Comments to the Climate-Related Market Risk Subcommittee under the Market Risk Advisory Committee (MRAC) of the Commodity Futures Trading Commission (CFTC)

Submitted by: Impax Asset Management – Ian Simm, Julie Gorte, Ken Locklin, Chris Dodwell

Dear Climate-Related Market Risk Subcommittee

Impax Asset Management is a leading global investor focused on the transition to a more sustainable economy. Over more than 2 decades pioneering a range of successful capital deployment vehicles for institutional investors worldwide, we have consistently been at the forefront of investor efforts to tackle one of the most critical issues of our time, climate change, and the associated risks it presents for financial markets.

We applaud the Subcommittee members and the CFTC for initiating this investigation into climate-related financial and market risks (CFMR) and thank you for the opportunity to offer comments. As the Subcommittee proceeds with its important work, we would be glad to provide additional perspectives directly or through our membership roles with leading sustainable investor organisations.

1. Identifying challenges or impediments to evaluating and managing CFMR

We consider that there are three main challenges to the evaluation and management of CFMR:

a) <u>Lack of experience in developing effective strategies for managing CFMR:</u> In relation to transition risks, corporates are faced with the challenges of trying to align their emission reduction strategies with an uncertain and inconsistent policy environment, as well as pressure from investors to decarbonize ahead of policy signals: investors meanwhile currently lack the skills and expertise to judge the adequacy of these strategies. Meanwhile, corporates are hampered by a lack of data on the vulnerability of their assets to future climate impacts on which they can base their adaptation strategies: so investors need to consider not only how to deal with an absence of well-developed strategies but also how to manage systemic factors at a portfolio level, such as the clustering of investments in highly vulnerable locations or sectors.

b) <u>Lack of standardized tools for evaluating CFMR:</u> Currently efforts to develop tools are numerous and uncoordinated with the result that attention is focused on servicing requests for data and analyzing potentially confusing outputs. In our view, regulators could accelerate progress by identifying a finite number of approaches which can provide ‘decision-useful’ information tailored to different financial sector audiences. Since CFMR analysis is still in its early days, regulators will need to balance the space given for experimentation, innovation and iteration, with clear direction and oversight.

c) <u>Lack of incentives for effective management of CFMR:</u> The uncertainty, potential scale/scope and likely timeframe of CFMR make them unusual. Currently prevalent incentive structures for capital allocators are typically poorly suited to this area of risk, for example performance payments linked to results over 3-5 years, or to outcomes in one asset class or sub-portfolio rather than management of systemic risks across the whole portfolio. Similarly, unless directed otherwise, allocators often have limited motivation to invest in the analysis needed to assess CFMR, or even more fundamentally, to join with peers to provide collective funding for the development of new analytical tools.

2. ***Identifying how market participants can improve integration of climate-related scenario analysis, stress testing, governance initiatives, and disclosures into financial and market risk assessments and reporting***

We suggest that the sub-committee tackles this by focussing on the following priority topics which offer a combination of quick wins and longer-term transformational impacts:

a) Standardizing **scenario analysis** around a finite number of clearly defined scenarios based on trajectories, each of which can be mapped to a climate outcome, e.g. 2.5 degrees of warming, while being "easy to use" in financial models. This contrasts with the current focus on developing highly complex scenarios that practitioners in the financial sector are finding it difficult to use.
b) Developing standard approaches to indicators of **physical climate risk** that will inform both data collection and modelling. Policy makers need to support the development of location-specific environmental hazard projections so that these are available in the medium term to allow corporates to compile and disclose information on projected impacts on their register of assets. In the meantime, lessons can be learned from the approaches taken by asset managers (like Impax) who are already undertaking reviews of physical climate risk by using available publicly information on the location of companies' major facilities and supply chains and on their likely vulnerability.
c) Clarifying **existing risk disclosure requirements** so that they incorporate the information need to undertake analysis of physical climate risk and transition risk, potentially through additional guidelines where required.
d) Integrating CFMR into mainstream **risk management and audit mandates and functions** which increase transparency and incentivize the development of necessary skills, both for market participants (e.g. through CFA and other specialist training) and related service sectors (e.g. accountants, lawyers, and risk management professionals).
e) Supporting the development of **clean investment dialogues** between the policy and investment communities which mitigate risks by increasing collaboration on the most effective way to finance the transition to a low carbon, climate resilient economy. Not only will these reduce risks by flagging the potential for stranded assets, but they will also encourage the deployment of capital in new infrastructure and technologies needed, enabling investors to benefit from the opportunities offered by the transition.

3. ***Identifying policy initiatives and best practices for risk management and disclosure of CFMR that support financial stability***

The most effective way to manage CFMR is by adopting policies which set out a pathway to a net zero economy, thereby delivering the emissions reductions needed to avoid dangerous climate change. Where there are many initiatives aimed at this goal, we have identified below those of greatest relevance to financial markets.

<u>Investor-led initiatives</u>

- Risk management through decarbonizing portfolios: **IIGCC Paris Aligned Investment Initiative**, the **Net Zero Owners Alliance** and **Transition Pathways Initiative**
- Tools and methodologies for incorporating physical climate risk into asset valuation: **Coalition for Climate Resilient Investment**

<u>Corporate strategies to reduce and report GHG emissions:</u>

- **Ceres Investor Network** has launched the Climate Action 100+ program that urges big emitters to set emissions reduction targets that are compatible with the Paris agreements.

- **CDP** has encouraged most larger companies, especially in developed markets, to disclose at least Scope 1 and 2 emissions. But to fully address the problem, we need mandatory disclosure that covers all emitters and all markets. Better still would be a requirement that companies produce **TCFD** reports, with scenario analysis as a kind of stress test of the viability of business models under various climate pathways.

Central banks and supervisors

Network for Greening the Financial System whose program includes sharing best practice on climate risk management and TCFD implementation.

4. ***Identifying appropriate methods by which market participants' data and analyses can enhance and contribute to the assessment of CFMR and their potential impacts on agricultural production, energy, food, insurance, real estate, and other financial stability indicators***

Climate-related financial and market risks are often specific to individual sectors, industries and subsectors, and it is important to assess the risks particular to specific business models including both transition and physical risks. We would particularly recommend reviewing the methods developed by the **Global Reporting Initiative**, with its sector supplements, and the **Sustainability Accounting Standards Board**, with its materiality map and paradigm.

Formatted: Font: Bold

5. ***Identifying financial and market risks arising from potential economic policy responses to climate change***

Our country faces an urgent need to craft an effective and equitable response to the global challenge of climate risk and we strongly endorse the focus of this sub-committee ~~in focusing~~ on integrating those risks into the operation of our financial markets. As stated above, effective management of CFMR requires economic policy responses which deliver deep emission reductions. These policies can and should be designed so as to minimize economic impacts and market risks (e.g. by recycling revenues from carbon taxes within the sectors affected).

Moreover, we believe that the transition to a low carbon, climate resilient economy will create new markets and job and generate enormous opportunities and wealth. Therefore, we encourage the sub-committee to identify not only the key financial/market *risks* but also the *opportunities* that will emerge from implementing climate *solutions*. In the end, it will be the implementation of these solutions that will be essential to guiding our nation to a safe and prosperous future.