FCA TCFD consultation: CP21/17

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

10 September 2021

About our response

In this document, "Cardano" or "we" respond to the consultation on "Enhancing climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers" published by the FCA in July 2021.

For questions or comment, email:

- Will Martindale, Group Head of Sustainability, w.martindale@cardano.com

Executive summary

We welcome the FCA's proposals.

We believe that:

- the largest asset managers should publish their TCFD report by mid-2022 – as is the case for the largest UK pension funds
- in subsequent years, all asset managers should be in scope, regardless of size
- there should be a degree of standardisation in metrics and scenarios, to allow for comparability. For corporate equity and debt, we favour financed emissions based on Enterprise Value Including Cash (EVIC). For government debt, we favour weighted average emissions per capita
- the publication of climate-related targets should be required – as is the case for UK pension funds
- metrics should be accompanied by narrative-based disclosures (to, for example, provide context to allocations to high carbon assets, where the asset manager is engaging in support of transition plans)

Questions

Q1: **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 you would prefer.**

Yes, we agree with the proposed scope of firms.

Despite recent momentum to address the climate crisis, the financial risks and opportunities posed by climate change are not fully understood and not fully priced by financial markets. Corporate and financial institutions are not, on the whole, prepared for the transition to a low carbon economy. This has led (and will continue to lead) to the misallocation of assets, the risk of asset stranding, and market volatility and dislocation.

TCFD reporting was established for issuers and financial market participants to organise and standardise climate disclosures through the intermediation chain. As such, we welcome the FCA's proposals to introduce disclosure requirements to asset managers (and the companies in which they invest).

As a first step, we welcome the tiered approach, where the largest asset managers, which tend to have more resources, are required to publish their TCFD reports in the first instance, extending to smaller firms.

Cardano believes that climate change represents a material financial risk for all investments. We also recognise the urgency of the climate crisis. As such, we believe that:

- The largest asset managers should publish their TCFD report by mid-2022 – as is the case for the largest UK pension funds
- In subsequent years, all asset managers should be in scope, regardless of size.

Q2: **Do you agree with our proposed scope of products? If not, what types of products should, or should not, be in scope and why?**

Yes, we agree with the proposed scope, and welcome efforts to standardise disclosure requirements across pension provision, whether regulated by the DWP or FCA.

We believe TCFD reporting should extend to private asset classes, where, in our experience, disclosures can be incomplete (see Q4 on engagement and use of proxies).

Q3: **Do you agree with our phased implementation and timings? If not, what approach and timings would you suggest and why?**

The purpose of TCFD reporting is to address information gaps in investment decision-making. We believe this can best be achieved through the harmonisation and standardisation of reporting requirements, including the timing of reporting requirements, across the intermediation chain, and in particular, from asset manager to asset owner.

As per our response to Q1, we believe that the largest asset managers should publish their TCFD report by mid-2022 – as is the case for the largest UK pension funds. It does not seem right to us that pension funds are required to publish their TCFD reports ahead of asset managers.

We also believe that, in subsequent years, all asset managers should be in scope, regardless of size.

Q4: **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.**

We support the transparent use of proxies where there are information gaps, particularly in 'hard-to-reach' asset classes such as derivatives, hedge funds or private markets, or in geographies where TCFD reporting is less well-established, and where the cost of acquiring the data may be substantial. Our Deputy CIO, Keith Guthrie, co-leads the IIGCC derivatives and hedge-fund working group. We would welcome a chance to meet with the FCA to discuss our approach.

Where gaps are substantial, investors should be incentivised to use their stewardship / engagement rights to seek to close data gaps. While our preference would be, in the first instance, to introduce company disclosure, followed by asset manager disclosure, we believe the urgency of climate change warrants the multi-dimensional approached.

In the near term, we encourage FCA to work with BEIS, DWP, TPR and Treasury to harmonise disclosures – including key metrics, as well as timing of disclosures – through the intermediation chain.

Q5: **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?**

We welcome the flexibility to cross-refer to other reports, if applied on a limited basis.

We expect – and encourage – the widespread use of climate change-related metrics by investors in their investment allocation decisions. We also expect that climate change-related metrics will be used by third-party fund rating providers. As such, we believe asset managers will be incentivised to articulate their climate change strategy as clearly as possible, without the need to cross-reference multiple reports.

Q6: **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?**

As per our response to Q11, we recognise that methodologies are evolving, and we welcome regulation that allows for innovation.

We think it reasonable to require funds to refresh climate metrics, including scenario analysis, on an annual basis, in order to support pension funds in their disclosures.

We are concerned that the UK regulatory framework is not accurately distinguishing between 1.5 and 2 degrees, through the use of terminology such as 'a below 2 degree scenario'.

It remains the goal of the Paris climate agreement, and supplemented through subsequent IPCC reports, to limit warming to 1.5 degrees.

We believe the difference between 1.5 and 2.0 degrees is not widely understood, however the physical impacts are markedly different. We note recent United Nations' analysis that at 1.5 degrees, there is a 3% probability on ice-free Arctic summer in any one year, rising to 16% at 2 degrees of warming.

Q7: **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?**

In our view, the publication of climate-related targets should be required – as is the case for UK pension funds.

We believe investors should be encouraged to align targets with net zero and the 50% emissions reductions by 2030 (30% for emerging market portfolios), with baseline year, 2019. Depending on the size and structure of the firms, we believe setting net zero targets should be the default position.

We would note however that, if not accompanied by narrative disclosures, setting decarbonisation targets at a portfolio level could lead to perverse incentives. Decarbonisation targets should not incentivise disinvestment from high carbon regions such as emerging markets which need capital to transition.

We therefore urge that interpretation of progress in line with decarbonisation targets be appropriately flexible with narrative describing progress being made in terms of real-world change in the underlying businesses. We are very supportive of forward-looking alignment metrics such as what proportion of the portfolio has set science-based targets to meet net zero greenhouse gas emissions. These are more powerful and tailored to specific circumstances compared to portfolio level decarbonisation targets.

In particular, we encourage the FCA to review the outputs of the Paris Aligned Investors Initiative and the Net Zero Investment Framework. We refer the FCA to IIGCC's response to this consultation, which we support.

Q8: **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**?

Yes, we agree that AFMs can delegate TCFD reporting to third-party portfolio managers (with appropriate monitoring and scrutiny of the reports).

Q9: **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, however reports need to be understandable by non-climate-specialists, and the information across the investment strategy needs to be accessible in a single place.

Q10: **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?**

Yes, however, we believe that if timelines were harmonised across the DWP and FCA TCFD reporting requirements then pension funds will have access to timely data consistent with their own reporting obligations.

We also believe that, for most investment strategies, an annual reporting cycle is reasonable, which should limit the need for multiple 'on demand' reporting requests. We also suggest that the industry standardise on a common in year period e.g. calendar year end, rather than financial year ends to simplify roll out.

Q11: **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?**

We would welcome further clarity on metrics. TCFD reporting is intended to allow for the flow of climate change-related risks and opportunities through the intermediation chain.

While climate metrics are evolving, and we want to continue to encourage innovation, we think the industry would benefit from a degree of standardisation. This allows asset owners to make comparisons across funds.

For corporate equity and debt, and infrastructure and real estate, we favour financed emissions. Through this approach, an investor's share of emissions is proportional to its exposure to the investee's total value.

Understanding financed (or "owned") emissions is necessary to assign responsibility and ensure accountability for emissions and track progress of investors towards the net zero goal. It can also serve other goals such as managing climate change-related risk and supporting the development of climate-aligned financial products.

There is emerging consensus around the best approach to calculate financed emissions in the context of Paris-alignment, including across the Paris Aligned Investment Initiative, PCAF and the EU Technical Expert Group, towards financed emissions based on Enterprise Value Including Cash (EVIC) (which includes market capitalisation, issued debt and cash).

For government debt, we favour weighted average emissions per capita. We also believe weighted average emissions per GDP has merit, however, we will prioritise per capita. We believe work should be done towards adjusting for imports to reflect the carbon footprint of consumption and prevent the "outsourcing" of carbon-related production to low income countries.

There is substantial variation in debt levels between countries, whereas a ton of greenhouse gas affects everyone on the globe, regardless of its origin. As such, we do not believe percent ownership of issued debt is a sensible measure.

We believe that the fairest and most effective way to measure the carbon footprint of sovereigns is to normalise by population.

For derivatives, we will consider the physical equivalent but new believe their impact should be separated out for the purpose of financial risk reward assessment whereas financed emissions of physically owned assets should be the primary real world decarbonisation metric. We also consider the sustainability of the counterparty.

Q12: **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**

Yes, we agree.

Q13: **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**

Yes, we agree.

We responded to the June 2021 TCFD consultation[1].

In particular, we said:

- The implied warming metric has some benefits, but we believe it should be a supplementary measure
- We believe Taxonomies will support companies and investors understand alignment with climate goals
- We think that setting and disclosing a carbon price is useful when undertaking scenario analysis, in order to understand carbon price assumptions

Q14: **Do you agree with our approach to additional metrics and targets? If not, what alternatives would you suggest and why?**

Yes, for additional metrics we encourage flexibility to allow for disclosures that are most relevant to the investment strategy. We do believe that proportions of the portfolio aligned with net zero greenhouse gas emissions, supported by science-based targets, is a powerful measure of real world progress towards net zero.

In addition to metrics, we would encourage engagement-related disclosures, such as involvement in initiatives such as Climate Action 100+. We note that some investment strategies may have higher exposures than the benchmark to high carbon investments, such as energy, utilities and mining, however, that the investor is using stewardship rights to support companies in their transition.

Q15: **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?**

Yes, however as noted above, we believe it important for firms to disclose a 1.5 degree scenario.

[1] See https://www.cardano.co.uk/wp-content/uploads/sites/3/2021/07/TCFD-Consultation-Response.pdf

We believe the FCA should encourage the concept of 'fair share' decarbonisation targets. In other words, countries with historically higher emissions (which tend to be developed markets) should decarbonise more rapidly than countries with historically lower emissions (which tend to be emerging markets).

We do not want to incentivise investors to allocate away from emerging markets that require private capital to enable the transition.

We would encourage the separation of sovereign-related debt from corporate equity / credit, private equity and real-estate in the scenario analysis. Scenario impacts of climate change on sovereign debt are far less clear and could obscure the more useful picture that emerges from bottom-up analysis on individual corporate investments.

Q16: **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?**

No answer.

Q17**: 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, we agree.

Q18: **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?**

No answer.

Q19: **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?**

No answer.

Q20: 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.

No answer.

About Cardano

Founded in 2000, the Cardano Group is a privately-owned, purpose-built risk and investment specialist. We are widely recognised as a market leader in the provision of specialised services to private-sector and collective pension schemes in the United Kingdom and the Netherlands.

Our c.350 professionals strive to deliver better and more secure financial outcomes: stability in an uncertain world.

For Cardano, sustainability areas of particular focus are:

- The climate crisis, including net zero carbon emissions by 2050 and global emissions reduction of 50% by 2030. This informs our decarbonisation targets
- Fairer society, including respect and support for human rights and to fight against human rights abuses
- Sustainable development in emerging markets

Cardano recognises the importance of sustainability – but also the challenges involved in ‘doing it well’. We continue to develop and evolve our policies to reflect sustainability challenges. This reflects the evolution of our thinking on sustainability and the changes underway in the financial services sector, and society more broadly.

We focus our resources where:

- We are passionate
- We are knowledgeable
- We can have an impact