THE UK, SUSTAINABLE FINANCE AND CLIMATE REGULATION: THE NEXT STEPS

On 9 and 10 November the UK Government and regulators made a number of coordinated announcements about the UK's plans for climate regulation and commitment to the ESG agenda. Over the past few months climate resilience, similarly to other policy initiatives, has not been the focus of the Government and financial regulators whose priority has been the Covid-19 pandemic as they sought to support livelihoods and limit damage to the UK economy. However, this week's announcements bring climate resilience and the transition to net zero carbon back to the top of the legislative and regulatory agenda. This alert summarises the key points made and outlines some initial high-level thoughts.

The Chancellor Rishi Sunak's speech to Parliament

The relevant section of this speech looked to cement the UK's commitment to green finance prior to hosting COP26 and the ending of the EU transition period on 31 December 2020.

Key points:

- Explicit recognition that financial services are an essential component to reach net zero.
- Continued commitment to global leadership in green finance ahead of COP26.
- Intention to issue its first Sovereign Green Bond in 2021.
- Implementation of more robust environmental disclosure standards.
- First country to mandate full TCFD aligned disclosures across the economy – beyond comply or explain.
- Adoption of a green taxonomy based on the EU taxonomy but amended as necessary to address UK needs.
- Establishment of a UK Green Technical Advisory Group to consider the UK green taxonomy.
- UK to join the International Platform on Sustainable Finance.

For more on the TCFD and the EU taxonomy see the Annex.

Key issues:

- UK Government and regulators refocus on commitment to green finance
- UK to issue a sovereign green bond in 2021
- UK to develop own green taxonomy
- Bank of England to launch climate stress test in June 2021
- FCA to require TCFD disclosures for premium listed issuers for periods beginning 1 January 2021
- FCA requirement to broaden and strengthen over time
- Expansion of mandatory TCFD disclosures across the economy between 2021 and 2025
- UK Government and UK financial regulators endorsed the IFRS Foundation proposal to establish a sustainability standards board

Our view

These are bold commitments that are intended to re-confirm the UK's focus on green finance, particularly in light of the UK leaving the EU and therefore the ambit of the EU's Sustainable Finance Action Plan and European Green Deal. Issuance of a sovereign green bond, aligns the UK with other governments that have demonstrated their commitment to green finance through sovereign issuance, including the EUR7bn French debut green OAT.

The Government's planned expansion of the mandatory TCFD-aligned disclosure across the economy is a significant development giving increased momentum to the growing international acceptance of the TCFD as the gold-standard for climate disclosures. Guidance around the reporting of scope 3 (supply chain emissions) and climate scenario analysis required by TCFD-aligned disclosure is still evolving, and this will need to be fully developed before such approaches become fully mandatory without a 'comply or explain' safety valve. TCFD-aligned disclosure is also likely to be challenging for many, particularly smaller, organisations that are not able to draw on the significant internal resource and sophisticated analytical capability that compliance will require.

The UK's Joint Government Regulator TCFD Taskforce, chaired by HM Treasury and made up of regulators and Government departments published its interim report on 9 November 2020 on the most effective approach to implementing the recommendations of the TCFD across the UK economy. This includes a roadmap towards mandatory climate-related disclosure by 2025, covering seven key sectors– we have summarised the key points in the Annex.

It is interesting that the Government has concluded that the UK needs to develop its own green taxonomy, and the differences needed for the UK market will be an area to watch. Given the challenges faced in development of the EU taxonomy, if substantive differences are proposed this process could be time consuming and resource-intensive for in-scope entities operating in both markets. Similar objections of potentially unnecessary and resource-sapping duplication have been levelled at other environmental regimes such as the proposed UK version of the EU chemicals regime REACH which will be implemented as from January 2021.

Governor of the Bank of England Andrew Bailey's speech at the Green Horizon Summit

This speech discussed the next steps in the Bank of England's plans to bring climate resilience back into focus after the enforced postponement as a result of the Covid-19 pandemic. As Andrew Bailey explicitly acknowledges, the emergency support granted to businesses and individuals did not discriminate on the basis of climate change implications. However, the speech signals to the financial services industry that it is time for a renewed focus on tackling climate change and indicates that there is a clear intention to embed climate resilience firmly in the way the UK economy recovers from the Covid-19 pandemic.

Key points:

- Intention to build on the 2019 supervisory expectations on banks and insurers in relation to management of climate risks.
- Climate stress test exercise announced in July 2019 to be launched in June 2021.
- Stress test will cover three different climate scenarios focussing on various configurations of physical and transition risks over a 30 year period.
- The results of the stress test will inform development of firms' risk management practices.
- Firms may need to reassess their near term capital requirements as a result of the stress testing process.
- Confirmation that the Bank will support asset allocation strategies that assist in aligning portfolios with the transition to a net zero carbon economy.

Our view

The focus of Andrew Bailey's speech may not be a surprise to many, as the PRA wrote to CEOs of regulated firms in July 2020, stating that firms should have fully embedded their approaches to managing climate-related financial risks by the end of 2021. However, it does hint at further things to come. This could in time include a green supporting factor or brown penalising factor for regulatory capital in order to assist in aligning portfolios with the transition to a net zero carbon economy. At the moment, the focus is very much on Pillar 2 capital requirements, through stress testing and the supervisory risk and evaluation process (SREP). Indeed, before introducing more prescriptive Pillar 1 capital adjustments to take into account climate and other ESG factors, an ESG taxonomy and related indicators and metrics would need to be developed, so this seems a longer term ambition. There is an open question as to whether it is appropriate to include ESG adjusting factors in Pillar 1 capital calculations, or what impact this might have on financial stability.

This question of whether a dedicated prudential treatment of ESG-related exposures and assets would be justified as a component of Pillar 1 capital requirements is also being considered by the European Banking Authority (EBA), which recently published a discussion paper on how to incorporate ESG risks into the governance, risk management and supervision of EU credit institutions and investment firms. The EBA consultation runs until 3 February 2021. It will be interesting to see how the EU and UK approaches to prudential supervision of ESG risks continue to develop after the end of the Brexit transition period.

Chief Executive of the FCA Nikhil Rathi's speech at the Green Horizon Summit

The speech outlined the FCA's focus on developing and maintaining transparency for customers and firms, trust in sustainable finance products and development of the right regulatory tools. It detailed the introduction of a new listing rule to align with the Government strategy of mandatory TCFD disclosure across the economy.

Key points:

- New listing rule requiring certain listed companies to make disclosures consistent with the TCFD to be introduced for reporting periods beginning 1 January 2021.
- Full policy statement and final rules to be published by the end of 2020.
- The initial listing rule will be on a 'comply or explain' basis but consideration will be given to changing this to require mandatory disclosure.
- The scope of the rule will be expanded to include broader range of issuers in Q2 2021.
- Proposals to expand TCFD disclosures to asset managers, life insurers and FCA regulated pension providers will be published in Q2 2021 with new rules following in 2022.

A copy of the FCA's proposed listing rule is set out in the Annex.

Our view

The introduction of a new listing rule confirms the FCA's direction of travel regarding sustainable finance. While the comply or explain basis will be familiar to premium equity issuers the potential expansion to require mandatory disclosure is an ambitious step clearly aligned with the UK Government's broader proposal for mandatory economy-wide TCFD-aligned disclosures by 2025 discussed above. The Government's proposal is also likely to be the driver behind the expansion of the rule to a wider group of issuers, although it is clear that the intention is only to catch equity and not debt issuers. To the extent the UK moves faster in this direction than other listing venues this could be a differentiator helping to embed London as key promoter of the TCFD standards, which is likely to be of significance to green and ESG investors.

The proposals to expand TCFD disclosures to asset managers, life insurers and FCA regulated pension providers is an ambitious step on the road to net zero and one that is not without obstacles, for example in relation to data quality. However, there is clearly regulatory momentum to improving transparency on sustainability credentials. Engagement by the industry in the consultation planned by the FCA for the first half of 2021 could help produce sector-specfic pathways to net-zero, which take account of the issues and deliver a practical way forward for this segment of the financial services industry and untimately for investors.

Annex

UK's Joint Government-Regulator TCFD Taskforce: Interim Report

This report was produced by a UK Taskforce of regulators and Government departments established to consider how the expectation in the UK Green Finance Strategy that all listed issuers and large asset owners would be disclosing in line with the TCFD's recommendations by 2022 could be met.

The Taskforce is composed of HM Treasury, the Department for Business, Energy and Industrial Strategy (BEIS); the Department for Work and Pensions (DWP); the Local Government Pension Scheme (LGPS); the Bank of England (the Prudential Regulation Authority (PRA)); the Financial Conduct Authority (FCA); the Financial Reporting Council (FRC); and the Pensions Regulator (TPR).

In summary the Interim Report:

- Sets out the case for mandatory TCFD-aligned disclosure.
    - Recognises that progress has been made towards voluntary compliance with TCFD but, in line with the recent TCFD status report, consultations by FCA and Department for Work and Pensions and analysis by the UN Principles for Responsible Investing, more work needs to be done.
    - Aims to encourage firms to go beyond disclosures to foster a step change in dealing with climate risks and opportunities and encourage firms to behave more strategically.
- Provides a roadmap towards mandatory climate-related disclosure, covering seven key sectors: listed commercial companies; UK registered large private companies; banks and building societies; insurance companies; life insurers; FCA-regulated pension schemes; and occupational pension schemes.
    - Recognises that different firms are on different trajectories in developing TCFD aligned disclosures so may need to proceed at different paces. In particular, there may be significant data gaps in certain sectors.
    - Roadmap envisages an increasing level of disclosure rules and requirements between 2021 and 2025.
    - Intention to develop proportionate requirements. Noting that the benefits of mandatory disclosure will be closely related to the size of an organisation.
    - Expectation is that most sectoral regulators will begin with a principles based approach but this may need to become more granular and metric focused over time.
- Proposed next steps include progression of strategies outlined in the roadmap; working with industry to facilitate implementation; and co-ordinating with international organisations to further global work on climate-related disclosures.
    - A progress report will be provided in 2022 with the refresh of the Green Finance Strategy.
    - Recognition that international standards and cooperation will be key in facilitating comparability of climate-related disclosures.
- Annexes provide an overview of proposals for each of the seven sectors within scope.

Full report available here.

Task Force on Climate-related Financial Disclosures

The industry-led TCFD's Recommendations and Detailed Guidelines (the 'Recommendations'), published in June 2017, encourage companies to include climate-related information within their financial disclosures.

The Recommendations are principally aimed at ensuring investors, lenders and insurance underwriters have sufficient information about how climate change could affect their actual and proposed investments. However, the Task Force suggests that all companies with public equity or debt should adopt them, both in financial and non-financial sectors.

There are four key areas for disclosure:

- Governance: The role of management in assessing climate change risks and opportunities, and oversight by the board
- Strategy: Where material, a description of impacts of actual and potential risks/opportunities from climate change upon the business's strategy and financial planning over different time horizons and the resilience of the organisation's strategy based on different climate scenarios
- Risk Management: Description of the organisation's process for identifying and managing climate-related risks and how these relate to the organisation's overall risk management framework
- Metrics and Targets: Where material, disclosure of the organisation's Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas emissions, and related risks; and a description of the metrics used to identify risks and opportunities

EU Taxonomy Regulation

The EU Taxonomy Regulation embeds a taxonomy for environmentally sustainable activities into EU law so that the classification system can be used in different areas, for example labels, standards and benchmarks. It sets out the criteria for determining if an activity (not a company or asset) is environmentally sustainable, but leaves future delegated regulations to detail the Technical Screening Criteria.

The Taxonomy applies to any EU or national regulator that sets out requirements relating to financial products or corporate bonds (notably not sovereign bonds) that are marketed as environmentally sustainable (such as 'green bonds'), to financial market participants in relation to offering financial products, and to non-financial statements prepared by large public-interest entities. Any company which intends to issue "green" bonds in accordance with the proposed EU Green Bond Standard will be required to demonstrate that proceeds are used only for Taxonomy-aligned activities.

**Must "contribute substantially" to one or more of the following environmental objectives:
Climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control and protection and restoration of biodiversity and ecosystems or be an "enabling" activity or "transitional" activity**

↓

Must not "significantly harm" any of the environmental objectives ("Do No Significant Harm" principle)

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Must comply with OECD Guidelines, UN Guiding Principles on Business and Human Rights, and conventions listed under the ILO Declaration on Fundamental Rights and Principles at Work and International Bill of Human Rights

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Must comply with additional specific technical screening criteria ("TSC")

FCA's proposed listing rule set out in CP 20/3

9 Continuing obligations

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9.8 Annual financial report

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Additional information

9.8.6 R In the case of a *listed company* incorporated in the *United Kingdom*, the following additional items must be included in its annual financial report:

…

(6) a statement as to whether the *listed company* has:

…

(b) …

(iii) the *company's* reasons for non-compliance~~; and~~

(7) a report to the shareholders by the Board which contains the information set out in *LR* 9.8.8R; and

(8) a statement setting out:

(a) whether the *listed company* has included in its annual financial report climate-related financial disclosures consistent with the four recommendations and the eleven recommended disclosures set out in Section C of the *TCFD Final Report;*

(b) in cases where the *listed company* has:

(i) made climate-related financial disclosures consistent with the recommendations and recommended disclosures set out in Section C of the *TCFD Final Report*, but has included some or all of these disclosures in a document other than the annual financial report:

(A) the recommendations and/or recommended disclosures for which it has included disclosures in that other document;

(B) a description of that document and where it can be found; and

(C) the reasons for including the relevant disclosures in that document and not in the annual financial report;

(ii) not included climate-related financial disclosures consistent with all of the recommendations and recommended dislosures set out in Section C of the *TCFD Final Report*, either in its annual financial report or other document as referred to in (i);

(A) the recommendations and/or recommended disclosures for which it has not included such disclosures; and

(B) the reasons for not including such disclosures; and

(c) where in its annual financial report or (where appropriate) other document the climate-related financial disclosures referred to in (a) can be found.

…

9.8.6B G For the purposes of *LR* 9.8.6R(8), in determining whether climate-related financial disclosures are consistent with the recommendations and the recommended disclosures set out in the *TCFD Final Report*, a *listed company* should have regard to:

(a) Section C of the *TCFD Annex* entitled "Guidance for All Sectors";

(b) (where appropriate) Section D of the *TCFD Annex* entitled "Supplemental Guidance for the Financial Sector"; and

(c) (where appropriate) Section E of the *TCFD Annex* entitled "Supplemental Guidance for the Non-Financial Groups".

9.8.6C G For the purposes of *LR* 9.8.6R(8), in determining whether a listed company's climate-related financial disclosures are consistent with the recommendations and the recommended disclosures set out in the *TCFD Final Report*, the *FCA* considers that the following documents are relevant:

(a) the *TCFD Final Report* and the *TCFD Annex*, to the extent not already referred to in *LR* 9.8.6R(8) and *LR* 9.8.6BG; and

(b) the *TCFD Technical Supplement*.

9.8.7 R An overseas company with a premium listing must include in its annual report and accounts the information in *LR* 9.8.6R(5), *LR* 9.8.6R(6), *LR* 9.8.6R(8) and *LR* 9.8.8R.

Appendix 1 Relevant Definitions

TCFD Annex	the document entitled "Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures" published in June 2017 by the Task Force on Climate-related Financial Disclosures, available at: https://www.fsb-tcfd.org/publications/.
TCFC Final Report	the report entitled "Recommendations of the Task Force on Climate-related Financial Disclosures" published in June 2017 by the Task Force on Climate-related Financial Disclosures, available at: https://www.fsb-tcfd.org/publications/.
TCFD Technical Supplement	the technical supplement entitled "The Use of Scenario Analysis in Disclosure of Climate-related Risk and Opportunities" published in June 2017 by the Task Force on Climate-related Financial Disclosures, available at: https://www.fsb-tcfd.org/publications/.

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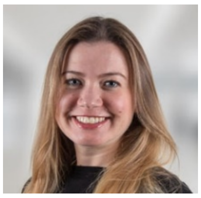

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