UK Sustainable Investment and Finance Association

Introduction

The UK Sustainable Investment and Finance Association (UKSIF) is the membership organisation for those in the finance industry committed to growing sustainable and responsible finance in the UK. Our vision is a fair, inclusive and sustainable financial system that works for the benefit of society and the environment. UKSIF was created in 1991 and has over 240 members and affiliates including financial advisers, institutional and retail fund managers, pension funds, banks, research providers, consultants and NGOs.

We welcome this discussion paper and any FCA action to promote sustainable and responsible finance. Our response focuses on the need for FCA-regulated firms to disclose more, better, clearer and comparable information, on the need for the FCA and firms to consider a broad range of environmental, social and governance (ESG) factors, rather than just climate-related financial risk, and on the need for ongoing clear leadership from the UK's financial regulators and Government. Our response therefore focuses on what the FCA could do to promote broader consideration of a range of ESG factors, which includes climate change.

Disclosures in capital markets

Q1: What, if any, difficulties do issuers face in determining materiality? We are also interested in exploring how investors consider materiality in this context.

Issuers

Issuers do face difficulties in determining materiality and are generally reluctant to make such determinations and disclose the results. The reason for this reluctance may be that there are first-mover disadvantages to disclosing new kinds of risk, the additional resource burden of investigating new factors, and a belief that ESG factors are not material now and in the next few years, and are instead an issue for the long-term future. The FCA should support and encourage issuers to make determinations of which ESG factors may be material. This would help investors make decisions that allow them to manage risk or find a product with an ESG profile. Among issuers there is a lack of knowledge that ESG factors can be material within the time-horizons of most investors. Issuers also face difficulties as a result of a lack of a common definition of materiality.

First, issuers may not understand that ESG factors, such as climate change, are relevant in the near future. For example, research by UKSIF has found that 90% of fund managers expect climate-related risk to negatively affect the value of international oil companies in the next two years.[1] The IPCC's recent report 'Global Warming of 1.5°C' was clear that that the impacts of global warming on natural and human systems have already been observed, and that mitigation and adaptation measures are already under way.[2] The physical risks and transition risks of climate change are crystallising now.

[1] 'Not long now: Survey of fund managers' responses to climate-related risks facing fossil fuel companies', UKSIF 2018. http://uksif.org/wp-content/uploads/2018/04/UKSIF-Not-Long-Now-Survey-report-2018.pdf
[2] IPCC, 2018: Summary for Policymakers. In: Global warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in

There is evidence that that is taking place in the real economy in the UK, for example when businesses in areas hit by flooding struggle to obtain insurance.[3]

Second, issuers lack a common definition of materiality. If issuers are to make determinations about the materiality of ESG factors, such as climate change, for the purposes of making disclosures, there needs to be a common approach set out in guidance from the FCA. Leaving issuers to adopt their own approach may result in inconsistent or incomparable data being disclosed. Lack of clear guidance and expectations on issuers creates the risk that issuers will not make a full and frank assessment about their exposure to ESG risks.

In UK equity markets, there is a long-standing convention that a 10% variation in profits must be announced. This existing indicator of materiality might perhaps be used in this new context: if the likely impact of reasonably forecastable ESG risks, such as carbon taxes, adequate health and safety measures or payment of liveable wages are greater than 10% of pre-tax profits then issuers must state it.

Investors

Investors require better, more consistent disclosures from companies to understand how those companies are managing climate-related risks and maximising opportunities. Disclosures need to be consistent within sectors and ideally across sectors. As a first step, we would welcome issuers reporting in line with the recommendations of the FSB's Task Force on Climate-related Financial Disclosures (TCFD). All financially material information should be contained in one place, which in the UK should be the issuer's strategic report.

The FCA should not limit its work to climate-related financial risk. It should instruct issuers to make determinations of materiality and disclose information relating to the full spectrum of ESG factors.

Q2: 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 most useful?

Comparable disclosures are vital for investors taking decisions and managing ESG risks, including climate change. As mentioned in our answer to the previous question, to allow investors to compare firms across sectors there should be cross sector disclosure requirements and sector specific requirements where necessary.

As noted above, disclosures in line with recommendations of the TCFD would be a good framework for issuers to use as a first step. We would welcome steps to promote clear and consistent disclosures relating to broader ESG issues. We support principles- and outcomes-based frameworks for mapping revenues to sustainable economic activities. The UN's Global Goals for Sustainable Development (also known as the 'Sustainable Development Goals') provide a good high-level set of principles for sustainable investment, and should be referenced in any framework for disclosures. We note that the EU is in the process of developing a taxonomy for mapping revenues onto sustainable economic activities, which itself references the Global Goals. While our members have

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the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty [V. Masson-Delmotte, et al (eds.)]. World Meteorological Organization, Geneva, Switzerland, paragraph A.3.1.

[3] Environmental Audit Committee, *Flooding: Co-operation Across Government*, 9 June 2016, HC 183, pp.44-46

some concerns that the present proposals may be too narrow and prescriptive, we would support the use of a framework along the lines of the taxonomy, once it is completed.

Q3: Would exploring a 'comply or explain' approach, or other avenues to encourage more consistent disclosures, be an effective way of facilitating more effective markets?

We support using a 'comply or explain' approach to encourage disclosures. However, the FCA must not rule out adopting a mandatory approach in the future and conduct regular surveys of the extent and contents of disclosures to gauge whether 'comply of explain' is achieving the desired outcome. If it is not, the FCA should be prepared to introduce mandatory requirements for disclosures in the future.

<u>Public reporting requirements</u>

Q1: Do you think that a requirement for firms to report on climate risks would be a valuable measure?

Yes, but after a period of time to allow firms to prepare. Initially we would support public reporting requirements which specify that reporting requirements should refer to the recommendations of the TCFD. The FCA should explore public reporting requirements covering a broader range of ESG issues than climate change.

Q2: Do you have any suggestions for what information could be included in a climate risks report?

A climate risks report should contain an assessment of the firm's resilience to three kinds of climate-related financial risk. First, physical risk, arising from the physical impacts of climate change and knock-on effects, such as supply chain disruption. Second, transition risk which arises from changes to public policy which shifts puts a price on carbon, and shifts the cost of carbon emissions from the environment to firms' balance sheets. Third, liability risks which may arise if parties which have suffered damage as a result of climate change seek compensation from those they hold responsible.

A climate risks report should contain forward-looking scenario assessments, which gauge the firm's resilience to at least the first two of the three risks noted above under different future emissions and warming pathways. The IPCC found that temperatures have risen by between 0.5-0.8C above pre-industrial levels, and that temperatures will continue to rise. There is uncertainty about the scale of future temperature rises, which depends on the speed at which policymakers may implement policies, and a climate risks report should show that businesses are taking steps to prepare for different outcomes.

In its assessment of a firm's resilience to climate-related risks, a climate risks report should contain evidence that the firm has a plan and governance structures in place to manage climate-related risks. A strategy should set out what measures the firm will take to manage climate-related financial risk in response to the findings of scenario assessments. It should set out at what level of seniority climate-related risks have been considered, and whether a senior manager has been allocated responsibility for overseeing the firm's approach to climate change, or whether climate-related risks have been considered at board level. We encourage the FCA to look at the Prudential Regulation

Authority's recent proposals for how banks and insurers should manage climate-related financial risks.[4]

Q3: Do you have any views on which regulated firms should be required to compile a climate risks report?

We believe that it is important that climate risks reports are completed by all FCA-regulated firms. For reasons stated above, it is important that reporting requirements apply across sectors so that investors can adequately manage their exposure to climate-related financial risk.

<u>**Additional questions**</u>

Q1: 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?

We welcome the FCA's engagement through the Climate Risk Forum. We would welcome the inclusion of other financial regulators in these discussions, as well as the government departments responsible for international and domestic climate policy and climate adaptation, the FCO, BEIS and Defra respectively, as well as the Committee on Climate Change. As part of its report to Defra under the National Adaptation Programme, the FCA should embark on a programme of engagement with industry to promote thought-leadership on how the UK financial sector can prepare and adapt to climate change.

As the trade association representing those in the UK financial sector who are committed to growing sustainable and responsible finance, we would be happy to work with the FCA on any future industry engagement.

Q2: 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 or consumer interests?

We support the FCA's proposed interventions in the discussion paper, particularly the intention to consult on rule changes requiring IGCs to report on their firm's policies on various ESG issues. We believe there are areas where the FCA could go further, which have been outlined elsewhere in our response.

We believe that there is an additional intervention the FCA could make which would serve consumer interests and help grow sustainable and responsible finance (including green finance). The FCA should introduce a requirement for financial advisers to ask clients about their sustainability preferences. Polling conducted by UKSIF in 2018 showed that 54% of investors want their

[4] Prudential Regulation Authority "Enhancing Banks' and insurers' approaches to managing the financial risks from climate change", Consultation Paper 23/18. October 2018. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp2318.pdf?la=en&hash=8663D2D47A725C395F71FD5688E5667399C48E08

investments to have a positive impact,[5] and a small change in the rules governing the conduct of advisers could promote investments in products with an ESG profile.

Q3: In light of 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?

UKSIF supports a robust set of standards which do not permit 'greenwashing', but also inclusive and flexible measures that do not prevent companies with new technologies from entering the market. Any form of common standards must be technology-neutral, focused on outcomes, and which encourages new technologies.

We note that the British Standards Institute have work underway on a green standard for financial products, which may feed into a new global Publicly Available Standard. In developing its approach, FCA and government must consider how the EU taxonomy will apply in the UK after EU exit, and how UK policy will reference the BSI work.

Q4: How could regulators and industry best work together as part of the Climate Financial Risk Forum?

We have addressed this issue in our answer to question 1 in this section.

Q5: What are your biggest concerns and commercial priorities regarding climate change?

That UK Government departments and regulators fail to take action to promote the resilience of the financial system to the risks arising from climate change, and that the UK falls behind other countries in managing the risks associated with climate change and exploiting the opportunities from the transition to a low-carbon economy.

Q6: What are the biggest barriers to the growth of green financial services in the UK?

The growth of 'green' financial services in the UK is impeded by several factors, which stem from the lack of agreed definitions and standards. Although we welcome the fact that the FCA is looking at ways to promote 'green' finance, we believe the FCA should consider a broader range of issues relating to the environment, to social impacts, and governance issues.

Despite the barriers, ESG investment styles are growing in the UK. The latest survey from Eurosif, Europe's sustainable and responsible investment membership organisation found the practice of integrating ESG factors into investment decisions has grown by 60% in Europe, and by 76% in the UK.[6] But this growth is inhibited by both the lack of good data, ineffective transmission of information along the investment chain, a lack of clear leadership from government and regulators, as well as some specific policy barriers which are preventing consideration of ESG factors.

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[5] http://www.goodmoneyweek.com/media/press-releases/make-our-money-count-public-demand-sustainable-pensions-savings-reaches-record

[6] http://uksif.org/wp-content/uploads/2018/12/UKSIFrelease_291118.pdf

For markets to do their job, investors need better quality, comparable metrics included in company reports. At present, the application and execution of standards, metrics and reporting is left to companies. Companies often use many of the initiatives which have developed to guide disclosures and measure different kinds of ESG risks. But with over 400 such initiatives,[7] there is a risk that companies make more disclosures while investors are no more able to obtain an adequate picture of a firm's ESG profile. Without leadership from Government, regulators and industry working together, there is a risk that a growth in interest in ESG may not improve practice.

Within the spectrum of ESG issues there is a good understanding of how certain factors can be material, but less understanding of how other issues should be measured. The most well developed factor relates to climate change and its associated risks. We believe the work of the TCFD has helped improve understanding and practice, and provides a good model for how one ESG factor (climate change) can be measured and managed.

Performance metrics for a range of other environmental issues, such as water quality, soil health, biodiversity, and air pollution are less developed than climate change. Ways of measuring social and governance factors are also not well developed. We note that the Government, as the largest purchaser of goods and services, has significant expertise in measuring the impact of its decisions. Defra's Natural Capital Committee (NCC) has also developed practical advice for measuring and monitoring the value of natural capital and risks to or from natural capital. The FCA should work with Government, the NCC and Defra's newly created green finance team to develop best practice advice and standards relating to determining how a broad range of environmental factors can be material, and how best for issuers to measure, monitor and report them.

As important as clear and consistent disclosure standards is a clear and consistent message from the senior leadership of the FCA that ESG factors can be material, and that firms are expected to measure and report on ESG factors. This discussion paper represents a welcome first step. However, we believe the FCA should embark on an awareness-raising campaign to promote best practice in the industry. The FCA should align this campaign with the Government's wider work on this agenda, including its forthcoming Green Finance Strategy.

Once again, we strongly welcome the FCA's engagement on these issues. The UK's financial sector, and UK financial regulation sets the tone for what happens around the world. Action by UK regulators to promote sustainable finance could become a great British export. We believe there has never been more urgency or opportunity to demonstrate British leadership on climate change and green finance. We look forward to the FCA's ongoing role in this area.

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[7] According to research by the Climate Standards Disclosure Board, accessed 21st January 2018 https://www.cdsb.net/harmonization/586/sustainability-reporting-rise-new-order