November 2020

Climate Related Disclosures For Financial Institutions – New U.K. Mandatory Requirements

By Arun Srivastava, Nina Moffatt, Konstantin Burkov & Zachary Benson

On 9 November, Rishi Sunak, the Chancellor of the Exchequer, set out the UK's ambitions for the future of financial services in his *Financial Services Statement* (the "Statement").

For banks and other financial institutions the *Statement* contains important details of the Government's proposals around mandatory disclosures in relation to environmental issues. These proposals need to be considered together with the EU's Sustainable Finance Disclosure Regulation and the Taxonomy Regulation which are part of the EU's Action Plan on Financing Sustainable Growth. It is clear, both at the EU level and the U.K. domestic level, that sustainability and Environmental, Social, and Governance ("ESG") issues are key issues on the regulatory agenda. All firms will need to address these issues as they become increasingly integrated in the way businesses operate, the investment decisions that they take and the products that they offer.

The intention of the policy is to ensure that financial institutions operate sustainably in their own right and play a role in directing capital and investment to businesses that promote sustainability. Environmental concerns around climate change also create risks, including risks arising from the physical impact of climate change and risks arising from the disruption caused by the transition to a lower carbon economy. There is increasing investor demand for information on and disclosure of such risks. Inadequate information about risks can lead to a mispricing of assets and a misallocation of capital. For banks and insurers, these risks can manifest themselves in increasing underwriting, reserving, and credit and market risk. For asset managers and owners, climate and other ESG risks can impact the value of investments held or under management.

To date provisions for disclosure on sustainability and ESG issues have not been mandatory. Compliance with such provisions has been voluntary. This "soft law" approach to disclosures and other related issues is set to change with a raft of mandatory requirements coming into force in the next 12 to 18 months.

The Chancellor's Statement

In his statement, the Chancellor announced the introduction of more robust environmental disclosure standards so that investors and businesses can better understand the material financial impacts of their exposure to climate change, price climate-related risks more accurately and support the greening of the U.K. economy.

The statement noted that the U.K. will become the first country in the world to create a Task Force on Climate-Related Financial Disclosures with the express goal of aligning disclosures and making those disclosures fully mandatory across the economy by 2025. The statement is accompanied by publications from the Joint Government Regulator TCFD Taskforce, which set out a road map for the changes that are planned to be introduced. In the sections below, we recap on the Task Force on Climate-Related Financial Disclosures, whose work underpins the new U.K. proposals, and then go on to provide an overview of the Government's proposals.

The Task Force on Climate-related Financial Disclosures (the Task Force)

The U.K. Government's proposals for mandatory climate-related disclosures are based on the recommendations of the Task Force on Climate-Related Financial Disclosures. This Task Force was established by the Financial Stability Board to develop voluntary consistent climate-related financial disclosures that would be useful for investors, lenders, and insurers in understanding material climate-related risks.

The Task Force produced recommended key climate-related financial disclosures for organisations to include in their financial reports and filings. These recommended disclosures were based around the following four areas:

- Governance – disclosures concerning an organisation's governance around climate-related risks and opportunities, including oversight by the board of climate-related risks and opportunities.
- Strategy – disclosure of the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.
- Risk management – disclosure of how an organisation identifies, assesses, and manages climate-related risks.
- Metrics and targets – disclosure of the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

The above four areas are backed by 11 recommended specific disclosures that provide more detail on the information to be disclosed under each of the four recommendations. The Task Force has also issued supplemental guidance for the financial sector.

The Task Force's view was that disclosures by the financial sector could foster an early assessment of climate-related risks and lead to more informed capital allocation decisions. The guidance broke the sector down between banks, insurers, asset managers, and asset owners, such as pension funds.

The position in the U.K.

The U.K. Government was one of the first to endorse the Task Force's recommendations. The Government's Green Finance Strategy set an expectation that all listed issuers and large asset owners would make disclosures in line with the Task Force's Recommendations by 2022.

The Government and regulators have now concluded that the U.K. should consider moving towards mandatory Task Force-aligned disclosures to help accelerate progress. For example, research carried out by the FCA showed that, in 2019, only around a third of (premium-listed) companies were making the relevant reports on average across the Task Force's 11 Recommended Disclosures.

To this end, the Government has now published a Roadmap, which presents a coordinated strategy for the imposition of disclosure requirements on seven categories of organisation, which are listed commercial companies, U.K.-registered companies, banks and building societies, insurance companies, asset managers, life insurers, and FCA-regulated pension schemes and occupational pension schemes.

Some work on disclosures has already been carried out by U.K. regulators and the Roadmap states that it will build on this existing work, including the following:

- Banks and insurers have already begun to take action in response to the Supervisory Statement (SS3/19) issued by the Prudential Regulation Authority (PRA) in April 2019 (*Enhancing banks' and insurers' approaches to managing the financial risks from climate change*). This statement provided a helpful overview of risks arising from climate change and set out the PRA's expectations as to how firms should respond to these risks. In the statement, the PRA said that it expected firms to develop and maintain an appropriate approach to disclosure reflective of the distinctive elements of financial risks from climate change.

- The FCA consulted on Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations in the FCA's CP20/3. This consultation was directed at listed companies, and the FCA noted that climate change threatens to have a significant and complex impact on most, if not all, listed companies. The FCA also proposed a new climate related disclosure rule to be contained in the FCA's Listing Rules. This is intended to promote the adoption of the Task Force's recommended disclosures. In addition, on 9 November, Nikhil Rathi, the FCA's CEO, confirmed that the new rules for premium listed companies will be introduced from 1 January 2021.

The European Union

As noted, the EU is proposing a new body of rules under its Sustainable Finance Action Plan. In June 2019, the EU published non-binding supplementary guidelines on the Non-Financial Reporting Directive that relate to corporate disclosure of climate-related information. These guidelines closely reflect the Task Force's Recommended Disclosures. The Disclosure Regulation and Taxonomy Regulation, together with the related Level 2 measures, will impose further obligations concerning sustainability-related disclosures in the financial services sector. These Regulations are particularly relevant for asset managers and advisers.

With the UK having left the European Union, the Disclosure Regulation and Taxonomy Regulation will not be applicable in the U.K. They come into force in March 2021 after the end of the current transitional period and do not form part of the body of retained EU law that has been incorporated into the UK statute book. The UK Government has stated that it intends to match the EU's objectives. At this time, however, there is some uncertainty as to the approach that the UK will take to implementation of similar provisions.

The Roadmap

The Roadmap sets out an indicative path for the introduction of regulatory rules and legislative requirements over the next five years, with most developments taking place over the first three years. The Roadmap illustrates how the scope of disclosures could increase each year as potential new measures come into force.

PERIOD	SECTORAL COVERAGE
2021	• Occupational pension schemes >£5bn • Banks, building societies and insurance companies • Premium listed companies

2022	• Occupational pension schemes >£1bn • Largest authorised asset managers, life insurers and FCA-regulated pension providers • U.K.-registered companies • Wider scope of listed companies
2023	• Other U.K.-authorised asset managers, life insurers and FCA-regulated pension providers
2024	• Other occupational pension schemes (subject to review) • Potential further refinements across categories

In implementing new requirements, the Government says that it will consider the need for proportionality. The Government expressly recognises the challenges faced by smaller organisations in complying, but notes that small, regulated financial institutions might harbour concentrated climate risks and should be brought into the net of new mandatory disclosure requirements in any event.

Likewise, the Government intends that the initial mandatory requirements should be principles-based and not prescriptive. However, it is also expected that rules will become more detailed over time. Finally, the Government acknowledges that implementation of any new mandatory measures should be phased in over time.

Asset managers & the Roadmap

The FCA will be consulting on Task Force-aligned disclosure rules, directed towards providing "decision-useful information to existing and prospective clients and end-investors".

It is anticipated that the FCA's proposals will include:

- disclosure of strategy, policies, and processes at the firm level and covering relevant recommended disclosures;
- more targeted disclosures at the fund or portfolio level;
- the scope of funds or portfolios that may be captured under these proposals has yet to be determined;
- the FCA would expect to set a scope that prioritised the information needs of U.K. clients and end-investors.

Given the global nature of the industry, the Government notes that there will be interactions with related international initiatives, including those that derive from the EU's Sustainable Finance Action Plan.

In terms of timing, the FCA would aim to finalise rules by the end of 2021, with these coming into force in 2022.

These proposals would appear to overlap with the EU's Disclosure Regulation, which concerns ESG issues. The Disclosure Regulation sets out sustainability disclosure obligations for manufacturers of financial products and financial advisers towards end-investors. The Disclosure Regulation is broader in scope than the environmental-related disclosures covered in the Government's Roadmap. The concept of ESG extends beyond climate issues and includes broader sustainability considerations. In addition to requirements around disclosures, the U.K. Government also proposes to develop its own green taxonomy, which will help to define environmentally sustainable investments; this proposal will sit alongside the EU's Taxonomy Regulation. The EU's rules will come into force beginning March 2021 but as noted above, with Brexit these rules will not apply in the U.K. and there is now some uncertainty as to the Government's intended approach.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

Arun Srivastava
44.020.3023.5230
arunsrivastava@paulhastings.com

Konstantine Burkov
44.020.3023.3321
konstantineburkov@paulhastings.com

Zach Benson
44.020.3023.5102
zacharybenson@paulhastings.com

Nina Moffatt
44.020.3023.5248
ninamoffatt@paulhastings.com