



Climate risk and asset
management

How boards should
respond to emerging
supervisory expectations

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1. This report's purpose and intended audience

This report, which is aimed at board members and senior executives, particularly those falling within the UK's SMCR and analogous overseas regimes, explores the rapidly developing regulatory expectations and requirements for asset managers in the area of climate risk. The report provides examples of positive and negative supervisory indicators that we expect supervisors will be focussed on in routinely assessing firms' progress on capturing climate risk at the portfolio and fund level¹ (this report does not cover climate risks that the firm itself may be exposed to). It also sets out suggested questions and challenges that boards of asset managers might consider with regards to climate risk related regulatory expectations around the governance, culture and conduct of asset management firms.



2. Overview

A battery of recent regulatory initiatives, including the Task-force for Climate related Financial Disclosures (TCFD), Sustainable Finance Disclosures Regulation (SFDR), amendments to UCITS/AIFMD/MiFID II and the new Investment Firms Directive/ Investment Firms Regulation (IFD/IFR), mean that asset managers are now having to incorporate climate related risks (a combination of physical and transition risks which may pose financial/reputational damage) and considerations into their investment decision making, governance, risk management, product design and suitability processes.

Given these new requirements, boards of asset managers will want to examine in depth their firms' climate risk exposure (at the portfolio/ fund level), and ensure that ongoing processes for capturing climate risk are granular enough to take account of the specific characteristics and risk profiles of the sectors and geographies they are exposed to. Given the long term and persistent nature of climate risk, boards also need to oversee the integration of climate risk considerations in their business strategies, governance and risk management processes, in order to meet rising regulatory expectations.

They will also want to satisfy themselves that the ethos and culture they wish to promulgate on climate is operative throughout the firm and is appropriately influencing behaviours rather than generating a "tick box" approach.

Changing investor preferences and growing awareness of ESG investments, undoubtedly bring opportunities for asset managers to offer new green products and sustainable investment strategies. Boards may want to consider what this means for their firms' product offering and consequentially their competitiveness. In doing so, however, boards will also want to pay keen attention to the risk of greenwashing and misrepresentation of investment strategies. Given the complexities and uncertainties attached to climate change, these can arise inadvertently as well as through malpractice; but either way regulators have said that they will be watching closely for any indications of this.

Throughout this report we suggest key questions and challenges that boards may wish to raise. In summary, we suggest that some of the most important questions and challenges include:



Questions

Has our overall climate ethos been embedded into the culture and mindsets of the organisation in a consistent and thorough manner so that it is influencing behaviour as we would wish? What metrics should we monitor to determine the climate change related culture in our firm?

Are we overly reliant on certain external parties for technical advice on climate risk? Have we established the limitations of this advice and contrary viewpoints?

Are our climate risk assessments granular enough to capture risk nuances at the level of individual investments, sectors and geographies?

Are our climate risk assessments being used sufficiently to inform investment strategies? Are we satisfied that they are not being done primarily as a “tick box” exercise?

Are we using climate scenario analyses of sufficient breadth and severity, and with sufficient frequency, to ensure that we are capturing how our portfolios and funds may perform over time if certain climate risks crystallise? Have we identified material data limitations?

Do we as a board receive sufficient information flow on the climate risk exposure in our portfolios and funds?

Are our climate risk disclosures to investors accurate and transparent enough, using appropriately plain language?

Have we assessed the potential for reduced returns due to climate risk/climate risk investment strategies and has this been disclosed to clients appropriately?

Do we have an effective strategy and governance oversight for mitigating asset transition risk whilst avoiding premature re-adjustment of portfolios?

Where are our risks of greenwashing, even if inadvertent, greatest in terms of impact and probability? Should we be commissioning deep dives in these areas?

Have we identified, and are we managing appropriately, all material conflicts of interest in our governance and management of climate risk?

Are our stewardship/voting practices aligned with our climate and sustainability strategy so as to manage any reputational risk?



3. Introduction: the emerging regulatory architecture of climate risk

Within the space of a few years, climate change has rapidly transitioned from being an aspect of corporate social responsibility to a top regulatory issue. Regulators in both the EU and UK have moved swiftly to create policies aimed at establishing climate risk at the heart of firms' investment decisions, governance and risk management processes.

Asset managers² are in a unique position due to their role in capital allocation, ability to engage with investee companies, their position as a conduit between investors' sentiments on climate change and the market, and their fiduciary duty to investors. **The TCFD (Task-force for Climate related Financial Disclosures) defines climate risk as 'a combination of physical and transition risks which may potentially pose financial and reputational damage to financial and non-financial services firms'**. Under the TCFD, asset managers are required to report on governance, strategy, risk and metrics around climate risk.

Given the scale of the value that asset managers manage, and their role in the economy, regulators are naturally interested in the asset management sector's processes for identifying and managing climate risk, and for communicating these to investors, particularly given the breadth of their exposure to asset classes, sectors and geographies worldwide.

The TCFD, which is currently a global voluntary standard and sets out disclosure recommendations for a wide range of industries to allow investors and other stakeholders to assess and price climate-related risks and opportunities, will become mandatory in the UK for the largest authorised asset managers in 2022 and for smaller firms in 2023. The 2020 TCFD status report found that whilst global support for TCFD disclosures has increased significantly, asset managers' current climate risk reporting to their investors is currently likely to be insufficient⁴ to capture the climate risk that investments are subject to. This may prompt other countries to make this a mandatory standard for asset managers in due course.

Level 1 measures of the [SFDR](#) are due to come into effect in the EU on 10 March 2021 and will impose significant requirements on asset managers to disclose how sustainability risks are integrated into investment decisions and the consequences of sustainability risk on product returns. **The SFDR⁵ defines 'sustainability risk' as 'an environmental, social or governance event or condition that if it occurs, could cause a negative material impact on the value of the investment...'** and requires firms to assess this type of risk on a continuous basis, whilst conducting due diligence prior to making investment decisions. The UCITS and AIFM directives are also in the process of being amended to include requirements for taking account of sustainability risk in the process of making investment decisions (due to come into effect in Q1/Q2 2022). The SFDR and amendments to UCITS and AIFM directives are both part of EU's Sustainable Finance Action Plan.

The SFDR and sustainability risk related amendments to UCITS and AIFMD will not automatically apply in the UK as they will come into effect following the end of the Brexit transition period. The UK has not provided concrete indication of whether equivalent domestic regimes will be introduced, however it has made clear that green finance is high on its agenda. On 07 September 2020, City Minister John Glenn stated in a [speech](#) addressed to the Investment Association that "... at the very least, [the UK] will match the ambition of the EU Sustainable Finance Action Plan". As such UK asset managers may benefit from familiarising themselves with the EU's direction on climate risk.

Additionally the European Banking Authority (EBA) published a [discussion paper](#) on the management and supervision of 'ESG risk' in credit institutions and investment firms, in October 2020 which defines **'ESG risk' as 'the risks of any negative financial impact to [a credit institution/investment firm] stemming from the current or prospective impacts of ESG factors on its counter parties (i.e. end-investor/ issuer) ...'**. If the suggestions in the discussion paper are formalised into proposals, they will create significant regulatory requirements for those firms in scope of the EU's Investment Firms Directive (IFD), to integrate

ESG risk considerations into their strategy, governance and risk frameworks. The UK is in the process of consulting on an equivalent domestic regime, called the Investment Firms Prudential Regime (IFPR). The FCA has stated that, with regards to disclosure of ESG risks under the IFPR, it will be following the EBA's consultations closely in order to determine their relevance to the domestic regime.

However, since there is currently no standardized method of calculating climate risk, asset managers will need to ensure their own proprietary processes for doing so are robust, and be able to demonstrate to regulators that the appropriate level of research and due diligence has been carried out to identify specific climate risks affecting specific investments. Asset managers will need to consider climate risk on both an enterprise level and on the level of individual portfolios and funds.



4. Key climate risks affecting asset managers

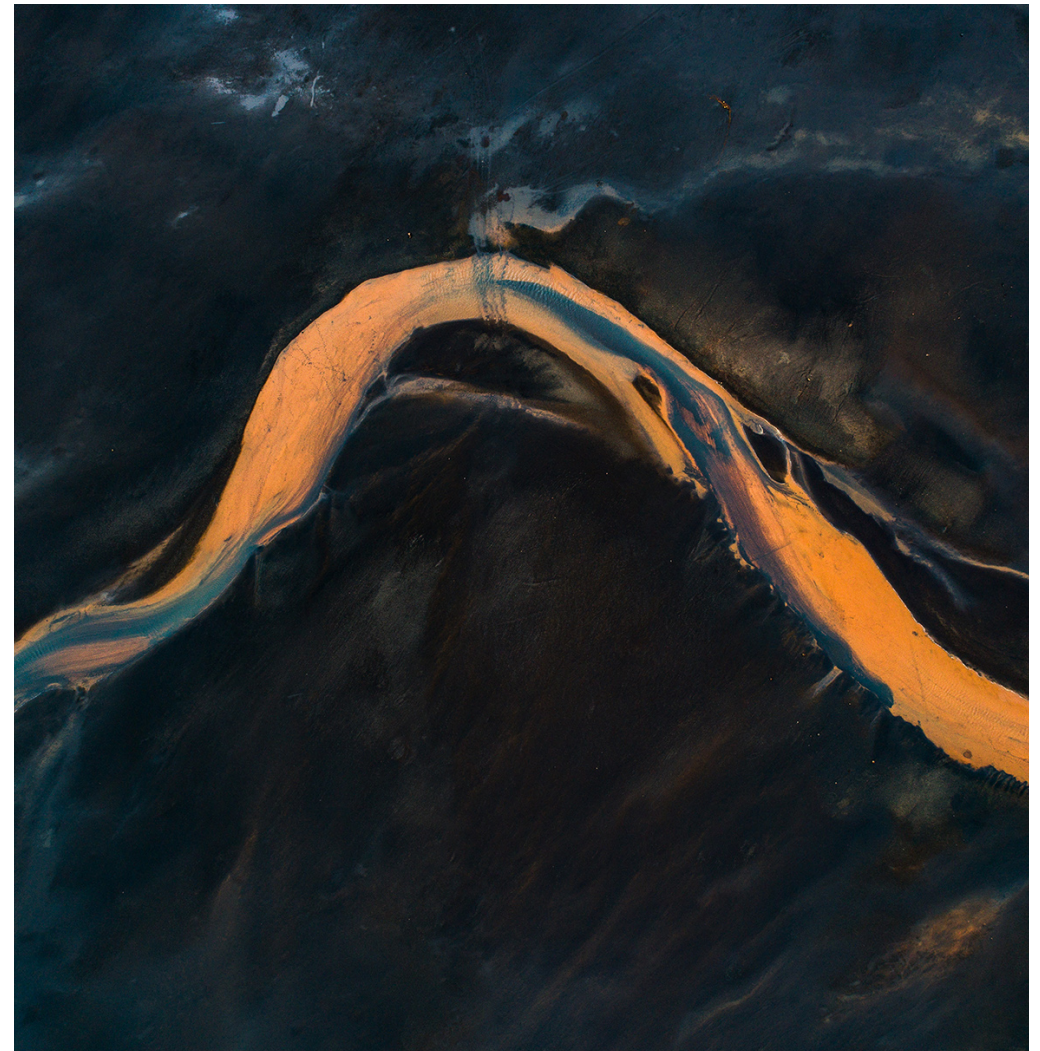
As recognised by both the TCFD and the EBA, climate risk can affect firms in the form of physical or transition risk. These may have significant consequences for asset managers, as set out below.



4.1 Physical risk

A physical risk can either be an 'acute risk' i.e. a one-off physical event such as flooding/hurricanes or a 'chronic risk' i.e. from the long-term effects of climate change events.

Since asset managers invest in a range of asset classes, sectors and geographies, the companies that they invest in may be exposed to physical risks that may affect certain sectors/geographies. To the extent portfolios and funds are not positioned to mitigate and manage this risk, investors' investments are subject to heightened valuation risk.





4.2 Transition Risk

There is now mounting regulatory and social pressure on companies in all sectors to adapt their operations and activities to mitigate environmental externalities. This may result in the rapid emergence of new risks that may ultimately call into question the viability of certain sectors. Asset managers will thus want to consider how the following are affecting investee companies:

- **Technological Risk:** many companies are going through, and will continue to go through, technological and operational changes so that they may operate more sustainably. Investments in technology may result in a lower short-term profitability and hence dividends available for investors. Whilst this may not be a reason to divest from a company, asset managers will need to monitor closely the implications of such transitions. This will be particularly important for portfolios and funds that have an income objective.
- **Reputational Risk:** media announcements regarding harmful or negligent environmental practices in relation to certain companies can cause immediate reputational harm, which may affect their market value.
- **Market Risk:** the value of companies may become increasingly vulnerable to changes in supply due to climate change events, changes in demand due to changing social expectations around climate change, and changes in product availability arising from the overall shift towards more sustainable practises.



4.3 Liability Risk

As expectations around assessing climate risk and making relevant disclosures become regulatory requirements, investors and other stakeholders will have legal avenues to challenge asset managers on inadequate disclosures and instances of greenwashing, exposing firms to liability risk. Firms that have, in recent times, publicly pledged their commitment to sustainable investments and stewardship may be particularly susceptible to this.

Legal/compliance departments of asset management firms may require significant investment in order to build expertise in the relatively new area of sustainable finance to be able to address potential climate-related litigation. Firms exposed to litigation may also incur regulatory fines and be exposed to reputational damage via media censure.

Investee companies, particularly those belonging to carbon intensive sectors, may themselves be exposed to litigation for alleged long term environmental and climate related damage and/or not adopting sustainable operations fast enough. Any such litigation is likely to affect companies' reputations and could potentially lead to compensation claims, both of which could reduce market values and investor returns. In this regard, asset management firms would benefit from following investee companies' progress on their sustainable agenda and be alert to any relevant media or third party censure and the risk of legal action.

5. Governance and culture

The overall climate change related culture at asset management firms will be crucial for regulators as much as for any other area of regulatory scrutiny. The aforementioned [EBA discussion paper](#) provides that "...the EBA sees a need for [credit institutions and investment firms] to incorporate ESG risks (interchangeable with climate risk for the purposes of this paper) in their internal governance arrangements". The EBA has suggested that this should cover the 'tone at the top' alongside practical decision making in relation to relevant functions. Other regulators are also likely to seek evidence that a central firm ethos or a set of beliefs around climate change is in place and actively influencing the firm's culture. In this respect a key regulatory indicator will be whether staff lower down the organisation share the board's target ethos on climate, understand the board's climate risk strategy and take it seriously to the extent that it actively influences decision-taking.

In order to ensure that the several regulatory burdens regarding tackling climate risk are satisfied, asset managers' management bodies will need to create a strong internal governance framework for climate risk. This may include allocating responsibilities regarding oversight of climate risk to certain individuals, creating

specialised internal climate risk committees, ensuring that any such committees meet regularly, and ensuring that the risk, compliance and audit functions are continually up to date on all decisions and challenges regarding climate risk.

Regulators will want evidence that boards have the competency required to challenge risk identification, assessment and management processes relevant to climate change. A key test here will be the board's use of expert opinion and advice and whether it is overly dependent on this. Boards will also need to ensure that management bodies have the right expertise and talent to integrate climate risk into the relevant processes. Appropriate MI should be provided to the board so that they are able to determine whether climate risk processes are functioning as intended and so they might have sight of any investor complaints related to climate risk. Boards must also ensure they have the capability to assess climate MI and to be able to challenge methodologies for climate risk assessments, as and when appropriate. Boards must satisfy themselves that MI is updated to reflect any developments in the fast-moving sustainable finance landscape.

The EBA discussion paper on ESG risks also suggests that 'a robust and appropriate incentives-based mechanism is important to support achieving an appropriate risk culture and should also account for ESG risks'. The SFDR also requires asset managers to update existing remuneration policies to ensure that they are consistent with integrating sustainability risks. Boards may want to assess to what extent they wish to use the alignment of remuneration policies to climate risk outcomes in order to maintain and disseminate a positive climate risk culture, and the appropriate methods for doing so. This may include linking parts of pay to climate risk related objectives or offering incentives for employees who suggest innovative ways of streamlining the climate risk assessment processes.

Lastly, Boards will be expected to monitor their firms' culture in relation to climate risk. This could be done by assessing the number of times employees engage in practices that conflict with firms' ethos, by encouraging the use of a whistleblowing policy or by the use of employee surveys. With growing investor and social pressure on financial services firms to tackle climate change, regulators will be keen to ensure that climate risk related issues are not just seen as a tick-box exercise, but that employees appreciate the value of engaging with them.

Positive supervisory indicators

- Boards are aware of industry trends in relation to climate change and understand regulatory concerns and perspectives.
- Boards are actively considering deep dives into areas of highest risk.
- Boards have the competency to oversee and challenge the creation of climate risk processes and assess whether they are functioning as intended.
- Boards are aware of any recurring deficiencies in the climate risk assessment process and associated and are able to discuss these and any relevant remedies with regulators when required.
- Boards periodically receive appropriate climate related MI.
- Boards have demonstrated an ability to assess MI and are actively challenging climate risk methodologies and perspectives.
- There is clarity among staff on where the responsibilities lay for climate risk assessments.
- Staff are not only aware of these cultural values, but act in accordance with them and receive appropriate recognition and rewards for doing so.

Negative supervisory indicators

- Boards are not receiving regular and rigorous MI on how climate risk processes are faring.
- Boards do not regularly challenge climate risk related issues or only defer to a single individual in relation to them.
- Boards receive incomplete information on climate risk processes and any relevant complaints.
- Climate risk related discussions at board meetings are rare.
- Employees are not sure about where responsibility for climate risk lies.
- The integration of climate risk into relevant processes is seen as a tick box exercise.
- Compliance, audit and risk functions are not fully versed on the board's assessments and opinions on how climate risk must be tackled in the firm.
- Board discussions regarding climate risk are narrowly focused and often centre around only one aspect of climate risk.



Questions for Boards

Do we have the right skills and experience at the board and senior management level to challenge climate risk related issues effectively?

Has our overall climate ethos been embedded into the culture and mindsets of the organisation in a consistent and thorough manner so that it is influencing behaviour as we would wish? What metrics should we monitor to determine the climate change related culture in our firm?

Are our existing processes for monitoring firm culture sufficient or do we need to expand or change them?

Are there any factors that may reduce the effectiveness of our processes for capturing climate risk? How do we identify and monitor these factors?

What metrics do we wish to consider in order to determine how effectively climate risk is being captured for different portfolios and funds?

Are we adequately incentivising and rewarding staff for acting in line with our climate risk culture and ethos? Are these rewards effective in driving change?

Is there a case for creating a dedicated internal climate risk committee?

6. Strategy and business model

Increasingly, regulators will expect asset managers to address climate risk at a strategic level.

The aforementioned amendments to UCITS and AIFMD, the imminent SFDR rules and the TCFD requirements, taken in combination, will require asset managers to address a number of strategic issues. Asset managers will have to consider how climate risk may affect their investment strategies for individual funds and portfolios, as well as the integration of sustainability risk into organisational procedures, systems and controls, resourcing and due diligence (amendments to UCITS and AIFMD). SFDR will require asset managers to disclose how sustainability risks are integrated into the investment process and remuneration practices.

Asset managers will need to assess how existing investment strategies and other strategic operations are affected by climate risks, how these must be adjusted to address the risks and their short- and long-term implications.

Firms will also need to be aware of the limitations of any climate risk related data and technical advice they receive and should ensure that this advice is drawn from a sufficiently wide range of sources and viewpoints. In parallel, it will be important to establish a clear board consensus on the limitations of that advice and awareness of contrary external viewpoints.

There is likely to be value in boards promulgating a firm-wide set of climate change related investment principles appropriate to the scale of their business. These will guide the governance and culture of the firm and form the starting point for climate and sustainability risk to be embedded in the firm's relevant operations and procedures. A strong culture based around a consistent message from the top will prevent misunderstandings within the firm as more regulations come into effect and the sustainable finance landscape continues to become larger and more complex.





Positive supervisory indicators

- The firm has a strong board-led climate related investment culture, which is evidenced in the firm's documents and decision making and guides other relevant activities in the firm.
- The firm's climate change risk strategy is reflected consistently in organisational arrangements.
- The climate change ethos, and relevant cultural implications have been explained to staff throughout the organisation, particularly to those in compliance, risk and legal functions.
- There are processes for continually reviewing investment strategies in light of relevant climate risks.
- Potential implications of changes in investment strategies on future performance are made clear to investors.
- Gap analyses have been conducted on relevant operations within the firm to ensure that they have been adjusted to account for climate risk.



Negative supervisory indicators

- There is no central strategy or guidance on climate risk or climate related investing.
- There is no joined up approach to climate risk, with separate groups within the firm approaching the subject in different ways that do not align.
- The firm has no central ethos for climate related investments, and this is left to the discretion of individual portfolio managers.
- There is no indication that investment strategies, organisational procedures, systems and controls and resourcing have been reviewed to account for climate risk.
- The firm is overly reliant on one or two sources of technical advice on climate risk, and advice is not adequately debated or challenged.



Questions for Boards

Are the overall climate related principles being distilled and embedded into the different relevant functions of the firm? Have we got the expertise and experience amongst staff at all levels to do this?

Are we applying sufficient resource and technical expertise to uphold our climate ethos/ climate change principles?

Recognising the importance of "tone from above", is there sufficient "buy in" to our climate ethos and culture at middle management levels?

Is there any indication that integrating climate risk considerations is not proceeding evenly across firm functions?

How often do we change investment strategies based on climate risk assessments? Is there any indication that it is too often or not often enough?

Are we overly reliant on certain external parties for technical advice on climate risk, and are we aware of the limitations of this advice?

Do we sufficiently challenge and debate technical advice received in the area of climate risk? How often do we review our technical advice providers to ensure we are receiving 'best in market' service?

7. Conduct, disclosure and the risk of “greenwashing”

The TCFD and SFDR require firms to make transparent disclosures, with the aim of providing the right quality and quantity of information to investors and other shareholders.

With regards to climate risk assessments, the TCFD recommends that asset managers disclose to investors ‘alongside their regular disclosures’, the role of the board and senior management, how climate scenario analyses are employed and how climate related risk and opportunities are factored into investment strategies at the portfolio and fund level.

The SFDR also requires pre-contractual disclosures in fund prospectuses with regards to how sustainability risk has been integrated into the investment decision process. Funds should consequently ensure they disclose any pertinent information in their prospectuses, or in the case of portfolio/wealth managers, through suitability reports. Asset managers should ensure that disclosures are in plain language that is easily understood by retail investors.

Furthermore, whilst making disclosures, or discussing the climate related risk and opportunities of various investments with investors, asset managers should be highly alert to the risk of greenwashing. Greenwashing occurs when investment products are made to appear as having a greater positive environmental impact than they actually do. Conventionally, greenwashing has been seen as a deliberate malpractice. However, due to lack of accurate data available on issuer companies, greenwashing can also occur inadvertently. As such, asset managers should attach high priority to disclosing to investors any data limitations that may have affected their climate risk assessments.

If investment strategies for individual portfolios require adjusting to mitigate climate risk, transparent discussions should be had with investors to ensure that the adjustments do not compromise or conflict with their existing objectives and other risk limits. If investment strategies for funds require adjusting, this may be made clear in prospectuses and any relevant consequences on the performance of funds must be made clear too.

Furthermore, as conflicts of interests are a key ongoing concern for regulators, firms will need to identify and mitigate potential conflicts of interests present in their climate risk assessment processes. If it appears that the re-positioning of portfolios or funds for the purpose of mitigating climate risk has led to excessive or unnecessary switching or churning, this will be looked upon unfavourably by regulators. Boards will therefore need to satisfy themselves that systems and compliance monitoring processes in place will identify any such churning.

Conflicts may also arise if asset management firms have other business interests with investee companies, which incentivise them to not capture climate risk in them appropriately or to not divest from them if it appears that the climate risk may negatively affect investments. Boards must be able to demonstrate to regulators that any potential conflicts identified are being actively and appropriately managed

Positive supervisory indicators

- Relevant documents i.e. prospectuses or suitability reports contain relevant details of climate risk assessments in concise and clear language, particularly where it has been found that the risks may affect expected returns.
- The rationale for re-positioning portfolios is well documented and is disclosed to investors and available for regulators' review.
- Data limitations have been recorded and openly discussed with investors as and when appropriate.
- Staff are trained in potential climate change related conduct issues such as greenwashing and mis-representing investment strategies.
- Conflicts of interest policies are amended to account for potential conflicts that may arise whilst assessing climate risk.

Negative supervisory indicators

- There is no evidence of pro-active attempts to mitigate the perception of greenwashing.
- Staff are not alert to the possibility of greenwashing.
- Disclosures do not adequately explain how the firm takes climate risk into account in its operations/ investment strategies or there is excessive detail which is not fit for purpose.
- There is no evidence that compliance and risk functions are actively monitoring the potential for conflicts with investors' interests such as switching and churning.
- When compliance has identified the potential for certain conflicts, these have not been acted upon by management and boards.



Questions for Boards

Do we have processes for assessing whether data limitations severely affect our ability to capture and disclose climate risk? If this is the case, are we disclosing this to investors with sufficient clarity and frequency?

Where are our risks of greenwashing, even if inadvertent, greatest in terms of impact and probability? Should we be commissioning deep dives in these areas?

Is there any potential for greenwashing in the way that we explain our processes or market our products? Are we adequately mitigating the risk of greenwashing? Is it being adequately captured in our board MI?

How do our "green" products benchmark against others in the market?

Do our climate risk assessments take account of second order effects, for example non-sustainable practices by those who administer, distribute and use our products?

Have we identified all material conflicts of interest in our governance and management of climate risk? Have we ensured effective management of these?

Have we any interests in investee companies that may incentivise us to not disclose climate risks that may affect client investments in them?

Are our climate risk disclosures to client accurate and transparent enough, using sufficiently plain language?

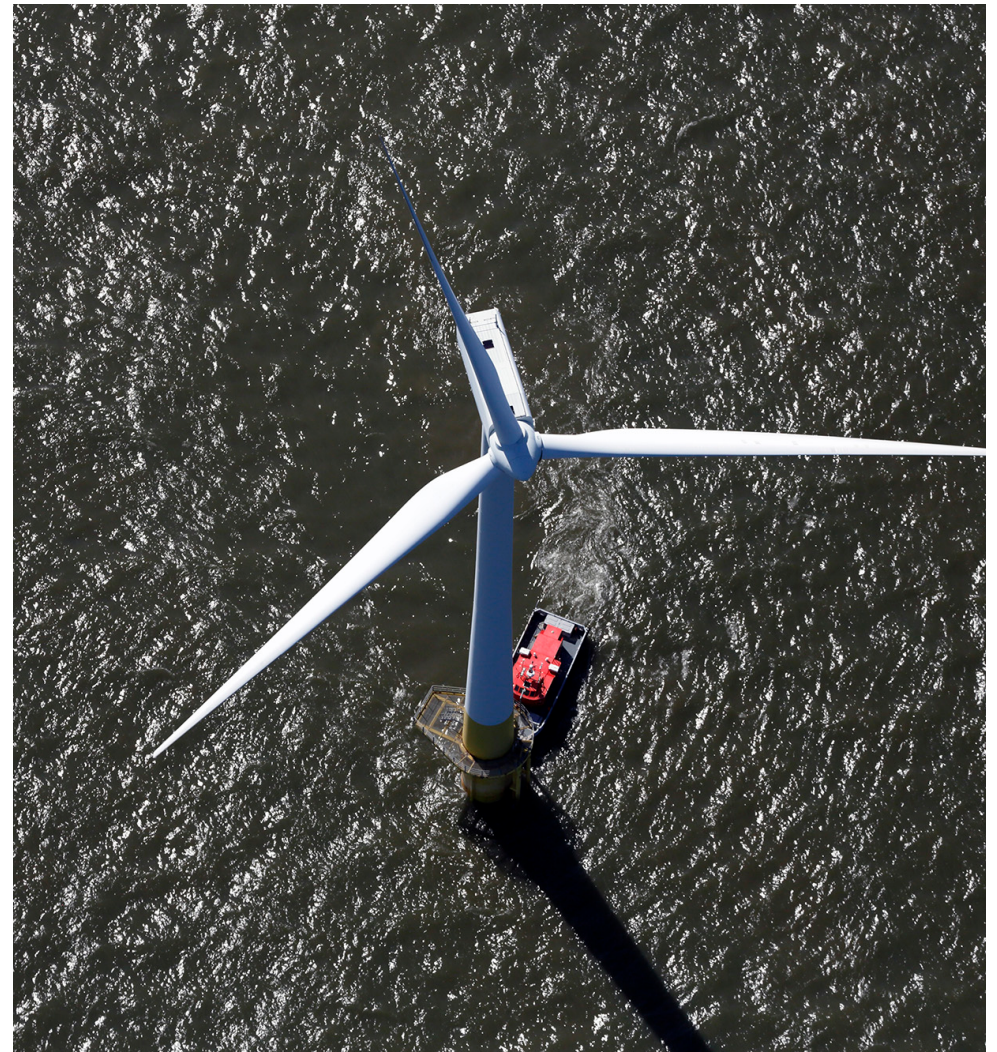
Have we assessed the potential for reduced returns due to climate risk/climate risk investment strategies and has this been disclosed to clients appropriately?

8. Identifying and integrating climate risk



8.1 Capturing climate risk in asset classes, sectors and geographies

Asset managers will need to identify, assess and manage climate risks within the different asset classes, sectors and geographies they invest in. To demonstrate robust and extensive climate assessments to regulators, asset managers will need to perform detailed due diligence which takes into account the varying climate risk considerations for the different categories of investments. As an example, climate risks may crystallise in different time horizons for property as compared to infrastructure, and physical risks may be more relevant for sectors dependant on natural resources whilst technological risk may be more relevant for investee companies providing only services.

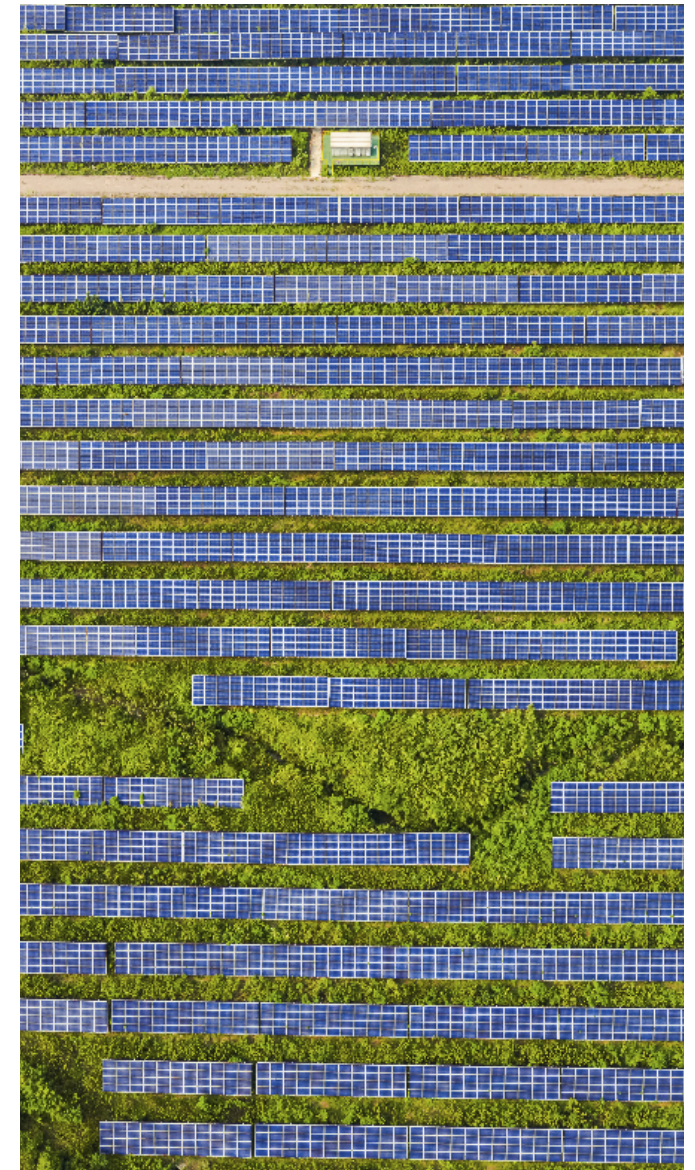


Positive supervisory indicators

- Senior Management has put processes in place to allow for extensive research and analysis of the different climate risk issues affecting investments.
- Investments are analysed for climate risk against their sector and geography, and in the context of technological, societal and policy changes.
- Relevant staff are trained and educated in the different issues affecting climate risk.
- The firm has access to the right data providers, the tools to analyse the data if required and the ability to spot incomplete data.
- Climate risk assessments are carried out periodically to account for any changes in climate risks.

Negative supervisory indicators

- The climate risk assessments are “one size fits all” and overly process driven and the nuances of different investments, sectors and geographies are not taken into account.
- Overly broad generalisations are applied to sectors or geographies and the internal governance, strategy and risk processes of individual investee companies are not taken into account.
- Boards and senior management are overly focused on only one or two types of climate risks to the exclusion of other types.





8.2 Climate Scenario Analysis

Many industry stakeholders believe that climate risks are not fully priced into financial assets and have the potential to cause disruptions in financial markets when prices adjust in response to crystallisation of these risks. In addition to this, given that climate risks could have potential consequences over the short, medium and long term, and that it is difficult to predict accurately when or which physical risks may crystallise, regulators will want to see evidence of how asset managers are determining the potential effects of climate risks on portfolios and funds over varying time horizons.

Scenario analysis is the process of identifying and assessing the potential implications of a range of plausible future scenarios under conditions of uncertainty.⁶ This type of analysis would allow companies to consider the potential implications of various climate risk scenarios on their strategy, costs, growth and operations, over varying time horizons.

The TCFD and the EBA suggest that scenario analysis is a useful tool for determining how climate risk may evolve under certain circumstances and what the implications may be for individual companies, and several industry stakeholders have put forward ideas on how to utilise this type of analysis.

In line with the TCFD recommendations, some issuer companies will have already carried out climate scenario analyses to determine how they might fare under certain conditions. This may allow asset managers to undertake climate scenario analysis at an individual portfolio or fund level, using the results of analyses provided by individual issuer companies. However, there is no standard methodology for conducting climate scenario analyses and asset managers must satisfy themselves the analyses done by issuer companies is suitably robust, failing which asset managers will need to consider supplementing this with their own analysis.

Firms will want to ensure that their climate scenario analysis considers the implications of a variety of positive and negative scenarios. Firms should consider making their assumptions and methodology transparent, and aim to create comparable scenarios that can be replicated year on year. Any scenarios should also consider a variety of time horizons.

Furthermore, a significant amount of data is likely to be required to ensure the analysis is robust and valid. Firms will therefore need to review their disclosure of the limitations of the data to investors and must take this into account whilst using the results of the analyses to inform investment decision making as well as investor marketing and communication generally.



Positive supervisory indicators

- There are appropriate tools and processes in place to consider the long-term consequences of climate risks on portfolios and funds.
- There is enough variation in scenario analyses to account for a wide and credible range of future possibilities.
- Scenario analyses can easily be compared with one another.
- Data limitations are understood by the firm and recorded alongside the analysis.
- The firm is engaging with peers and other industry stakeholders to share information on climate scenarios (while being mindful of any competition law considerations).
- Scenario analyses findings are discussed during investment decisions, and investors are made aware that these are different possibilities, not certainties.
- Fund prospectuses, other relevant documents, or appropriate areas on the asset manager's website describe the potential effect of climate risk on respective funds depending on certain future events.
- There are clear records of previous climate scenario analyses and whether and how they were used to inform investment strategies.



Negative supervisory indicators

- Climate risk is seen as a short-term risk or a regulatory compliance duty only; longer-term risks are not properly considered.
- Climate risk assessments are seen as a one-off exercise by senior management and are not regularly refreshed.
- Portfolios and funds are re-positioned based on initial assessments but are not continually monitored.
- Climate scenarios are not varied enough in terms of the types of events that have been considered.
- There are no records of climate scenario analyses being carried out for funds and no indication of results on prospectuses or websites.

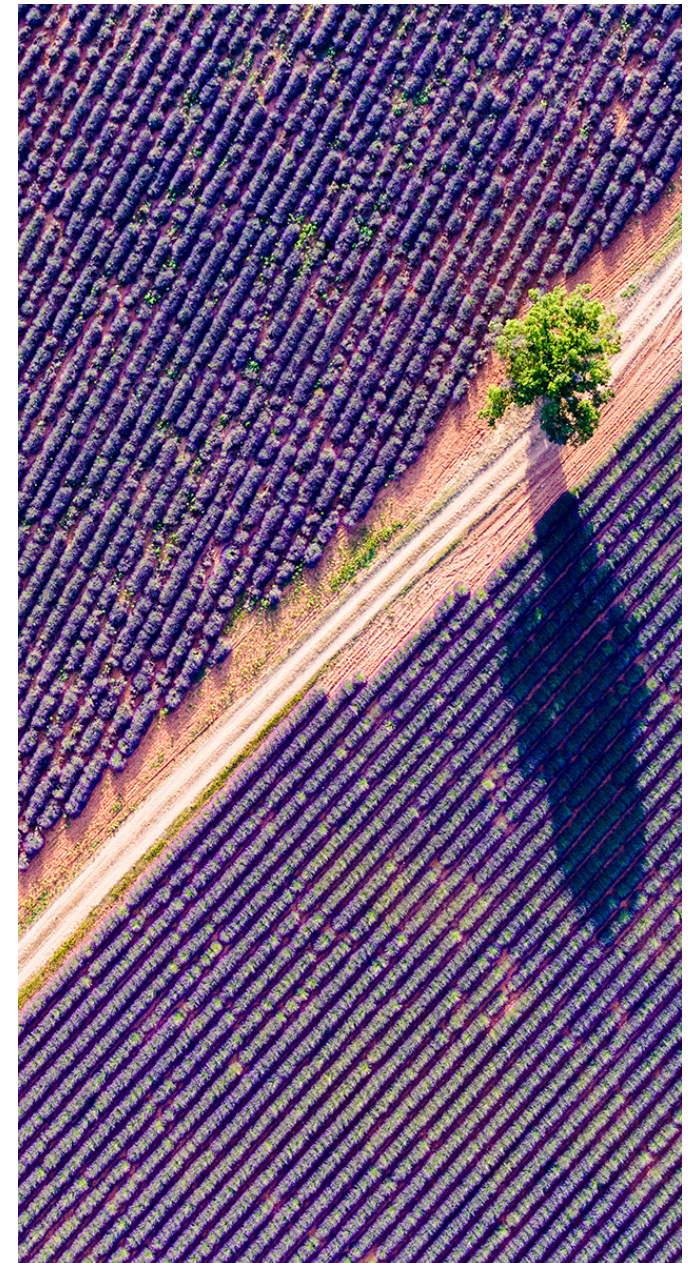




8.3 Incorporating climate risk into investment strategies and the overall risk framework

An important regulatory objective is that investors are aware of and understand the relevant risks and opportunities that climate change may pose to their investments. Hence it is crucial that asset managers are able to demonstrate to regulators that climate risk assessments have been pro-actively used to inform investment strategies, whether for portfolios or funds. Regulators will also expect that approaches to climate risk are embedded in the firm's overall risk framework, and that senior management has a clear indication of how relevant climate risk is to their portfolios and funds relative to other risks.

Ensuring that compliance and risk functions continually monitor the processes for climate risk assessments, and whether they are being utilised to inform investment strategies, will be essential to demonstrate to regulators that this risk is being given due consideration.





Positive supervisory indicators

- Climate risk has demonstrably been factored into investment decisions i.e. where portfolios and funds have been repositioned due to climate risk, there are records of the rationale behind this.
- The overall risk management framework includes climate risk and there are records of ongoing assessments of the relative importance of climate risk to the firm.
- There are records of assessments of the relative importance of climate risk to individual portfolios and funds.
- Compliance procedures are in place to ensure climate risk assessments are being carried out at the appropriate frequency and are robust.
- Relevant fund documents explain the relative exposure to climate risk of the fund and what this may mean in terms of satisfying investors' objectives over the relevant time horizons.



Negative supervisory indicators

- Boards are not aware of the importance of climate risk for the firm and are not able to explain to regulators the relative importance of the risk to the firm, as compared to other risks.
- Climate risk assessments are seen as a tick-box exercise by senior management and are not considered whilst making investment decisions.
- Climate risks are not continually monitored.
- The approach to climate risk is carried out in isolation and is not embedded into the overall risk framework.





8.4 Incorporating sustainability risk into UCITS & AIFMD

The European Securities and Markets Authority (ESMA) provided [final technical advice](#) in April 2019 on amending the UCITS and AIFM directives to include **sustainability risk considerations** into organisational procedures, systems and controls, resources and existing risk frameworks. At the time of writing, the new rules are expected to apply from Q1/Q2 2022.

ESMA's technical advice stipulates that UCITS and AIF management companies must have sufficient human and technical resources for the assessment of sustainability risk and that senior management will collectively be held responsible for its integration into firms' processes. Furthermore, in identifying conflicts of interests, asset managers must include any conflicts that may arise in relation to the integration of sustainability risk – examples of these include greenwashing or misrepresentation of investment strategies.

ESMA has suggested that UCITS and AIF management companies should take an integrated approach to due diligence and risk management, and that due diligence (of investee companies) processes are most effective when they assess sustainability both in relation to:

- Risks of a decrease in financial value/performance for portfolios due to sustainability-related causes.
- The potential long-term consequence of the investee companies' business activities on sustainability factors (as defined in the SFDR).



8.5 Aligning with investors' sustainability preferences

New EU rules will require firms providing MiFID investment advice and portfolio management to obtain investors' sustainability i.e. environmental, governance and social – ESG preferences ([see our recent paper here](#)) as part of their periodic suitability assessments. These rules are due to come into effect in Q1/Q2 2022.

Due to regulators' strong focus on suitability and investor outcomes, and asset managers' role as conduits between retail investors and the real economy, it will be important for asset managers that provide advisory services to be able to demonstrate that climate risk assessments for individual portfolios have been considered alongside the relevant investors' sustainability preferences and overall suitability requirements, including general risk appetites.

Regulators will also expect firms to have robust compliance processes to remedy promptly any contradictions between investors' preferences and risk appetite and the climate risk assessments of their portfolios. Records of all relevant conversations should be maintained to inform investors' future investment strategies and to help resolve any potential disputes.

Questions for Boards

Are our climate risk assessments granular enough to capture risk nuances at the level of individual investments, sectors and geographies?

Is our climate risk appetite adequately integrated into our control and limit setting processes and operational risk management?

Can we demonstrate to regulators and other third parties that climate risk has been integrated into the overall risk framework?

Are our climate risk assessments being actively used to inform investment strategies? Are we satisfied, and can we demonstrate that they are not being done primarily as a “tick box” exercise?

Are we using climate scenario analyses of sufficient breadth and severity, and with sufficient frequency, to ensure that we are capturing how our portfolios and funds may perform over time if certain climate risks crystallise? Are aware of material data limitations?

Are our product designs, investment and marketing strategies being sufficiently informed by investors’ sustainability preferences, climate scenario analyses and climate risk assessments?

Are we updating investors adequately on changes in climate risk exposures and any associated fund re-positioning?

Do we as a board receive sufficient information flow on the climate risk exposure in our portfolios and funds?



9. Asset transition risk

In the context of climate risk, assets that are prematurely devalued or face unanticipated write-downs due to climate related events are called 'stranded' assets.

Assets can become stranded due to physical risks crystallising, i.e. climate events destroying certain physical inventories, or due to certain products and sectors becoming obsolete as a result of a regulatory or societal move away from those activities contributing to climate change. Regulators will expect asset managers to pay keen attention to the possibility of portfolios and funds being invested in certain companies or sectors that may be prone to stranded asset risk.

Some sectors such as the energy industry may be more susceptible to stranded assets. However, re-positioning portfolios too soon may result in unnecessary costs to investors. Where this is the judgement reached, it is important that asset managers can demonstrate an audit trail of the relevant decision-taking. Furthermore, asset managers need to ensure that if portfolios are being re-positioned due to the potential for stranded assets, this is done in a way that it does not compromise investors' returns or objectives, or if it does that this is being adequately explained and communicated.



Positive supervisory indicators

- Firms undertake appropriate due diligence on individual companies and sectors to determine whether there is a potential for assets being stranded.
- Before re-positioning portfolios, the rationale is discussed with any advisory investors and non-advised investors are made aware of the relevant costs and why the decision was made.
- There are detailed audit trails on asset transition risk assessments done on portfolios and funds.
- There is evidence that the firm continually monitors asset transition risk, potentially by investing in research on how certain physical and liability risks are evolving.

Negative supervisory indicators

- Portfolios and funds are re-positioned without sufficiently robust analysis of whether assets are likely to be stranded in certain sectors.
- For advisory investors, general objectives and risk appetites are not adhered to whilst re-positioning.
- Asset transition risk is not continually monitored; relevant staff have little understanding of the implications of 'stranded assets'.

Questions for Boards

To what extent are our portfolios and funds exposed to asset transition risk? In what time horizon, and with what certainty, is this risk expected to materialise?

Do we have an effective strategy and governance oversight for mitigating asset transition risk whilst avoiding premature re-adjustment of portfolios?

How do we ensure that investors are aware of the costs of adjusting portfolios due to asset transition risk?

Are we at risk of being caught up in a 'green bubble' and being pushed to take action prematurely? Are we sufficiently communicating any "bubble risks" to investors?

Do the sustainable investments and green technologies that we are building exposure to have credible track records? If challenged, could we demonstrate their green credentials?

10. Stewardship

In 2019 the FCA launched a joint discussion paper ('Building a regulatory framework for effective stewardship') with the Financial Reporting Council (FRC) examining what the minimum expectations should be around effective stewardship. This discussion informed the creation of the voluntary [UK Stewardship Code](#) which consists of 12 principles for asset managers, which focus on the activities and outcomes of stewardship. The expectation is for stewardship to be exercised across all asset classes including listed equity, fixed income, private equity and investments outside UK.

Organisations that wish to become signatories to the UK Stewardship Code are required to produce an annual Stewardship Report explaining how they have applied the Code in the previous 12 months; the FRC will evaluate the reports and those that meet the reporting expectations will be listed as signatories to the Code. Asset managers must submit their first report to the FRC by 31 March 2021 to be considered.

The FCA has also [stated](#) that it is working with other regulators to address remaining barriers to effective stewardship including pursuing a number of actions to promote better disclosure of firms' stewardship practices and outcomes.

Separately, the [EU Shareholders Rights Directive II \(SRD II\)](#) which became effective in June 2019, and applies to MiFID firms providing portfolio management, AIFs and UCITS funds, requires asset managers to draft and disclose engagement policies that must cover, amongst other things, how the firm monitors and conducts dialogues with investee companies and uses its voting rights. Furthermore, the [ESMA technical advice](#) on integrating sustainability risks into UCITS and AIFMD, suggests that engaging with investee companies would be a prudent way of conducting due diligence for the purposes of determining sustainability risk.

Clearly, there is strong regulatory expectation that asset managers must use their power of capital allocation and voting to allow investors' voices to be heard by the boards of issuer companies. There is also a growing regulatory interest in the disclosure of details of the engagement with investee companies. In the context of climate change, asset managers may be able to assist issuer companies with robust climate scenario analyses, suggest incorporating sustainability practices into their long-term strategies, and use their voting rights to veto unsustainable practices.

Due to growing social expectations around sustainable investing, there is a clear reputational risk for asset managers who claim that climate change is at the heart of their investment strategy, but do not follow through by engaging with issuer companies and vetoing contradictory practices. There has also been growing media censure of asset managers who have publicly stated their intentions to engage in robust stewardship but have not focused on resolving any conflicting behaviour within their firm. Boards will benefit from carefully considering whether the existing level of stewardship is consistent with current regulatory/investor expectations and whether the firm has the right resources and expertise to uphold any public statements of stewardship.

Boards may also wish to question how effectively the stewardship process is integrated across all stages of the investment process, as regulators and investors are likely increasingly to seek evidence of the role of engagement with investee companies in capital allocation decisions.

Questions for Boards

Are we in a position to make public statements about our stewardship commitments? If we do, will we be able to consistently uphold the statements, or do we run significant reputational risk?

Are our stewardship/voting practices aligned with our climate and sustainability strategy?

If in scope, should we join voluntary stewardship codes? What are the reputational implications and risks of this? Have we the systems, MI and practical resources to adhere to any such codes consistently and for the board to monitor such adherence?

Should we establish separate committees for stewardship?



Endnotes

1. [For the purpose of this report, 'portfolio' refers to individual clients' portfolios managed by portfolio/wealth managers and 'funds' refers to investment/asset managers' investment product range.]
2. Defined for the purposes of this report as portfolio/wealth managers and those providing a range of investment funds, and hereafter referred to as 'firms'
3. <https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf>
4. <https://www.fsb.org/2020/10/2020-status-report-task-force-on-climate-related-financial-disclosures/>
5. The SFDR also requires disclosures of 'adverse impacts' at the entity level for certain entities however this is beyond the scope of this paper
6. <https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf>

Authors



Andrew Bulley

Partner

EMEA Centre for Regulatory Strategy

+44 20 7303 8760

abulley@deloitte.co.uk



Felix Bungay

Senior Manager

EMEA Centre for Regulatory Strategy

+44 20 3741 2939

fbungay@deloitte.co.uk



Isha Gupta

Assistant Manager

EMEA Centre for Regulatory Strategy

+44 20 7303 7989

iggupta@deloitte.co.uk

Contacts



James Alexander

Director

Consulting

+44 7980 311504

jdalexander@deloitte.co.uk



John Wilson, CFA

Senior Manager

Consulting

+44 20 7303 5244

johwilson@deloitte.co.uk



Paul Fraser

Senior Manager

Risk Advisory

+44 20 7007 3843

pfraser@deloitte.co.uk

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