THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

T +44 20 7831 0898
E enquiries@theia.org
W theinvestmentassociation.org
Twitter @InvAssoc

INVESTMENT ASSOCIATION RESPONSE TO FCA DP18/08: CLIMATE CHANGE AND GREEN FINANCE

ABOUT THE INVESTMENT ASSOCIATION

- The Investment Association (IA) champions UK asset management, supporting British savers, investors and businesses. Our 250 members manage £7.7 trillion of assets and employ around 100,000 people across the UK
- Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.
- Our purpose is to ensure investment managers are in the best possible position to:
    - Build people's resilience to financial adversity
    - Help people achieve their financial aspirations
    - Enable people to maintain a decent standard of living as they grow older
    - Contribute to economic growth through the efficient allocation of capital.
- The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs.
- The UK is the second largest investment management centre in the world, after the US and manages 35% of all assets managed in Europe.

31 January 2019

The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

1. INTRODUCTION

Social and environmental change is happening faster than ever. Climate change, shifting demographics and technological revolution are reshaping our planet and, as an industry, we find ourselves at a critical juncture in embracing sustainability as a defining feature of investment.

The Investment Association thanks the FCA for the opportunity to share industry views on the FCA' s proposed approach to the impact of climate change on financial services, including the consideration of climate change risks in robust risk management processes, as well as support for innovation and growth in specialist green finance solutions.

We welcome the FCA's open and discursive approach to setting out proposed actions in relation to climate change and green finance and appreciate the commitment to keep this approach under review.

In particular, we would like to echo the belief that innovation in financial services, including in green finance, "will help the successful transition to a low carbon economy while helping ensure the UK's position as an attractive prospect for international businesses and finance".

The Role of Asset Managers

As asset managers, it is our role to help investors – whether individuals or institutions – achieve their investment objectives.

These objectives can be financial, for instance to retire with enough money to live on, and also non-financial, such as to invest in companies or projects that have a specific social or environmental benefit.

As significant long term investors on behalf of our clients in the UK and globally, asset managers also play a key role in channelling finance from savers to companies and infrastructure projects. This means our industry plays a vital part in promoting sustainable growth.

Green finance is one important way in which asset managers can deliver on these objectives. It is one approach in a whole suite of sustainability and responsible investment approaches that asset managers provide to savers and investors.

Similarly, climate change risk is one example of a long and varied list of Environmental, Social and Governance risks (ESG) that may be impactful on the prosperity of a business.

This is crucial, as a key way in which asset managers play a part in promoting sustainable growth is by integrating an assessment of ESG factors in their investment processes. This

involves asset managers continually monitoring and mitigating ESG-related risks, and benefiting from ESG-related opportunities. Asset managers do this with the aim of ensuring that these companies remain successful for years to come and provide their clients with long-term risk-adjusted returns on their investments.

Active engagement by asset managers with investee companies further helps to identify, analyse and influence the management of ESG risks and to seek out and benefit from ESG-related opportunities. Engagement will typically cover a company's governance arrangements, as well as the management of social and environmental risks and opportunities that are relevant and material to the business.

Asset Owners and the Investment Chain

Finally, asset managers do not operate in isolation in the economy. They form a central component of the investment chain. A joined up approach across the investment chain is needed to ensure that climate change-related, and other ESG considerations, are meaningfully factored into investing:

- Issuers need to be incorporating ESG considerations into their business strategy and reporting on how they do this in a meaningful way. This should reflects a company's specific business model and demonstrates consistency with its long-term strategy;
- Asset managers need to engage with investee companies to enhance disclosure, improve outcomes from those investee companies, and make capital allocation decisions based on the material risks and opportunities they pose. They are also increasingly being looked to, to provide innovative solutions to changing client demands and shifting capital allocation. Across the board, asset managers are increasingly seeking to articulate to clients and the wider public the consequences of their activities in a meaningful way.
- It is important that asset owners are engaged and driving demand for long term sustainable approaches to investment.
- For this reason, industry welcomes the UK Department for Work and Pensions' new regulations on pension fund trustees,[1] and the FCA proposals set out in this DP for contract-based pension schemes.

International Cooperation

---

[1] The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018

As you point out, there are many various initiatives related to climate change and green finance, and to sustainable finance more widely, both in the UK and across the world.

The UK can play a key role in developing and raising standards in sustainability and responsible investment as well as in exporting these standards globally.

As we make clear in our answers below, we are very supportive of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations. This is one example of an internationally applicable framework that could be adopted globally.

We look forward to supporting the FCA in its collaboration with international peers as we develop sustainable finance practices for global application.

The Investment Association's Industry-led Work

At the start of 2018, the Investment Association identified sustainability and responsible investment as a dedicated policy area in its own right to assist firms in thinking about their wider role in society and the environment and to promote all forms of sustainability and responsible investment.

The IA's Sustainability and Responsible Investment Committee was established to provide strategic direction to this new policy area and has a broad mandate to consider and lead on all issues affecting member firms in sustainability and responsible investment.

Following significant work by this Committee, we wanted to make you aware that the IA is now reaching out to members more widely to shape our future policy efforts and to seek industry views on key components of the debate, including:

- Industry-agreed definitions;
- Proposed retail product label; and
- A clearer view on asset managers' use of disclosure frameworks on sustainability.

We look forward to sharing our key findings with you in due course and to supporting the development of FCA's approach however we may be of assistance.

2. QUESTIONS

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

Material risks should reflect a company's specific business model and long-term performance drivers. As investors, we are looking to understand the processes companies have adopted to establish, and report against, the materiality of their specific ESG risks and opportunities.

We also want to see how a company's Board oversees and responds to these risks. This helps us to better understand whether companies are sustainable long-term investments.[2]

More specifically, investors tend to think of materiality in the following way:

- Which of E, S & G risks and opportunities are material to this sector and/or this company?
- How will these risks or opportunities impact the company? (Supply chain, product, customer preferences, regulatory impact, insurance premiums etc.)
- Will this impact be short or long term?
- Have these risks/opportunities already been priced into the value of the company or are they actively being addressed?

These questions will determine the extent to which a company is able to respond to risks and consequently adapt. For example, a company has greater flexibility to adapt if the risk concerns their product, whilst it will be harder for them to do so if the risk stems from customers or suppliers. The company will have less influence over their customers or suppliers than their product and may have to wait for them to change.

Materiality and Climate Change Risk

The materiality of different ESG risks, including climate-change risks, will impact certain companies and certain sectors more than others. Companies' understanding of these risks will be driven by research, guidance and legislation for particular industries. The possible materiality considerations in relation to climate change, more specifically, are manifold and complex. In particular, climate change risks are wide in scope, covering physical, transition and liability risk and they also interact with other ESG risks that companies face.[3]

As a minimum, all companies should undertake a wide-ranging risk assessment to ascertain the extent to which ESG risks, including climate risk, have a material impact on the success of their business, in the short and long term. This initial risk assessment should be the responsibility of the Board. This would mean that the Board will have had to approve whether climate change poses a material risk to the business. Only where such an initial risk assessment has determined that climate change risks pose material risk to the company, would we expect more thorough climate change risk disclosure.

---

[2] More information about the expectations of issuers from investors in this respect can be found in the IA's long-term reporting guidance https://www.ivis.co.uk/media/12519/Long-Term-Reporting-Guidance.pdf

[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf?la=en&hash=EF9FE0FF9AEC940A2BA722324902FFBA49A5A29A

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?

Investors see company disclosures on ESG risks and opportunities, including climate change, as essential to inform their investment decision-making processes. ESG disclosures and, where material, climate change risks should form part of companies' risk disclosure. Investors want to be able to integrate this information into their financial analysis of companies' prospects and for it to inform their approach to stewardship and engagement. With this in mind, greater comparability of disclosures within sectors would be beneficial. However, it is essential that comparability does not come at the cost of *material* disclosure, given the different ways that climate change risk will interact with different companies, even within the same sector.

There have been frameworks and investor demand for companies to report on their material ESG disclosures for a number of years, including at the IA since 2001, with the latest being the IA's Long Term Reporting Guidance.[4] There are also company reporting requirements on ESG risks and specifically carbon emissions for UK incorporated companies as set out in law. It is important to recognise the existing reporting requirements that already serve to facilitate ESG disclosure. In the first instance, FCA should consider whether these are working effectively or whether it would serve asset managers better for these requirements to be more rigorously implemented. One example is the use of Viability Statements. Asset managers are concerned that the majority of companies report on their viability over a 3 or 5 year period. If companies were to adopt this reporting requirement over a longer time period, this should lead to the incorporation of longer term material ESG risks, such as climate risks, which would therefore be more beneficial to asset managers.

Whilst these initiatives have led to changes in company reporting and improved disclosure, we would advocate the use of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations for those companies where an initial risk assessment has deemed climate change risks to be material. Clearly, climate change risks will tend to have a more material

---

[4] The IA's Long Term Reporting Guidance assists corporates in the disclosure of meaningful information to facilitate an assessment of that company's long term prospects. Such an assessment is designed to enable investors to identify those companies that are able to deliver sustainable value creation to shareholders over the long term. The Guidance addresses a number of themes against which corporates are encouraged to structure their disclosures, namely: productivity, capital management; material environmental and social risks; and human capital and culture.

impact on certain sectors over others and we would anticipate this to be reflected in the reporting of these risks by such sectors.

We also agree with the FCA's suggestion that the use of the TCFD framework on a "comply or explain" basis is likely to be the most effective means of its application. This would ensure that it is used to reflect company-specific business models where risks are material.

Furthermore, it may be helpful for companies to be required under the UK Listing Authority rules to state that they have done a risk assessment on the materiality of climate change to their business using the points set out in our response to Question 1, followed by TCFD reporting in cases where risks have been deemed material.

As a guiding principle, it is important that companies think about disclosure in relation to strategic value creation. As such, their choice of disclosure framework should be justified within this context. The worst outcome would be to prescribe certain frameworks and as a result inadvertently encourage disclosure as a "tick-box" exercise with little or no relevance to long term value creation.

Moreover, we would stress the importance of improving consistency and comparability of ESG disclosures across all asset classes. Much of the progress has been equities-centric thus far, whilst disclosure requirements for fixed income issues on data around climate-change are considerably more limited.

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 a "comply or explain" approach to the application of the TCFD recommendations to encourage corporates to disclose more consistently. "Comply or explain" has been particularly effective in the context of the UK Corporate Governance Code and UK Stewardship Code. More recently, the adoption in France of Article 173 of the Energy Transition Law on a "comply or explain" basis has proved effective as a means of encouraging improved disclosure of how ESG factors are integrated into the investment process.[5] Article 173 was also given as an example of good practice in the Final Report of the European Commission's High Level Expert Group on Sustainable Finance.[6]

---

[5] https://www.frenchsif.org/isr-esg/wp-content/uploads/Understanding_article173-French_SIF_Handbook.pdf
[6] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf pp.24-25

A "comply or explain" approach would permit companies to explain their deviation in approach if necessary. Importantly, investors would want such explanations to be well-reasoned, clearly linked to the business strategy of the company and to outline how risks of diverging from the disclosure recommendations have been minimised. Our members are committed to considering such explanations in the context of the individual circumstances of the company. The TCFD recommendations should not operate on a strict compliance basis and it is important that companies feel that they can explain where they deviate from them.

As we point out above, all companies should carry out an assessment in the first instance which would determine the materiality of climate-related risks alongside other ESG risks. Only where such risks are found to be material, should they be expected to use the TCFD recommendations to disclose further information.

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

Financial services firms should also be expected to report against the TCFD recommendations on a "comply or explain" basis.

Instead of focussing on the development of a separate and specific climate risk report for financial services firms, we would advocate focussing attention on how to apply the TCFD recommendations most effectively across different sectors.

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

As above, financial services firms should also be expected to disclose against the TCFD recommendations on a "comply or explain" basis.

A number of different initiatives are underway or have been undertaken to help financial services firms implement the TCFD recommendations with specific application to their industry.

Below is non-exhaustive lists of examples.

- The Institutional Investors Group on Climate Change (IIGC) has produced a guide to help investors with climate scenario analysis.[7] It sets out a five-step framework to

[7] http://www.iigcc.org/publications/publication/navigating-climate-scenario-analysis

help asset owners and managers use scenario analysis in setting out how climate change can drive financial impact across their portfolios.

- The United Nations Environment Programme Finance Initiative (UNEP FI) is in the process of developing guidelines towards a first set of climate-related investor disclosures in alignment with the TCFD recommendations (including development of scenarios, models and metrics)[8]

- The Bank of England's Prudential Regulation Authority's CP of October 2018 sets out a strategic approach to managing the financial risks from climate change.[9]

Given the challenges involved in implementing the recommendations in practice, we would welcome the FCA looking into further guidance on how financial services industries can consider different scenarios and how the impact assessment should be undertaken.

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

As above, financial services firms should also be expected to report against the TCFD recommendations on a "comply or explain" basis.

ADDITIONAL QUESTIONS

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 would like to reiterate our thanks for the FCA's open and discursive approach in this DP. Above all, it will be important for the FCA to work together with industry to promote and develop all forms of sustainability and responsible investment. By supporting the breadth of approaches available to meet investors' varied and manifold sustainability objectives, we are best able to develop this fast-growing market place and encourage innovation. Within this context, we would welcome the opportunity to work with FCA on how we might develop a more common approach to language and use of terminology. Of course, encouraging greater consistency in disclosures will also be an area where we would appreciate the opportunity to

---

[8] http://www.unepfi.org/investment/tcfd/
[9] https://www.bankofengland.co.uk/prudential-regulation/publication/2018/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change (p.12)

work closely with FCA, a key example being the implementation of the TCFD recommendations.

In terms of the development of specialist green investment opportunities, we welcome the FCA's support of innovative green solutions through the Green Fintech Challenge. It will also be important to explore minimum standards for green products to protect consumers and facilitate greater visibility and comparability of sustainable investments.

Finally, across all of these respects we would welcome the FCA collaborating internationally to promote greater global harmonisation, together with industry counterparts.

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 are supportive of the FCA's intention to consult in Q1 2019 on

- The requirement for Independent Governance Committees (IGCs) to report on their firm's policies on evaluating environmental, social and governance considerations, including climate change; how they take account of members' ethical and other concerns; and stewardship; as well as
- The introduction of related guidance for providers of workplace personal pension schemes to clarify providers should consider financial factors (such as ESG and climate change risks and opportunities) as well as non-financial factors (such as reporting to members' ethical concerns) when making investment decisions.

These proposals are important in ensuring consistency across the workplace DC market by ensuring that providers of contract-based schemes face similar requirements to trust-based DC schemes in relation to their policies on ESG and stewardship matters. With a significant amount of savers' money invested in contract-based workplace DC schemes, we agree with the FCA's assessment that pension providers should be taking account of ESG factors as part of designing and implementing scheme investment strategies. Extending the role of IGCs to hold providers to account in this area will be important in ensuring that members' interests are safeguarded.

As referenced in the DP, the European Commission is developing its own far-reaching Sustainable Finance Package. We offer our support to the ambition to include sustainability preferences in investment advice (as proposed by the European Commission in the Action Plan). Nevertheless, we have concerns around how these requirements may be scoped. It is crucial that any changes to requirements in investment advice permit investors to access the full range of sustainability and responsible investment approaches on offer to them and that

they are not restricted to a very small pool of niche investments. As such, we would ask that the FCA ensure that any changes to investment advice to accommodate sustainability preferences permit the full ranges of investment approaches and do not stifle choice or innovation.

Q3: In light of the 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?

First and foremost, any proposed taxonomy must be clear in its scope and intended use.

A taxonomy designed to help identify specialist "green products" could be a helpful tool. However, such a taxonomy should not be thought of as a blueprint for "sustainable finance" more widely, as it would not reflect the full breadth of sustainability and responsible investment approaches on offer.

Moreover, the development of a taxonomy of "green" activities should not be conflated with the process of identifying environmental risks (in the context of integrating ESG considerations in investment decisions) which will be specific to that particular sector and company based on an assessment of possible risk's material impact.

We do not see the EU Taxonomy providing common standards and metrics across the whole of the sustainability and responsible investment landscape. Instead, it appears to be intended to be used for the identification of economic activities that are environmentally sustainable (at least at the present time). The EU taxonomy work is therefore helpful in the context of specialist green financial services products and it is important that this is recognised.

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

We welcome the creation of the Climate Financial Risk Forum, in particular, its collaborative approach.

It is important that the Climate Financial Risk Forum seeks to develop solutions and approaches with global application.

We note that only green bonds are currently widely available as a product with direct environmental outcomes. Authorities could look to enabling a larger set of investors to access green investments. This might include consideration of tax treatment for green assets in investment portfolios.

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

Industry benefits from a stable policy and regulatory environment which sends clear and consistent policy signals supporting the promotion and development of all forms of sustainability and responsible investment. Such an environment should also provide the flexibility for firms to develop a wide range of sustainability and responsible investment approaches to meet investors' many and various objectives. Moreover, many of our members operate globally – it is important that international cooperation is encouraged and that we work towards greater global harmonisation.

In this context, key concerns would include a lack of clarity around policy objectives – it is important to recognise that there are many interlinking drivers for the development of sustainability and responsible investment, including the consideration of material risks, which can include climate change, in the interest of long term value creation as well as the fulfilment of investors' manifold sustainability objectives, which might include supporting companies or projects that have a specific social or environmental benefit.

Any approach which serves to narrow the suite of existing sustainability and responsible investment approaches to investors or curtail further innovation in this fast-growing marketplace would also be a key concern.

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

Data is one of the very largest barriers to growth in this market that we have identified, alongside confusion around the meaning and scope of sustainability, in other words, a lack of common language.

Data

- As set out in this DP, it is important to encourage consistent, comparable and meaningful disclosure of material ESG risks, including climate change risks, from issuers.
- With respect to specialist green products, as well as impact investment products (among other sustainability-related products), a lack of data evidencing these investments' returns history can pose a barrier to growth.

Lack of Common Language

A key priority is to improve communication to investors of the wide range of sustainability and responsible investment approaches available to them.

More specifically, there continues to be confusion around the extent to which ESG considerations should be taken into account in the interests of generating sustainable returns

over the long term. As such, to reiterate our point above, we are very supportive of changes to requirements that clarify these considerations to asset owners (e.g. the Government Response to the DWP consultation on clarifying trustees' duties as well as the changes that the FCA proposes in this DP to IGCs' requirements).

There are also issues around the visibility and comparability of sustainability and responsible investment products and solutions, in particular, to the retail market. One way in which this might be alleviated would be to include sustainability considerations in Suitability Assessments and investment advice. However, we would urge for any approach taken to ensure that investors are able to be matched with the full range of products that may be appropriate to them, and that the expression of sustainability preferences does not automatically restrict an investor to a very small part of the sustainable investment universe.