

**Response to the Prudential Regulatory
Authority's Consultation Paper 23/18 on
Enhancing banks' and insurers' approaches to
managing the financial risks from climate change**

by

**THE
TRANSPARENCY
TASK FORCE**

January 2018

About the Transparency Task Force

The Transparency Task Force (TTF) is the collaborative, campaigning community, dedicated to driving up levels of transparency in financial services, right around the world. We believe that higher levels of transparency are a pre-requisite for fairer, safer and more efficient markets that will deliver better value for money and better outcomes to the consumer.

Our overall purpose is to help reform the financial services sector such that it better serves the consumer.

For further information about the Transparency Task Force see Appendix A and refer www.transparencytaskforce.org

The contributors to our response were:

- Sandy Trust of Grant Thornton, Lead Author
- JB Beckett of the Association of Professional Fund Investors
- Paul Pritchard of Iken Associates
- Andy Agathangelou of the Transparency Task Force

Note that not all the participants necessarily agree with every point we make in this response; the views expressed represent the general consensus that has been formed for the purpose of this response.

We do not regard any part of this response as confidential and are happy for the PRA to share it with other parties.

1. Introduction

Consistent with our response to previous related consultations (2017 EU HLEG consultation on Sustainable Finance, 2018 DWP consultation on clarifying trustee duties), The Transparency Task Force ('TTF'), sees an urgent need to align financial system goals with societal goals more broadly (the Sustainable Development Goals or SDGs).

What do we mean by this?

Quite simply, we mean that the financial system needs to begin to consciously consider the impact of its investment and lending activities in terms of the SDGs. By way of a simple climate related example, when considering whether to invest in renewable energy or coal, we need to consider not only the financial outcomes but also the impact in terms of SDG13 Climate Action and the goals of the Paris Agreement.

However, this is a paradigm shift for a financial services industry which has largely been trained and rewarded to consider financial outcomes only, often over a short timescale, meaning regulatory intervention will almost certainly be required to accelerate this shift.

We therefore welcome the Prudential Regulation Authority's consultation paper 23/18, 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' and the draft supervisory statement therein.

We have previously stated that it is appropriate to call out climate change as a particular example of a material risk. A failure to mitigate climate change will significantly increase the challenge of dealing with almost all of the other Sustainable Development Goals due to the interconnectedness of risks¹ and as many recognise we are now in a perilous situation with regards to climate². However, very few understand the potentially severe impacts of an extra degree of global warming and still fewer understand the probabilistic nature of the Paris goals (i.e. that the global carbon budgets only give a 2/3 chance of meeting temperature goals).

However, despite an increasing awareness of both the changing physical risk environment and the transition risks associated with climate change, relatively few organisations appear to be adopting a strategic approach to this. The reasons for this include a lack of awareness of relevant techniques, a lack of knowledge of this area, a lack of accountability, a perception that this is low priority and simple wilful blindness. So we see this SS a critically important step to driving climate risk rapidly up the corporate agenda within the financial services sector.

The other point we would make, accepting that this may be beyond the legal remit of the PRA, is that firms, through their investment and lending activities, have great potential to mitigate climate change by investing in the transition to a low carbon economy and that there exist significant opportunities in this space. We encourage the PRA to consider whether it is able to include any statements around this opportunity.

We have structured further detailed comments below in line with the draft SS.

We agree with the proposed scope of the SS and the positioning statements in 1.2 and 1.3. For ease of reference we will refer to the companies in scope as either firms or financial services and use these terms interchangeably.

We agree that the financial risks from climate change will increase over time and also note that both physical and transition risks are occurring now.

We agree that some firms are adopting a strategic approach to climate change and note that firms which have adopted a strategic approach have taken action, for example, the National Employment Savings Trust or Swiss Re. These firms have not taken action for ethical reasons. They have taken action because they have assessed the financial risks and opportunities related to climate change and found these to be material. For example, in evidence given to the Environmental Audit Committee's Green Finance enquiry in 2018, NEST's Head of Responsible Investment, Diandra Soobiah stated that:

"All the evidence points to climate change being a big economic risk in the future...this is about managing material financial risk for our members in the long-term."

Should we then conclude that any firms which have not yet undertaken such an assessment or are agnostic about climate change are now taking risks they may not be aware of?

¹ World Economic Forum, Global Risks Interconnection Map 2018
<http://reports.weforum.org/global-risks-2018/global-risks-landscape-2018/#risks>

² IPCC, Special report on Global Warming of 1.5°C <https://www.ipcc.ch/sr15/>

2. Financial Risks from Climate Change

We agree that classifying climate change related risks into physical and transition risks is appropriate. Clearly, liability risks exist but the sooner a consistent risk taxonomy can be adopted the better; and we are supportive of aligning risk taxonomies with the recommendations of the Financial Stability Board's taskforce on climate related financial disclosures (TCFD).

We broadly agree with the rest of this section and in particular with a number of comments in 2.5, particularly:

- That climate risks are potentially non-linear, correlated and irreversible
- That the full impact of climate risks may crystallise outside many business planning horizons
- That using past data may not be a good predictor of future climate change risks

In our view, these 3 points and other related characteristics of typical risk management frameworks that currently operate in financial services mean there is a high chance of climate related risks not being identified by current risk management frameworks. This is because:

- Current risk management frameworks often consider risks in isolation, i.e. do not adopt a systems approach, with correlation captured primarily in capital calculations only.
- Many forecasts are linear in nature, yet the world is not. In particular, disruption is non-linear and so linear forecasts may under-estimate transition risks.
- Current analysis is often short term in nature, so by definition all longer term or systemic risks are missed. See 'All Swans Are Black in the Dark'³ for further analysis on this point.
- Given the changing climate and the energy transition, it is perhaps more true than it has ever been before that past data is not a good predictor of the future.

Put another way, it seems unlikely that the market has priced in climate risk and so the potential for severe market movements as and when the market does price in these risks is significant. EIOPA estimated that € 1 trillion of insurance assets may be exposed to climate risks in their December 2018 Financial Stability Report⁴, noting that even this figure may be understated.

Our other general comment in this section relates to the generally very poor understanding of the level of risk associated with failing to meet the Paris goals. We are currently on-track for a 3°C temperature rise by 2100 (with an increasing risk of triggering non-linear global climate tipping points⁵) – yet global emissions continue to rise. At some point, possibly before 3°C and almost certainly before 4°C, there would be severe climate impacts, for example, vast regions becoming unable to sustain their current human populations due to combinations of factors such as water shortages, crop failures, heat stress and extreme weather. Long term under those changes, mass migration (or de-population) of arguably between 2 to 5 billion people would be required. It is difficult to envisage how current sovereign and economic structures could withstand such significant strains or even more modest variants.

³ "All Swans Are Black in the Dark: How the short term focus of financial analysis does not shed light on long term risks", Generation Foundation, 2° Investing Initiative <https://www.genfound.org/media/1383/all-swans-are-black-in-the-dark.pdf>

⁴

https://eiopa.europa.eu/Publications/Reports/EIOPA%20FSR%20December%202018_Ch5_Risk%20assessment.pdf

⁵ "Trajectories of the Earth System in the Anthropocene", Steffen et al, 2018 <https://www.pnas.org/content/115/33/8252>

However, few understand this level of risk and the potentially fatal implications for the stability of Earth and human systems of an additional 0.5°C or 1°C of warming. After all, to the general public (and to financial services professionals) 3°C doesn't sound so very different to 2°C. We therefore encourage the PRA to bring these points out more powerfully in this section, as current readers could assume from paragraph 2.6 that there is some risk present but not fully understand the severity or the urgency.

Another way of saying this, is that there is a very low level of carbon literacy⁶ in financial services. And without understanding the nature of the problem it is hard to manage the risks associated with it.

3. A Strategic Approach

We agree with the requirements outlined here and have provided some further thoughts around certain elements which we have detailed below.

Scenario analysis

There are many possible climate pathways and hence scenarios. This may complicate the process for firms. Further, although many scenarios have been proposed by various stakeholders there has been very limited work carried out around the likelihood of different scenarios, which we feel is important to consider.

We therefore encourage the PRA to run a stress test based around a probable or likely climate scenario as we believe few organisations have significant capability in this space and anticipate some guidance for firms will be required, including a requirement to carry out scenarios on consistent timeframes.

We point to the work that the Principles of Responsible Investment are carrying out under their Inevitable Policy Response⁷ initiative as indicative of some good thinking in this space. In a nutshell, it seems unlikely that the world will continue on its present trajectory as the increasingly severe physical impacts of climate change are felt. This implies a significant change of course will take place, possibly within the next decade. This in turn implies some significant disruption which any linear scenarios may not capture.

Furthermore, there have been significant advances in climate risk quantification, with investors now being able to access both bottom up (stock level) climate risk assessments, as well as top down (macro-economic) climate risk assessments, for a range of climate scenarios.

It is also worth noting that UNEPFI's work on scenario analysis including Extending our Horizons and Navigating a New Climate are arguably the most detailed approaches to date and the ones that most strongly align with current risk management practice. They do involve a lot of work which is almost certainly beyond the capabilities of many in the sector. The key risk is therefore that limited exercises will be conducted arriving at 'non-material' conclusions by many in the sector. It would therefore be highly beneficial if the sector could be guided to share information and look outwards to draw on existing capabilities outside the sector.

⁶ [Carbon Literacy](#) are a globally leading UK based NGO focused on climate change education, or carbon literacy.

⁷ <https://www.unpri.org/climate-change/the-inevitable-policy-response-to-climate-change/3578.article>

Disclosure

We view transparency and disclosure as absolutely critical and have been encouraged by the relatively rapid changes that have occurred in France as a result of the disclosure requirement under Article 173 of France's Energy Transition Law.

This requires French firms to disclose not only on physical and transition risks but also to assess and report on their contribution to international efforts to mitigate global warming and support the energy transition.

We encourage the PRA to go further than encouraging firms to engage with wider initiatives. We believe the PRA should mandate a 'TCFD compliant' disclosure to avoid a potential proliferation of inconsistent disclosures across the market. As a first step, the PRA could require firms to submit this to regulatory authorities before full public disclosure.

4. Further dialogue

We welcome the opportunity to enter into further dialogue with the PRA on the matters outlined in this response and propose an informal round-table discussion with members of PISCES (See Appendix A) as a pragmatic way forward.

In the first instance please liaise with:

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Founding Chair, Transparency Task Force

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See next page for Appendix A: Further information about the TTF

APPENDIX A: Further information about the TTF

The Transformational Power of Transparency

We seek to harness the transformational power of transparency; a power that has been known about and understood for over a century since the seminal work of Justice Louis D. Brandeis and his 1914 book “Other People’s Money and How the Bankers Use It.” This is the work that gave the world the idea that “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”an idea that is at the very heart of what the TTF is all about.

The transformational power of transparency works because of the correlation between transparency, truthfulness and trustworthiness.

Free of commercial conflicts

The TTF is free to consider what is ultimately best for the consumer without commercial conflicts and we are perhaps unique in being made up of a truly pan-industry cross-section of individuals that includes market participants, researchers, academics, legal professionals and those formally representing trade bodies and professional associations. As such we are well-placed to establish consensus that does not merely reflect the wishes of one particular “tribe” or another. We are therefore able to work to one simple and straightforward guiding principle: “What is best for the consumer?”

Our Special Interest Groups

The TTF seeks to operate in a collaborative, collegiate and consensus-building way; focusing on solutions, not blame. Our solution-orientated approach is made possible because of the work of volunteers. We have over 500 volunteers organised into 18 Special Interest Groups (SIGs), with each group working on a campaign to help drive reform that will improve outcomes for consumers.

Our SIGs are:

- Costs & Charges
- Market Integrity
- Financial Stability Team
- Banking
- Anti-Scams
- Foreign Exchange
- Asset Management
- APAC
- Americas
- EMEA
- Global Transparency Index
- Pensions
- Financial Planning
- FinTech

- Compliance, Legal, Audit, Regulatory, Governance, Custodian,
- Investment Consulting & Fiduciary Management
- Communications
- **PISCES**

PISCES is directly relevant to this response. PISCES is made up of members who like the idea of the world's capital markets becoming a 'force for good'. We believe there is tremendous scope for the way the financial services sector influences what happens in our world.

To explain the name of the SIG: the **P** is for Purpose; **I** is for Impact Investing; **S** is for Sustainability; **C** is for Climate Change; **E** is for Environment, Social and Governance; and **S** is for Socially Responsible Investing.

For further information about our Special Interest Groups and to download a spreadsheet showing their members see here:

<https://www.transparencypolicytaskforce.org/teams-of-volunteers/>

The TTF Strategy for Driving Change

Our Strategy for Driving Change is all about bringing together two groups of people:

#1, those with a sense of passion & purpose about what needs to be changed, such as our 350+ volunteers; and

#2, those with the power & position to make change happen i.e. the regulators, senior civil servants, policymakers and Parliamentarians.

We bring these two groups together in many ways, for example through our Transparency Symposia; and through our Special Events. Here's three examples of our Special Events:

1. 12th September 2016 at the Houses of Parliament, Co-chaired with Tom Tugendhat MBE MP, where we held "The first Transparency Strategy Summit in the World," the primary purpose of which was "to begin to build consensus on the best way to protect the interests of the UK's pensions-savers through full disclosure on all the costs and charges they are paying but not being told about." That special event led to the TTF sending a letter to the Chair of the Work and Pensions Committee asking the Committee to open an inquiry on pensions costs and transparency.
2. 26th June 2017 at the Houses of Parliament, Co-chaired with Lord Cromwell, where we presented TTF Banking Team's White Paper on Current Accounts entitled "Sensible recommendations about the lack of transparency around charges for Free-If-In-Credit personal current accounts."
3. 7th February 2018 at the Houses of Parliament, Co-chaired with Lord Cromwell; a very special meeting where we presented our White Paper entitled "Ideas to help reduce the chance of another Global Financial Crisis" which subsequently initiated the launch of a new All Party Parliamentary Group on Financial Stability. The draft Purpose Statement for the

new APPG is “To respond to the universal shared interest in avoiding another Financial Crisis by providing a helpful forum for parliamentarians to work cross-party, developing fledgling policy initiatives to buttress the resilience of our financial system; supported by participation from industry, academics, experts, think tanks, civil society, campaign groups and regulators.”

Our “North Star” Question

We are guided by our “North Star” question, which is – “What is best for the consumer?” and we think this is an important perspective to take because the inherently lucrative nature of the financial services sector means that there will always be tens of thousands of market participants, trade bodies and professional associations around the world that are extremely adept at representing their commercial interests.

Many of these organisations are very well resourced, with large budgets for campaigning/lobbying/influencing and it is obvious that they have had a great deal of influence over the writing of the rules that are used to regulate and govern the sector.

The overall impact of this reality is that the best interests of the consumer are very often overshadowed by what will enable market participants to continue to flourish and enjoy high profit margins; sometimes at the expense of the consumer because of an attitude of “profit before principle.”

Fortunately, there are some organisations that do not seem to follow the “profit before principle” mindset at all; they are very often characterised by enlightened, values-based leadership that seems to fully understand the importance of the sector reforming how it works; and there are also some market participants that have a not-for-profit or mutual structure and are therefore more predisposed to a customer-centric way of working.

However, in the overall scheme of things there is a very one-sided battle when it comes to the sum total of influences acting on the regulators and policymakers on behalf of market participants compared to those acting exclusively on behalf of the consumer. This can typically be evidenced by the amount of consultation responses representing the commercial interests of market participants (both directly and via their trade bodies) when compared to the amount of responses from organisations that take a wholly pro-consumer stance.

The cumulative effect of powerful lobbying over decades has contributed to a financial services sector that sometimes seems more committed to its commercial self-interests than purposefully serving the customer. We believe this needs to change – not only for the benefit of the consumer but also for the benefit of the sector itself. The last point might seem surprising but we truly believe the financial services sector as a whole is suffering as a consequence of having not been sufficiently careful about looking after the consumer’s interests. This manifests in many ways and a particular concern we have is around the trust deficit.

TTF Governance

The TTF has an Advisory Board, the overall purpose of which is to help set our strategic direction and priorities; and to help deal with the hugely important issue of fund-raising as we are severely limited by a lack of resource.

The Advisory Board Chair is John Howard who presented the BBC Radio 4 pro-consumer programme “You and Yours” for 14 years; and is a former Chair of the Financial Conduct Authority’s Financial Services Consumer Panel.

For further details about our Advisory Board see here:

<https://www.transparencytaskforce.org/about-1/advisory-board/>

The TTF Ambassadors

The issues that the TTF are looking to help fix are not confined to the UK. We are therefore building a global network of Ambassadors such that we can deal with matters on an international basis. For further information about our Ambassadors see here:

<https://www.transparencytaskforce.org/ttf-ambassadors/>