



# FCA Discussion Paper on Finance for Positive Sustainable Change: governance, incentives and competence in regulated firms (DP23-1)

## IFoA response

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.

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA discussion paper on Finance for Positive Sustainable Change: governance, incentives and competence in regulated firms (DP23-1). This response was written by the IFoA's Sustainability Board and has been considered from an independent, public interest perspective.
2. The IFoA has a global membership of over 32,000 actuaries, working across the financial sector. Actuaries have a crucial role to play in promoting the understanding and integration of climate risks and opportunities within decision-making, and in supporting making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. By evaluating systemic sustainability impacts on the financial systems, actuaries are involved in assessing how sustainability topics and the transition to net zero may impact on our assessment of future liabilities and the adequacy of returns to meet these future liabilities.
3. In our climate change statement<sup>1</sup> and Risk Alert<sup>2</sup>, the IFoA emphasises the need for all members to consider climate-related risk appropriately in the work they do and, where necessary, to reflect on any development needs to help them do this effectively.
4. Climate change represents material financial risks for financial institutions. As such, we would expect financial services firms to embed sustainability-related considerations in their business objectives and strategies and ensure appropriate skills and knowledge.
5. At the same time, Government should recognise the limitations of the financial sector in managing sustainability risks without broader political and civic support.
6. Before introducing new expectations, we suggest the FCA consider the following:
  - Setting out clear outcome-focused principles for any new expectations. Examples may include aligning financial flows with sustainable economic needs or focusing on aligning with consumer duty to clearly articulate the sustainability outcomes from products and services and how these

<sup>1</sup> <https://actuaries.org.uk/climate-change-statement/>

<sup>2</sup> <https://actuaries.org.uk/media/btbbojzp/2022-climate-change-and-sustainability-risk-alert-final.pdf>

align with their needs.

- Articulating the harms the FCA is seeking to avoid. For sustainability, these may range from the risks to investments and the financial sector to the risks of the financial sector on planet, people, or prosperity. An approach that focuses purely on a financial risk approach will not achieve the financial capital flows required for a sustainable economy (as committed to in Paris and Montreal-Kunming). At best, we believe it will only reduce unprofitable harms.
- Clarifying how these competency needs are intended to interact with other regulatory needs. Where existing mechanism already exists, it may be sufficient to provide clarification and guidance on how sustainability is captured through existing expectations, and the regulatory enforcement that can be expected.

**Q12: What do you consider to be the main sustainability-related knowledge gaps across the financial sector and how can these best be addressed? What do you consider to be the potential harms to market integrity, consumer protection or competition arising from these knowledge gaps?**

7. As part of the IFoA Actuarial Monitoring Scheme, the IFoA carried out a review in 2021 on actuarial involvement in climate-related risk<sup>3</sup>. This review found that, in many organisations, actuaries are among those leading the thinking on climate-related risk. The key areas of work carried out by actuaries are scenario modelling and stress testing, as well as working alongside others in asset management.
8. In pension funds, scheme actuaries are involved in climate change scenarios, either as part of the actuarial valuation or as an integrated risk management exercise. This is sometimes initiated by the trustees of larger schemes, who may decide to invest in low carbon funds, shorten a scheme's journey plan to buy-out or strengthen the level of prudence in valuation assumptions.
9. In insurance, much of the climate-related risk modelling work is centred around scenarios and stress testing, with the former supporting business planning, including own risk and solvency assessment requirements.
10. This is generally due to the nature of actuarial skills that focus on using analytical skills to understand and manage long term financial risks over the long term, a core requirement when seeking to understand the potential risks and opportunities from climate change on the financial sector.
11. While disclosure requirements and consumer trends have led to an increased focus on ESG and sustainability, there remains significant sustainability-related knowledge gaps across the financial sector.
12. First of these is a focus on the short rather than long term. Our research found that, for smaller pension funds, the risk posed by climate change was less important to pension scheme trustees than other immediate risks, such as pension scheme deficits, current investment risk and sponsor covenant. Some actuaries were unclear what impact, if any, climate-related risk currently has on such functions as valuation, reserving and capital work.

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<sup>3</sup> <https://www.actuaries.org.uk/system/files/field/document/Climate-related%20risk%20report%2C%202021.pdf>

13. However, this underestimates the speed of transition change. As Simon Sharpe points out, in 2005 analysts expected around 50 GW of solar power to be installed globally by 2020, whereas the actual solar PV capacity installed by 2020 was 714 GW. Ten years ago, it looked as if fossil fuel assets would only be stranded if policies were strengthened, whereas we now estimate at least a trillion dollars' worth could be stranded under the current transition.<sup>4</sup>
14. While trustees should be aware of these transition opportunities and risks, we also call for a clearer definition of fiduciary duty<sup>5</sup> which removes the distinction between financial and non-financial factors in fiduciary duty. This would enable investors to factor in not only the impacts of social and environmental issues on their investments, but also the impact their investment decisions on society and the environment.
15. Secondly, there is a lack of understanding around the complexities and interactive effects of climate change. Climate change is happening more quickly than anticipated with more severe impacts. Multiple climate change tipping points, which may be irreversible, are already being triggered.<sup>6</sup>
16. The Financial Stability Board's Climate Scenario Analysis by Jurisdictions<sup>7</sup> in November 2022 found that scarcity of available data and modelling limitations and uncertainties were key reasons mentioned by authorities to suggest that preliminary scenario results might "significantly understate actual climate-related risks and impact".
17. "In many cases, metrics are not capturing second-round effects, potential climate non-linearities, and the costs and potential further externalities from risk management measures taken by financial and nonfinancial firms. Many exercises also did not consider other potentially large sources of risk, such as those stemming from an abrupt correction in asset prices when transition shocks result in fire sales of assets in exposed sectors."
18. The lack of standardisation of methodologies needed for scenario modelling provides another impediment. TPR's Brendan Walshe noted that the first 24 TCFD reports contained 40 different scenarios by more than ten different scenario providers.<sup>8</sup>
19. Trustees and asset managers need to be able to understand the limitations of scenario analyses and interrogate the results. However, there is often a lack of knowledge on climate change implications (the degree of transition required and physical impacts of climate change at + 2/3/4 degrees), the current status of the nature crisis and key economic dependencies and impacts.
20. Turning to advice specifically is too superficial, falling short of the true macro-economic quantum of impact, and thus lacking a focus on the "so what" and therefore action-oriented guidance. There needs to be an ability to call out basic points such as inappropriate estimates of 30 year impact of failed transition. To quote Brendan Walshe: "A four degree warmer world is not 'business as usual'. You'd have resource wars, mass migration, mass dislocation so to think that may take 10 to 20 basis points off the expected returns doesn't seem right."<sup>9</sup>

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<sup>4</sup> <https://blog.actuaries.org.uk/2023/3/not-really-trying-our-surprisingly-bad-assessments-of-climate-change-risks/>

<sup>5</sup> <https://www.actuaries.org.uk/system/files/field/document/07-31-Law-Commission-14th-Programme-of-Review.pdf>

<sup>6</sup> <https://actuaries.org.uk/media/gebdhxzi/climate-emergency.pdf>

<sup>7</sup> <https://www.fsb.org/wp-content/uploads/P151122.pdf>

<sup>8</sup> <https://vimeo.com/772451413/eb755a2d8f>

<sup>9</sup> <https://www.pensionsforpurpose.com/assets/PDFs/2022-01-20-impactlens-v11.pdf>

21. Knowledge is also lacking on the social side. As an example, 45% of senior managers are unaware that modern slavery exists in the UK.<sup>10</sup>
22. These examples highlight that, while there is a need to develop scenario modelling capabilities, there is also a need to improve communication over the limitations of existing modelling approaches and the inherent uncertainty involved in assessing the financial implications from climate change. Due to weaknesses in underlying modelling approaches, widely available climate change scenario analyses systematically underestimate climate change impacts (no tipping points, inadequate damage functions, etc<sup>11</sup>). There is a risk that financial services professionals are not aware of these gaps and do not communicate them appropriately to decision makers.
23. There are also significant knowledge gaps for consumers, especially with regards to what sustainable or green means. For instance, the level of Scope 1 or 2 GHG emissions is not sufficient to show which portfolio is greener or less exposed to climate transition risk. Consumer duty suggests that it may not be sufficient for financial services providers to provide sustainability information, but may need to develop skills to understand and coach clients' sustainability awareness and guide them through the process.
24. Metrics become even more complicated when you look beyond climate at nature impacts. The risks associated with destruction of the environment and loss of biodiversity are hard to quantify in financial terms due to the lack of a clear consensus on natural capital measurements and the long-term, uncertain and intangible nature. Therefore, while biodiversity risk, alongside climate risk, represents a systemic risk to the economy, both with regards direct physical risks as well as transition risks, this is only just starting to be understood from a financial perspective.
25. We very much support the framework proposed within the Dasgupta report of the aggregate of three capitals – Productive, Natural and Human. There is much work to be undertaken in developing these principles. But measurement of these activities – across governmental and business sectors – would be a start to develop into goals and ultimate system incentives.<sup>12</sup>

**Q13: Do you think there is a need for additional training and competence expectations within our existing rules or guidance? If so, in which specific areas do you consider further rules and/or guidance are required? Please explain your views.**

26. We welcome the FCA's identification in the consultation of key knowledge gaps<sup>13</sup> and the need for training and upskilling at all levels.
27. This is a nascent and developing area, where scientific knowledge is advancing rapidly. It makes sense to focus on the achievement of competency goals rather than be prescriptive on knowledge and qualifications. Responsibility for upskilling is a collective one between companies, the individual, professional bodies and regulators.

<sup>10</sup> <http://www.antislaverycommissioner.co.uk/news-insights/new-joint-report-on-modern-slavery-and-financial-services/>

<sup>11</sup> IFoA paper 'The Emperor's New Climate Scenarios' with Exeter University, to be published in June 2023

<sup>12</sup> PRA, (2019), Enhancing banks' and insurers' approaches to managing the financial risks from climate change, Bank of England: Prudential Regulation Authority, Supervisory Statement SS3/19, London, UK, Available online: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319> [Accessed 7 April 2021]

<sup>13</sup> Chapter 4 of consultation, pp 32-34

28. Before introducing new expectations, we suggest the FCA consider the following:

- Setting out clear outcome-focused principles for any new expectations. Examples may include aligning financial flows with sustainable economic needs or focusing on aligning with consumer duty to clearly articulate the sustainability outcomes from products and services and how these align with their needs.
- Articulating the harms the FCA is seeking to avoid. For sustainability, these may range from the risks to investments and the financial sector to the risks of the financial sector on planet, people, or prosperity. An approach that focuses purely on a financial risk approach will not achieve the financial capital flows required for a sustainable economy (as committed to in Paris and Montreal-Kunming). At best, we believe it will only reduce unprofitable harms.
- Clarifying how these competency needs are intended to interact with other regulatory needs, especially the overlap with PRA on macro-prudential and the Chancellor’s request to considering impact on reaching UK’s net zero goals, along with the UK commitments to ensuring sustainable financial flows from Paris and Montreal-Kunming agreements. Where existing mechanism already exists, it may be sufficient to provide clarification and guidance on how sustainability is captured through existing expectations, and the regulatory enforcement that can be expected.

29. We note the EU competence framework on sustainability (GreenComp)<sup>14</sup> and sustainable finance competences in the EU/OECD Financial competence framework for adults (2022)<sup>15 16</sup>. The FCA might consider similar core guidance. We suggest this should be applicable to all, although it will be more important in some roles than others. This would be in addition to specialist knowledge that should be available either within firms or somewhere they have continual access to.

30. We look forward to the introduction of a UK Taxonomy and the development of a Common Lexicon as we believe that these tools will help provide consistency and clarity. In addition, we would also welcome guidance on communication standards and Know Your Client (KYC) requirements around sustainability.

31. In addition to the gaps highlighted in the consultation, we would like to see further transparency and discussion around:

- Gaps in macro-economic and physical risks within scenario projections. For example, how Integrated Assessment Models (IAMs) generally do not measure climate feedbacks, such as flood losses or adaptation costs due to rising sea levels<sup>17</sup>
- Financial risk versus double materiality (assessing both the impact of sustainability risks on the business and how business activities impact society and the environment)
- Complexity of metrics – both climate and beyond climate
- Post modern portfolio theory does not allow for future sustainability risks, with implications for both capital allocation and robo-advice

32. Guidance should support longer-term decision making to better manage systemic risks and support the growing group of institutional investors, who are looking beyond integrating ESG to system-level

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<sup>14</sup> <https://publications.jrc.ec.europa.eu/repository/handle/JRC128040>

<sup>15</sup> <sup>15</sup> <https://www.oecd.org/daf/fin/financial-education/financial-competence-framework-for-adults-in-the-European-Union.pdf>

<sup>16</sup> [https://www.openriskmanual.org/wiki/Sustainable\\_Finance\\_Competence\\_List](https://www.openriskmanual.org/wiki/Sustainable_Finance_Competence_List)

<sup>17</sup> <https://www.carbonbrief.org/qa-how-integrated-assessment-models-are-used-to-study-climate-change/>

investing to support the health and stability of the social, financial and environmental systems on which they depend for long-term returns<sup>18</sup>.

**Q3: What steps can firms take to ensure that they have the right skills and knowledge relating to material climate and sustainability related risks, opportunities and impacts on their boards? Should we consider setting any regulatory expectations or guidance in this area? If so, what should be the scope of such expectations?**

33. Not having the right Board skills represents a material risk for a company. Firms can appoint non-executives who have appropriate skills or provide coaching.
34. Dependent on the introduction of any sustainability competence expectations (Q13), there should be clear expectations on Boards on how to apply them. Guidance would help boards understand their regulatory requirements in this area and identify gaps in their knowledge.

**Q10: Should we consider additional regulatory measures to encourage effective stewardship, particularly in relation to firms' governance and resourcing of stewardship, and associated incentive mechanisms and conflict of interest policies? Are there regulatory barriers that we should consider? Please explain your views.**

35. If the financial service industry is to take ownership of long-term systemic risks, then it needs to rethink its stewardship model. Managing long-term systemic risks requires a far greater focus on macro-prudential stewardship, and to be built around individual and collective agency for change. Stewardship has a critical role in assessing exposures and financial risks from climate. Many companies say they manage this through engagement, with divestment as a last resort.
36. Government should recognise the limitations of finance in managing these risks without broader political and civic support.

**Q11: What additional measures would encourage firms to identify and respond to market wide and systemic risks to promote a well-functioning financial system? How can the collective stewardship efforts of asset owners and asset managers best be directed towards the most pressing systemic issues? And how can remaining barriers best be reduced? Please explain your views.**

37. Scenario testing clearly has a role to play in identifying systemic risks. However, there are material idiosyncratic risks that are not covered by scenarios projections. It is critical that modelling limitations and assumptions that place material weight on a smooth (modelled) transition are understood and communicated. Professionals are required to make judgements, even if the modelling is not there yet, rather than placing undue weight on quantifiable metrics, that contain material simplifications.
38. Actuaries focus on the tail risks – the things we want to avoid. Exploring adverse outcomes is key, even if they are unquantifiable. Giving this parity with quantifiable scenarios is important in managing uncertainty. A risk management approach helps us to understand what might go wrong, build resilience and maintain optionality, as well as decide measures to limit the probability of very bad outcomes.

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<sup>18</sup> <https://www.top1000funds.com/2021/04/seeing-systemic-risks/>

39. An understanding of systems interactions is also key – understanding how the balance sheets of financial sector actors are interlinked. There is a need to explore extreme outcomes and how climate and non-climate risks may interact. Climate-change risks exacerbate existing weaknesses in our societies, act as multipliers to other risks and contribute to system-wide failures.<sup>19</sup>

**Q8: What matters should firms take into consideration when designing remuneration and incentive plans linked to their sustainability related objectives? In particular, we welcome views on the following:**

- a. **the case for linking pay to sustainability related objectives**
- b. **whether firms should break down their sustainability related commitments into different factors, allocating specific weightings to each**
- c. **whether short term or long term measures are more appropriate, or a combination of both**
- d. **whether sustainability related incentives should be considered for senior management only, or a wider cohort of employees**
- e. **how firms could consider remuneration and incentive plans in the design and delivery of their transition plans**
- f. **remuneration adjustments where sustainability related targets (at either the firm level or individual level) have not been met. Please explain your views.**

40. We understand that it is certainly difficult and complex to measure and incentivise performance based on sustainability KPIs, such as an ESG metric, given the evolving framework and calibration methodology. Nevertheless, we think it is useful to link pay with firms' sustainability objectives in order for firms to make an impact and meet their sustainability outcomes. Firms should consider breaking down long-term objectives into shorter term milestone targets, i.e., things management need to be doing now to support longer term outcomes. Remuneration linked to these interim targets could be used as a catalyst for positive change in the organisation and for its stakeholders, in lieu of traditional, short-term financial performance.

If you would like to discuss any of the points raised in this response, please contact Caroline Winchester, IFoA Policy Manager ([caroline.winchester@actuaries.org.uk](mailto:caroline.winchester@actuaries.org.uk)).

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<sup>19</sup> Luke Kemp paper "Climate Endgame" : <https://www.pnas.org/doi/10.1073/pnas.2108146119>