Response to the Financial Conduct Authority's Discussion Paper Regarding Green Finance

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Abstract: This piece is a direct response to the Financial Conduct Authority's Discussion Paper regarding Green Finance (DP18/8). At its core, the FCA's Discussion Paper deals with transparency in regards to climate change. Financial institutions have an obligation to disclose the effects of climate change on their operations and profits. In addition, institutions should disclose steps they are taking to mitigate climate change. The FCA provided a form for response, accessible at the following link: https://www.fca.org.uk/dp18-08-response-form

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

The influence of climatic events on profit has varied over the past few decades, but this influence is likely to increase. Mark Carney's 2018 speech focused on weather-related losses having increased significantly, implying that profits have been decreased as a result.[1] Climatic change is currently affecting, and will continue to affect, materiality.

Due to the effects of climate change, it is becoming harder to accurately predict the strength and frequency of extreme climatic events. For example, storms that would previously have been determined to be "once-in-100-year" events may become much more frequent, and in some cases more extreme. The

[1] Mark Carney. "A Transition in Thinking and Action", International Climate Risk Conference for Supervisors, 6 April 2018, De Nederlandsche Bank, Amsterdam.

predictability of these events varies, in part because climate models typically rely on data from the past. With extreme climate events becoming more common, existing models cannot keep up with new trends. This means that accounting for climatic events in any analysis of materiality will be difficult, and that financial models will need to be updated. If a firm were to find that certain climatic events (i.e. extreme storms) were regularly affecting profit, then it would be necessary for this firm to update its modelling to reflect this. If these events are having an indirect effect, it becomes more challenging but still necessary to predict and determine materiality accordingly.

For materiality to be accurately determined with regards to climate change, access to as much data as possible is critical. This data should be presented to investors in an effective and clear manner. Investors require a better understanding of the risks associated with climate change as the purpose of investment is, ultimately, to generate profit for the investor. Mandatory reporting standards may change in the future, as regulatory authorities develop more robust methods for understanding climate change and its effects on the financial world.

2. **Would greater comparability of disclosures help investors in their decision-making more generally? If so, what framework would be most useful?**

Greater comparability of disclosure would help investors with their decision-making.

At the very least, it provides investors with more information regarding their choices; for the ethical minded investor, comparability makes it easier to determine how her capital is affecting the environment. The most useful framework at present is that designed by the Task Force on Climate-Related Financial Disclosures.[2] This framework is separated into four sections: governance, strategy, risk management, and metrics and targets. Within each section, there are recommended disclosures, which could be undertaken to allow for insight as to how firms are trying to address their own impact on climatic issues.

The comparability framework can be improved by implementation of a 'rating system', which would need to be developed by the TFCD or the FCA. This hypothetical rating system would rely on the disclosures each entity is making, and provide a grade for each section of framework. The average rating for each entity could then be taken and presented, making it easy to compare various institutions at a glance.

[2] Task Force for Climate Related Disclosures, "Recommendations of the Task Force on Climate-Related Financial Disclosures", pg. 13 – 17.

In practice, this would appear as:

	Institution A	Institution B
Governance	A+	B
Strategy	B-	B+
Risk Management	C	A
Metrics and Targets	B+	A-
Average Rating	**B**	**B+**

With this rating system, it becomes possible to see which institution is performing better and fulfilling its obligations. If these reports were required on a regular basis, it would subsequently become possible for regulatory institutions to determine which entities are consistently meeting their obligations, and which are not (opening the way for penalties, if need be). From the above example, Institution A and B are performing similarly within the framework, but it also shows that it is possible for both to improve. This current hypothetical model assumes each category is weighted to the same extent. For the purposes of regulation, it could be practical to alter this. Perhaps risk management would be more important than metrics and targets in some cases.

As the authority on the matter, it would be appropriate for the FCA to set a mandate for regular reporting, annually at a minimum. An annual, or more frequent, reporting requirement ensures information is updated on a regular basis. It also allows the FCA to track the progress of various firms on meeting their own targets. Annual reporting should not be seen as the permanent solution, but is a starting point. For higher-quality information, the FCA should instead enforce bi-annual or quarterly reporting.

It may also be prudent for the FCA to request backdated reports. This is unlikely to be feasible in all cases, but provides the opportunity for firms already tracking their own climate change contributions to demonstrate what actions they have already taken to minimise or mitigate their impacts.

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

A 'comply or explain' approach would help to encourage consistent disclosure.

By providing an easy-to-follow framework, disclosures should become more accurate and reliable than in the past. Through a 'comply or explain' approach, it would also be possible to gather more information regarding those who choose to utilise a different framework. If there are specific reasons (as is mentioned in the discussion paper), then it could be possible to develop or alter the existing framework so it could be utilised by other companies.

It is important to note that this approach could cause some issues. Some firms may feel the framework does not apply to them, or cannot be utilised effectively, and would instead develop their own framework. While this may be appropriate in some cases, it is likely to lead to issues regarding inaccurate disclosures, variable data, and a general lack of consistency. If such a case were to occur, it would become difficult for institutions such as the FCA to utilise this data effectively. Referring back to the example diagram in **Q2**, if Firm A followed the TCFD framework, but Firm B had instead developed its own, issues would immediately arise when attempting to figure out which firm is doing its best to address climatic issues.

While there may be some overlap between different frameworks, a lack of uniformity would lead to issues in the long-term. In some cases, it may also see a 'shifting of goal-posts'; some firms may intentionally develop a framework that makes them appear to be performing better than they are. A simple solution for this issue would be implementing a 'minimum reporting' criteria; certain data which each firm is required to report on, with severe penalties for those who fail to disclose. This 'minimum reporting' will be further discussed in response to **Q5**.

4. **Do you think that a requirement for firms to report on climate risks would be a valuable measure?**

The answer is an unequivocal *yes*.

Climate change is an existential issue facing the planet. It endangers not only the present, but also future generations. To ignore the threats is highly unethical let alone irresponsible. The act of reporting on climate risks serves to satisfy a minimum moral obligation, as it ensures firms can be held to account for their actions. In an ideal world, this information would be reported voluntarily, and on a regular basis. Unfortunately, this is not the case, and there is currently a serious lack of reporting on climate risks. It has only been in the past 5 – 10 years that there have been concentrated attempts to mitigate climate change and report on climate-related issues but even then, not every company does so.

Reporting on climate risks allows for more information to be gained regarding the influence of financial firms on climatic change, as well as the actions they are taking to minimise risk. As mentioned in response to **Q2**, this also allows for comparisons to be made between firms. The comparison could be particularly useful for the Financial Conduct Authority, as it may help to stimulate competition in the long-term (which is one of the FCA's stated objectives). Those doing better at mitigating their climatic effects or helping to reduce climate change would likely be favoured by the ethical investor and this may help to stimulate interest in taking action.

If firms are not going to voluntarily offer this information, then it is necessary to enforce reporting. The method of enforcement would need to be decided by the Financial Conduct Authority, but there are two basic paths: a penalty-driven system (wherein those who do not report are punished), or an incentive-driven system (wherein those who do report are rewarded). Whichever option the FCA chooses to use, it needs to be robustly designed to ensure it has meaningful effect. The only thing worse than no system is a poorly designed one.

5. What information could be included in a climate risks report?

A variety of information could be included in a climate risk report:

- Average CO^2 emissions (yearly or monthly)
- Estimated total CO^2 emission over the company's lifetime
- Actions (if any) being taken to reduce emissions
- Impact of investments
- 'Green' investment as proportion of total (here, a goal could also be set. For instance, 20% of investment going towards 'green' funds/technologies; the FCA would oversee goal setting)
- Climate-altering investment as a proportion of total (as with the green investment, a goal could be set. For example, less than 40% of capital involved with technologies which are damaging the global climate)
- Social impacts related to climate risk

The more information provided, the better. Those trying to create a 'climate risk' template should consult with leading authorities on climate science for further advice. In doing so, it would also be useful to connect these authorities with those within the financial world. Fostering connections between the realm of climate science and economics makes it possible to create a 'climate risk' template which can stand up to criticism from both disciplines. A multi-disciplinary approach such as this will be crucial to ensuring green finance is sustainable, and undertaken in an appropriate manner.

It would also be necessary to set a minimum reporting standard, as mentioned in the response to **Q3**. Until the FCA is able to enforce a uniform framework for reporting, a minimum standard would at least allow for gathering and monitoring the most important information. At the very least, this minimum standard needs to include three things:

- Information regarding CO^2 emissions (this is one of the easiest ways to observe a firm's contribution to climate change)
- The proportion of capital directly supporting climate-changing services (the fossil fuel industry, for example)
- Actions being taken to minimise/mitigate each firm's contribution to climate change

6. **Which regulated firms should be required to compile a climate risks report?**

Ideally, all firms would generate climate risk reports, and provide these on a regular basis.

Until climate risk reporting is the norm, it is important to recognise where this information would be most important. Firms, which have major effects on present, and future, populations are some of the first that should be reporting regularly on climate risks. In this vein, it would be prudent to ensure firms involved with national pension or superannuation plans begin to report climate risks as soon as possible. Pension and/or superannuation plans are designed so employees see a small portion of their income invested to help provide for their retirement. As these plans rely on investment to generate profit (and subsequently provide for those paying into them in the long-term), any climatic dangers putting these investments at-risk should be reported. It is reassuring to see that the FCA has already acknowledged the importance of these firms in the United Kingdom.[3]

There is also an element of ethical responsibility in these plans that should be further examined by the Financial Conduct Authority. As a brief example, in New Zealand it was revealed that many of the different KiwiSaver funds were investing in weapons manufacturing and the fossil fuel industry.[4] For the average New Zealander, this came as a shock, and many felt outraged that their income was subsidising these investments. This led to the development of BetterSaver, a company that has been rating each KiwiSaver fund to find which generates the 'most' social good, and which generates the least. None of the current funds in New Zealand generate higher than a C+ on the BetterSaver scale, indicating that many of these funds are not ethical investments.[5] For any New Zealander who is seeking to have their superannuation fund focus on ethical investment, it is difficult (if not impossible) to do so. While the ethical issues with these funds do not purely stem from climate change, it would be expected that if there were greater support and regulation surrounding the reporting of climate risk, some of these funds would increase their 'ethical rating'.

7. **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?**

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3 Financial Conduct Authority, "Climate Change and Green Finance," Discussion Paper, October 2018, pg 10.
4 New Zealand Herald, "Dirty Secrets of Your KiwiSaver," accessed 18 Feb 2019.
5 BetterSaver, "Compare KiwiSaver Funds," accessed 18 Feb 2019.

There are two major options: recognition of firms providing significant pathways for green investment, and working with other global groups to promote alternative forms of investment.

The first proposed option would rely on the FCA and/or other authorities developing an award/recognition system, which acknowledges the firms providing the greatest number of green investment opportunities. If the FCA chose to implement a 'rating system' as proposed in response to **Q2**, this could subsequently be used as the template for an awards system. By acknowledging consistently high performers, the FCA would be able to promote alternative ways forward as well as increase the visibility of green investment opportunities.

Another possible option would be for authorities to work with groups trying to promote alternative forms of investment, which focus on social good. One example is the Global Impact Investing Network (GIIN). By working with groups such as GIIN and promoting impact investment in sustainable technologies, the FCA and other authorities could encourage investors to change their ways of thinking regarding their investments. This will be discussed further in response to **Q11.**

8. **What should be the extent of the FCA's proposed interventions on climate change-related financial disclosures? Is there a specific need for the FCA to intervene further in the interests of market integrity or consumer interests?**

The current interventions proposed by the FCA are appropriate, but there is always more that can be done (as has been discussed throughout this response).

9. **In light of the EU work on taxonomy, what should be common standards and metrics for measuring and reporting against green financial services products?**

Common standards and metrics need to be uniform and easy to interpret. It would be pointless to develop a system that requires an advanced degree in economics to understand, as this begins to lock people out of understanding the system. As the EU will soon be receiving feedback regarding its taxonomy proposals, it would be prudent to wait and see how the EU interprets this and adapts its plan.

10. **How could regulators and industry best work together as part of the Climate Financial Risk Forum?**

For regulators and industry to work together effectively, there must be open discussion and clear guidelines for the Climate Financial Risk Forum. This forum must also seek to advocate new strategies, which aim to mitigate the effects of climate change, even if some strategies are untested.

At present, the FCA provides a good example of what should be expected of a Climate Financial Risk Forum: the FCA has an easy-to-navigate website, where it publishes consultation and discussion papers and openly seeks feedback. This is a good model to follow going forward. Another model is the Climate Policy Initiative, as it follows a similar strategy to the FCA. Open discussion provides a pathway to engage more people and organisations, and so it should be the focus with any Climate Financial Risk Forum.

11. **What are the biggest concerns and commercial priorities regarding climate change?**

The biggest concern regarding climate change is the consumption and production of fossil fuels.

As shown by the work done by the Carbon Disclosures Project (CDP) (as well as decades of research), the fossil fuel industry is the major producer of CO^2 emissions, and thus one of the greatest contributors to climate change. The CDP also place a heavy amount of the responsibility at the foot of investors in the fossil fuel industry.[6] This is currently unsustainable. The FCA and other regulatory bodies will need to do what it can over the coming years to promote investment into alternative energy sources. One potential way to do so would be to promote green impact investment. At present, the GIIN has information regarding two separate funds which sought to raise capital for sustainable energy; both funds were successful in their objectives.[7,8] As the field of impact investment grows, and research into climate-saving technologies increases, it seems likely there will be greater interest in impact investment. The work of the Climate Policy Initiative shows there is significant demand for green finance, and this is only predicted to increase in the future.[9]

12. **What are the biggest barriers to the growth of green financial services in the UK?**

There are currently two major barriers to the growth of green financial services in the United Kingdom.

The first major issue is the uncertainty of the UK's membership of the European Union and the related economic fears. At the time of writing, the United Kingdom and the EU have not come to an agreement regarding Brexit, and there

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[6] Carbon Disclosure Project, Carbon Majors Report 2017, pg 8.
[7] Global Impact Investment Network, "Energy Access Debt Fund", accessed 19 Feb 2019.
[8] Global Impact Investment Network, "Sunfunder Beyond the Grid Fund", accessed 19 Feb 2019.
[9] Climate Policy Initiative, "Global Landscape of Climate Finance 2017", pg. 1 – 2.

may be no agreed-upon deal before the United Kingdom's membership of the European Union ends. This issue has introduced instability into the financial markets and until it is resolved it will create barriers to the effective growth of financial services. If no deal is reached before the deadline, then the economic instability which will be introduced as a result may see a retraction of financial services in the UK and green finance will find it difficult to take hold.

The other barrier is not financial in nature, nor is it isolated to the United Kingdom: it is the sustained growth of short-term thinking throughout the world. The problem of short-term thinking has been identified in academic literature in various fields, most prominently in history.[10] It is important to recognise that this issue extends further than academia, however. The growth of short-term thinking has been a major contributor to many of the current issues facing the planet. Many individuals and corporations tend to think ahead only to the next quarter, or election cycle. Short-term thinking has resulted in a lack of action on climate change. This situation must change. Thinking about the future must extend beyond the next fiscal quarter to the next generation of humans. As this is a much wider issue, it is important to note that it falls outside the direct goals of the FCA. Regardless, the FCA can play a role in combatting short-term thinking. This epidemic requires a multi-disciplinary approach to be solved and the FCA may be able to assist. By working with other groups, and helping to connect the 'long-term thinkers' with those who typically think in the 'short-term', the FCA would be able to promote the development of new ways of looking at the world. The FCA could also try to convince firms and investors to take a longer-term look at their own opportunities.

What are the ethical obligations of financial services with regards to climate change? What role does the FCA play in this?

There is a final aspect that the response form does not touch upon; the ethical obligations of financial services and regulatory bodies such as the Financial Conduct Authority. Looking forward, this is something that needs to be at the forefront of financial thinking. This is something the Financial Conduct Authority is already doing, even if it is not explicitly stated in its objectives.[11] An underlying thread connects the FCA's objectives: ethical and moral conduct in finance. By protecting consumers, the FCA honours a moral obligation to those who are most at-risk in investment opportunities. The FCA's dedication to improvement of market integrity seeks to ensure that all financial actions are occurring within an ethical framework, as does its focus on advancing competition in the interests of consumers. As the FCA is also concerning itself with the conduct of organisations regarding green finance, it can be seen to fulfil

[10] Jo Guldi and David Armitage, *The History Manifesto* http://historymanifesto.cambridge.org/, pg. 1 – 2.
[11] Financial Conduct Authority, "Climate Change and Green Finance", Discussion Paper, pg 7.

a wider moral obligation to the world, acting on climate change under its own initiative. Going forward, it would be prudent for the FCA to place further emphasis on this ethical and moral conduct. Some potential questions for the FCA to consider follow:

- What other ethical concerns fall within the FCA's purview?
- Can the FCA increase its profile in the field of financial ethics?
- Should the FCA and other regulatory bodies pursue the creation of an independent, ethics-based body? If so, what form would this take (i.e. would it have regulatory authority, or would it be merely an advisory body)?
- What further steps can the FCA take to protect those most at risk from climate change?

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