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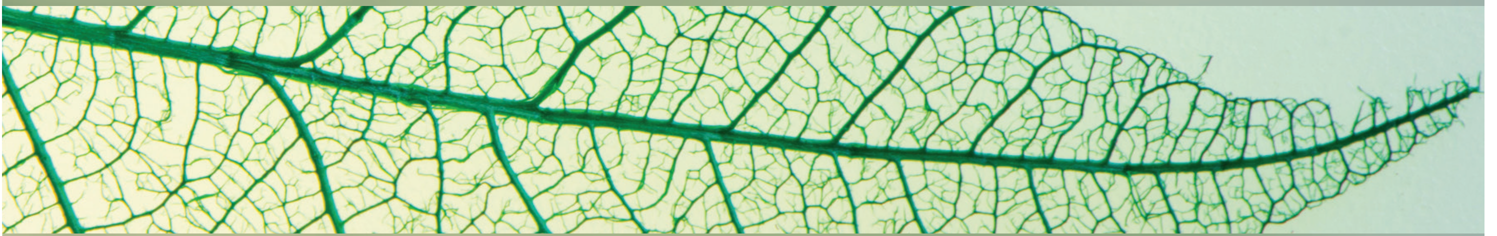

A GREEN AND SUSTAINABLE ROUND UP

OCTOBER 2018

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Against the well-publicised backdrop of the IPCC Report there have been a number of other papers and publications in recent weeks that also continue to shape the regulatory environment on green and sustainable finance. This briefing summarises the TCFD Status Report, the PRA and FCA papers on climate change and green finance and the European Parliament's proposed amendments to the Commission's benchmark regulation proposals from June. It also looks briefly, in the context of the Green GB Week, at some of the key UK government's proposals on green finance and climate change.

This briefing looks at:

- TCFD Status Report
- PRA Report 'Transition thinking: Impact of climate change'
- PRA consultation on managing the financial risk from climate change
- FCA discussion paper on climate change and green finance
- European Parliament's amendments to the carbon benchmark proposals
- Current UK initiatives

TCFD

On 26 September, the Task Force on Climate-related Financial Disclosures (TCFD) published its first status report (the **Status Report**). The Status Report provides an overview of current disclosure practices and their alignment with the core elements of the TCFD recommendations.

By way of reminder, the TCFD was established by the Financial Stability Board in 2015. The TCFD went on to produce voluntary recommendations in 2017 on climate-related information that companies should disclose to help investors, lenders and others make sound financial decisions. The recommendations focussed on enhancing disclosure on governance, risk management and strategy as well as including specific metrics and targets to help create more consistent, comparable and reliable disclosure.

The Status Report is the first real analysis of how the TCFD's recommendations have fared since publication. Key findings include:

- The number of firms supporting the TCFD recommendations has grown to over 500 representing almost USD8 trillion in market capitalisation.
- The majority of the firms surveyed disclose information aligned with at least one of the TCFD recommended disclosures.
- While many companies describe climate-related risks and opportunities, few disclose the financial impact of climate change on the company.
- A minority of companies disclose forward-looking climate targets or the resilience of their strategies under different climate-related scenarios, including a 2°C or lower scenario – a key recommendation of the TCFD.
- Disclosures vary widely across industries. More non-financial companies reported their climate-related metrics and targets; than did financial companies. However, financial companies were more likely to disclose how they had embedded climate risk into overall risk management.
- Disclosures are often made in sustainability reports or spread across financial filings, annual and sustainability reports.

Climate-related data is increasingly cited by investors as lacking when they are making investment decisions. As such, the level of uptake is encouraging, particularly as the recommendations are still relatively new.

The challenge for those producing the information will be to ensure the information is produced is "decision useful" – not easy, particularly when the risks that are being highlighted are often relevant across much wider time horizons than "standard" corporate disclosure.

It will also be interesting to see how regulators react to the TCFD's recommendations. Both the EU Sustainable Finance Action Plan and UK Green Finance Initiative have made proposals to integrate the TCFDs recommendations more fully into the regulatory framework. Look out in particular for the results of the Commission's fitness check of EU legislation on public corporate reporting due in Q1 2019.

The PRA Report and Consultation Paper

The Prudential Regulatory Authority (**PRA**) published its *Transition in thinking: The impact of climate change on the UK banking section* report (the **Report**) in September and followed this a few weeks later by a Consultation Paper setting out a draft supervisory statement on how banks and insurers should manage climate-related financial risks. The PRA's analysis and proposals address these financial risks through the lens of its primary object of maintaining the stability of the UK financial system to ensure an orderly transition to a low carbon economy.

The Report primarily does two things, it summaries the key financial risks to banks resulting from climate change and also categories banks' current approach to climate change. The Consultation Paper, *Enhancing banks' and insurers' approaches to managing the financial risks from climate change*, builds on the Report to set out the PRA's expectations of how banks and insurers should apply effective governance, risk management, scenario analysis and disclosures to manage climate-related financial risks. The consultation closes on 15 January 2019.

The Report

The Report indentifies two broad forms of climate related financial risks, physical risks and transitional risks. Physical risks arise from the material damage done by climate change, for instance, properties being destroyed due to increased flooding or agricultural yield decreasing due to changes in climate in certain areas. Transitional risks then can be seen predominantly through the effects of moving towards a low-carbon economy, such as adapting to climate-related policy and regulatory changes, changes in public sentiment and consumer demand and new or disruptive technology. These risks are then categorised further, as the PRA determines that these risks will impact banks from three different perspectives: credit risk, market risk and operational risk.

Within the dynamics of these risks, the PRA stresses that timing and the speed of transition needs to be a key consideration as the transition towards a low-carbon economy gathers pace. In not acting quickly enough, the physical effects of climate change, such as more extreme weather events or rising sea levels, may be disastrous and therefore present huge credit, market and operational risks to the banking sector. However, moving too quickly to a low-carbon economy could have a dangerous effect on financial stability. For instance, a sudden shift away from carbon-intensive sectors could de-stabilise the bonds, equities and

other assets held on the balance sheets of banks. Mark Carney notes this as a paradox where "success is failure".

The PRA surveyed over 90% of the banking sector and categorises the surveyed banks into three groups according to how they treat climate change as an organisation:

Responsible:	30% were 'responsible' – meaning they were reacting to climate change from a corporate social responsibility perspective. These banks were focusing on the reputational risks which might be presented by, for instance, investing heavily in the coal industry, rather than looking at climate change as a substantial, long-term threat to their balance sheet
Responsive:	60% were 'responsive' – banks in this category did view climate change as a financial risk but still in short-term time horizons which the PRA felt to be rather narrow
Strategic:	10% were 'strategic' – these banks considered the financial risks of climate change at the board level and looked at the financial interests of the firm in the long-term

Unsurprisingly the PRA advocates firms enhancing their governance and risk management to become more like the 'strategic' 10% who are better placed to successfully address the unique and complex challenges identified in the Report.

The Consultation Paper

The draft supervisory statement set out in the consultation requires banks and insurers to take a more strategic long term approach to the climate-related financial risks that result from the type of physical, transition and liability or litigation risks identified in the Report. It expects firms to identify both current and future risks as well as the actions which can be taken to mitigate such risks.

The supervisory statement is intended to apply to all UK banks and insurers (collectively referred to as **firms**). The consultation recognises that practice on climate change risk management will develop over time so the supervisory statement expectations are deliberately high level, and overarching these expectations is the principle that a firm's approach should be proportionate with the nature, scale and complexity of its business.

The proposed PRA expectations as set out in the draft supervisory statement are categorised into four main themes: governance, risk management, scenario analysis and disclosure.

Governance: climate-related financial risk should be incorporated into the governance frameworks of firms. Boards must understand and assess these risks and ensure they are aligned with the overall business strategy and risk appetite of the firm. The PRA will expect to see evidence of this.

Risk management: existing risk management frameworks should be used to address climate-related financial risks. Firms will need to demonstrate an understanding of how climate-related financial risks could affect their business models and plan for these. Again the PRA will expect to see evidence of this.

Scenario analysis: scenario analysis should be used to determine the strength of their risk profiles and business models. These should be based on a range of outcomes of climate change, including severe physical risks and different speed transitions to a low-carbon economy.

Disclosure: firms' existing disclosure requirements relating to material risks is likely to be affected and should be reviewed in line with the expectations. Firms will also be expected to engage with wider initiatives on climate-related financial disclosures, such as the TCFD recommendations.

FCA Discussion Paper – Climate Change and Green Finance

The FCA Discussion Paper can be seen as a companion piece to the PRA papers. It asks some questions of stakeholders but also trails some future consultations on potential guidance. Views are sought by 31 January 2019.

The paper reiterates that the FCA's strategic objective is to ensure that financial markets work well and in the context of climate change the FCA must seek to:

- ensure issuers of listed securities satisfy their disclosure obligations;
- ensure that firms have suitable controls in place to consider climate risks, including transition risks; and
- protect consumers who want to buy green finance products.

While recognising that there are many potential areas for engagement on climate change and the low carbon transition, the FCA specifies four areas of initial regulatory focus.

Pensions schemes: the FCA, as regulator of personal pensions schemes, will be consulting on rule changes as to how environmental, social and governance factors and other ethical concerns are considered when pension providers make investment decisions. A package of changes will be proposed in Q1 2019.

Innovative green finance: innovative green finance products or services can benefit from the regulatory "sandbox" and other incentives. The Green FinTech Challenge, launched as part of Green GB Week, is intended to provide support to entities developing innovative products and services to assist in the UK's transition to a greener economy. The Challenge is open to start ups, incumbents and technology providers. The eligibility criteria for application are that the products or services assist in the green transition of the economy, are of benefit to the UK market and consumers and would benefit from access to the Innovate services, such as guidance, authorisation or regulatory support and access to live testing in the sandbox.

Disclosure requirements for issuers of securities: as the value of securities will be affected by climate risks, it is crucial that the regulatory environment supports asset buyers in making informed risk assessments on investments and asset allocation by ensuring that adequate climate risk disclosures are made. To that end the FCA will consult on guidance to issuers on how the current regime might be interpreted to apply to climate change related risks. The FCA also seeks feedback on what would constitute meaningful and comparable

disclosure of climate risks, including on a proposal that companies with premium listed shares be required to adopt a 'comply or explain' approach to the TCFD recommendations.

Public reporting on climate risks: the FCA seeks views on a new requirement for financial services firms to report publicly on how they manage climate risks.

The final section of the report outlines the FCA's involvement with a number of domestic and international initiatives on climate change, including the establishment of the Climate Financial Risk Forum with the PRA.

EU Benchmark Regulation proposals

In June of this year the Commission, as part of its Sustainable Action Plan, put forward legislative proposals relating to the creation of regulated carbon impact benchmarks. The European Parliament's suggested amendments to the Commission's proposals highlights a difference in approach. The Parliament is particularly concerned by the risk of greenwashing and its amendments seek to ensure that these benchmarks and the methodology adopted by administrators of those benchmarks ***fully*** align with the Paris Climate Agreement targets.

We discussed in our earlier briefing, *The EU's Sustainable Finance Legislative Proposals – What you need to know*, that in proposing the development of two different types of benchmark, a low carbon impact benchmark and a positive carbon impact benchmark, the Commission appeared to support the dual track approach of both 'light' green and 'dark' green projects and investments being part of the low carbon transition process. The Parliament take a different view. It highlights the concern of greenwashing in connection with low carbon benchmarks and suggests that investors could be confused by the different approaches and carbon targets of such benchmarks. The amendments therefore focus on ensuring that all carbon impact benchmarks are fully aligned with the commitments in the Paris Climate Agreement, that administrators use standardised methodology to calculate carbon impacts and that there is specific disclosure of the extent to which scope 1, 2 or 3 emissions are taken into account. The Parliament also proposes that a standard methodology for measuring the social and governance impact of all financial benchmarks is developed. The proposal is that by 2022 all benchmarks be aligned with the Paris commitments and prepared according to a standardised methodology.

The European legislative process has a way to go before the benchmark proposals are finalised, and whilst we applaud the Parliament's ambition, the amendments seem to remove any meaningful distinction between the two different types of benchmarks. This removal of the "lighter green" option goes against the (possibly prevailing) view that all green projects and investments are worthwhile if they are part of a compelling low carbon transition story. The proposals to prepare standardised methodologies covering carbon emissions and social and governance impacts also adds to the Commission's increasingly long list of sustainable finance taxonomy and methodology related projects.

The Commission's proposal:

- **low carbon benchmarks:** the underlying assets that have less carbon emissions than a standard investment index
- **positive carbon impact benchmarks:** the underlying assets where the carbon emissions savings exceed their carbon emissions, allowing investors to align with the 2 degree Celsius objective in the Paris Climate Agreement.

The Parliament's proposals:

- **Low carbon benchmarks:** the underlying assets are fully aligned with the de-carbonisation pathway required to achieve the commitments of the Paris Change Agreement
- **Positive carbon impact benchmarks:** the underlying assets display emissions savings that are expected to be the minimum required to achieve the Paris Climate Agreement commitments.

What's happening in the UK?

The UK Government continues to be committed to the green agenda and Green GB Week (15 – 19 October) aimed to promote and increase discussions around financial solutions and innovation to achieve the low carbon economy transition.

Specific actions of the UK Government, departments and regulators includes:

- publication of a Green Finance Strategy in spring 2019 to build on the Green Finance Taskforce's March 2018 Report
- co-funding a new Green Finance Institute with the City of London to act as hub for UK green finance activity
- launch of the Green FinTech Challenge by the FCA (see above)
- investment of up to £20 million, together with £20 million of private sector funding, in a venture capital fund, the Clean Growth Fund, which will support development of clean technology
- commitment to hold a national conference and regional workshops during 2019 to facilitate discussions between local authorities, cities and civil society on how best to support local green projects and infrastructure
- development of new standards in sustainable investment and activities by the British Standards Institute
- launch of the BEIS run programme UK PACT (Partnering for Accelerated Climate Transitions) to share UK skills globally.

C L I F F O R D

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