How ready is the legal and governance framework in the United Kingdom to meet the challenge of climate change?

UKELA
Better law for the environment

Sectoral summary: financial services regulation

Q1: Is climate change expressly recognised in the legal framework for financial services regulation?

Yes. Climate change is specifically recognised, among other, in the Financial Conduct Authority (FCA)'s rules on disclosures based on the Task Force on Climate-related Financial Disclosures (TCFD). Currently, these rules are voluntary and apply to listed companies, but the FCA is consulting on proposals, based on the Joint Government Regulator Task Force Roadmap, to make these climate disclosures mandatory and expand the entities that would be subject to these requirements, as detailed below.

There are also FCA rules on 'ESG financial considerations', which means environmental, social and governance factors (including climate change) that are material to the sustainability of an investment'. This is relevant to independent governance committees for certain pensions products.

The other regulators; the Prudential Regulation Authority (PRA) and the Bank of England (BoE) recognise that climate change creates financial risks and economic consequences which matter for its mission to maintain monetary and financial stability (see BoE's climate change webpage). The PRA has issued reports and supervisory expectations, such as Supervisory Statement (SS3/19), stressing the need for banks and insurers to embed climate risk in governance arrangements, financial risk management practice strategy and also develop an approach to disclosures. The stress test for insurance contains specific climate change physical and transition risks impacting both firms' liabilities and investments.

Q2: What are the main issues arising from climate change for the sector?

Climate change creates both physical risk, such as severe weather, transition risk when transitioning to a net-zero carbon economy and litigation risk.

Physical risks have an impact for instance on asset values, the cost and availability of insurance and the creditworthiness of borrowers. Together with the FCA, the BoE has established the Climate Financial Risk Forum which has published a guide to help the financial industry both address and approach these climate-related financial risks. An example of physical risk is that as a result of floods, real estate assets may have become uninsurable, or significantly reduced in value, and can therefore no longer be useful as security/collateral for a bank loan and therefore reduce credit worthiness of the asset owner.

There may also be a risk that companies that fail to disclose, mitigate or adapt to financial risk arising from climate change may be exposed to climate-related litigation which could affect their market value, which in turn affects asset owners and managers, as well as their consumers.

Q3: What initiatives are taking place within the sector to further the goal of achieving net zero and how might other sectors learn from that?

On its sustainable finance and ESG webpage, the FCA summarises its rules and guidance and initiatives which focus on transparency/disclosures, trust/taxonomy and tools/innovation.

Transparency/disclosures will help consumers and investors to select sustainable services and products. However, to increase trust and prevent 'greenwashing' (i.e. when the 'environmental', 'sustainable', 'green' or similar label is mis-used by financial institutions) it is important to have a classification or taxonomy.

The FCA is consulting on proposals for mandatory TCFD-aligned disclosures for a wider range of firms including by asset managers, life insurers, and FCA-regulated pension providers (CP21/17 and CP21/18), along with ESG topics in capital markets, including prospectuses, the role of verifiers and ESG data and rating providers.

Other initiatives include the FCA's letter on specific transparency requirements for ESG funds and sustainable funds. In relation to a green taxonomy, the expert group: Green Technical Advisory Group (GTAG) has been launched. This group will oversee the Government's delivery of a 'Green Taxonomy' – a common framework setting the bar for investments that can be defined as environmentally sustainable (which among others will help prevent greenwashing and will also make it easier for investors and consumers to understand how a firm is impacting the environment).

Q4: What initiatives are taking place within the sector to adapt to climate change and how might other sectors learn from that?

In relation to tools, the FCA is encouraging innovative development and solutions through its 'digital sandbox', for example on ESG data and disclosure and has launched a 'Green FinTech Challenge' to continue to develop innovative products and services to help with the UK's transition to a greener economy. Examples include start-ups and established firms such as Barclays which will be developing 'an impact investing ecosystem platform which aims to connect accelerators, fund managers, institutional investors, investor networks, and wealth managers'. There are also platforms matching investors' sustainability preferences to investments.

Q5: Is the regime effective in light of future challenges?

Yes, but to make the regime even more effective and useful, particularly for global entities, and to avoid regulatory arbitrage or a 'race to the bottom' to attract business, it would be helpful to ensure that the requirements are set at a global level. This would reduce potentially conflicting regional rules, such as divergence between UK and EU requirements.

Q6: What are the top additional interventions (of any kind) that would improve the legal and governance framework in the sector?

1. Investors and customers should be able to access reliable climate and other ESG integration information from firms, in order to be able to select their preferred financial products and services. This need for climate information and labels will be relevant also to non-financial sectors and products, including retail/clothing and food and drink.
2. It remains difficult objectively to measure climate change impact and key performance indicators (KPI) should therefore be more easily available. Further rules on ESG data and rating providers, which is covered in FCA's consultation paper CP21/18, is needed.
3. It is important that increased transparency and disclosure requirements are proportionate and do not unfairly burden smaller firms. It is also necessary to facilitate quality of and access to climate change data required for accurate disclosures to increase trust and reliability of the disclosures. This may create opportunities for new RegTech disclosure tools and impact and green investment platforms which bring together product providers and investors.

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