Institute and Faculty of Actuaries

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Decarbonisation of the UK Economy and Green Finance

IFoA response to the Treasury Committee

26 July 2019

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Institute and Faculty of Actuaries

RT Hon Nicky Morgan MP
Treasury Committee
House of Commons
London
SW1A 0AA

25 July 2019

Dear Ms Morgan

Institute and Faculty of Actuaries response to Decarbonisation of the UK economy and Green Finance inquiry

1. The Institute and Faculty of Actuaries (IFoA) is active in the climate change space and recognises there are financial risks arising directly from climate change and from measures taken to avoid or mitigate it, such as the measures taken to transition to a net zero UK economy. The role of actuaries is to promote the understanding of climate risk, provide advice on investment portfolios, to promote stewardship and to allocate capital. The IFoA issued a profession-wide risk alert in May 2017 to raise awareness and understanding of climate change and the associated risks, and to encourage all IFoA members to take appropriate account of climate-related risks in their work.

2. The IFoA therefore welcomes the opportunity to respond to the Treasury Committee inquiry on the decarbonisation of the UK economy and Green Finance. The IFoA's response is limited to the Green Finance strand of the inquiry as it is most relevant to the skills and expertise of its members.

Detailed comments

<u>What role do UK financial services firms currently play in the decarbonisation of the economy, (for example, through stewardship, capital allocation to green projects, green financial products)? What more can they do?</u>

3. IFoA members and their employers generally fall within the pensions, investment or insurance sectors. The IFoA has and continues to engage with members and their employers to raise awareness of the existence of climate risk and to increase understanding of the need for action. In addition to publishing a risk alert encouraging all actuaries to consider the implications of climate-related risk in their work, the IFoA's Resource and Environment Board is developing a series of practical guides to assist members to identify the best ways to manage those implications. Guides for actuaries working in both defined benefit (DB) and defined contribution (DC) pensions are currently available. Separate guides for actuaries working in general insurance, life insurance and investment are currently being developed.

4. The IFoA is a listed supporter of the Task Force on Climate-related Financial Disclosures (TCFD) as we agree that effective and thoughtful disclosure is essential to understanding the financial risks

of climate change and of actions taken to manage it. Corporate disclosures currently fail to provide sufficiently comprehensive, accurate and consistent information on sustainability risks for the purpose of enabling investors to make adequately informed decisions. The 'TCFD: 2019 Status Report' found that disclosure of climate-related financial information has increased since the release of the final TCFD recommendations in 2017 and that over 370 financial organisations have committed to support TCFD.[1] However, despite this increase in commitment, only around 25% of companies disclosed information aligned with 5 or more of the 11 recommended disclosures and only 4% of companies disclosed information aligned with at least 10 of the recommended disclosures[2]. Financial services firms should be encouraged to devote greater resource to collating the required information for quality disclosures. We welcome Government's recent Green Finance Strategy and the expectation for all listed companies and large asset owners to disclose in line with TCFD recommendations by 2022.

5. If decarbonisation is pursued, financial services firms could give greater support to decarbonisation of the UK economy through the following activities:

- Divestment – while divestment is an activity firms can undertake, we note that engagement is needed to transition from the current carbon intensive economy to a zero carbon economy and divestment alone will not be enough.

- Stewardship – impactful, active stewardship by financial services firms on behalf of their end investors could support the transition to a zero carbon economy. However, current regulation on stewardship is focused on activity-based assessments of compliance, rather than the outcomes of these activities. For example disclosure and regulation focusses on the investing firm's activities to monitor and engage with a company an on matters such as climate risk, rather than on whether these activities result in the company developing a robust strategy for considering and responding it. The development and oversight of impactful stewardship is hindered as compliance is split between the FRC (stewardship code) and the FCA (shareholder rights directive). More thoughtful inclusion of active stewardship within regulatory frameworks could address this and could support firms to carry out greater stewardship activities.

- Scenario analysis – Greater use of scenario analysis would support financial services firms in their strategic planning. Scenario analysis can help firms to consider a broad range of assumptions, uncertainties and potential future states when assessing financial implications of climate change and reactions to it. Firms that use scenarios can also report on the resilience of their strategies in their climate-related financial disclosures. This would improve the quality of disclosures, enabling them to make better informed investment decisions.

- Green/sustainable investment – the capital within the UK financial sector would have a transformative impact if it were allocated to projects which support the transition to the zero carbon economy. Increased 'green' investment by pension funds and insurers would go a long way to support this. However, we note that it is not the amount of capital that is the issue. Rather, it is structural and systemic barriers which are preventing the delivery of this type of investment, such as liquidity requirements and limited clarity around policy intent; as discussed in greater detail in paragraphs 11-15.

[1] TCFD, TCFD: 2019 Status Report (June 2019), https://www.fsb-tcfd.org/publications/tcfd-2019-status-report/

[2] Ibid.

What steps have UK banks, asset managers, and pension funds taken to 'green' their business models, investments strategies and balance sheets, taking into account climate and transition risks?

6. Recognising the existence of climate risks and identifying the potential implications of taking or not taking action is the essential first step to appropriately taking them into account. As identified above, the IFoA is engaging with members to raise awareness of this risk and to encourage embedding consideration of it in their work. It is positive to note the efforts of some actuarial employers to model risk and to ensure climate considerations are a core part of the advisory and decision-making processes. Tools and techniques are continually being developed and good practice is evolving.

7. Some steps taken by financial service firms have been in response to the actions of government and regulatory bodies. We note that there are numerous risks that exist for firms, such as Brexit and cybersecurity. There is a role for Government and regulators to support firms in thinking about risks that are longer term, such as climate risk. For pension funds, we note the Department for Work and Pensions' (DWP) regulations announced in September 2018, which clarified that pension trustees can and should take account of ESG considerations, including climate change, where they are financially material. We are supportive of these regulations and we welcomed the explicit identification of climate change as a financially material consideration. The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) have acknowledged that climate change is likely to have significant impact upon the UK's economic and financial stability. The PRA recently published a supervisory statement for banks and insurers outlining its expectations for approaches to managing climate change risks. Similarly, the FCA sought views on its proposed approach in a recent discussion paper. A continued high level of regulatory engagement will be essential if the goals of the Green Finance Strategy are to be achieved.

8. Many organisations within the financial sector, including the Church of England Pension Fund, have utilised the Transition Pathway Initiative (TPI) tool to assist them in their consideration of the risks of transitioning to a net zero economy. The TPI is a global, asset-owner led initiative which assesses companies' preparedness for the transition. The tool enables identification of transition risks and assesses those organisations that are most exposed to the risk[3]. This then informs where greater engagement and stewardship efforts should be directed in the first instance.

9. TPI is one example of the continued development of analytical tools and techniques which support financial firms to assess climate and other non-traditional risk factors and to incorporate this analysis into their decision making. Accepting that there is a degree of uncertainty in any of these, it is now possible for firms to analyse both micro (i.e. in relation to individual stocks and bonds held) and macro-economic (i.e. in relation to national GDP and other key economic indicators) risks and opportunities in relation to climate change and green finance. Given the degree of uncertainty, this emphasises the need for firms to appropriately consider a range of possible future scenarios, including careful thought about which scenarios are likely, as it is difficult to see how firms can develop an appropriate strategic response without undertaking this process. However, this level of rigour is, in our view, found in relatively few firms, with the widespread adoption of such practices yet to become commonplace.

10. We are also increasingly seeing asset managers, insurers and pension funds incorporate ESG factors into their investment decision-making processes. The IFoA's Sustainable Development Goals campaign is exploring the role for actuaries, and the wider financial sector, in achieving the goals. Through the campaign we have identified examples of institutional investors using the goals as an investment framework and have subsequently promoted this amongst actuaries. While we

[3] Transition Pathways Initiative, TPI Tool, http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/

welcome this, we recognise efforts may be required to avoid green-washing – for example developing, and ensuring market participants' knowledge of, high quality standards and labels.

Are there any barriers (regulatory or otherwise) preventing financial services firms from delivering green finance or investing in 'green' assets?

11. Failure on the part of decision makers within firms to recognise responding to climate risk as a shared responsibility is one of the greatest barriers to green finance. This is exacerbated by a belief that investing in 'green' assets may impact negatively on financial performance and so be incompatible with their fiduciary duty. Senior individuals should be stewards of the long-term and of the broad interests of their firms, rather than pursuing short-term financial goals. Green finance and investment must be viewed as a priority by those at senior levels, rather than as "someone else's problem", if it is to be delivered successfully.

12. Failure to take ownership for addressing climate risk may be further exacerbated by uncertainty around how policymakers view, and intend to address, climate risk. For example, given the contribution of the aviation sector to global carbon emissions, Government's proposed expansion of Heathrow Airport is inconsistent with its recent declaration of a climate emergency. Such inconsistency presents a concern for investors and will likely act as a barrier to considering green products. However, we are pleased to note that Government have recently taken steps to articulate that addressing climate risk is an important priority. Government could build on this by embedding shared objectives for the delivery of green finance to support the transition to a net zero economy.

13. From an asset allocation perspective, the green finance market is not very liquid and at present not mature enough to appeal to institutional investors. We are conscious that although a product may be 'green', it may not necessarily be considered a good investment, either because it does not deliver the right return requirements, or because the ESG credentials are otherwise inappropriate. In response to this, the Government should engage with market and regulatory participants to ensure the framework encourages investment by large investors and does not create any unnecessary regulatory burden. Suggestions for specific actions Government may consider to support greater illiquid investment by different investor types include:

    - Ensuring a framework which enables the development of a less liquid investment vehicle that would support DC and retail investors to invest in new green finance projects. These investors are currently restricted by the very limited number of projects that already have a securitised vehicle.

    - Introducing 'comply or explain' requirements for minimum green finance investment by funded public service pension funds and insurers. Introducing this requirement will encourage firms to give greater consideration to their ability to invest in illiquid green finance options.

    - Introducing a 'comply or explain' requirement for DC master trusts to offer illiquid green finance options to members. Requirements could also require the consideration of selecting these options as part of a default investment strategy on a 'comply or explain' basis.

14. The distinction often made between financial and non-financial/ESG risks can be unhelpful here. ESG risks are sometimes referred to as non-financial but this can be misleading. Initially ESG factors may not have an obvious short-term impact on financial metrics such as revenue, profit and share price. However, we note that ultimately ESG factors are likely to affect financial performance over the medium to long term.

15. Improved transparency and disclosure of ESG risk factors can also assist here. Increased availability of tools and risk models to measure and understand the implied, long term ESG and climate risks embedded in portfolios could enable better capital allocation decisions by those entrusted with lending or investment decisions, and better governance of these factors by companies.

What prudential risks does climate change pose?

16. There is an increasing body of evidence demonstrating that climate-related issues represent a material risk to future economic stability. IFoA is committed to raising awareness of these risks and of the implications they may present for the work of actuaries within the profession. It continues to do this through the delivery of member-led research on climate-related financial disclosures, the previously mentioned practical guides for actuaries working across all practice areas and relevant CPD opportunities and events.

What is the Financial Conduct Authority and the Prudential Regulation Authority doing to support decarbonisation and a 'greening' of the financial system?

(b) What expectations do (and should) they place on regulated firms about their role in the transition through their policy and supervisory activities?

17. UK financial services regulators are live to the financial risks arising from climate change. The Prudential Regulation Authority (PRA) has outlined its expectations on banks' and insurers' approaches to managing climate change risks in its recently published supervisory statement. This is a very useful document in helping to put the financial risks from climate change at the forefront of firms' agendas, which is especially important at a time when firms are also grappling with other major issues such as the uncertainty of Brexit.

18. A cultural shift is necessary for firms to engage with climate change risk and to assess the corresponding potential financial impacts. Such a shift is compatible with an acceptance that there is uncertainty about the extent and timing of climate change. Within the context of a potential range of climate effects and the timing of these, and of the implications of reactions to them, firms and their actuarial advisors can then consider the potential consequences – including the real prospect that revised risk exposures may impact on valuations of both assets and liabilities. We have seen examples of organisations within the financial sector that have undertaken analysis on the potential implications of climate change have concluded it represents a material financial risk and opportunity and have developed a strategic response. This includes the Environment Agency Pension Fund (EAPF), a DB Local Government Pension Scheme, which published its 'Policy to Address the Impacts of Climate Change' in 2015 after a decade's worth of work by the Fund to consider climate issues as part of its strategy.[4] The policy outlines the EAPF's plan to deliver strong long term financial returns for members as the impacts of climate change materialise. The PRA's expectations are helpful in this respect: they go beyond corporate social responsibility and firms being aware of their carbon footprint; and extend to how firms understand, manage and disclose the impact of climate change risks on their business models and strategy.

19. Similarly, the Financial Conduct Authority (FCA) has acknowledged climate change is likely to have a significant impact upon the UK's economy and financial services market, and will impact its strategic objective to ensure financial markets work well. In a recent discussion paper, it outlined its proposed approach, which it plans to keep under review. We particularly welcomed the FCA's consideration of how regulators and industry could best work together to address climate-related financial risk. We are pleased to see the Climate Financial Risk Forum has been established and

[4] Environment Agency Pension Fund, Policy to address the impacts of climate change, https://docs.hartlinkonline.co.uk/repo?docid=r3QvCgiSc0qXMhO84PuRXw

provides a forum where both the FCA and PRA can encourage industry to play an active role in driving initiatives in this space. A co-ordinated and consistent message from all UK financial services regulators will be critical to the increased uptake green finance practices amongst regulated firms.

20. We are also aware of the FCA's current work to develop a scenario analysis handbook for insurers. We anticipate this will be a useful document in supporting insurers to understand what climate scenarios they should be considering. Such a handbook would be useful within other practice areas, such as pensions, and would be welcomed by the IFoA. We encourage and, where appropriate, support efforts to develop guidance which assists practitioners.

<u>Do accompanying documents for 'green' instruments (bonds, funds, etc) articulate why and how the composite holdings within that instrument are 'green'? Are obligations placed upon listed companies, to report their carbon emissions, to inform fund composition?</u>

21. Under the Companies Act 2006 (Strategic and Directors' Reports) Regulations 2013, quoted companies are required to report their annual greenhouse gas emissions in their directors' report. While carbon reporting is a vital step for companies to make reductions in emissions, obligations must go further and require companies to report on their exposure to climate-related risk. If the exposure to climate-related risk of a company within in an investment fund is not adequately assessed, it would not be possible to accurately assess the overall exposure to climate risk within the fund.

22. Effective and thoughtful disclosure is essential to understanding the financial risks of climate change. However we consider that corporate disclosures currently fail to provide sufficiently comprehensive, accurate and consistent information on sustainability risks for the purpose of enabling investors to make adequately informed decisions. Therefore the IFoA welcomes the Government's recent Green Finance Strategy and the expectation for all listed companies and large asset owners to disclose in line with TCFD recommendations by 2022.

23. For public disclosures, a suitable format should be found to inform customers in regards to both their business approach and management of operational risks. Disclosures of climate risk exposures and management within investment portfolios should also be enhanced and reported in a way that is clear to the customers. Understanding of good practice with respect to climate change risk disclosure is continually developing and government has a role to play in facilitating this understanding. Government's approach of establishing a joint taskforce with UK regulators to examine the most effective way to approach disclosure, as outlined in the Green Finance Strategy, is a sensible one.

Should you want to discuss any of the points raised please contact Faye Alessandrello (Faye.Alessandrello@actuaries.org.uk / 020 7632 1459) in the first instance.

Yours sincerely,

John Taylor
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