UKSIF
UK Sustainable Investment and Finance Association

26th January 2017

Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Sir/Madam,

I am writing to you in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association to respond to the FCA consultation, *Our Future Mission*.

About UKSIF

UKSIF is the membership network for sustainable and responsible financial services in the UK. We promote and support sustainable and responsible investment (SRI) and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments. UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF has around 240 members and affiliates including financial advisers, institutional and retail fund managers, pension funds, banks, research providers, consultants and NGOs.[1]

Introduction

This consultation is timely. More than ever financial services are conducted across borders and face risks and opportunities which do not respect national borders. Globalisation has brought vast opportunities to the UK's investment sector, but also fresh challenges which stem from social and environmental concerns, particularly climate change, that are rarely recognised or addressed through the traditional lens of financial regulation. The UK's vote to leave the European Union has highlighted much of the positive financial legislation, regulation and other initiatives stemming from Brussels which has sought to address some of these challenges and which we are now at risk of losing. Examples include IORPs 2, the Non-Financial Reporting Directive and the new High Level Expert Group on Sustainable Finance (HLEG)[2] all of which will help to allay concerns over the potential impact of climate change on investments. The HLEG has been specifically created with the aim to develop an EU strategy for a sustainable financial system. Of critical importance will be the group's work which will 'have regard to the challenges posed by climate and environmental risk to the financial system and the need to harness financial market in responding to these challenges'.

Questions remain over the extent to which there is the political will in the UK to preserve and build on the many positive steps taken in the EU in relation to both climate risks and opportunities once

[1] For more info about UKSIF, please visit www.uksif.org.
[2] European Commission decision on the creation of a High-Level Expert Group on Sustainable Finance in the context of the Capital Markets Union, October 2016 http://ec.europa.eu/finance/capital-markets-union/docs/20161028-decision_en.pdf

we have left. It is therefore incumbent on the FCA to provide appropriate regulatory oversight in a period of unprecedented political uncertainty.

This consultation paper is a detailed examination of the FCA's approach to regulation of the sector, so we do not intend to answer specific questions. Instead we hope to make the case that the impact of climate change, as well as other environmental, social and governance factors on the financial services sector is something which is real and which must be fully recognised and addressed by the FCA. UKSIF promotes the consideration of all financially material environmental, social and governance (ESG) factors in financial services, but in this paper gives prominence to climate change since it represents the best known long-term threat to financial stability and has resulted in various national and international initiatives designed to address it, but it has yet to be recognised as a financially material factor by the FCA.

Climate Risk and the FCA's Objectives

We consider climate risk to manifest itself in at least three ways which are relevant to the firms you regulate, and which were outlined by the Bank of England and the PRA.[3] These risks may apply to pension funds, insurance firms, banks, consultants and financial advisers.

First, physical risks, which relate to the direct impact of natural disasters and windstorm and flood related hazards. These risks tend to relate to property and infrastructure assets. Evidence from the PRA report points towards both a tripling of weather-related loss events and inflation-adjusted insurance losses, rising from $10bn to $50 since the 1980s. Second, transition risks, which relate to ensuring global warming is in-line with the Paris Agreement agreed at COP21. Remaining within a 2°C carbon budget requires a transition to a low-carbon economy. These risks arise from the re-pricing of carbon intensive assets as a result of that transition. As such the risk itself is closely linked to national and international policy initiatives and includes the concept of stranded assets, with some estimates that up to 80% of known fossil fuel reserves are unburnable.[4] The potential for significant ramifications for investors exposed to carbon-intensive industries such as pension funds, insurance firms and banks, as well as their managers and advisers, is clear. Thirdly, and specifically for insurance firms, liability risks. These risks may arise due to third party liability contracts where parties seek to recover losses from others where that loss is a result of climate change.

It is our view that the exclusion of climate risk considerations is incompatible with the FCA's statutory and operational objectives as outlined by The Financial Services and Markets Act 2000. The FCA outlines these as follows:

'Our strategic objective is to ensure that the relevant markets work well. To advance our strategic objective we have three operational objectives. These are to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers.'

[3] Bank of England and PRA, *The impact of climate change on the UK insurance sector*, September 2015 http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf
[4] Carbon Tracker, *Unburnable Carbon 2013: Wasted capital and stranded assets* http://www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carbon-2-Web-Version.pdf

It is inconceivable that, without any recognition of climate change as a financially material factor or efforts to promote thinking around climate risk, the FCA can claim to have secured an appropriate degree of protection for consumers or the integrity of the UK financial system. Indeed we consider this to be a completely inappropriate degree of protection. We stress that we are in no way calling for the FCA to take a position on green finance, exposure to carbon assets or divestment from fossil fuels, merely to recognise climate change as a factor which may be material to the value of an investment and consider how this impacts on its objectives. This should not be a controversial step and it is worth pointing out that this is the approach of the Prudential Regulation Authority. It now actively considers the financial impact of systemic environmental risks on its statutory objectives which includes 'the role of central banks and financial regulation in addressing financial stability risks from climate change and supporting an orderly transition to a lower carbon, environmentally sustainable economy.'

The FSB's Taskforce on Climate-related Financial Disclosures (TCFD) is an international initiative you will undoubtedly be aware of. Similarly to the FCA's strategic and operational objectives, the FSB is mandated to promote international financial stability and strengthen financial markets through a framework geared towards the identification of systemic financial risk. It is in this context it has, through the TCFD, started to think about ways in which it can measure and respond to climate change risks. This is through the development of voluntary, consistent climate-related financial risk disclosure for use by companies in providing information to investors, lenders, insurers and other stakeholders. Given this initiative is specifically aimed at many of the firms regulated by the FCA, it is clear that the FSB considers climate change to be a financially material factor. We would therefore strongly encourage the FCA to consider ways in which it can support this important work.

Financially material ESG Factors

Arguments that ESG factors can be financially material have resonated with policy makers. The IORPs 2 Directive which was recently passed makes specific reference to ESG factors and will require European occupational pension schemes to consider them. It is worth noting that despite Brexit this Directive will be transposed into UK law well before the two year window for the UK to withdraw from the EU is complete. It will therefore apply to UK occupational pension schemes. On the trust side of the market, the Law Commission ruled in 2014 that trustees of pension schemes *should* take into account all financially material factors including those arising from ESG. It further recommended the Government amend the Investment Regulations to reflect this, although DWP later declined to do so citing a "lack of consensus" on how to do so from respondents.[5]

Building on the work of the Law Commission in the UK, the Pensions Regulator (TPR) has revised its code of practice for DC pension schemes and referenced the materiality of ESG factors and climate change in its new investment guidance. This was a particularly positive step and UKSIF and our members worked with TPR to ensure its inclusion in the document and we continue to work together for overarching guidance relevant to trustees of all schemes. Despite this excellent progress, and TPR highlighting the importance of ESG factors (indeed stating trustees need to "wake

[5] UKSIF Press Release, *UKSIF reaction to Government announcement fiduciary duty will not be clarified in law,* November 2015 http://uksif.org/wp-content/uploads/2015/11/Government-Announcement-of-Fiduciary-Duty.pdf

up and smell the coffee")[6] we have been disappointed with trustees' knowledge of their roles and responsibility in relation to the investment process. Some remain under the misapprehension that taking account of climate change is an ethical or moral concern and should therefore not be considered by fiduciaries.

In a recent survey of pension fund trustees 53% said they did not consider climate change to be a financially material risk to their own or their clients' portfolios, with one describing climate risk as 'overblown nonsense'[7]. Mounting evidence has shown this to be false, and by not integrating it as a legitimate factor in the investment process, investors encourage the potential for value destruction and may invite legal challenge. This was the opinion of Keith Bryant QC and James Rickards on the legal duties of pension fund trustees in relation to climate change.[8] The problem stems from a lack of knowledge or preconceived beliefs which has led some trustees to ignore it as a material factor. One answer is more and better education for trustees on these issues and we will continue to press TPR to do more. Another is by bringing consultancy firms and those which advise trustees under the remit of the FCA, as proposed in the recent AMMS interim report.[9] As advisers it is hardly farfetched to think these groups would foot at least some of the bill arising from any legal claim against trustees for losses relating to climate risk where this was not considered. Bringing consultants into the FCA's remit and encouraging thinking around climate risk and other financially material ESG factors would ultimately help consumers in DB and DC schemes and provide enhanced protection to the overall financial services sector.

In any case, UK occupational pension schemes will need to consider how they integrate ESG factors once IORPs 2 is transposed into UK law. We think the FCA should take this opportunity level the playing field in the contract side of the pensions market in the interests of the firms it regulates, investee companies and savers. One key recommendation from a recent PRI report calls for regulators to communicate how they interpret their mandate in relation to ESG issues.[10] We fully support this: If the experience on the trust-side of the market is indicative of trends elsewhere, it is vital the FCA explicitly recognises financially material ESG factors and how they are relevant to its objectives. In addition, new rules from the Department for Communities and Local Government now require LGPS administering authorities to have an ESG and stewardship policy. The FCA is the last regulator with responsibility for pension funds to consider ESG factors as being financially material and has become a laggard in this respect. This is to the detriment of consumers and the integrity of the UK financial system.

Recommendations for the FCA

[6] Andrew Warwick-Thompson speaking at the Professional Pensions DC conference, September 2016.
[7] Michael Klimes, Professional Pensions, *Climate change is 'overblown nonsense' and not a material risk, says industry,* August 2016 http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry
[8] Client Earth, *QC Opinion The legal duties of pension fund trustees in relation to climate change*, November 2015 http://www.documents.clientearth.org/library/download-info/qc-opinion-the-legal-duties-of-pension-fund-trustees-in-relation-to-climate-change
[9] FCA, *Asset Management Market Study interim findings,* November 2016 https://www.fca.org.uk/publications/market-studies/asset-management-market-study
[10] PRI and MSCI in collaboration with UNEPFI, *Global Guide to Responsible Investment Regulation,* January 2017 http://bit.ly/2gY8tBw

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As part of the FCA's review into its future mission we believe it is essential it considers how it can demonstrate and encourage better education for investors on the materiality of climate change as a financially material factor. As a minimum we recommend the following steps:

1. Launch a review into the financial impact of systemic climate risks on its strategic and operational objectives: As part of its review into its future mission, the FCA should examine the extent to which climate risks, as outlined by the PRA, impacts on its strategic and operational objectives. In particular it should examine whether there is currently an appropriate degree of protection for consumers and financial markets and if there is not, it should look at ways of incorporating climate risk into these objectives.

2. Level the playing field in terms of responsible investment and ESG: Trust-based pension schemes and LPGS funds are reacting to recent changes to the law relating to ESG considerations. Following IORPs 2 being passed in the EU Commission last summer, the FCA should consider how it can level the playing field and educate relevant firms on their legal duties in relation to responsible investment ahead of the Directive being transposed. The FCA should also examine how it can support the work of the Taskforce on Climate-related Financial Disclosures.

3. Take positive and proactive steps to promote responsible investment now: A review into the impact of climate risk on the FCA's objectives and the promotion of RI education are medium to long-term goals. But there are ways the FCA can help protect consumers, firms and the wider financial services sector by taking steps to encourage more responsible investment now. The AMMS proposes several positive steps including the regulation of investment consultants, and a new duty on fund managers to act in investors' interests. Expanding the remit of Independent Governance Committees from costs and charges to examine long-term performance of funds would be one such helpful step.

We trust the above information is clear, but if you require clarification on any of the points raised please do not hesitate to contact us.

Yours faithfully,

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)