Rt Hon Michael Gove MP
Secretary of State for Environment, Food and Rural Affairs
Department for Environment, Food and Rural Affairs

22 March 2018

Dear

The Environmental Audit Committee is writing regarding Defra’s consultation into Adaptation Reporting Power to recommend that the Government formally require the Pensions Regulator, Financial Conduct Authority and Financial Reporting Council to produce adaptation reports in respect to their public functions.

As you are aware, the committee is currently conducting an inquiry into Green Finance examining how the UK can mobilise the investment necessary to meet our climate change targets and factor sustainability into financial decision-making. During this inquiry the Bank of England has told us that:

‘...climate change, and society’s response to it, present financial risks that speak to our objectives of the safety and soundness of the firms we regulate and the stability of the financial system.’

We are pleased to note that the Department has approached the tPR, FCA and FRC to engage with them on the possibility of participating voluntarily in the third cycle of adaptation reporting. The Adaptation Reporting Power (ARP) was intended to ensure that climate change risk management is systematically undertaken by bodies with public functions. Given the recent work by the Bank of England and Task Force on Climate-related Financial Disclosures identifying financial risks from climate change – at both micro and macro levels - we believe it is imperative that the tPR, FCA and FRC prepare adaptation reports to consider the implications of climate change for their areas of regulatory oversight.

In his September 2015 speech on ‘the Tragedy of the Horizon’ the Bank Governor, Mark Carney, warned that the timescales involved in climate change mean that regulators and other actors may be late to recognise and respond to the risks:

'We don't need an army of actuaries to tell us that the catastrophic impacts of climate change will be felt beyond the traditional horizons

of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix. That means beyond: the business cycle; the political cycle; and the horizon of technocratic authorities, like central banks, who are bound by their mandates.²

Evidence to the inquiry has echoed Governor Carney’s concerns and also suggests that a common problem – amongst both regulators and financial actors - is the perception of climate change as an ethical issue, rather than a potential material risk. Client Earth said:

Our view, as lawyers, is that there are more than enough laws out there. They are just not being used effectively, and what we are seeing is that climate change has moved from an ethical environmental issue to a core business issue. That core message is not being picked up by regulators themselves because they are also caught in short-term horizons. Nor is it being picked up by industry companies and investors.³

The Law Commission has pointed out in reports published in 2014 and in 2017 that the conflation of ‘social, environmental or ethical considerations’ is confusing and that material environmental risks can be considered financial factors. The Bank of England and others have also pointed out during our inquiry that climate change is not just a corporate social responsibility issue, but must now be considered a real material risk, particularly to long-term investments like pensions. As the chair of HSBC’s pension scheme Russel Picot said:

‘The country’s pension schemes are DB or DC so if you are a member of a defined contribution pension scheme—that is most young people nowadays—the reality is that you are probably going to be 40 to 50 years away from retirement, and whatever those sorts of timescales climate risk and ESG factors will be material to the financial performance of your funds. I think that is almost a statement of the obvious.’⁴

A young person auto-enrolled on a pension today may be 45 years away from retirement. Over that timescale climate change risks will inevitably grow as we have heard in our inquiry. The insurance and asset management firm, Aviva, presented a

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sobering assessment of the possible extent of climate change risks to the economy over the course of the twenty first century:

'If you look at the trajectory, even now post the Paris agreement, we are talking about 2.7 degrees of change is plausible. Many scientists are saying that 4, 5, 6 degrees is at least a risk that we need to be considering. At 4 degrees the insurance business model fails to exist. We could not underwrite to the price that the economy can afford. At 6 degrees the present value of getting to 2100 and seeing a 6 degree change, according to an economist intelligence unit study that we sponsored, the present value of risk from 6 degrees change is £42 trillion. Of course, these are models but, in terms of the hazards that we would experience, we are talking about economic meltdown.\(^5\)

The physical impacts of climate change are already being felt around the world and regulatory action to curtail the use of carbon intensive fuels is increasing across jurisdictions in the wake of the Paris Agreement. Yet, amongst financial regulators in the UK, only the Bank of England and its Prudential Regulation Authority have given the issue serious attention. Our green finance inquiry has led us to conclude that there is a case for other regulators to use the opportunity of the current reporting round to integrate climate change risk management into their work.

The Pensions Regulator (tPR)

Considering climate change risk from the perspective of pension regulation is especially important given the long time-scales involved in pension saving. Given the Pension Regulators role in providing guidance to pension fund trustees on governance and how best to engage with beneficiaries around the Statement of Investment Principles and sustainability issues, we believe it would be timely for the tPR to participate in this round of Adaptation Reporting.

A number of inquiry submissions also point out that there is currently a disparity in the guidance to trust based pension schemes (regulated by the Pensions Regulator) and contract based schemes (overseen by the Financial Conduct Authority) when it comes to considering environmental risk as a financial factor. Completing Adaptation Reports to assess the risk facing long term pension savings could help to address these disparities.

Financial Conduct Authority

We are particularly concerned that the Financial Conduct Authority needs to develop its thinking in this area. The physical impacts of extreme weather and flooding linked

to climate change was identified as a risk in the FCA's latest Risk Outlook included in its Business Plan 2017/18. The language used in the FCA risk outlook would suggest the FCA perceives the risk as being confined to the insurance sector related in any impact it may have on financial services (and risks to FCA objectives). The risk outlook made no mention of the liability risks identified by the Bank of England or the transition risks highlighted by both the BoE and TCFD, such as those potentially facing fossil fuel companies that do not diversify and make a timely transition to cleaner forms of energy production.

Following the Financial Conduct Authority's appearance before the committee on the 20th February we are not convinced that the regulator understands the material risks that climate change poses. The witness gave the impression that the FCA considers climate change as an ethical option, rather than a potentially serious financially-material risk for pension funds and businesses. When asked when the FCA would update guidance to reflect the Law Commission's clarification that environmental, social and governance factors can be considered material risks and as such are financial factors, he said:

‘There is a potential tension with the fact that people are under-saving towards their pensions, they are expecting companies to maximise returns, and in some cases they may be giving up returns by taking some form of social investment as an aspect of their pension funds.

The Law Commission also said—again, we agree—that firms should understand the investment objectives of their scheme members. If their scheme members share those concerns, of course they should act on that. They should invest in accordance with the wishes of their members.’

Financial Reporting Council

The environmental lawyers Client Earth told us in evidence that 'we have seen a number of examples of failures by regulators, such as the Financial Reporting Council (FRC), to properly scrutinise and enforce existing corporate disclosure law as they relate to climate change.' Client Earth highlighted a case from August 2016, where brought a complaint against the FRC for failing to challenge two oil and gas exploration companies - Cairn Energy (Cairn) and SOCO International - for making no mention of climate change in their Strategic Reports.

Given the FRC's role in monitoring the annual climate-related financial disclosures – recommended by the Task Force on Climate-related Financial Disclosures and endorsed by the Government – and setting the Corporate Governance Code and

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Stewardship Codes, we believe it would be appropriate and timely for the regulator to consider how climate risks and opportunities are relevant to its area of oversight.

The committee asked the FRC whether it would be prepared to produce Adaptation Reports at our recent hearing with financial regulators and we were pleased with its positive response:

'Q337 Chair: Before we move on, I am going to go back to the regulators. DEFRA is consulting on this adaptation reporting power. We have heard the power of an adaptation report being produced on the insurance industry from the Bank of England. Do you commit to producing an adaptation report in this round of reporting, examining the risks of climate change on your area that you supervise?'

Stephen Haddrell: Yes, I think we should understand it much better than we do.

Q338 Chair: Are you going to produce an adaptation report?

Stephen Haddrell: I will look at producing a report in this area. I just need to get more familiar with exactly what is required and the extent to which it is relevant.\(^8\)

In conclusion, financial regulators have a responsibility to understand risks to financial stability and the financial institutions which they supervise. Evidence to our inquiry has suggested that there are failings in how the UK’s framework of financial regulation is currently monitoring climate change risk management. Given the long time-scales involved in pension saving there seems to us a case for both the tPR and FCA to integrate climate change risk management into their work. The FCA particularly seems to particular need to update its thinking on this, given its lack of guidance to contract based pension schemes on environmental risks and the limitations of its Risk Outlook on climate change. If financial regulators are not asked to report in this reporting round, it would be a missed opportunity for them to properly consider and integrate climate change risk management into their work.

Yours sincerely,

Mary Creagh MP
Chair of the Environmental Audit Committee

\(^8\) http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/environmental-audit-committee/green-finance/oral/78606.pdf