



Institute
and Faculty
of Actuaries

DP18/8: Climate change and green finance

IFoA response to the Financial Conduct Authority

31 January 2019

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

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Disclosures in capital markets

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

There are a number of difficulties issuers may face in determining materiality. These include:

- a. Issuers may misunderstand or lack awareness about the risks associated with climate change and the significant impact these risks can have for the financial sector. In general, there is weak understanding by corporates on the potentially longer term impacts of transition and physical climate risks on business. The Taskforce for Climate Related Financial Disclosures (TCFD) propose a framework that can help businesses understand the risks they face but even progressive firms such as Bloomberg are only just discovering the potential impact of physical risks. The general knowledge of the risks and impacts is still in its infancy.
- b. Understanding materiality is further hampered by the significant politicisation of these risks, ongoing denial of their existence and a lack of political clarity on potential policy approaches. More generally, there is a lack of awareness of physical impacts of 2°C, 3 °C, & 4°C of warming alongside any mitigation public bodies might take. Issuers would need to understand this for their global business yet on a local scale, reflecting the locations of physical operations, to be able to give informed disclosures and take appropriate mitigating actions.
- c. Both issuers and investors may be working with quite short-term time horizons. Climate change may not cross a materiality threshold in shorter timeframes, yet it definitely would over a longer time horizon. We encourage the FCA to be as explicit as possible about the time periods over which materiality should be measured.

We also note that various definitions of materiality exists, such as those used by the different groups involved in setting financial reporting standards. In regard to exploring how investors consider materiality in this context, we are not aware of any sophisticated discussion of this topic. As such, we encourage the FCA in its efforts to explore this and further discussion.

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 more useful?

The IFoA considers effective disclosure to be essential to understanding the financial impacts of climate change. However we consider corporate disclosures currently fail to provide sufficiently comprehensive, accurate and consistent information on sustainability risks for the purpose of enabling investors to make adequately informed decisions. As such, issuers should be encouraged, or mandated if they operate within high impact sectors, to devote greater resource to collating the required information necessary for decision useful disclosures. Information which provides understanding of the impact of their supply chain should be included since in many cases much of the impact will be caused by resource extraction, energy and transportation activities.

We are a listed supporter of the TCFD, the recommendations of which are acknowledged in the DP. The recommendations provide a framework for companies to deliver forward-looking disclosures about climate-related financial risks and opportunities. Disclosures made in line with the TCFD recommendations will enable investors to make better-informed decisions.

However, we acknowledge the TCFD recommendations are mostly a risk framework and should be viewed as a first step. The recommendations should be reviewed and refined on a regular basis. Significant progress will be made when greater understanding of suitable scenarios, interconnected business impacts and best practice for both narrative and quantitative disclosures is developed. As such, steps should be taken to promote discovery of best practices and accelerate broader adoption across all companies.

Would exploring a 'comply or explain' approach, or other avenues to encourage more consistent disclosures, be an effective way of facilitating more effective markets?

Globally, and across the investment chain, significant developments are taking place in relation to climate change. Asset owners, investment managers, corporates and consumers are all taking action. We are encouraged that while the TCFD recommendations are voluntary, the growing list of global supporters suggests movement toward a more proactive position, particularly within the financial sector. However, unless regulation mandates consideration of longer-term risks and opportunities, there remains a risk that decisions in financial services are focused on short-term financial outcomes.

Therefore, the IFoA would be supportive of a 'comply or explain' approach as long as proportionate. Proportionality is important here given that reporting in line with the TCFD recommendations is still new for many and it is an evolving process. The FCA's suggestion to limit 'comply or explain' to companies with premium listed equity shares therefore seems sensible, although we would also recognise the potential for a more forceful 'comply' approach for high impact sectors.

High impact sectors would include the financial sector due to its impact on market functioning and those with significant direct carbon risks including power, transport and oil and gas. We would expect TCFD compliance for these sectors, noting there are very limited mandatory requirements in the recommendations beyond creating a structure to consider the risks

Public reporting requirements

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

Yes, as stated, effective disclosure to be essential in understanding the financial impacts of climate change. It is increasingly recognised that climate change represents a material risk to future economic stability. Reporting on exposure to climate-related risk and risk mitigation strategies will allow for the better long-term management of these risks.

As also stated, disclosures made in line with the TCFD recommendations will enable investors to make better-informed decisions. We agree with the FCA's overall proposed comply or explain approach although would also support a mandatory comply for larger companies and high impact sectors. For public disclosures, a suitable format should be found to inform customers in regards to both their business approach and management of operational risks. Disclosures of climate risk exposures and management within investment portfolios should also be enhanced and reported in a way that is clear to the customers.

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

A distinction should be made between the information provided for customers and the information provided for investors. For customers we would expect reports to be accessible and may relate to specific products. For investors, information can be more detailed and technical and relate to aspects

of the firm's business. For investors, we would encourage information to be included in line with the TCFD's recommendations.

We are supportive of the inclusion of scenario analyses within the TCFD's recommendations in order to identify risk exposure and the potential effects of various mitigation measures. Understanding the potential implications of climate-risk from these analyses will enable users to make more informed investment decisions. Without this understanding, companies could face liability, physical and reputational risks. In addition, if a company does not take stock of its exposure to climate risk now, the costs of transitioning to a low carbon environment in the future are likely to increase, placing a company at a competitive disadvantage.

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

The FCA suggests adopting a 'comply or explain' approach to disclosure for companies with premium listed equity shares. We note that this is likely to apply to quite a small subset of FCA regulated firms. As such, we agree with the FCA's overall proposed comply or explain approach although would also support a mandatory 'comply or explain' approach for larger companies and high impact sectors. It would be logical and straightforward to require this group to compile a climate risk report. In the interest of consumer protection, we also suggest that all funds sold to the retail market are required to compile a climate risk report.

Over time, we encourage the FCA to seek to apply the requirements to an ever wider set of companies. We would also encourage seeking to extend disclosures beyond climate risks to all resource and environmental issues.

Additional questions

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?

Authorities have a responsibility to encourage a shift toward green investment. Those in the financial sector charged with making lending and investment decisions will be helped by improved disclosure of ESG risks.

There is a significant market gap in providing access for retail and defined contribution (DC) customers into new green investments. Investment into new projects is significantly hampered by requirements for daily (biweekly) pricing and liquidity. The FCA should consider the development of investment vehicles that would be suitable for new green projects for DC and retail investors. Such investments could be held on a longer term basis without the need for the vehicle to provide bi-weekly liquidity and pricing.

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 of consumer interests?

We agree with the FCA's overall proposed comply or explain approach although would also support a mandatory comply for larger companies and high impact sectors. This is consistent with the proposal in the PRA's draft Supervisory Statement (CP23/18, 3.21) that firms should be expected to consider the potential benefits of TCFD or similar initiatives.

We would propose monitoring the introduction of this approach, and anticipate that it would evolve and strengthen overtime to improve market integrity and consumer interests.

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?

The IFoA considers it important to embed flexibility when defining standards for sustainable assets. Where possible, alignment with major existing frameworks that promote high-quality sustainable assets should be sought.

We support standards which seek to encourage behaviour changes in market participants. For example, implementing the TCFD's recommendations will make it easier for investors to measure the climate impact of their portfolios. Improving market participants' knowledge of such standards will reduce the risk of green-washing by companies. Introducing sustainability components into professional standards /education syllabi for all market participants would send a powerful signal.

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

The FCA and other regulators could encourage industry to play an active role in driving initiatives in this space.

The IFoA would be supportive of efforts of regulators and industry working together on this important issue and if the actuarial profession is able to support this, we would welcome opportunities to do so. We would be interested to hear more about the Forum as developments occur.

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

The IFoA's biggest concern is to support its members in greater consideration of climate risk. In 2017, we issued a [Risk Alert on Climate Change](#) to raise awareness around the financial risks posed by climate change. We urged all actuaries, whichever field they are working in, to consider how the implications of climate change affect their work, actions and decision making.

For our members, concerns regarding climate change can be divided into risks and uncertainties. The risks of climate change reflect the risks that arise from the transition to low carbon economy, the physical risks from the change in climate and legal liability risks from actions or inactions regarding these risks. Transition and physical risks are large and likely to be significant. Poor quantification of these risks, and a lack of a good understanding of the broader economic impacts and influences on macro-economic variables such as inflation and interest rates, gives rise to uncertainties. Large uncertainties make the range of potential outcomes very large and very hard to quantify. As a result, these uncertainties make managing risks and advising on suitable reserving and investment policies particularly difficult.

As the IFoA is a public interest body we do not have direct commercial concerns, however we do have an active interest in improving the understanding of how climate change has the ability to destabilise financial systems globally.

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

The IFoA believes that the most important issue to address is embedding a shared sense of objectives in finance, and to implement appropriate risk management around these objectives. Objectives have arguably been set with the Sustainable Development Goals (SDGs) and climate change objectives agreed at COP21 and COP24. However, in reality the business practices of organisations may not always align with the SDGs and the statements they are making. The key actions we suggest to support this include:

- a. Setting an appropriate price on carbon. Fossil fuel subsidies and the lack of an effective carbon price distort the market.
- b. Mandating fiduciary duty to consider ESG factors.
- c. Being mindful that the distinction often made between financial and nonfinancial/ESG risks can be unhelpful. ESG risks are sometimes referred to as non-financial but this can be

misleading. Initially ESG factors may not have an obvious impact on financial metrics such as revenue, profit and share price. However, we note that ultimately ESG factors are likely to affect financial performance.

- d. Improved transparency and disclosure of ESG risk factors, such as the TCFD's recommendations. This will enable better capital allocation decisions by those entrusted with lending or investment decisions, and better governance of these factors by companies.
- e. A less liquid investment vehicle which would support Defined Contribution (DC) and retail investors in investing new green finance projects. These investors are currently restricted by the very limited number of projects that already have a securitised vehicle.
- f. Incentivising green finance investment through capital requirement rules for banks and insurers.
- g. Introducing compulsory requirements for minimum green finance investment by Public Sector Pension funds and Insurers through a 'comply or explain' approach. Introducing this requirement will encourage firms to greater consider their ability to invest in illiquid green finance options. Should this genuinely be inconsistent with investment needs, for example if funds have a high proportionality of employees close to retirement and require a short-term time horizon, firms could opt to explain this.
- h. Introducing a compulsory requirement for DC master trusts to offer illiquid green finance options to members. Requirements could also require the consideration of selecting these options as a default fund on a 'comply or explain' basis. Again, should this genuinely be inconsistent with investment needs, trusts would not need to meet the requirement and could explain why they have not done so.