with the investment time horizons of clients and/or beneficiaries; and
    - ensure service providers have received clear and actionable criteria to support integration of stewardship and investment, including material ESG issues.

The outcome which the FRC is seeking is that signatories are able to explain how information gathered through stewardship has informed acquisition, monitoring and exit decisions, either directly or on their behalf, and with reference to how they have best served clients and/or beneficiaries.

In February 2020 the FRC announced a major review of how companies and auditors assess and report on the impact of climate change. The FRC will review the extent to which UK companies and auditors are responding to the impact of climate change on their business to ensure reporting requirements are being met. The review will consider how the quality of information can be improved to support informed decision-making by investors and other stakeholders.

The FRC said that it will also consider how investors are addressing the climate challenge in the stewardship of their investments and in their response to systemic and market risks when it monitors the first reports under the new Stewardship Code, which will be issued from the beginning of 2021. Its audit monitoring will consider the adequacy of auditors' work over principal risk disclosures (including climate risk) and the financial statement implications of climate change.

TPR FOCUS

INVESTMENT GUIDANCE FOR PENSION TRUSTEES

In June 2019, TPR published Investment Guidance for Defined Contribution Schemes which addresses general investment issues for pension schemes, but also addresses the need for trustees to consider the implications of the systemic risk of climate change on investment decisions in the context of their scheme when developing the statement of investment principles (SIP). In particular, from 1 October 2019 trustees have been required to specify their policies in relation to financially material considerations (including those relating to ESG considerations such as climate change), over the appropriate time horizon of the investments including how those considerations are taken into account in the selection, retention and realisation of investments.

Following on from this, in September 2019, TPR published similar Investment Guidance for Defined Benefit Pension Schemes which again addresses the need for trustees to consider climate change when producing their investment strategy and developing their SIP.

In March 2020 the Pensions Minister, Guy Opperman, announced the public consultation on new non-statutory guidance for trustees of occupational pension schemes on the risks and opportunities associated with climate change. This builds on the Government's Green Finance Strategy which set an expectation that all large asset owners would be disclosing in line with the recommendations of the TCFD by 2022. TPR welcomed the launch of the consultation for the trustees of occupational pension schemes on assessing, managing and reporting climate-related risks in line with the TCFD. The consultation has now ended and the final guidance is yet to be published.

SUMMARY AND NEXT STEPS

It is clear that climate change presents a number of significant financial risks across multiple financial sectors. However, we can summarise the key immediate regulatory focus areas as follows:

- ensuring the most systemically important firms have properly considered the risks of climate change to their businesses and are taking actions to mitigate these risks appropriately, thereby ensuring the financial resilience of firms and market integrity;
- requiring asset managers and owners, IGCs and pension trustees responsible for investing assets to integrate climate change and other ESG factors into their investment activities for the ultimate protection of the people they serve;
- challenging 'greenwashing' and ensuring 'green' claims are genuine – this should give consumers the confidence that they are investing in products or asset classes which suit their preferences, which should in turn enhance competition in the green finance sector and encourage a move to a net zero emissions economy; and
- focusing on innovation and Green FinTech to encourage firms to develop innovative solutions to support the UK's transition to cleaner economic growth.

There are many regulatory initiatives on climate change currently in motion and this is certainly an area which firms can expect increased regulatory attention.

If you think you may be impacted by any of the above, we can help you carry out a 'gap analysis' and consider what climate change considerations you should be making in the context of your business. For further information, please do not hesitate to contact us.

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