Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers

UK Finance response to the FCA Consultation Paper CP 21/17

10 September 2021

Overview

UK Finance is the collective voice for the banking and finance industry operating within the UK. Representing around 300 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

Sustainability is one of our six strategic priorities. We are wholly supportive of the UK's goal to achieve net zero emissions by 2050, as well as the interim targets set out in the carbon budgets, and recognise the important role for the financial sector in this historic transition. Our Board in May passed a resolution expressing support in principle for the global Net Zero Banking Alliance (NZBA), formed as part of the Glasgow Financial Alliance for Net Zero (GFANZ) announced only the month before, and encouraging all members to embed climate responsibility into their governance and strategy in support of whole economy transition to net zero by 2050 premised upon *just transition* principles.

TCFD reporting is central to this historic transition, and something we have endorsed previously, such in our response on 5 May to the BEIS consultation on Mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs and our response on 1 October 2020 to the FCA consultation on enhancing climate-related disclosures by premium listed companies. Likewise, we are broadly in support of the initiative to regulate for climate-related financial disclosures by asset managers, life insurers and FCA-regulated pension providers – though our membership only intersects with these sectors to the extent that some of our members provide private banking and wealth management services. Therefore we broadly welcome many of the proposals in this Consultation Paper, to the extent that relate to sections of our membership. There are, however, issues arising from the consultation that we believe need thinking through carefully, as set out below.

Response to the discussion paper questions

<u>Design, scope, timing of implementation and compliance basis</u>

Scope: Firms in scope of our proposals

1. **Do you agree with our proposed scope of firms, including the £5 billion threshold for asset managers and asset owners? If not, please explain any practical concerns you may have and what scope and threshold would you prefer.**

Yes we agree. The proposed coverage of 98% of assets under management is appropriately high, though the threshold should be reviewed from time to time.

Scope: Products and portfolios in scope of product or portfolio-level requirements

2. **Do you agree with our proposed scope of products? If not, what types of products should, or should not, be in scope and why?**

We consider the proposed list of in-scope products to be too broad. This is because it mandatorily includes all types of fund and segregated accounts without making any distinction as to the types of asset that the fund or account invests in. This is important because there are significant differences in the availability of climate-related data for some of the asset classes compared to others. For example, sovereign debt is an asset class where climate-related data is not readily available. Others include ABS, currency and derivatives. We believe asset classes where the metrics either cannot be obtained or where the metrics are not relevant should be out of scope.

To illustrate further:

- **Legacy asset backed securities** (ABS) – these not only have data gaps but it is not practically possible to gather data on these at a future date either because there is no corporate entity that investment managers can engage with to request the data from. Unless the information was provided at deal launch we do not see any practical way to gather this data and for some ABS it may not even be relevant.
- **Currency instruments -** we do not believe that the climate related metrics are relevant or applicable for currency instruments.
- **Derivatives –** we believe that there are challenges to employing climate related metrics with respect to derivative instruments. Derivative instruments often do not have an issuer linked to it to determine the metrics. Even if the derivatives instruments were linked to a corporate (e.g. credit default swaps or equity derivatives), holders of derivatives do not have any direct ownership or influence on the company and its GHG emissions.

Timing of implementation

3. **Do you agree with our phased implementation and timings? If not, what approach and timings would you suggest and why?**

The FCA's proposed implementation timetable is swift. We believe that there should be at least 12 months before the final rules come into effect, instead of final rules being published in Q4 2021 and coming into effect on 1 January 2022.

The phased implementation process potentially creates misalignment across the industry. For example, a large insurance company may be subject to the rules in Phase 1 but its appointed portfolio managers may not be subject to the rules until Phase 2 calling into question whether the insurance company will be able to procure the information that it needs.

There will be a need to manage the sequencing of implementation of multiple legislation on this (especially for global organisations) – e.g. the DWP's regulations on TCFD reporting by occupational pension schemes coming into force from 1st October this year resulting in asset managers effectively already being in scope of TCFD reporting ahead of the FCA's rules coming into force.

A preferable approach would be for the rules to apply mandatorily to all firms on the basis of the FCA's current phase 2 timings.

Compliance basis

4. **Would there be significant challenges in using proxy data or assumptions to address data gaps? If so, please describe the key challenges and implications as well as any preferred alternative approach.**

The ability to use proxy data and assumptions is valuable when there is insufficient data and gaps must be filled. It should also be noted that the major data providers currently use proxies and assumptions. For example, widely used measurements such as the CO_2 emissions estimate. It is important that the FCA's approach permits the data providers' methodology to be used and incorporated into firms' own approaches. It is challenging to report on the basis of 'best efforts' using assumptions and proxy data as leads to inconsistency and client confusion. Mandated reporting should only apply where data is available, relevant, and methodology is clear.

<u>Entity-level disclosure rules and guidance</u>

TCFD entity report and compliance statement

5. **Do you agree with our proposals for the provision of a TCFD entity report, including the flexibility to cross-refer to other reports? If not, what alternative approach would you prefer and why?**

One member noted that entity reports are less informative to individual clients in the agency asset management industry. Instead, they reflect the general make-up of a firm's product range and 'ESG boutiques' will show a very different profile from firms providing a wider range of mainstream products (many of which may still include investee companies in the transition phase). In addition, the entity reports will vary from year-to-year as the size of a firm's AuM fluctuates. We would ask the FCA to consider the extent to which entity level reports provide extra useful, decision-relevant information.

Contents of the TCFD entity report

6. **Do you agree with our proposed approach to governance, strategy and risk management, including scenario analysis? If not, what alternative approach would you prefer and why?**

Yes, however we note that the FCA's guidance could create a potential conflict with the BEIS consultation's approach to TCFD disclosure. For non-UK listed financial services firms, the FCA requirement to issue TCFD disclosures aligned to the recommendations (for insurers, asset managers and pension providers) is too granular and we would recommend alignment to the TCFD principles, allowing firms to assess their own materiality considerations for disclosure under the TCFD framework. The BEIS approach (which would capture UK operations of non-UK firms) is more proportionate and we would recommend that where an asset manager, insurer or pension provider is part of that group, they should be able to align the overall UK group to the TCFD principles, which would allow better deference to the non-UK parent's TCFD disclosure which is often under the TCFD principles.

7. **Do you agree that firms not yet setting climate-related targets must explain why not? If not, what alternative approach would you prefer and why?**

Yes.

Specific proposals for asset managers

8. **Do you agree with our proposals for AFMs that delegate investment management services to third-party portfolio managers? If not, what alternative approach would you prefer and why?**

We agree with the proposal to require the AFM to produce an entity level TCFD report since the AFM is responsible for running the fund. However, in doing so, it is entirely reasonable for the AFM to rely on TCFD disclosures made by any investment manager to which management of the fund's investments is delegated, since it is the latter that will be deciding how climate-related matters are taken into account when investing the fund's assets.

9. **Do you agree with our proposals for asset owners to cross-refer to group-level, third-party or delegate reports, where relevant? If not, what alternative approach would you prefer and why?**

Yes.

<u>Product or portfolio-level disclosure rules and guidance</u>

Product or portfolio-level disclosure requirement, timing and location

10. **Do you agree with our proposed requirements for product or portfolio-level disclosures, including the provision of data on underlying holdings and climate-related data to clients on demand? If not, what alternative approach would you prefer and why?**

One member noted that enabling clients to request underlying data would likely to lead to licencing issues with data providers. Even if the data providers permit the data to be shared, providing it is likely to be expensive to firms. Instead, clients ought to rely on the aggregated portfolio data which is also a simpler approach for the clients.

Regarding 'on demand' reports, firms should be able to design a standardised report for the on demand product reports instead of allowing clients to request their reports in a format which is acceptable to them. Meeting individual bespoke client reporting requests will be very expensive and time-consuming for firms.

This said, we do not support mandated climate-related disclosures to be made on underlying holdings (or at a granular portfolio level) within the product to client. While firms are committed to high standards of client transparency, in many situations this will not work in practical terms as licensing agreements with data providers do not always permit granular data to be shared with third parties. We would recommend this information to be provided at an aggregate product or mandate level instead.

Content of product or portfolio-level disclosures

11. **Do you agree with the list of core metrics, including the timeframes for disclosure? If not, what alternative metrics and timeframes would you prefer and why?**

The TCFD Recommendations and Guidance provide a principles-based framework, and a list of suggested metrics provided including WACI, portfolio carbon footprint, and total carbon emissions. The FCA's approach should be similar and not prescribe a list of metrics but allow firms the flexibility to assess and disclose the most appropriate metrics.

This is especially pertinent given current limitations in data availablity. We also note in the TCFD 2020 Status Report that WACI has the lowest percentage of uptake across the range of carbon footprint and exposure metrics. This demonstrates the challenges with disclosing WACI due to data limitations. We also believe Scope 3 GHG emissions should not be mandatory across all asset classes from as early as 30 Jun 2024 due to data availablity and methodology issues.

12. **Do you agree that firms should calculate metrics marked with an asterisk according to both formulas set out in columns A and B of Appendix 3? If not, please explain why, including any challenges in reporting in accordance with either or both regimes.**

It is challenging to report two different formulas of metrics as this increases the reporting burden whilst potentially causing confusion for investors. We support the FCA adopting one set of standards, based on the TCFD recommendation as the global standards for climate reporting. We believe the recent changes put forward in the June 2021 consultation on updates to TCFD recommendations is likely to align TCFD reporting more closely to SFDR reporting in terms of scope 3 inclusion, therefore double reporting may not be necessary . Given clients in scope for SFDR will require this reporting anyway, making SFDR reporting optional rather than mandatory makes more sense for other clients.

We encourage regulators and authorities to work together to ensure that standards developed are aligned at a global level to minimise these issues going forward. Specifically, they may want to consider denominators that are relevant by asset class e.g. market capitalisation is not a useful metric for calculating carbon footprints of fixed income portfolios.

13. **Do you agree that, subject to the final TCFD guidance being broadly consistent with that proposed in the current consultation, our proposed rules and guidance should refer to: a. The TCFD Final Report and TCFD Annex in their updated versions, once finalised b. The TCFD's proposed guidance on metrics, targets and transition plans and the proposed technical supplement**

on measuring portfolio alignment If not, what other approach would you prefer and why?

Possibly, though we would need to review the final version of the supplement before endorsing it. We responded to a TCFD consultation on forward looking metrics in January urging caution in placing weight on portfolio alignment metrics given their immaturity and the many hurdles to be overcome in order for them to become reliable and decision-useful. Whilst portfolio alignment metrics offer significant benefits in theory, we see significant risks in premature regulatory reliance on these metrics. There are some serious impediments to the usefulness of portfolio alignment metrics for TCFD disclosure and we would urge caution in seeking adoption. If adopted, there needs to be additional transparency about the methodology used, as the connection between carbon intensity and the implied temperature rise can be highly variable between methodologies and present a misleading impression of a portfolio's alignment to climate change outcomes.

14. **Do you agree with our approach to additional metrics and targets? If not, what alternatives would you suggest and why?**

15. **Do you agree with our approach to governance, strategy and risk management, including scenario analysis at product or portfolio-level? If not, what alternative approach would you prefer and why?**

16. **What form(s) could quantitative scenario analysis outputs at product or portfolio-level take? What do you consider the cost and feasibility of producing such outputs might be? How useful would such outputs be for users' decision-making?**

Forward looking temperature alignment metrics and scenarios are currently more viable for producing meaningful output compared to Climate VaR analysis, which remains a difficult concept for the industry as a whole. Fundamentally, the methodology to translate climate scenarios to a meaningful 'finanical value' of investments at risk does not currently exist and could be misleading. For instance, the models do not incorporate any mitigation measures already implemented and assume 100% of the value is at risk when in reality only a portion may be at risk. Accordingly, we would encourage the FCA to focus on temperature alignment metrics for the time being as opposed to more sophisticated but emerging metrics.

In terms of output, the FCA's requirement that carbon intensive products undertake scenario analysis across three scenarios will, in some cases, be supefluous. In our view two scenarios are often sufficient: the best-case orderly scenario and the worst-case hothouse scenario. An intermediate scenario may be less informative (but incurs extra work to produce).

Scenario analysis should not be mandatory for all asset classes. In particular, it does not produce useful information where there is a mismatch between the time horizon of the scenarios and shorter-term investment horizons. Instead a 'comply or explain' regime should be applied to scenrio analysis with firms employing it where it provides useful and relevant product insights.

Specific proposals for asset managers

17. **Do you agree with our proposed approach that would require certain firms to provide product or portfolio-level information to clients on request? If not, what approach and what types of clients would you prefer and why?**

Yes.

Specific proposals for asset owners

18. **Do you agree with our proposed approach for life insurers when mirroring an external asset manager's strategy? If not, what alternative approach would you prefer and why?**

19. **Do you agree with our specific proposals for asset owners, including the proposed threshold to exclude the smallest default schemes? If not, what alternatives would you prefer and why?**

20. **Do you agree with the analysis in our CBA? If not, we welcome feedback in relation to the one-off and ongoing costs you expect to incur and the potential benefits you envisage. Contextual information about your firm's size and structure would be helpful.**

N/A.

For further information on this submission please contact Paul Chisnall, Director, Sustainability, UK Finance (paul.chisnall@ukfinance.org.uk).