

The Financial Conduct Authority's Adaptation Report

January 2025

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Chapter 1

Executive Summary

- 1.1** We have prepared this report following an invitation by the Department for Environment, Food and Rural Affairs (DEFRA) to report on climate change adaptation challenges faced by the financial services firms we regulate. This is part of the 4th round of reporting under the climate adaptation power.
- 1.2** We have produced this report based on informal engagement with financial services firms and our understanding of market dynamics. It is not a comprehensive assessment and further, systematic research would be needed to verify these findings. This report is not intended to set out regulatory expectations for the firms we regulate.
- 1.3** We believe there are 3 major issues affecting climate change adaptation in the financial services industry:
- Data and modelling to help financial services quantify and manage climate risks.
 - Barriers and enablers to insurance underwriting for climate risks and in consequence lending and investment.
 - Barriers and enablers to financial services in allocating capital to adaptation.
- 1.4** Firms must also protect their critical infrastructure, in particular IT systems, while making sure that net-zero transition plans consider necessary adaptation.

Chapter 2

Introduction

- 2.1** Using the definition in the 3rd National Adaptation Programme, '*Climate adaptation relates to actions that protect us against the impacts of climate change. This includes reacting to the changes we have seen already, as well as preparing for what will happen in the future*', this report focuses on:
- Risk management adjustments that financial services firms need to make due to climate change. This includes changes to insurance and loan underwriting practice and due diligence in investment markets.
 - Changes made by financial services firms to manage exposure to physical climate risk that could affect consumers and wider market stability.
 - The importance of financial products in enabling and supporting adaptation and transition in the wider economy. This includes allocating capital to activities that support adaptation and underwriting risks.
- 2.2** These 2 areas are closely linked because a good understanding of climate risk is needed for both.

Chapter 3

Our remit on climate adaptation

- 3.1** Our functions are set out principally in the Financial Services and Markets Act 2000 (FSMA 2000). When undertaking our general functions under that Act – including, among other things, making policy and rules and issuing guidance – we must act, so far as is reasonably possible, in a way that is compatible with our strategic objective and which advances one or more of our operational objectives, as well as our secondary objective.
- 3.2** Our strategic objective is ‘ensuring that the relevant markets function well’ (s.1B(2)), FSMA 2000).
- 3.3** Our 3 operational objectives are to:
- Protect consumers from poor conduct by regulated firms.
 - Protect and enhance the integrity of the UK financial system.
 - Promote effective competition in the interests of consumers.
- 3.4** Our secondary objective is to facilitate, subject to aligning with relevant international standards, the international competitiveness and growth of the UK economy.
- 3.5** In addition, when undertaking our general functions, we must have regard to the regulatory principles set out in s.3B(1) of FSMA. These include (among other things) ‘the need to contribute towards achieving compliance by the Secretary of State with section 1 of the Climate Change Act 2008 (UK net zero emissions target) and section 5 of the Environment Act 2021 (environmental targets) where each regulator [the FCA or the PRA] considers the exercise of its functions to be relevant to the making of such a contribution’. The duty to have regard to the ‘net zero’ target came into force on 29 August 2023 and the duty on ‘environmental targets’ came into force 1 January 2025.
- 3.6** We consider that climate change adaptation may pose risks to financial markets. They could be affected by either a failure by firms to adequately adapt to climate change or the consequences of adaptation measures. Similarly, adaptation risks could lead to harm to consumers of financial services, harm to the soundness, stability and resilience of markets and harm competition.
- 3.7** Failure to adapt to climate change could present a prudential risk to financial services firms as mispricing climate risk may lead to losses and the erosion of capital. The Prudential Regulation Authority is responsible for the prudential regulation of banks and insurers. For these firms our concerns are the affordability and availability of insurance and bank lending for consumers.
- 3.8** Where, in the context of our functions under FSMA, we use our powers to address the issue of financial market adaptation, this may contribute towards achieving the UK net-zero emissions target. As set out below, successful net-zero transition, including climate change adaptation, depends upon the financial services sector providing the necessary financial support. Financial services firms are increasingly adopting climate

transition plans. We believe that net-zero transition planning provides an opportunity to consider adaptation to climate change.

3.9 The financial services industry provides a source of finance and manages financial risks. In this report, we consider three economically critical core functions:

- The provision of credit and payment services by banks and other lenders.
- Investment markets bringing together investors and commercial investees in a mutually beneficial relationship.
- Insurers covering defined risks to physical assets, wealth and future earnings.

3.10 As the climate changes, financial firms face significant adaptation challenges if they are to continue to perform these core functions within stable, well-functioning markets. This will likely require firms to adequately assess changing risk, promote climate resilience and modify their operations accordingly.

Chapter 4

Adaptation risks in the financial service sector

- 4.1** In our most recent [climate-related financial disclosure](#), we highlighted the major climate risks faced by various financial sectors. Our conclusions were:
- 4.2 Market-wide** – All financial services firms are likely to face risks to their own critical infrastructure, in particular IT systems. In many cases this will require consideration of adaptation in supply chains and third-party providers. Firms will need to ensure their operational resilience planning is adequate to assess climate-related risks. Their disaster recovery plans will need to be reviewed and updated as necessary to reduce impacts on consumers and markets.
- 4.3 General insurance** – The effects of climate change are already observable. Increasing frequency and severity of climate-related natural disasters have led to sharply increased claims in recent decades. (Source: [Swiss Re Institute](#)). These increasing losses due to floods, storms and subsidence create concerns over the future affordability and availability of insurance cover in the UK for both individuals and businesses. The international nature of the UK insurance industry exposes insurers to risks not currently experienced or significant in the UK such as hurricanes, tornados and severe hailstorms. London market insurers are very active in global marine, aviation and energy insurance (hydrocarbons and renewables). The availability and affordability of reinsurance may be affected by overseas losses with implications for UK domestic cover.
- 4.4** Extreme heat events may cause problems for liability insurers as commercial policyholders face claims from employees or customers exposed to hazardous temperatures. Health insurers may also face elevated claims levels from increasing heat levels and wider health-related impacts of climate change.
- 4.5 Banking** – Climate-related events (such as extreme weather and floods) can have direct physical impacts on people and property. Longer term climatic changes introduce risks to the business models of counterparties which in turn may increase risks to lenders.
- 4.6** Increasing climate-related risks are a concern where lending is underpinned by a charge on physical property. This is particularly the case where the property is expected to produce a long-term income stream as the duration of risk is extended and the dual cost of repairing the damaged asset and a loss of the income stream needs to be considered. An example would be a loan to finance a solar farm development.
- 4.7** This risk becomes significantly elevated if insurance cover is restricted or unavailable. The availability of insurance is critical to mortgage lending, in particular coverage against flood. Such cover is generally widely available in the UK at present, to a greater extent than comparable European countries (in Germany for example only around half of households have cover). However, some lenders are already declining to lend to a small number of particularly vulnerable properties and others have expressed concern over the long-term availability of insurance cover. Following severe flooding in 2007,

Flood Re was established by the insurance industry with government backing to provide affordable reinsurance to cover the risk of exceptional flooding. Although Flood Re has brought stability to flood insurance for homes, the scheme is scheduled to end in 15 years, shorter than the term of most new mortgages. The scheme does not cover commercial property or most blocks of flats.

- 4.8** Certain climate-related risks are either uninsurable or insurance is very limited. Examples would include coastal/river erosion, drought and sea level rises. Lenders must develop their own assessment methodologies and cannot rely on the existence of insurance as a basis for lending decisions.
- 4.9** Broader climate-related risks beyond specific physical damage to property may have economic impact. For example, extreme heat events or a general fall or redirection in consumer spending after natural disasters. This may affect the rate of default in commercial lending in particular.
- 4.10** Banks also have an important role in funding adaptation, such as lending to homeowners and small businesses.
- 4.11** **Investment (including pensions)** – Investment markets are subject to physical risks from climate change. But they can also play an important role as providers of finance for adaptation measures.
- 4.12** The risks are similar in nature to bank lending. Physical damage and broad economic effects may impact asset values, although it is often difficult to isolate climate effects from general economic effects. Longer duration investments and investments in industries reliant on the natural environment are considered by the Climate Financial Risk Forum (CFRF) to be at greatest risk.
- 4.13** In addition to direct physical damage from specific climatic events, gradual climatic changes may have a material effect on affected companies.
- 4.14** Asset managers operate largely in secondary markets as shareholders or bond holders. So generally, they do not have as much influence as direct lenders or insurers. The direct loss from a fall in asset values falls mostly on the clients of asset managers and pension providers. But there is some direct loss of fee income and a risk of a loss of consumer confidence in investment products.
- 4.15** Investment banks are not as exposed as retail banks or insurers when undertaking their capital market function due to the shorter duration of risk. But investment banks will still need to have regard to disclosure of climate risks. This is particularly the case for Initial Public Offerings (IPOs) where there may be no pre-existing climate-related disclosures. If engaged in corporate lending however, they are exposed to the same risks as retail banks.
- 4.16** Investment firms and capital markets will need to adapt to the risk of increased volatility in agricultural commodities markets. They will also need to adapt to the effect of possible water shortages on companies reliant on high water consumption. This could affect a wide range of companies including agriculture, textiles, beverages and mining. Capital markets offer a potentially significant source of finance for adaptation measures

(sometimes referred to as 'adaptation finance'). This generally requires attractive investible propositions. Finance can be provided through instruments like green bonds, or through investment vehicles that channel funds to adaptation projects.

4.17 Additionally, blended finance structures, through which public funding is used to co-finance initiatives and/or provide guarantees, can be used to help reduce risk for investors and draw in private capital. Across these different options, sustainable finance frameworks can help align finance with the specified adaptation goals.

4.18 In all cases, a key risk element is the duration of the contract. The CFRF comment:

'When assessing risks, financial institutions should consider risks over the full lifetime of the asset and, in the case of investors, factor that both into pricing as well as consideration of next steps – including decisions on whether to hold, engage or sell. For banks and insurers, they should consider what this means for resilience requirements when lending to or underwriting assets. The under-pricing of risk due to the short-term perspectives is part of the problem and dis-incentivises action'.

4.19 Medium or long-term decision making will be required for many forms of bank lending, most notably mortgages but also corporate loans. However, while seemingly able to operate flexibly, in practical terms, many investment funds do not operate on a short-term basis, especially when adopting a value investing strategy or operating a long-term asset fund. Whilst general insurance is usually offered on terms of 12 months, there are reputational risks associated with rapid withdrawal from certain types of cover and market instability may result. Long term assessment of climate risks against a range of scenarios will be required.

4.20 Financial firms are however reliant on the degree of adaptation undertaken by both businesses and individuals. Greater levels of adaptation in the wider economy will reduce risks for all. Financial services firms are in a position to promote adaptation and it may be in their best interests to do so.

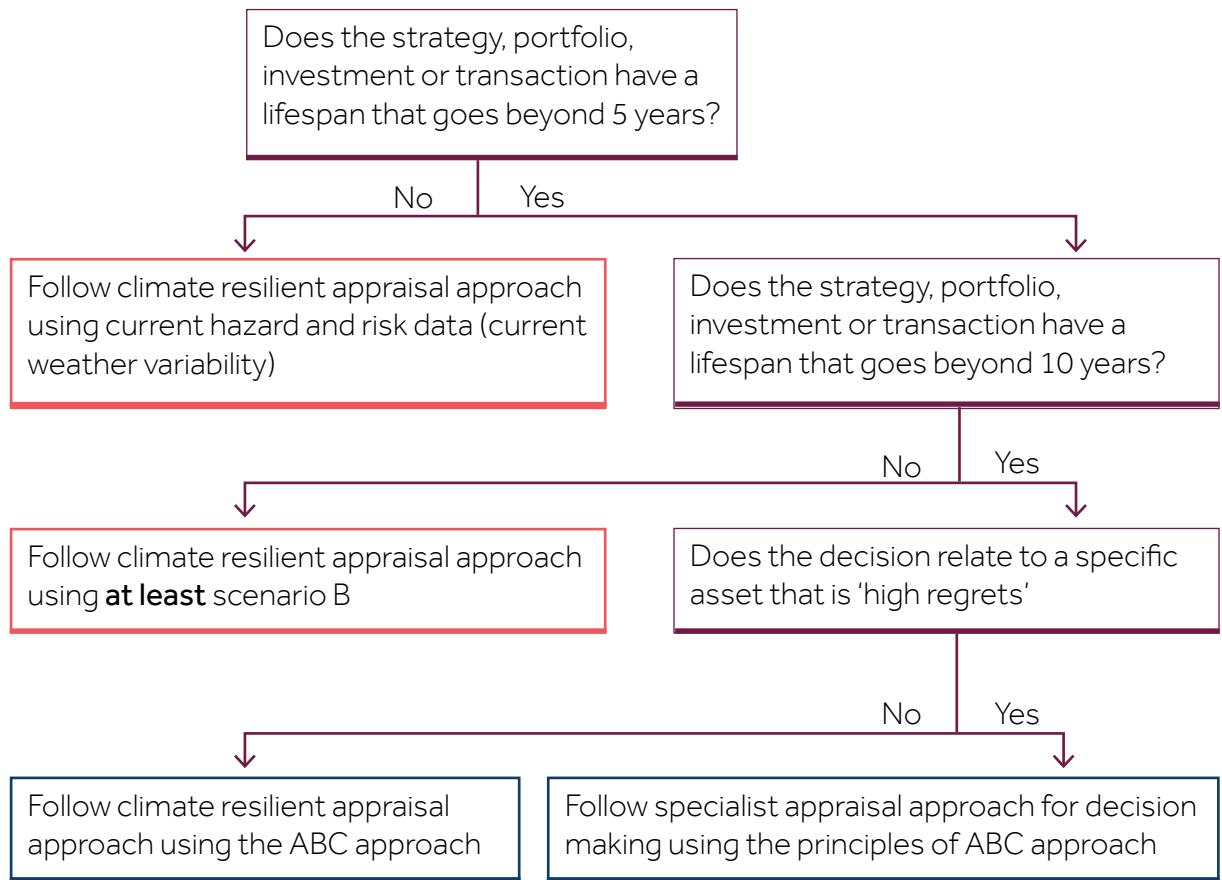
Chapter 5

The financial service industry's adaptation response

- 5.1** We have a role, as a financial regulator, to consider the industry's climate adaptation, as it relates to our remit. Our Sustainable Finance Division includes subject matter expertise to enable us to do this. This section describes our work to support climate adaptation across the financial services industry.
- 5.2** Existing financial regulation includes provisions to ensure that risks are appropriately identified and managed and critical financial services are operationally resilient. All FCA-regulated firms 'must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems' (FCA High Level Standards – Principle 3).
- 5.3** So, there is an existing duty for firms to consider novel or changing risks and make sure they have rigorous risk management systems.
- 5.4** We require asset managers, FCA regulated asset owners, life assurers, pension providers and UK listed companies to disclose climate risks in line with the task force for climate-related financial disclosures recommendations (TCFD). This requires climate-related financial risks to be systematically disclosed to enable informed decision-making.
- 5.5** The IFRS S1 & S2 standards (see p.13) were produced by the International Sustainability Standards Board (ISSB). These standards will supersede TCFD. These new standards are similar to TCFD and include requirements to disclose climate-related risks and opportunities under a range of climate scenarios. We intend to update our rules for listed companies after the UK endorsement of the ISSB standards is completed, which is expected in 2025.
- 5.6** Our approach to regulating climate adaptation risks must balance the need for financial services firms to manage their own climate-related risks with the consequences of these risk management measures on consumers and markets. To understand these consequences at market-wide level, we work with industry bodies to monitor trends.
- 5.7** We also have a role in convening others in the industry to focus attention and initiate action. In 2019, we and the Prudential Regulatory Authority jointly established and co-chair the Climate Financial Risk Forum (CFRF). Its membership is drawn from the insurance, banking and investment sectors as well as other interested parties.
- 5.8** The CFRF established an Adaptation working group in 2023, and their findings have informed this report. This section of the report draws on the CFRF report published on 10th October 2024.

- 5.9** The CFRF's Adaptation working group have collaborated closely with the Met Office, enabling them to incorporate world-leading climate science into their analysis. They took 'advice from the scientific community on which climate scenarios and datasets should ideally be used by the finance sector for scenario analysis over differing timescales to inform physical climate risk management and adaptation planning'.
- 5.10** The CFRF recommend in their report an Aim-Build-Contingency (ABC) adaptation response, reflecting three climate scenarios:
- **Aim** to keep warming below 2⁰c (and ideally no more than 1.5⁰c). Even at this level material risks will require some adaptation.
 - **Building** and budgeting on the assumption that warming will be ~2⁰c by 2050 requiring significant adaptation.
 - **Contingency** planning based on warming of 2.5⁰c and the need for very significant adaptation and resilience measures.
- 5.11** The approach to be taken depends upon the likely duration of the risk, itself determined by the nature of the financial product being provided.
- Short-term decision making (up to 5 years) – Hazards can be assessed using local climate data.
 - Medium-term decision making (5 to 10 years) – Recommend that planning should be based on one scenario (the ~2⁰c scenario is suggested), considering the range of climate responses that may result.
 - Long-term decisions (More than 10 years) – Need to consider a range of possible emissions pathways and their impacts, including future divergence in global warming levels.

Approach to using data and scenarios within decisions



Source: Mobilising Adaptation Finance to Build Resilience – CFRF October 2024

5.12 The CFRF recognise there are uncertainties under all durations and recommend:

- Sensitivity testing – Would a similar outcome arise if a different model was selected?
- Robust decisions but guided by firm risk tolerance.
- Flexible planning.
- Monitoring and adjustment.

Proposed elements of and adaptation framework for firms

Principles	Ambition	Action		Accountability	
Planning process	Key stages of transition planing				
Disclosure Elements	↓	↓	↓	↓	↓
	Integrated adaptation plan				
	<p>1. Foundation</p> <p>1a. Set adaptation objectives and priorities, taking account of national adaptation plans</p> <p>1b. Assess physical climate risks and opportunities and wider business model implications in line with TCFD (and TNFD)</p>	<p>2. Implementation strategy</p> <p>2a. Integrate adaptation into business planning and operations, including deploying tools to assess risks, price and DNSH</p> <p>2b. Apply adaptation taxonomies to identify adaptation opportunities across sector</p> <p>2b. Develop adaptation product and service offering for clients</p>	<p>3. Engagement strategy</p> <p>3a. Engage with clients/investees to understand physical risks and adaptation plans stewardship</p> <p>3b. Engagement with third-parties as relevant</p>	<p>4. Metrics and targets</p> <p>4a. Setting basic targets and metrics at institutional level to guide and disclose risks and actions, including both physical risk KPIs and adaptation KPIs</p> <p>4b. Setting more advanced targets and metrics across business lines with quantification</p>	<p>5. Governance</p> <p>5a. Integrate adaptation into institutional governance mechanisms, including board oversight and reporting accountability</p> <p>5b. Capacity building</p> <p>5c. Consider links to incentives, culture, remuneration etc</p>

5.13 Additional CFRF resources:

- [CFRF Adaptation Working Group Report](#)
- [A summary of the report](#)
- [A set of adaptation finance-focused case studies](#)
- [A summary of the results of a survey of CFRF AWG members](#) and data providers on sources of physical risk data current in use
- [A searchable database of hazard data sources](#)
- [A searchable taxonomy database](#)
- [Resilient Planet Lab Databases](#)

Chapter 6

Barriers and enablers to adaptation, gaps and additional action that could be taken

- 6.1** Both the recent CFRF report and the Association of British Insurers consultation on proposed reforms to the National Planning Policy Framework provided on 24th September 2024 disclose financial industry concerns over the progress of adaptation, as well as suggestions for additional actions.
- 6.2** The CFRF Adaptation working group members identified a number of challenges to increasing efforts to mainstream adaptation and scale-up financing on p4 of their report. These are:
- Concerns about the quality and relevance/usefulness of data for supporting physical risk analysis – particularly when moving from global emission scenarios to local hazard and asset level data.
 - Lack of guidance on how to integrate that scenario analysis into investment, lending and underwriting decisions – and how best to disclose it to the market.
 - Lack of clarity on national and international adaptation goals and lack of consensus on standards and definitions for adapted assets to support strategic decision-making on adaptation responses by firms.
 - Lack of scaled deal opportunities for adaptation activities.
- 6.3** In consequence, we have concerns over the continued supply of insurance, lending and investment to support adaptation. We will consider this under 3 key areas:
- Data and modelling to help financial services to manage climate risks.
 - Barriers and enablers to insurance underwriting for climate risks and in consequence lending and investment.
 - Barriers and enablers to financial services in allocating capital to adaptation.

Data and modelling to help financial services manage climate risks

- 6.4** Barriers & gaps – A major issue is the availability and quality of local hazard data and models. Financial services firms need this to assess, and price, climate-related risk with sufficient accuracy. The CFRF say the quality and consistency of reporting in the financial sector could be improved. In particular:
- 6.5** Models have been developed by individual firms for different purposes and aggregation or repurposing of data may be unreliable.
- Firms may also hesitate to share commercially valuable data, compiled at their own cost.

- Hazard data for short term risks (up to 5 years) is often available at least in the UK: longer term risks are less predictable, especially given uncertainty over how transition will progress in the coming decades.
- Local data for overseas risks may be unavailable and gaps exist in UK data.
- Data is not always available in a format that is usable for decision making.

6.6 Enablers & additional action – Drawing largely on the CFRF's recommendations:

- Working with the scientific community to identify gaps in local hazard data sets and how these could be addressed by creating a hazard data portal and tools that can be used by financial sector organisations to improve local risk assessments.
- The quality of hazard data could be improved by sampling a greater range of natural variations. The CFRF consider that government investment in updating the UK Climate Projections dataset produced by the Met Office should be a priority.
- Making sure data is readily convertible into relevant hazard information. For example, conversion of rainfall information into potential flood levels, to enhance modelling of climate risks.
- Producing more holistic information, including tipping points, correlated and compounded hazards, to produce more representative modelling.
- Recognised standards for third-party data providers to build trust.
- Pooling of expertise by greater co-operation within the finance industry, utilities firms, academia and scientific bodies.
- An 'on-line' hub for enhanced guidance and improved database of KPIs, metrics and sources.

6.7 Different sectors can collaborate on data sharing for mutual benefit. While it is recognised that such data may be commercially sensitive, industry bodies can perform an important role in collating and anonymising data. Other contributors include academia, local authorities, government departments and agencies and the expertise of the Met Office. There have been encouraging signs of such collaboration for some years.

Barriers and enablers to insurance underwriting for climate risks

6.8 The financial services industry can only do so much when it comes to adaptation. Factors outside the direct control of financial services (such as investment in flood defences and planning decisions) affect their exposure to climate risks. Therefore, co-ordination between financial firms, government (central, local and government agencies), construction and utilities is essential to maintain the stable provision of financial products.

6.9 The survey conducted among financial institutions participating in the Climate Financial Risk Forum (CFRF) aimed to explore the complexities and practices surrounding adaptation to physical climate risks. Initially, respondents classified their organisation's main area of activity within the financial industry, revealing a diverse representation ranging from public asset management to corporate banking and insurance. Motivations

for climate adaptation varied, but compliance mandates (eg Task Force on Climate-related Financial Disclosures 'TCFD') and potential financial loss from physical climate impacts emerged as primary drivers. Notably, respondents demonstrated a nuanced approach to decision making timelines, emphasising medium-term planning for strategic activities and longer horizons for risk management strategies.

- 6.10** Barriers & gaps - There are a growing number of properties that fall outside the Flood Re scheme. All domestic properties built after 2008, blocks of more than 3 flats and commercial properties cannot be ceded to Flood Re. 2,283,920 new homes have been built since 2008 according to research by Aviva, since 2013/14, 8% of new homes have been built in the highest flood risk areas.
- 6.11** In France, in the aftermath of a loss, AXA will pay 50% of the extra cost of 'green' improvements, covering both climate adaptation and transition. UK insurers might consider whether such a scheme would be viable in the UK.
- 6.12** Insurers have an important role to play in promoting risk management measures. However, there are limits to what they can achieve. For example, major infrastructure projects such as coastal defences are the responsibility of local and central government. There are also significant types of risk which are not likely to be insurable, including coastal/riverbank erosion or the effects of extreme heat on structures.
- 6.13** Additionally, much of the insurer's work on adaptation occurs after a loss has been suffered. But it is preferable to carry out the work before losses are incurred.
- 6.14** Innovative financial solutions do exist beyond traditional insurance, such as parametric triggers backed by catastrophe bond issuance. This has been a steadily growing market in recent decades. But the number of deals remains fewer than 100 a year, mostly covering overseas risks and generally covering large industrial risks. The adaptation advantage of such instruments is greater flexibility in how the proceeds of the bond is used, including funding risk improvements to reduce future loss. The capital markets have significantly greater wealth at their disposal than the insurance industry and this may be an alternative. The challenge will be in making catastrophe bonds a workable solution for millions of homeowners. For the present however, the traditional insurance market remains the dominant form of risk funding as far as UK property is concerned.
- 6.15** Flood Re has stabilised the home insurance market since its introduction. But the scheme is scheduled to come to an end in 2039, which would lead to market pricing. There is a risk that this could make insurance cover unaffordable or unavailable for many consumers. The intention was that over the duration of the scheme, the necessary adaptation measures would be put in place which would allow for the insurance of homes at affordable cost. However, the Association of British Insurers comment in their recent consultation response to the National Planning Policy Framework 'Unfortunately, we continue to see evidence of poor-quality buildings, which have not been built to the standard that is expected yet had been signed off by building control'. Amongst the ABI's concerns are:
- Climate and flood risk is not always embedded in planning decisions
 - Developers can build and sell homes leaving space for future flood defence to be installed in future rather than ensuring it is in place prior to sale

- Developers are not necessarily liable for breach of planning conditions (and not liable at all after 10 years) and it is difficult for homeowners to hold them to account
- Although passed, schedule 3 of the Floods and Water Management Act 2010, covering sustainable drainage systems to deal with surface water runoff, has yet to be implemented

- 6.16** In addition, the ABI believe one of the barriers to funding adaptation is that many households may not realise the degree of risk they face so do not seek to improve resilience. Although Energy Performance Certificates are mandatory, there is no equivalent for flood risk. This point is also made by the CFRF in their paper on adaptation.
- 6.17** Enablers & additional action – The future insurability (and therefore mortgageability) of properties should be considered. To quote the ABI *‘Planners, designers, and contractors need to engage with insurers at the start of the process to make sure that the buildings they intend to design, and build are insurable’*. Planning permission should only be granted once the insurance implications are understood and confirmed. This is essential to ensure new home and business owners can access insurance and that the market remains competitive.
- 6.18** Where flood defence measures are required, the ABI consider that these should be in place before properties are sold or purchasers should be provided with clear plans and timescales for their implementation with provision for ongoing servicing / maintenance. Purchasers will then be able to make informed judgments about the risk.
- 6.19** The ABI also believe there is a case for making developers liable to purchasers and their successors for a failure on the part of the developer to carry out adaptation measures that were a condition of planning consent and were the responsibility of the developer. This would incentivise developers to ensure that planning conditions are adhered to.
- 6.20** The ABI consider that Schedule 3 of the Floods and Water Management Act 2010 should be enacted given the significance of the surface water flooding risk.
- 6.21** Flood Re’s work on the introduction of flood performance certificates enjoys the support of the CFRF and ABI and should continue. Added to publicly available information on the gov.uk website, this will enable homeowners to make informed decisions.
- 6.22** This view that greater coordination between interested parties is required is echoed by the Institute and Faculty of Actuaries in their recent paper The future of UK flood policy.
- 6.23** Greater co-ordination between stakeholders and better information for households can play a vital role in improving the resilience of UK buildings to flood and other climate-related perils.

Barriers and enablers to financial services allocating capital to adaptation

- 6.24** The Climate Change Committee estimates around £5–10bn per year or £50– £100bn over the next 10 years will need to be invested in adaptation in the UK across both the public and private sector to address climate and physical risks. Much of this investment, particularly in the private sector, will need to be provided by financial services firms.
- 6.25** Pension funds and insurers, for example, are expected to be able to invest up to £190 billion in infrastructure over the next ten years. The Infrastructure and Projects Authority estimates that total infrastructure investment over the next 10 years, including private investment, will be nearly £650bn; that is, 35 times larger than the adaptation costs estimated in the 3rd Climate Change Risk Assessment for climate-proofing infrastructure.
- 6.26** Research conducted by Standard Chartered, published in its Adaptation Economy Report, found that for every US\$1 spent on adaptation this decade, an economic benefit of US\$12 could be generated. This highlights the significant economic pay-off of early action towards adaptation and the potential gains for investors. Meanwhile, research by Impax Asset Management found that adaptation sectors collectively delivered total cumulative returns 16.3% higher than the market over the previous five years.
- 6.27** Barriers & Gaps - A significant problem is how adaptation is to be funded. Larger companies are likely to have the expertise and resources to adapt and will usually be working closely with lenders and insurers to that end. They may carry large insurance deductibles providing a financial incentive to invest in adaptation measures. This may not be the case for small businesses and private individuals. The costs of adaptation may well be greater than the cost of insurance and many households may find such costs unaffordable. This is particularly the case at times of economic stress. There is also the problem that householders may not appreciate the risks and therefore the need for adaptation measures.
- 6.28** While financial firms could potentially require adaptation measures as a condition of loans or insurance, this risks reducing take-up of key financial products. Additionally, the costs to insurers and banks means it is likely that this approach will be limited to larger policies and loans. It should be noted that the data available is usually at postcode level rather than property specific. The cost of establishing the resilience of a particular property is prohibitive in the great majority of cases. This leads to a risk that insurance and loans may be refused based on the postcode, even though some properties may be acceptable risks. If firms withdraw from high-risk geographical areas, it could lead to localised negative economic effects due to a lack of insurance and credit. This could exacerbate the difficulty of funding adaptation in high flood risk areas.
- 6.29** Enablers & additional action – There is a well-established insurance principle called betterment, that insurers will not pay for any improvement to a building when settling a claim. Insurers could, however, look to develop cost- neutral adaptation measures and, considering the benefits of greater resilience to future flooding, adopt a liberal position when settling claims.

- 6.30** Flood Re, being free of the constraints of traditional insurance, is an example of what can be achieved with their 'build back better' scheme. This provides up to £10,000 over and above the indemnity cost for resilience measures. Insurers have to voluntarily sign up for the scheme and many of the larger home insurers have done so. It is important to note that insurers must offer the scheme even to properties that have not been ceded to Flood Re.
- 6.31** Availability of credit – Insurers will have the opportunity to drive adaptation on properties that have suffered damage, however climate resilience should ideally be incorporated before a loss is suffered. Banks and other lenders have a role to play in funding adaptation. There is a case for provision of low-cost finance for risk improvement in high-risk areas at least. Amongst the benefits will be a reduction in risk to the lender by reducing the risk of impaired collateral, thus reducing credit risk.
- 6.32** Discounted green loans for businesses are offered by many banks, with the condition that the money is used towards eligible green assets. The eligible assets tend to be heavily focused on transition rather than adaptation (see Barclays for example). While encouraging transition is a positive initiative, there seems no reason why the list of eligible assets should not be expanded to include adaptation measures.
- 6.33** A similar situation arises when home loans are considered. Some firms offer discounted or even interest free green loans up to a given threshold. These must typically be spent on 'energy-efficiency improvements'. Again, this could be extended to fund climate resilience measures. This would protect the position of the lender as well as the homeowner. The Green Finance Institute's Green Home Finance Principles (GHFPs) are a framework of guidelines that help financial institutions allocate funds to green home projects, including resilience measures. For example, flood doors and windows, resilient wall and floor finishes, resilient insulation, external shutters, external insulation.
- 6.34** The financial services industry can only do so much when it comes to adaptation. They are reliant on government to construct large scale flood or coastal defences and they have limited influence on the planning process. However, they are expected to cover the financial risks for many years after a development is complete. Given that built-in resilience is preferable to retrofitted resilience, co-ordination between financial firms, government (central and local), construction and utilities is essential to maintain stable provision of financial products.

See Mobilising Adaptation Finance to Build Resilience – CFRF

The need for adaptation to be embedded in transition plans

- 6.35** Our existing TCFD regime encourages listed companies and regulated firms to draw up robust climate transition plans and consider the UK's net-zero 2050 target in doing so. We recognise that some climate change is inevitable due to prior and continuing emissions. There is an opportunity for financial services firms to use their climate transition planning to assess the impact of such change and how this might affect their operations. We have contributed to the Transition Plan Taskforce formed 'to establish the gold standard for transition plans' which explicitly includes the need for adaptation

alongside transition. Of particular importance is the Disclosure Framework published by the TPT in October 2023. The TPT has now concluded its work, but responsibility has passed to the International Sustainability Standards Board (ISSB), a standard setting body operated by the International Financial Reporting Standards Foundation. We have supported the work of the ISSB and will consult with listed companies over the introduction of the IFRS S1 and S2 standards once they are formally adopted by the UK (expected Q1 2025). At the same time, we will consult on strengthening our expectations for their transition plan disclosures, with reference to the TPT framework. Ultimately, this will support those companies to respond to the effects of climate change.

6.36 We receive quarterly reports from all firms who are required to submit datasets. But these may not focus on climate change issues and we must take a proportionate approach. Annual climate-related financial disclosures are published by most of the larger financial services firms. These are however limited to material risks to capital, ability to raise finance and cashflow. This means risks that are not material to the firm's financial reports but possibly material to their customers are not required to be disclosed. We reviewed the quality of reporting by listed firms in 2022 (not all financial services firms).

Chapter 7

Conclusion

- 7.1** Financial firms need to make sure that they adapt their risk assessments to consider the economic impacts of climate change. This must however be accompanied by adaptation in the wider economy to minimise these financial impacts if financial firms are to continue to fulfil their economic roles, including funding of adaptation and transition.
- 7.2** Through the work of the CFRF and other industry bodies, the financial services sector is developing adaptation responses as far as their underwriting and due diligence is concerned. However, there is concern over the continued availability and affordability of financial products in areas at significant risk of climate-related damage. The solution to this lies outside the control of financial services firms in many cases.
- 7.3** Industry has identified a deficit of high quality and relevant/useful data as a clear obstacle to identification, quantification and consideration of physical risks, as well as the lack of a clear 'roadmap' for adaptation standards and metrics. However, as mentioned above, industry research demonstrates there are clear incentives for financial services to invest in climate adaptation. The issue is making sure they are clearly sighted on where those opportunities and solutions exist, and how they can be successfully delivered.

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