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The international business of Federated Hermes' response to the FCA CP20/3 proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations

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1. About the International Business of Federated Hermes and EOS at Federated Hermes

Federated Hermes is a global leader in active, responsible investment. We are guided by the conviction that responsible investing is the best way to create long-term wealth. We provide specialised capabilities across equity, fixed income and private markets, in addition to multi-asset strategies and proven liquidity-management solutions. Through our world-leading stewardship services, we engage companies on strategic and sustainability concerns to promote investors long-term performance and fiduciary interests. Our goals are to help individuals invest and retire better, to help clients achieve better risk-adjusted returns, and, where possible, to contribute to positive outcomes in the wider world. As of 30 June 2020, Federated Hermes had £507.5bn assets under management. Hermes Investment Management and Federated Investors rebranded as Federated Hermes in February 2020. All activities previously carried out by Hermes Investment Management now form the international business of Federated Hermes. EOS at Federated Hermes ('EOS') is a leading stewardship service provider. Our engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues. We believe this is essential to build a global financial system that delivers improved long-term returns for investors, as well as better, more sustainable outcomes for society. EOS represents £914.8bn of assets under advice as of 30 June 2020. EOS conducts proactive and reactive engagement with the companies in which its clients invest on a regular basis on environmental, social, governance and strategy, risk and communications concerns. Our team engages in active stewardship on behalf of clients, voting at AGMs and other shareholder gatherings to achieve our clients' responsible ownership aims and fulfil their fiduciary duty to be active owners. EOS is a stewardship services provider and does not carry out regulated activity.

2. Introduction

We welcome the fact that the FCA is proposing to regulate disclosures in relation to climate change. The proposed disclosure requirements will bring much needed clarity to the market that climate change is likely to be a material issue for all companies and is a key matter to be considered at board level. If implemented consistently, the disclosure regime proposed will help provide much needed consistent and comparable information for investors, lenders and insurers and – we hope – act to accelerate company actions to determine and respond to climate change-related risks and opportunities.

We are concerned – given the urgency of the need to mitigate further warming of the global climate and adapt to the changes that are already here and will increase – that the proposed regime strongly encourages but doesn't mandate disclosures consistent with the Task Force on Climate-related Financial Disclosures' (TCFD) recommendations. We believe that it would be better to begin the process of mandating disclosures in the final rules, starting with premium listed firms and then progressing rolling them out to other entities (standard and then AIM-listed firms), as market experience of improving disclosures grows. While companies may not be able to disclose fully against the TCFD framework from 'day one', disclosures relating to governance and risk management in line with TCFD should be relatively straightforward to begin developing and disclosing, especially given the growing amount of advice to and experience in the market. But, as the patchy application of the TCFD framework to corporate reporting shows, there needs to be a universal impetus to do so – hence why we suggest a mandatory approach to move the whole market forward.

Some flexibility will need to be shown by the regulator in overseeing in the first few years of disclosure of quantitative metrics and targets beyond scope 1 and 2 carbon foot printing – those that relate, for example to the use of scenario analysis - as custom and practice in this area is still evolving. This is especially true for companies not at the short-term forefront of transition risk to the same extent as – say – the oil and gas, power and auto sectors are. However, this could be managed by:

(i) Making it mandatory for companies in scope to make disclosures consistent with the TCFD's recommendations in their annual financial report; and
(ii) Where disclosures are incomplete, making it mandatory for companies in scope to provide an explanation of why and over what expected timescale any gaps will be addressed.

3. Response

Scope

Q1. Do you agree that our new rule should apply only to commercial companies with a premium listing, at least initially? If not, what alternative scope would you consider to be appropriate, and why?

Investment managers very frequently refer to the need for consistent and comparable information to be disclosed by investee companies in relation to climate change and wider environmental, social and governance (ESG) factors. This combined desire for good quality data and the urgency of the climate change crisis argues for disclosures across as wide a group of companies as possible. As the Disclosures Chapter of the Climate Financial Risk Forum Report states, some disclosures are better than none and companies need to get started.[1] The case for this is ever more compelling as 2020 becomes yet another year for unwanted climate change 'firsts' - from wildfires spreading across vast tracts of Australia and California in the US to declining sea ice coverage in the Arctic – and a situation still persists where companies that need to be at the forefront of the climate transition still do not all routinely disclose in line with TCFD and/or have the appropriate governance in place to deal with this strategic threat to the business[2].

For this reason, we suggest requiring disclosures of premium listed companies in or after January 2021 but then moving in January 2022 to include standard listed firms. In January 2023 this could be then rolled out to AIM-listed companies. By then there should be some experience and therefore clarity on what are the most appropriate metrics and targets to report in each sector – which will aid AIM-listed companies with compliance with the rules.

[1] https://www.fca.org.uk/publication/corporate/climate-financial-risk-forum-guide-2020-disclosures-chapter.pdf

[2] For example, recent IA research found for example that while 70% of FTSE 100 companies this year have described their governance of climate- related risks and opportunities, only 8 companies (~50%) in high risk sectors had designated a director or committee to be responsible for overseeing the company's response to climate change.

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Regardless of the level of data availability, there is plenty that companies can be doing to begin their journey toward fully reporting in line with the TCFD – for example addressing governance requirements; starting to develop, if not implement, a risk management approach that incorporates the results of scenario analysis; looking at strategy; and scope 1 and 2 carbon foot printing and starting the process of determining what the most appropriate quantitative metrics/targets for reporting are.

The Climate Financial Risk Forum guidance has also made clear that reporting is not only about data and metrics – although this is an important element. There should also be a focus on governance, risk management operations and starting to develop scenario analysis to inform strategy. This reinforces the points we have made above.

Q2. Do you agree that sovereign-controlled commercial companies with a premium listing should also be in scope? If not, why should these companies not be included?

We support sovereign-controlled commercial companies with a premium listing being included in the scope of the new rules.

Asset Managers with a Premium Listing

The FCA expects in-scope [asset managers and insurance companies with asset management businesses i.e. those with a premium listing] to prepare enterprise-level disclosures in their capacity as issuers, rather than in their capacity as regulated firms.

Q3. Do you agree with our approach?

We agree that for now the focus should be on requiring disclosures from listed companies - both financial and non-financial - only. Requiring disclosures from regulated firms can come later – when experimentation with guidance from the Climate Financial Risk Forum Report has had a chance to 'bed in'.

Providing disclosures as regulated entities is a more complex undertaking for asset managers compared to preparing issuer-based enterprise-level disclosures. This is because regulated firms will be reliant for their disclosures on the quality, consistency and comparability of informational inputs from investee companies – which is why we believe it is so important that the listing rule changes proposed in this consultation be introduced on a mandatory basis. As noted in our answer to Question 1 above, regardless of the level of data availability, there is plenty that companies can be doing to begin their journey toward reporting in line with the TCFD recommendations and firms should all make a start on the process of TCFD alignment sooner rather than later.

Nonetheless we would welcome a commitment from the FCA on a timeline for introducing new rules for asset managers and insurance companies with asset management businesses to disclose in line with the TCFD recommendation as regulated firms to enable plenty of time to prepare.

Consistency with Global Standards

Q4. Do you agree that our rule should reference the 4 recommendations and 11 supporting recommended disclosures including in the TCFD's June 2017 final report? If not, what alternative approach would you prefer, and why?

Yes, we agree with this approach. The TCFD recommendations already have significant traction with investors, banks, insurers and non-financial companies. In addition, there is already practical guidance available to both non-financial (for example, the work of the Climate Disclosure Standards Board) firms and financial firms (for example, guidance from the Climate Financial Risk Forum) on how to implement the TCFD's recommendations.

The ongoing work of the Climate Financial Risk Forum should also help develop consensus on which methodologies, data and metrics are most useful for quantitative reporting – which can subsequently further support any FCA decisions on more detailed metric-based reporting requirements from listed and, in due course, regulated firms.

Q5. Do you agree that we should make explicit reference in the Handbook guidance to the TCFD's 'guidance for all sectors' as well as the supplemental guidance for non-financial groups' accompanying each recommended disclosure? If not, what alternative approach would you prefer and why?

Yes, we agree with this.

Q6. Do you agree that we should include additional guidance which references the wider set of materials that have been published both within and alongside the TCFD's final report, as useful sources of guidance and interpretation when complying with our proposed rule?

Yes, we agree with this. For financial firms it would also make sense to refer to the Climate Financial Risk Forum guide – which was co-sponsored by the FCA along with the PRA – and provides further detailed industry-specific disclosure guidance in line with the TCFD.

Proportionality: Ability to Explain

Q7. Do you agree that we should introduce the new rule on a 'comply or explain'? If not, what alternative approach would you prefer, and why?

We don't agree with the proposed 'comply or explain' approach. As noted earlier, investment managers (along with banks and insurers) frequently refer to the need for consistent and comparable information to be disclosed by investee companies in relation to climate change and wider environmental social and governance (ESG) factors before they themselves can then disclose this information to clients. This desire for good quality data combined with the urgency of the climate change crisis argues for disclosures both across as wide a group of companies as possible and on a mandatory basis. For this reason, we suggest the FCA move to mandatory reporting, with an immediate expectation of reporting on governance, strategy and risk management but with flexibility around requirements for specific reported metrics and targets to allow systems to 'bed in'. That said, some guidance on minimum data-based reporting requirements, such as for scope 1 and 2 carbon foot printing at the very least, would be a useful place to start.

Materiality Assessment for Governance and Risk Management Disclosures

Q8. Do you agree that the recommended disclosures under the 'governance' and 'risk management' recommendations should not be subject to a materiality assessment? If not, what alternative approach would you prefer, and why?

We agree that disclosures under the 'governance' and 'risk management' recommendations should not be subject to a materiality assessment. The very fact that the FCA is requiring such reporting signals the issue is material. This will almost certainly be true for firms across the board in relation to physical risk (which is universal in some form or other), and for a significant proportion of firms in relation to transition risk, and so the FCA is on solid ground in signalling this. As such investors should expect all companies to have a governance and risk management processes in place to manage and oversee their response to climate change with clearly defined responsibilities for oversight and management.

Q9. Do you agree that issuers should ordinarily be able to make the recommended disclosures under the governance and risk management recommendations?

Yes, we agree. Much of this will need to focus on operational changes – to which there should not be a barrier with respect to implementation beyond the will and then the resources to do so.

Q10. Do you agree that explicit guidance is needed to clarify that it would be acceptable for an issuer to explain non-disclosure of these recommended disclosures only on an exceptional basis?

We generally don't agree with the 'comply or explain' premise of the question – disclosures should be mandatory. The exception to this may be in the case of reporting some of the more complex data and metrics, including scope 3 emissions, and/or the setting of targets. which may need to come some time after risk assessments and risk management plans have been put in place. These could be required – in the first year of the new rule being introduced to each group of listed companies (as per our proposal) – on a 'comply or explain' basis.

Location of Disclosures, Assurance and Statement of Compliance

Q11. Do you agree that the statement of compliance and the proposed disclosures should be made within an issuer's annual financial report? If not, what alternative approach would you prefer and why?

Yes. In the short term *how much* is disclosed in the annual report will depend on how material climate change is to the business. Initially there will be a focus on transition risk. Over time, more firms will likely realise the imperative of identifying and responding to physical risks and report this too. Disclosures deemed to be material should be made in summary in the annual report – since they should be key drivers of strategy and risk management decisions – more detail can be provided by firms in a separate TCFD report, which will also be useful for users. As set out in our answer to Question 8, governance and risk management disclosures should not be subject to a materiality assessment and should be included in the annual report (with the option to expand in more detail in a separate TCFD report) as investors should expect all companies to have governance and risk management processes in place to manage and oversee their response to climate change.

We would also stress that it is vital that a company's accounts reflect climate risks. Investors expect all companies to consider the implications of transition and physical climate change risks in their accounts. Where companies have identified significant risks arising from climate change that will materially impact their financial position, these should be reflected in critical assumptions, estimates and the use of sensitivity analysis.

Q12. Do you agree that the FCA should not require third-party assurance of issuers' climate-related disclosures at this time? More generally, we welcome views on the role of assurance for climate-related disclosures.

We agree. The audit industry is not yet skilled up to undertake such audits in any case, although we'd expect this to change over time. What will be most important to investors is transparency around assumptions and methodologies used in assessing risk and opportunity and decisions made on the basis of them.

Q13. Do you agree that an issuer should be required to include within the statement of compliance a description of where in its annual financial report (or other relevant document) its TCFD-aligned disclosures can be found? If not, what alternative approach would you prefer and why?

Yes, we agree.

The Duties of Sponsors

Q14. Do you have any feedback on the interactions between our proposed rule and the role of sponsors in assisting premium listed issuers?

No comment.

Application of Established Concepts and Principles

Q15. Do you have any other feedback related to the interaction between our proposed rule and existing legislative and regulatory requirements and industry standards and practice?

None beyond those already made. We think the FCA making a clear statement of expectations from listed firms will provide clarity to regulated firms - especially on the materiality question.

Managing Challenges, Risks and Unintended Consequences

Q16. Do you consider that our proposals adequately address the challenges, risks and unintended consequences described above? If not, what additional measures would you suggest?

We consider the proposals to be adequate but would re-iterate the importance of setting out a clear timeline for the next steps to require asset managers to report as regulated firms.

Timing of Implementation

Q17. Do you agree that our new rule should take effect for accounting period beginning on or after 1 January 2021? If you consider that we should set a different time frame, please explain why?

Yes, we agree with the 1 January 2021 implementation timescale.

Q18. Do you agree with the conclusion and analysis set out in our cost benefit analysis (Annex 2)?

We agree.

Technical Note

Q19. Do you agree with the guidance provided in the draft Technical Note set out in Appendix 2? Are there any changes that you would suggest? If so, please describe.

We agree with the draft Technical Note. As per our response to Question 1 and stressing the importance of other asset classes, we welcome the note that, "issuers should assess climate-related risks and opportunities and other ESG considerations carefully in informing their disclosures, both in respect of equity and non-equity securities".