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PRA to Consider Impact of Climate Change on Financial Stability

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Under a proposed amendment to the **UK's Financial Services and Markets Bill**, the **Prudential Regulation Authority (PRA)** could be empowered to review appropriate risk weighting and capital requirements associated with a financial institution's exposure to fossil fuel exploration, exploitation and production. The PRA is the UK's prudential financial services regulator and is responsible for the supervision of around 1,500 banks, insurers and investment firms. The Financial Services and Markets Bill, which we **reported on** when it was first announced on July 20, 2022, is currently being considered by the House of Lords, the upper chamber of the UK Parliament. The proposed bill, which is at the "committee stage" in the House of Lords and was debated on March 1, 2023, would grant UK regulatory authorities new powers and revoke retained EU laws governing the regulation of financial services. The **proposed amendment** provides that in "setting the capital adequacy requirements of a credit institution, the Prudential Regulation Authority shall have regard to—(a) the level of exposure of an institution to climate-related financial risk; (b) the level of compliance of the institution with the recommendations of the Task Force on Climate-Related Financial Disclosure; and (c) the objectives of the Climate Change Act 2008 as amended by the Climate Change Act 2008 (2050 Target Amendment) Order 2019 (S.I. 2019/1056)."

Baroness Sheehan, a sponsor of the bill, **explained** during the committee debate, that "[c]limate risk is not specifically factored into either the regulatory capital risk requirements for banks or the solvency requirements for insurers." Sheehan further argued that "billions to trillions of pounds will be invested over the near to medium term into an economy that is transforming with increasing rapidity into a low-carbon one. It is clear that climate risk is financial risk: returns on investments and the ability to pay back loans are exposed to the risks of rising temperatures, as evidenced by recent catastrophic climatic events, and action taken by policymakers to transition to a low-carbon economy, such as the US Inflation Reduction Act. Businesses, big and small alike, are poised to pull the start trigger on investments but are held back in the UK by lack of clarity about the Government's intentions."

The proposed climate-related amendments to the Financial Services and Markets Bill will, if enacted, also impact investment managers. Under one of the **amendments** to the bill, the FCA would be required to publish guidance for investment managers to consider "the impact of their investments on society and the environment" and "the long term consequences of investment decisions." The amendment states that FCA-regulated firms must make these assessments "without undermining their fiduciary duty to act in the financial interests of clients." On February 20, the FCA **published** a discussion paper seeking views on the current regime for regulating funds and asset managers. The paper has proposed changing the rules regarding a fund's prospectus to include "example information and labelling around environmental, social and governance matters." Interested parties have until May 22, 2023 to respond.

Taking The Temperature: The question of the impact of climate change and climate transition on financial stability remains subject to significant debate. We have reported, for instance, on climate activists advocating the adoption of a "one for one" rule, whereby for each euro/pound/dollar that finances new fossil fuel exploration or production, banks and insurers should set aside a euro/pound/dollar of their own funds against potential losses. The "rule" is based on the idea that fossil fuel assets of financial institutions will diminish in value or become worthless in connection with climate transition and that they will suffer significant losses as a result. While that rigid type of approach (sensibly) does not appear to be gaining traction, regulators are demanding that financial institutions account for risks associated with climate challenges.

Meanwhile, the complexities and the scope of the changes proposed by the Financial Services and Markets Bill, together with the implications of revoking parts of the EU law-derived legislative framework, have slowed the bill's progress through the UK's legislative process. On the other hand, the extensive consultation and review phase currently underway could result in clear regulation that is informed by, and, to the extent possible, aligned with, other initiatives in the EU and the U.S. As we have reported, climate-related regulation in other jurisdictions, such as the EU's Sustainable Finance Disclosure Regulation, has come under criticism for lack of clarity. The final House of Lords committee session will be held on Tuesday, March 7. At the conclusion of the committee stage, the bill will move onto the "report stage" where all members of the Lords will be permitted to examine, and suggest amendments to, the bill. This typically commences 14 days after the committee stage has concluded.