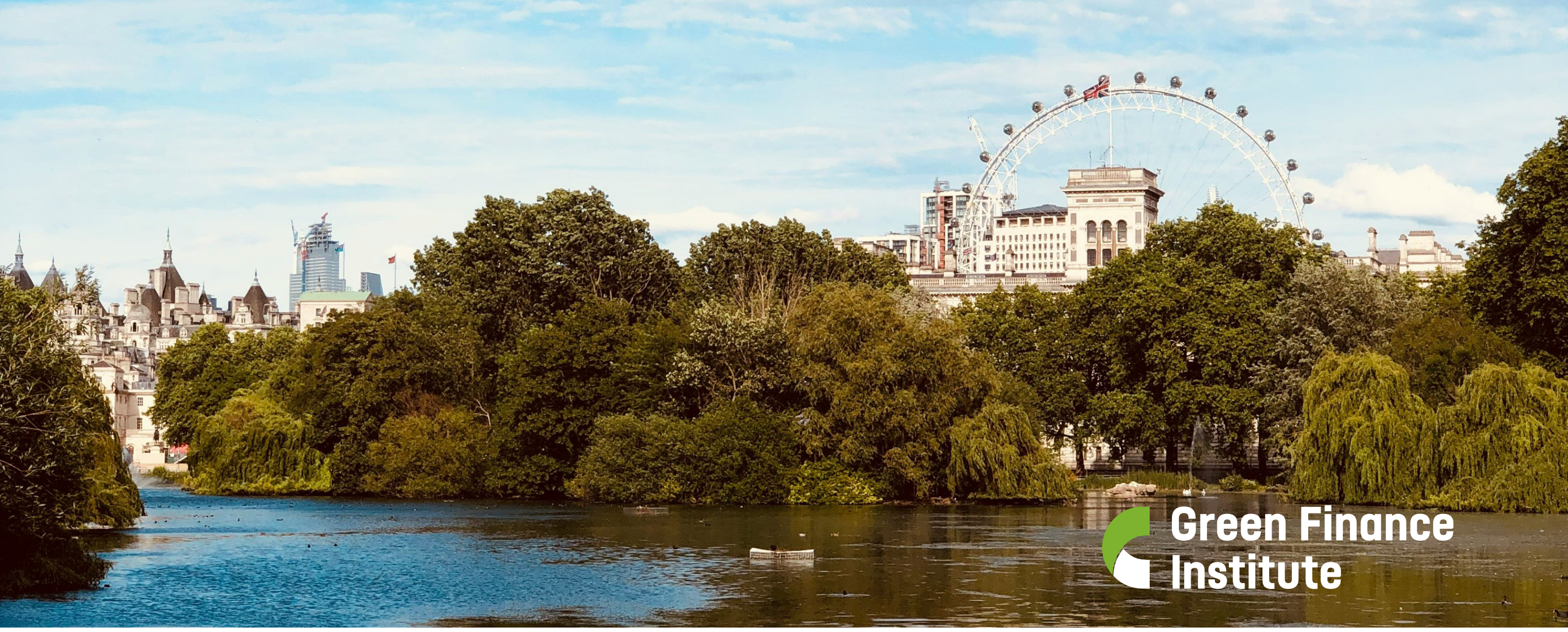
DECEMBER 2023

What next for financial regulation in the UK?



Written in collaboration with Tina Mavraki (Fellow, Chapter Zero)

A slew of new financial regulations aiming to facilitate the integration of climate change but also wider environmental, social, and governance (ESG) risks into financial market regulation has come into force since the Paris Agreement was made in 2015. Much of this has been catalysed by the Task Force on Climate-related Financial Disclosures (TCFD)[1] – launched in 2015 - and by the EU and its 2016 High Level Action Plan on Sustainable Finance.[2] Since then, the UK and other jurisdictions have followed suit with climate and wider sustainability-related disclosures, taxonomies, and enhanced financial conduct requirements. This has been met by a backlash against ESG regulation in some quarters, particularly in the US, and that, unsurprisingly, has prompted questions from market participants on how much financial regulation is enough? This briefing note considers that question in the UK context.

1. https://www.fsb-tcfd.org/
2. See - https://www.greenfinanceplatform.org/policies-and-regulations/european-commissions-action-plan-financing-sustainable-growth#:~:text=The%20Action%20Plan%20on%20Sustainable,3)%20To%20foster%20transparency%20and

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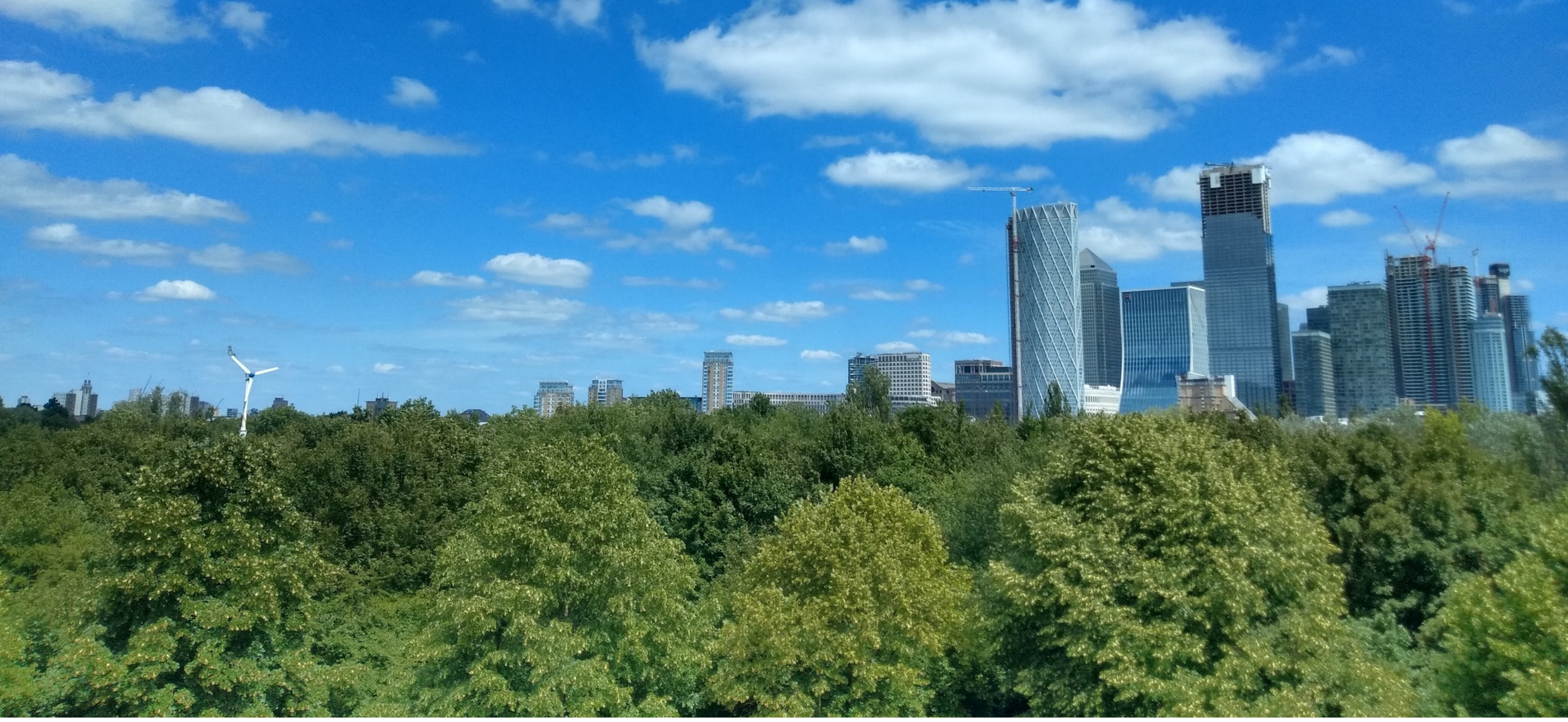
J.P.Morgan

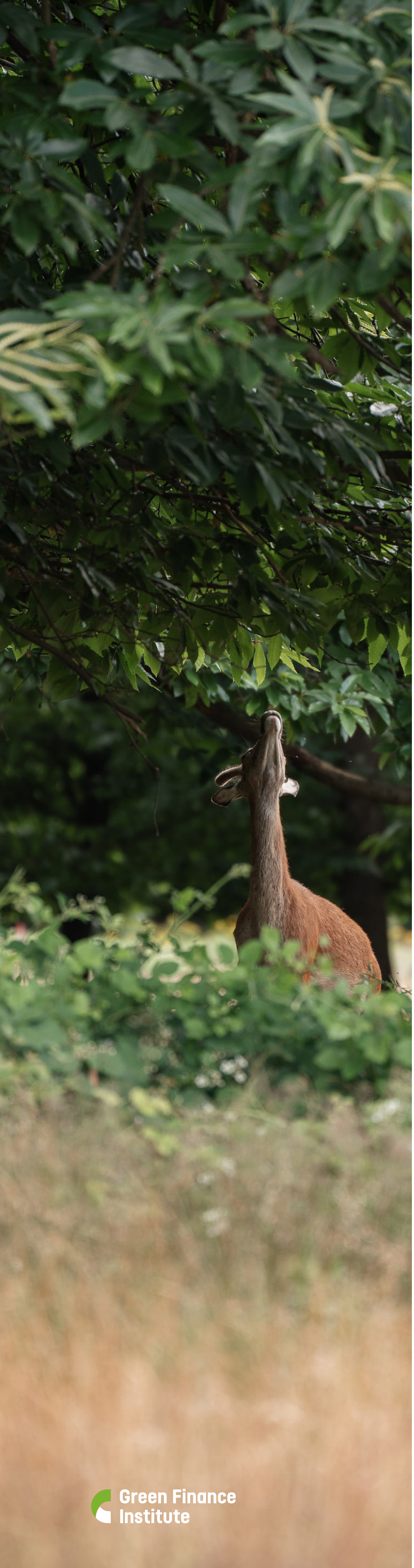


INTRODUCTION

With the recent reporting of ESG regulation pushback, it can be easy to forget the central premise of climate-related financial regulation, which is that climate risk is also financial risk. It is credit risk and it is liquidity risk. As such it poses significant risk to financial stability, alongside the physical, transition and liability risks, as set out in Mark's Carney's 2015 'Breaking the Tragedy of the Horizons' speech.[3] In the UK, that concept, not regulatory overreach, is behind the leadership shown on climate change from the Bank of England. Where financial stability is under threat, the Bank and more specifically the Prudential Regulatory Authority (PRA) are mandated to act. And where the Bank of England leads, others have followed with the establishment of the joint PRA-FCA initiative the Climate Financial Risk Forum (CFRF),[4] the FRC strengthening the Corporate Governance and then Stewardship Codes,[5] the FCA's Financial Conduct Regulation and later Sustainable Fund Labels,[6] and UK Government commitments to introduce[7] Disclosure Requirements and a Green Taxonomy. Thus, it is through this lens that regulatory intervention should be assessed, and the responses of financial institutions follow.

> Climate risk is also financial risk.

3. https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability
4. https://www.bankofengland.co.uk/climate-change/climate-financial-risk-forum
5. https://media.frc.org.uk/documents/UK_Corporate_Governance_Code_2018.pdf and https://media.frc.org.uk/documents/The_UK_Stewardship_Code_2020.pdf
6. https://www.fca.org.uk/news/news-stories/fca-updates-sustainability-disclosure-requirements-and-investment-labels-consultation
7. *ibid*



Disclosures as a means to an end only

In the UK, firm-level behavioural change in relation to governance, and later climate and sustainability issues has traditionally been driven by principles-based disclosures. Thus, transparency has been deployed to drive the operational changes required to tackle climate change. Examples include the Stewardship Code, which provides guidance on asset allocation, manager selection, and engagement strategy. Importantly, this is framed in the context of stewardship as the "responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society".[8] The Department of Work and Pension's disclosure requirements go further in terms of their level of prescription, requiring that TCFD disclosures include, 'as far as they are able', 1.5°C and 2°C transition scenarios and that disclosures be provided on a comply or explain basis.[9]

> Climate disclosures should be an output of core business strategy and operational changes instituted to deliver that strategy – not an end in themselves.

But climate disclosures should be an output of core business strategy and operational changes instituted to deliver that strategy – not an end in themselves. The act of disclosure *should* be the culmination of a strategic business process to identify, price and address physical, transition, and liability climate risks and opportunities, as these are presented in each industry/sector. The process *should* enable disclosure of a firm's exposure to climate risk but *also* stimulate development of a clear transition plan to manage it to protect corporate value.

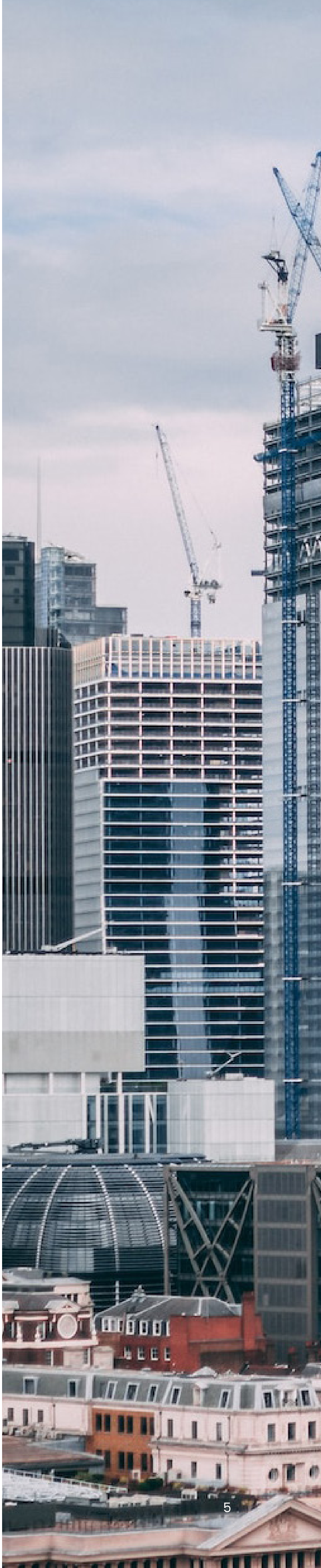
8. https://www.frc.org.uk/library/standards-codes-policy/stewardship/uk-stewardship-code/#:~:text=The%20UK%20Stewardship%20Code%202020,-The%20UK%20Stewardship&text=Stewardship%20is%20the%20responsible%20allocation,economy%2C%20the%20environment%20and%20society.
9. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1006024/statutory-guidance-final-revised.pdf

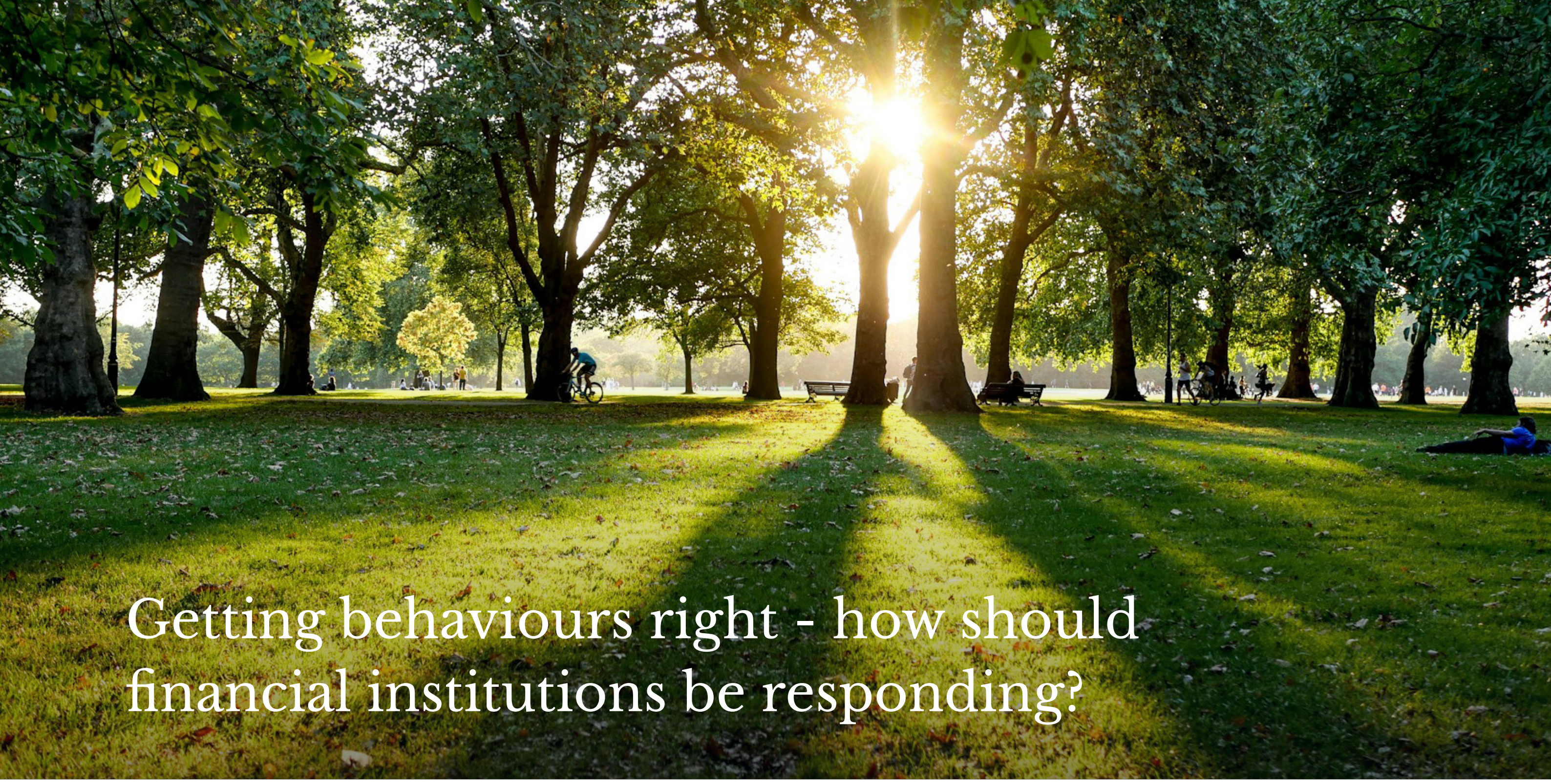
Tick box responses from the market risk more prescription from regulators

In cases where financial institutions approach complying with such regulation with a reporting-only mindset, this disclosures-driven approach is bound to fail. Efforts have been made by the PRA and FCA to move regulated firms beyond this tick box approach through initiatives such as the CFRF – which seeks to reduce barriers to firms implementing strategic approaches to identifying and managing climate risk by developing practical tools and approaches. Now in its third session it is looking beyond risk management, scenario analysis, disclosures and innovation to tackle capital mobilisation, carbon budgets and climate litigation risk among other things. This helps but is unlikely to be enough on its own. Significant change needs to be driven from the top and, of course, through changes to real economy policy to develop a scaled pipeline of investible green projects. It is a truism that financial services will only be as green as the economy they serve. But that doesn't mean financial services firms should wait passively for that pipeline to emerge.

What do firms want?

It is fair to say firms do not want more financial regulation. They also want the existing approach to be simpler and most want it connected to domestic real economy policy ambition that catalyses green investment opportunities. This will require more clarity on the broader sectoral enabling environment, including clear signalling from governments on what their priority sectors are for decarbonisation and what policy, incentives and fiscal support is being made available, and the longevity and consistency of these decisions. This starts to position regulation and investment as two sides of the same coin, as policy indicates what counts as green and creates durable investment roadmaps for firms to act on. Investments that align with these will de facto be climate-proofed. The U.S Inflation Reduction Act is a clear example of this but in the UK, the Net Zero Council is also mandated to achieve some of the same goals.





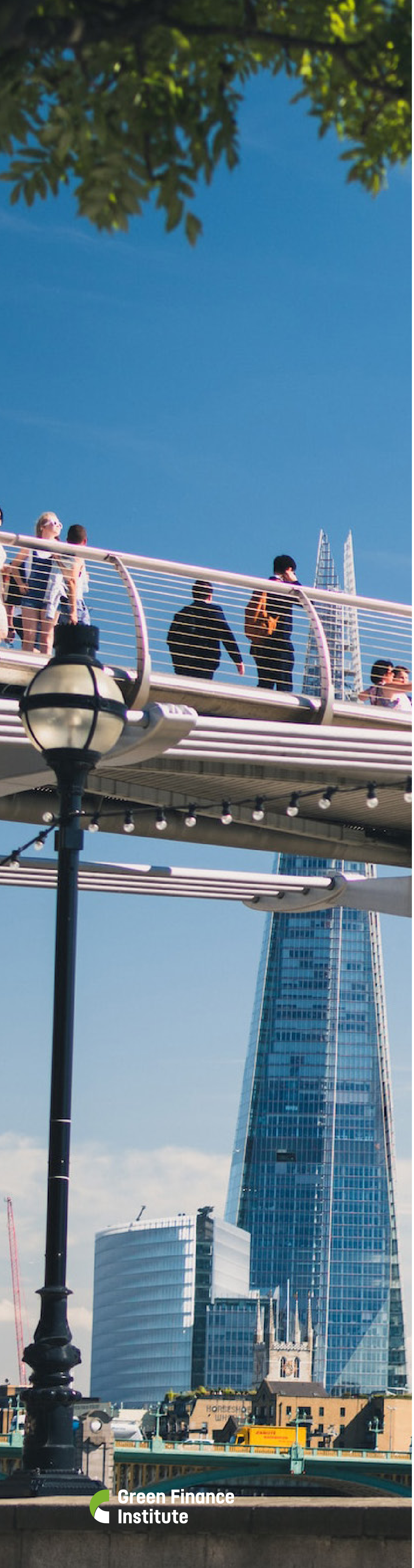
Getting behaviours right - how should financial institutions be responding?

> Policymakers have indicated that senior engagement at CEO level on climate change is critical to drive decision making forward.

The board is the natural focus for strategic risk management on climate, as it is for all strategic business decisions. Execution needs to be owned and designed by the executive and delegated to senior management and expert professionals for cascading and implementation. It is not therefore a function in and of itself, designed first and foremost to comply and in so doing, mitigate in a very narrow sense, regulatory risk. There remains, however, an implementation gap – which is partly why regulatory attention is increasingly focusing on conduct.

Policymakers have indicated that senior engagement at CEO level on climate change is critical to drive decision making forward. This must include clear communication about the real issues involved in climate transition for firms, alongside clear, tangible asks on the policy enabling environment. This is not then about ease of compliance or otherwise, it is about real business risk, challenges around the transition plans needed to mitigate that risk, and finally its implications for whether policy and regulation are enablers here, or a compliance exercise that cuts across business strategy.

Thus, it is time for CEOs to mandate internally the production of credible, assured climate transition plans that acknowledge the clear relationship between their fiduciary duty and practical management and conduct accountability on climate matters. This then needs to be communicated externally, notably to their investors, as a proactive step to retain long-term shareholder value. At present, some investors respond positively to backsliding on climate risk mitigation because of perceptions around short-term profitability. This dynamic is dangerous and ultimately will destroy value for investors.



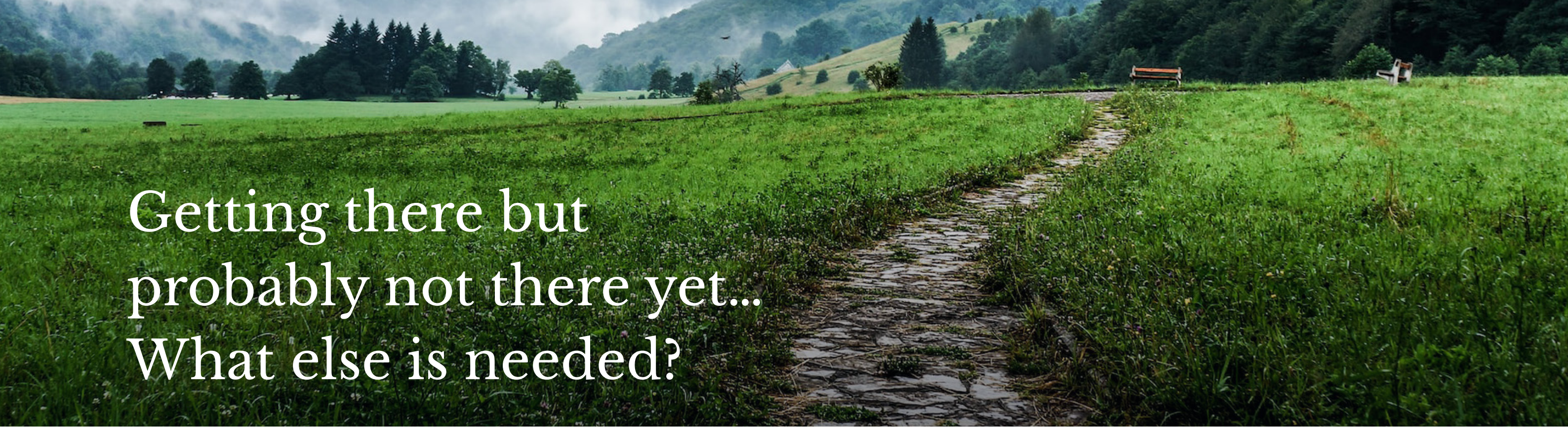
This analysis implies two deliverables from firms:

> A tangible action plan and commitment of resources to understand, approximate, and refine climate risks at the financial and operating level and their monetary impacts on the business in the short, medium, and long term. This should entail among other things:

- Scenario analysis – 1.5°C but also 2.7°C (the projected global temperature increase based on current policies)[10] to assess impacts across all aspects of the business, including solvency and balance sheet risk
- Pricing non-linear, transversal and self-reinforcing risks as well as concentration risks
- Price in contingency risks as an interim step. For this, firms can call on climate scenarios, for example from the Network for Greening the Financial System as well as – noting some of the limits of this approach - emerging alternatives including UNEP's One Earth Climate Model.

> This risk assessment and subsequently published action (transition) plan will shed light on firm capability and maturity when it comes to measuring and mitigating climate risk. It then follows that firms need a concerted holistic plan to upgrade training and development of sophisticated climate talent, integrated fully into business operations, across all levels and functions. This effectively involves investments in people skills, which in the aggregate calls for a practical cultural shift which must be driven from the top.

10. https://climateactiontracker.org/global/temperatures/



Getting there but probably not there yet... What else is needed?

Are regulators and financial institutions on top of the risks that climate change poses? There can be little doubt that we are heading for a financial crisis that would render 2008 a mere blip – failure to manage climate risk is leading us to an end of century collapse in the financial system. Failure to address physical risk will lead to the implosion of the insurance industry even as we stoke hyperinflation and kill economic growth. Governments do not have, and nor will they ever have, the fiscal capability to successfully deliver a climate collapse bailout. It has to be addressed now – choices made between now and 2030 determine the range of options and the range of outcomes for the rest of the century.

To mitigate this risk, transparency, culture and also real economy policies need to be in place. Readying the supply of finance through effective financial regulation requires a 'grand bargain' on climate risk, fiduciary duty and investment opportunity – which is not yet manifesting as it should and must, prompting the question: are there policy interventions available to accelerate change? Several are under discussion in the UK and merit consideration. These include:

Make climate transition plans mandatory in the financial sector. Transition plans are fundamental to driving investment behaviour. It is not the disclosure itself, but the act of fundamentally analysing exposure to climate risks and its impact on investment returns that counts. This allows for complete alignment between an investment strategy that addresses climate risk and fiduciary duty to clients.

Include climate in the Senior Managers Regime (SMR).[11] The SMR sets out how firms should implement the highest standards of governance and accountability in company leadership. It currently doesn't explicitly reference climate change and the need to incorporate a specific business strategy and risk management approach. The SMR is not popular with regulated firms – is there a way to do this in a light touch but effective way?

Include climate considerations in executive remuneration, which is cascaded across senior functions and climate-related significant persons. Ultimately remuneration is tied to long-term value creation but as set out above, there may be a case to shorten the time horizon and get specific on climate risk.

Publish the UK Green taxonomy, requiring corporates to disclose data ahead of financial institution disclosures. Objective definitions of green are needed to tackle greenwashing – and taxonomy reporting will help ensure robust Transition Plans are produced with robust and measurable metrics. The taxonomy in particular does some of the policy heavy lifting by pointing to what good looks like - which investors, banks and NGOs can help enforce as an output of reporting mechanisms.

11. https://www.fca.org.uk/firms/senior-managers-and-certification-regime/senior-managers-regime

When considering these further options, it is important to note that the UK's regulatory strategy is to shape global regulatory approaches and become an early adopter as we have seen with TCFD and now the International Sustainability Standards Board (ISSB), which should link to the Sustainability Disclosure Requirements (SDR). This represents an opportunity for the UK to triangulate between the EU approach on corporate and financial disclosure, which market participants cite as too cumbersome, and the U.S whose equivalent moves are in their infancy.

But opportunity is there for financial institutions as well. Decisions are made by those who show up. The UK has an incredible track record in effective collaborative policy making across financial institutions, academia and NGOs . The early sessions of the CFRF, which in effect was an experiment in industry-led TCFD implementation, has informed the practicalities of implementing the framework into UK law. And as of 1 January 2022, under the FCA's ESG rules, firms must now publish a TCFD report either within its annual financial report for its financial year starting on or after 1 January 2022, or as a standalone which is cross-referred to in its annual financial report. The Transition Plan Taskforce (TPT) has set out how to achieve this in a best practice fashion. Similarly, the FCA's announced that its SDR and labels policy statement, which have been developed with substantive inputs from financial institutions, academics and NGOs to ensure they set a high bar but are also practical and useful, published in Q4 2023, with emphasis placed on taking time to consult to ensure the framework is as robust and useful as possible. Finally, the advice developed by the Green Technical Advisory Group (GTAG)[12], chaired by the GFI, over a period of 2 years to support UK Green Taxonomy has been informed by an engaged group of experts that went beyond the GTAG itself to draw on the insights and expertise within finance, business, NGOs and academia – with a focus on robustness, ambition but also usefulness for the market.

This model of regulatory development needs to continue, supported by ongoing constructive input from financial institutions to ensure any future regulation coming down the line does what is intended – to help shift capital markets and the economy on a net zero nature positive footing, and enables these firms to make good on their net zero and nature positive commitments.

12. https://www.greenfinanceinstitute.com/programmes/uk-green-taxonomy-gtag/