# FCA Discussion Paper DP21-4 Sustainability Disclosure Requirements (SDR) and investment labels

## Submission by The Financial Inclusion Centre

**About The Financial Inclusion Centre**

The Financial Inclusion Centre is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

**Promoting system level change**

Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

**Ensuring households' core financial services needs are met**

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform.

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**Introduction**

We are pleased to submit a response to DP21-4. Our submission is at a fairly high level at this stage as we are currently in the process of undertaking a project called '*The Devil is in the policy detail: will financial regulation align the financial system with climate goals*?'. This is undertaking detailed evaluation of conduct of business, prudential, reporting and disclosure regulations, rules, and guidance to assess whether these will drive real behavioural change in the financial system.

In our submission to HMT's Future Regulatory Framework Review, we argue that the current set of statutory objectives given to financial regulators, including the FCA, do not reflect the scale of the challenge if we are to align financial market behaviours with climate and other public policy goals.[1]

We are campaigning for a new Financial Sustainability Committee (FSC), similar to the Monetary Policy Committee, to be established within the Bank of England. The FSC would have a statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability, and coordinate the work all the regulators involved in managing climate related risks – the Bank of England, PRA, FCA, FRC, and The Pensions Regulator (TPR). The regulators would be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objective. The FSC would publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA, FRC, and TPR would also publish an annual assessment on how their activities have contributed to the FSC' objective.

The FCA, along with the PRA, has the lead front-line role in ensuring behaviours and activities in the financial system are aligned to climate and other policy goals. In particular, the FCA has the lead role in regulating how financial institutions, listed companies and larger private companies disclose compliance with sustainable, responsible, and social impact (SRI) criteria.

To explain our answers to the questions, we should explain that, rather than use the three category 'ESG' approach (which is too limiting), we think that the policy objectives are better understood and managed in four categories. Policy and regulatory reforms should:

- promote environmentally **S**ustainable financial activities and deter environmentally damaging activities
- promote **R**esponsible corporate behaviours (treatment of workers, supply chains etc) and deter irresponsible corporate behaviours
- promote activities that have a positive social **I**mpact (on local economy and communities, financial and social inclusion etc)

We term these three sets of activities as **SRI** finance, and are similar to the 'E' and 'S' from the acronym 'ESG'. The fourth category is Governance and relates to how companies are run and accountability to shareholders and bondholders. This is the same as the 'G' in 'ESG'.

[1] This is explained in more detail in our report Time for Action – Greening the financial system [Time for Action – Greening the Financial System | The Financial Inclusion Centre]



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## Response to specific questions

**Q1: What are your views on the tiered approach set out in Figure 2? We welcome views on any concerns and/or practical challenges.**

We support the general concept of a tiered approach for two main reasons:

- There are a number of forms any marker aimed at ordinary end-users (retail investors, insurance policyholders, pension fund trustees) could take. This could be a label, classification, one-to-five rating, or traffic light system. Regardless of the form, the marker must be made up of a pyramid structure of layers of constituent data and information. The integrity, accuracy, quality, and relevance of that constituent data and information will be as important as the marker chosen to communicate the meaning of that data to external users. A tiered approach allows for proper scrutiny of the component data.
- As the FCA suggests, different external users of relevant data and information will need to have access to (or be interested in) different levels of component data.

There are a number of serious presentational and compositional challenges with any marker whether it is a label, a classification system, a ratings system, or 'traffic light' system.

It is not clear why the FCA seems to think that a label would be easier to construct or assumes that a label/ classification system is any more 'objective' than a ratings/ traffic light system.

Even a classification system will involve a degree of subjectivity. For example, the FCA suggests descriptive labels that '*reference for instance the proportion of sustainable investments, or the nature of the product's objectives or strategy*'.

But, 'proportion' is a numerical calculation (ie. a quantity, a factual assessment) whereas 'sustainable' is by definition subjective and contains value judgments (unless an independent, regulatory authority mandates which specific component investments are to be deemed as sustainable/ not sustainable or attributes a numerical sustainability score eg. 70% sustainable).

So, in terms of logical construction, a label derived by combining a factual/ quantitative term with a subjective term does not make that label an objective marker.

Moreover, if the FCA opts for a label derived from calculating proportions, there is no doubt that the market will respond by creating comparison websites and 'best buy' lists which would become de facto traffic light or star/medal type lists. These in turn would also need to be regulated to ensure manipulation of investor behaviours does not occur. So, it is not clear what the advantages a label type marker has over a traffic light or star based rating systems.

As mentioned above, the other major concern relates to the integrity and accuracy of the constituent data. This is critical. Any presentational method whether a label, % rating system, or one-to-five star system will be seriously compromised if the constituent data and definitions of 'sustainable', 'responsible', or 'social impact' is not consistent or cannot be trusted.

Lack of consistency on constituent data and information across different investment products and funds could, by definition, render any label/ rating system invalid. It is not difficult to see this happening given the number of external agencies involved in rating investment funds and underlying investments.

Inconsistencies in the input data would mislead investors – albeit inadvertently. Worse would be the opportunities for fund managers and fund providers/ platforms to game the system by choosing the most favourable external ratings provider. This will create opportunities for greenwashing.

So, regardless of which system is chosen – label, % rating, or star/ traffic light system etc – the priority for the FCA is to:

- ensure the integrity of constituent input data that forms the building blocks of any system; and
- police the methodologies and process by which fund managers, fund providers, and any external agencies manufacture and present any labels, ratings, or stars/ traffic lights.

A general concern we have about the DP21-4 is the lack of emphasis given to supervision, enforcement, and sanctions. There is too much reliance on transparency and disclosure to police market behaviours.

**Q2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of product than for others, please provide examples.**
Regardless of which type of marker is chosen to communicate to the end-user (end-user in this case includes retail investors, pension fund trustees and scheme members, and insurance policyholders), all types of firms and products (investment funds, insurance based funds, investment trusts etc), and other institutional structures such as pension funds should be in scope.

In terms of the sophistication of end-users, we do not necessarily draw a distinction between retail and institutional. The composition of pension fund trustee boards means the members can be as vulnerable to misselling as retail investors. Indeed, given the scale of the assets involved, and the level of fees involved, the conflicts of interest are evident. The risks and consequences of misselling, misrepresentation, or poor decision making can be even greater.

**Q3: Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable and impact) and how best should we engage with them?**
There is no easy answer to this challenge. The fact that there are so many different industry body initiatives and market driven classification initiatives should not necessarily be seen as a positive example of diversity. Rather, it is adding to the confusion and complexity surrounding the issue. Proliferation, confusion, and complexity undermine effective decision making and efforts to control negative behaviours in markets.

We would urge the FCA to take the lead and develop and implement *the* common set of standards and terms to be used by firms within its remit.

**Q4: Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.**
We do not agree with the classification framework outlined in Figure 3. Nor do we support the FCA's views of what a 'label' should represent.

As mentioned above, it is not clear why the FCA takes the view that a label/ classification system is any more 'objective' than a ratings/ traffic light system. To set our comments about Figure 3 in context, it may be helpful to explain the principles we have used to develop our framework – see below.

**The principles underpinning a marker aimed at end-users**
Collective structures such as investment funds, insurance based products, investment trusts, structured products, funds of funds, platform lists, pension funds and so on do present a challenge. Individual securities (shares and bonds) are dealt with separately and can be covered under company reporting regimes.

The purpose of any marker is to synthesise, in an easily understood format, the degree to which a collective fund/ product complies, or is aligned, with agreed public policy goals (eg. climate/ sustainability, responsible corporate behaviours, or social impact).

There are a number of core principles which should govern the development, construction, and use of a marker aimed at end-users (eg. retail investors, pension scheme trustees, small businesses, charities etc).

- A collective fund/ product, regardless of the legal or corporate form, is comprised of individual securities (shares and bonds), deposits with specific financial institutions, and other assets such as direct property, private equity and so on. The utility of any representative marker will depend on the quality and integrity of the data and information relating to the constituent assets.
- To allow end-users to differentiate between funds/ products, any type of marker must have categories, groupings, or range bands (determined by quantitative or numerical ranges). End-users have to be able to readily identify to what degree the fund/product complies, or is aligned with, policy goals. Narrative descriptions of degrees of compliance will not allow end-users to make informed comparisons.
- Regardless of whether it is a label, % rating, one-to-five stars, or traffic light marker, any collective fund/ product covered by that marker must be:
    1. analysed for the degree of compliance of goals; and
    2. undergo some form of comparison and rating process using objectively determined ranges or bands – otherwise, end-users cannot distinguish between good and bad collective fund/ products.
- And regardless of the marker chosen to represent the degree of compliance or alignment with goals, the constituent assets within the collective structure must first be assessed for compliance.

**Comments on the FCA's proposed classification framework in Figure 3**
In Figure 3, the FCA outlines five groups which could underpin a sustainable product classification and labelling system: 1. Not promoted as sustainable; 2. Responsible (may have some sustainable investments); and three 'Sustainable' blocks 3. Transitioning (low allocation to Taxonomy aligned sustainable activities); 4. Aligned (high allocation to Taxonomy aligned sustainable activities); and 5. Impact (objective of delivering positive environmental or social impact, a category in its own right).

**The need for objective quantitative data, measurement, and ratings/ rankings**

The FCA describes a label/ classification system as being more 'objective' than a ratings/ traffic light system. But, this cannot be the case. Any marker or label, if it is to be objective must be derived from some form of rating or ranking. Or else, end-users would not be able to differentiate between collective funds/ products.

So, for any marker to be meaningful and usable, it will contain both objective (rating/ ranking) and subjective (qualitative/ narrative) elements. Value judgments, underpinned by robust and objective quantitative analysis, cannot be avoided.

Objective quantitative or numerical based criteria are also necessary to measure progress against regulatory objectives or fund goals. It is difficult to see how the FCA or stakeholders can measure the effectiveness of policy and regulatory interventions unless progress can be quantified.

Similarly, if collective funds/ products are to be allowed to be marketed as 'transitional', then some form of quantitative or numerical based criteria will be needed to measure progress towards goals.

If we consider the process that would be used to create a marker aimed at end-users, we can see why objective quantitative data and some form of rating/ ranking is necessary.

The individual constituent assets that form collective funds/ products must be evaluated and rated or scored. To be meaningful, this has to be undertaken using both objective/ quantitative measurement (eg. assessment of emissions, pollution levels) and subjective/ qualitative assessment (eg. assessment of corporate strategy and policies).

The next step then is to then assess the overall collective fund/ product structure. This will be an aggregate assessment of the individual constituents. Again, there will need to be an overall rating or score attributed to the collective structure.

The next step then is to determine which group or band the collective fund/ product falls within. This must also be done using subjective/ qualitative judgment and objective/ quantitative measurement. This should be a comparatively straightforward process as the grading, scoring, or rating achieved by the collective fund/ product can be fitted within the range bands.

Even for the FCA's suggested approach in Figure 3 to work, requires some form of objective quantitative or numerical based criteria to be applied to determine which group or band a collective fund/ structure should be allocated.

The criteria (or range bands) which determine qualification for inclusion within the five groups suggested by the FCA must require subjective and qualitative judgment. For example, what determines 'low', 'some', or 'high' allocation to taxonomy aligned activities? Is 50% -75% medium and 75%-100% high? So, some form of grading, scoring, or rating must be used to determine the boundaries of the groups suggested.

**Other comments on Figure 3 classification framework**

It is not clear what the advantages of having, or the distinctions between, the groups: 4. Aligned (high allocation to Taxonomy aligned sustainable activities); and 5. Impact (objective of delivering positive environmental or social impact). If a collective structure that scores very highly on allocation

to climate goals, is that not making a positive environmental impact? We would welcome further clarification on what is intended by group 5.

We have concerns about the categories 2. Responsible (may have some sustainable investments); and three 'Sustainable' blocks and 3. Transitioning (low allocation to Taxonomy aligned sustainable activities).

With regards to the Responsible group, what constitutes 'some' sustainable investments? If a collective structure contains just a small amount of sustainable investment, it cannot realistically be considered sustainable.

Even collective structures which are not expressly marketed as sustainable will inadvertently contain investments/ bond holdings in firms that are undertaking some degree of sustainable activities. Allowing financial institutions to market a collective structure in an advantageous, positive way as 'Responsible', when that collective structure is no better than non-sustainable counterparts, surely risks misleading end-users.

Similarly, with regards the Transitioning group, how would the commitment to a higher alignment be measured, monitored, and communicated? Collective structures grouped as 'Not promoted as sustainable' will in all likelihood will experience transition towards alignment with goals by default – as they will have a stake in the real economy which is undergoing transition anyway.

So, the FCA proposal could allow financial institutions to market a collective structure in an advantageous positive way as 'Transitioning' when in fact that collective structure is having no more positive impact than a non-sustainable financial product.

**Financial Inclusion Centre framework proposals**
We are developing an alternative framework which we think would be better aligned to policy objectives and goals. Policy and regulatory interventions, to be judged a success, must drive major behavioural changes in the financial system. These, in turn, must drive major behavioural changes in the real economy. We see four clear objectives and goals for policy and regulatory reforms. Reforms should:

- promote environmentally **S**ustainable activities and deter environmentally damaging activities
- promote **R**esponsible corporate behaviours (treatment of workers, supply chains etc) and deter irresponsible corporate behaviours
- promote activities that have a positive social **I**mpact (on local economy and communities, financial and social inclusion etc)

We term these three sets of activities as **SRI** finance. These can be seen as similar to the 'E' and 'S' from the acronym 'ESG'.

The fourth category we use in our analysis relates to Governance. This relates to how companies are run and accountability to shareholders and bondholders. This is the same as the 'G' in 'ESG'.

We are currently developing a framework to assess the degree to which the constituent assets within collective funds/ products comply with SRI goals in a consistent way. This can be constructed

into aggregate ratings for funds/ products to allow cross fund/ product/ sector comparison. Below is a draft outline.

**Figure 1: SRIG comparative assessment grid for constituent assets/ collective structures**

| | Sustainable | Responsible | Impact | Governance |
|---|---|---|---|---|
| High alignment/ Dedicated | | | | |
| Significant alignment | | | | |
| Medium alignment | | | | |
| Low alignment | | | | |
| Non-aligned | | | | |

The use of clear boundaries or ranges is the most realistic way of assessing compliance with SRI goals and communicating results to end-users, and therefore driving behavioural change. This grid could be used consistently at the various levels of analysis required to derive a representative marker (label, ratings, 5 star system etc).

At the base level it could be used to measure, say, ABC Corporation's alignment with SRIG goals. The measurement could be in the form of a score, say, out of 100 or a 5 point rating system. Ideally, a system should measure and communicate *negative* and *positive* impacts – see below.

This process could be repeated for all the constituent assets within a collective fund/ product. And, from this process, an overall calculation of the collective fund/ product's compliance with SRIG goals could be derived.

We are still working on this framework. But, we envisage a system where to be grouped as Medium Alignment the collective structure would have to achieve a weighted average score in the range 40-60, Significant Alignment would score 60-80 and so on. Or, a 5 point rating system could be used derived from a weighted average of the constituent asset scores.

In the grid, the terms high, significant, medium, low, and non-aligned signify ranges or boundaries to allow for objective measurement of compliance with goals. In terms of a label, those funds/ products with high alignment to sustainable assets could be marketed as 'sustainable (dedicated)', significant alignment as 'sustainable (targeted)', medium alignment as 'sustainable (neutral)', low alignment as 'sustainable (low)', and funds/ products with the lowest alignment 'sustainable (non-aligned)'.

The same rating and label could be applied to responsible or impact funds/ products.

But, it would be easier to have a clear one-to-five rating system with collective funds/ products with a high alignment given a Sustainable (5), Responsible (5), or Impact (5) rating depending on the objectives and focus of the fund/ product etc.

Another approach would be to use a label with star ratings. For example, for sustainable fund/ products, a Green Label could be used with the number of green stars denoting the degree of compliance with sustainability goals.

Ideally, any rating or label would allow end-users to identify funds/ products which make a ***negative*** contribution to goals. As we outline above, the objective of policy and regulatory interventions should be to promote positive behaviours and deter negative behaviours. For this to happen, end-users must be able to see clearly which funds/ products are still invested in activities which damage the environment or companies with poor employment/ human rights practices.

This could be done by utilising methodologies that measure and rate constituent assets on, say, a minus-five to plus-five scale. From this, a net compliance score for the collective fund/ product could be calculated. This could then be converted into one-to-five green stars denoting degree of positive contribution and one-to-five *hazard* symbols denoting degree of negative impact.

A one-to-five rating, or label-plus-star rating, approach would then allow for more detailed narrative descriptions to be then used to elaborate on the fund/ products aims and objectives and degree of compliance.

The approach we advocate could also be used for collective structures such as segregated pension funds (which may have a mix of direct holdings and investment fund holdings), funds of funds, or platform recommendations.

The approach we set out has been tried and tested in mainstream financial markets. For example, credit rating agencies rate individual company bonds and bond portfolios, loans and loan books, while investment analysts rate individual shares and provide overall risk ratings for pension funds and investment funds.

In addition to providing consistency and objectivity, the other main advantage of our proposed approach is that it allows end-user to tailor financial decisions to their SRIG preferences and risk tolerances. Some end-users will want to focus purely on S, others on R or I. Our approach allows collective structures to be rated according to just their S performance, R performance, or I performance.

But, it also allows for a blended approach. Some end-users might have a dual interest in S and R but not I and G and so on.

This SRIG grid system also allows for providers of collective structures to market their offers as being 'transitional' – and, importantly, for fund governance bodies and the FCA to supervise and monitor claims. For example, an investment fund might be categorised as being a Medium Alignment Sustainable/ Responsible/Impact Fund but the accompanying marketing and disclosure material might state that it aims to transition to High Alignment within 3 years. The SRIG grid system would allow the FCA to assess this claim at authorisation stage and on an ongoing basis.

As we mention elsewhere, the utility and integrity of any system will depend on the integrity and objectivity of third parties and the models used to evaluate the compliance of constituent assets with relevant policy goals.

**Q5: What are your views on 'entry-level' criteria, set at the relevant entity level, before products can be considered 'Responsible' or 'Sustainable'? We welcome views on what the potential criteria could be and whether a higher entity-level standard should be applied for 'Sustainable' products. We also welcome feedback on potential challenges with this approach.**
We do not think the idea of 'entry-level' criteria can used for the terms 'Responsible' and 'Sustainable' within the structure outlined in Figure 3 of DP21-42. As we explain above, this could lead to greenwashing, misselling, misrepresentation, and end-users inadvertently making poor financial decisions.

Moreover, it does not have the advantage in terms of consistency and flexibility as the SRIG framework we have outlined above.

Of course, if the FCA was minded to only allow collective structures that meet certain criteria to be marketed as 'sustainable', this could be accommodated within the SRIG framework outlined above. For example, only collective structures that meet the criteria for Significant Alignment or High Alignment/ Dedicated could be approved for marketing as sustainable/ responsible/ impact.

**Q6: What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.**
It is not possible to say what might be the appropriate precise balance between principles and prescription at the moment without seeing a further, more developed iteration of the FCA's thinking.

But, we do know from experience that, even if the FCA *intends* to use a principles-based approach, once the regulator begins to supervise and enforce against any new principles, it will not be long before the industry demands more prescription, precision, and guidance.

Perhaps the more important question is how to balance qualitative/ subjective assessment and judgments with objective/ quantitative measurement. As we explain in our response to Q4, any approach will have to combine both subjectivity and objectivity, qualitative assessment and quantitative measurement. Any classification system regardless of whether it is a label, rating, grading will require some form of comparative measurement. And this, by definition, will require prescription. Classification systems based on qualitative assessments or narrative descriptions will be of limited utility.

The other crucial issue is the role of constituent data and information that will be used to construct any marker – for example, sustainability ratings. The integrity and usefulness of any marker will depend on the integrity and relevance of that input data. It will be very important for the FCA to be very prescriptive on what input data is valid for constructing any marker.

With regards to thresholds, we would argue that the approach we outline above using ranges and boundaries would be the most practicable and easier to understand.

**Q7: Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics: • intentionality • return expectations • impact measurement • additionality • other characteristics that an impact product should have**
Yes, for the most part. It is particularly important that intentionality and additionality be incorporated. It is difficult to see how a collective fund/ product could be considered as having an 'impact' unless it is intended to do something additional and achieves it.

It does not matter if a meaningful definition results in fewer products/ funds being defined as Impact. Allowing a weaker definition would just enable Impact-washing and result in end-users being misled.

Care must be taken with the additionality definition promoted by the OECD. The fact that a collective structure might make additional capital available to fund, say, affordable social housing or green infrastructure should not automatically qualify it for Impact. Impact capital – even if provided at a lower-than-market return – will be more costly than funding available via the state (state financing is cheaper than private finance).

A good example is provided by the ability of local authorities to access capital from central government at very low cost. The financial sector is actively promoting the idea of funding social housing and other social infrastructure – these assets are being promoted as suitable for pension funds and insurance funds. This is branded 'inclusive capitalism'. Impact capital could actually crowd out local authority funding. However, Impact capital will be more costly than low cost local authority funding. The effect of this could be to increase rents or service charges on infrastructure higher than is necessary. This would allow for value extraction from poorer households/ communities and a transfer of wealth. So, this would have a net **negative** social impact.

With regards to performance expectations, it is important that it is made clear that returns from true Impact funds are likely to be lower than fully market exposed investments. If Impact investing is to make a difference to, say, financially excluded households or deprived economies then by definition less value should be extracted than would be expected with 'pure' market investments. Therefore, the financial return should be expected to be lower than pure market investments.

**Q8: What are your views on our treatment of transitioning assets for: a: the inclusion of a sub-category of 'Transitioning' funds under the 'Sustainable' label? b: possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?**
No, we do not support the idea of a sub-category for Transitioning. This increases the risk of greenwashing. As explained in our response to Q4, the best way to accommodate collective structures (and underlying assets) that claim to be transitioning is for the FCA to:

- Require them to publish independently audited figures on their current exposure to climate damaging activities; and
- Allow them to include 'statements of ambition' with clear targets and timeframes in disclosure and marketing documents. These statements should be scrutinised and reported on by fund governance bodies and supervised by the FCA.

**Q9: What are your views on potential criteria for 'Responsible' investment products?**
We are concerned that the proposed criteria set out in DP21-4 have the potential to confuse and mislead end-users.

BSI's PAS 7341 defines responsible investment as '*the consideration of the impact of material factors, including material ESG considerations, on financial risk and return to better manage both risks and opportunities and deliver long-term sustainable returns and investment decisions*'. ESG integration is defined in PAS 7341 as '*the systematic and explicit inclusion of material ESG criteria into investment analysis and investments decisions*'.

As a narrative expression, this is fine. But, an approach based on narrative descriptions will be of limited use, and have the potential to be misleading, unless underpinned by objective quantitative metrics to enable external scrutiny and performance measurement.

Moreover, the FCA states in para 3.38 that 'Responsible' products may have high, low or no allocation to sustainable investments. An investment vehicle that has medium, low, or no allocation to sustainable activities cannot be considered as responsible. This would undermine the meaning of any marker/ label and the basic integrity of any system.

As outlined above, we would argue that only collective structures that have significant or high alignment to qualifying assets should be approved for marketing as sustainable/ responsible/ impact.

**Q10: Do you agree that there are types of products for which sustainability factors, objectives and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?**
Of course, there will be funds and products which do not have SRI objectives and goals. These could be labelled as Non-aligned.

However, this should not mean that providers, fund managers, or relevant fund governance bodies should then be absolved of responsibility to report on issues particularly if the investment strategy is having a negative impact on the environment or employee and human rights.

If policy interventions are to be effective they must not only encourage positive financial market behaviours, they must also deter negative behaviours. A risk rating approach outlined above in the response to Q4 would accommodate this. Funds/ products which aim to make a positive contribution could be rated plus one-to-five. Those which hold assets which make a negative contribution could be rated minus one-to-five.

**Q11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?**
Funds/ products should be allowed to be marketed as aligned with those benchmarks as long as:

- it is accompanied by independent analysis and ratings described in the response to Q4, above; and
- relevant fund governance bodies/ pension fund trustees etc confirm that the fund/ products are compliant with those benchmarks and the FCA scrutinises and supervises the use of such terms in marketing and promotions.

**Q12: What do you consider the role of derivatives, shortselling and securities lending to be in sustainable investing? Please explain your views.**
It is too early to say what the impact of derivatives, shortselling, and securities lending will be in sustainable investing. It is not at all clear that the use of these techniques will be beneficial. There is a risk that the additional complexity and opacity associated with these activities will make it more difficult to analyse whether collective structures are making a negative or positive contribution.

The critical point is that any rating system should ensure that these financial activities is not used to artificially inflate exposure to positive assets or downplay holdings of climate damaging assets within portfolios.

**Q13: What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?**
We support the overall intention of the FCA that the consumer facing layer of disclosure should be a subset of the detailed information that firms would be required to provide, and also support and complement the classification and labelling regime. Avoiding duplication and ensuring consistency and coherence in the provision of relevant information is also important.

We also support ensuring that any UK regime is aligned as far as possible with existing EU frameworks.

**Q14: What are your views on consumer-facing disclosures, including the content and any considerations on location, format (eg an 'ESG factsheet') and scope?**
We support the idea of a layered approach to disclosure. Retail investors will not be in a position to process all of the complex information and data relating to sustainable and responsible investing.

It is not possible to reach firm conclusions on the precise format until further consumer testing has been undertaken. But, the content of the disclosure set out in para 4.6 seem to cover the relevant factors that need to be understood by retail investors.

Within this set of factors, the most important will be:

- An investment product rating which must be based on independently measured, objective constituent data. A narrative based 'label' on its own will not be effective.
- Proportion of assets allocated to sustainable investments. Again, this must be independently audited.
- Independently audited performance metrics which measure performance against strategic objectives.

We also support the idea of a factsheet which allows for easy comparison between different funds/ products.

**Q15: What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?**
We support the idea that product-level disclosure should contain more detail than the consumer facing disclosure.

But, the critical factor will be the integrity and consistency of the input data and methodologies used to measure compliance with goals and subsequent performance. The FCA seems to imply in para

4.15 that it is willing to allow providers to self-select how they develop and use their own performance metrics, and for the market to determine whether methodologies converge.

If this is the case, we would strongly advise against this. Having different methodologies will create confusion and undermine the effectiveness of any disclosure regime. From the outset, it is important that the FCA ensures consistency. So, a high degree of prescription will be needed.

**Q16: What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?**
We have no particular comment on this question as this is primarily aimed at the industry except to say that the SRIG grid framework we outline in the response to Q4 would facilitate the layered approach the FCA would like to introduce. It would also allow the FCA to expand the scope of the disclosure regime beyond climate related issues.

**Q17: How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.**
It is unclear what is meant by this question. If the FCA is asking whether it should comply with best practice at EU and international level, then yes. We would add that the FCA should not be tied by those EU and international standards if there is an opportunity to further enhance the UK domestic regime.

But, this is more of a political decision. Post Brexit, the government quite rightly wants the UK to become a centre of global SRI finance. There are two competing schools of thought on how best to achieve this.

One school of thought, promoted by civil society organisations, is that the UK should compete to attract business on high standards, and the integrity and quality of its financial system. The UK should be a beacon of best practice in the SRI finance sector.

The other school of thought sees regulation as a 'burden' as 'stifling innovation'. We are very concerned at the government's intention to the FCA/ PRA secondary competitiveness and growth objectives as part of the Future Regulatory Framework (FRF) Review . Competitiveness always sounds harmless. But, it is not the same as 'competition'. If introduced, this could be a 'Trojan Horse' for deregulation and reductions in consumer protection. This objective would allow industry to argue that regulations and rules are increasing costs for financial firms so reducing international 'competitiveness' in the SRI finance sector. There is a risk of regulatory arbitrage which, in turn, risks the facilitating of greenwashing and other irresponsible financial practices.

Linked to this, as part of the FRF Review, government wants the power to require the FCA to change its rules if the government deems it in the 'public interest'. The finance lobby is much more powerful than the civil society lobby. This will allow it to press HMT to change rules in the 'public interest'. The public interest, no doubt, being their interests.

We are concerned that the proposed reforms set out in the FRF would have the effect of compromising the independence of the FCA. Regulatory independence is critical. We would urge the FCA to resist the competitiveness and growth objectives, and the proposed power to give government more direct influence over FCA's rules.

**Q18: What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?**
It is important that the FCA prescribes in detail how index and ratings providers operate.

The FCA should regulate the use of names and terms used to describe indices to minimise the risk of overclaiming with regards to compliance with climate and other goals. The FCA should also prescribe how fund/ product providers make claims about tracking indices. This would mean the FCA prescribing tolerances with regards to how closely a fund/ product's asset allocation/ exposure to sustainable assets matches an index construction. The degree of matching should be independently audited and reported on.

We very much support the idea of bringing ratings agencies within FCA regulation. Once (if) this happens, the FCA suggests that a new regime might focus primarily on transparency, governance, and management of conflicts of interest. These elements are undoubtedly important. But, the FCA should go further and be more prescriptive about the methodologies used by ratings agencies. The lack of standardisation and consistency in the provision of ratings undermines the ability of end-users to make informed decisions.

We support the FCA's view that it would be appropriate to confirm that advisers should consider sustainability matters in their investment advice and ensure their advice is suitable and reflects consumer sustainability-related needs and preferences.

**Q19: Do you consider that there is a role for third-party verification of the proposed approach to disclosures, product classification and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?**
For any new approach to work the various regulatory authorities (FCA, PRA, TPR, and FRC) will have to:

- Prescribe in detail how each layer of a fund/ product aimed at end-users is to be assessed and rated (whether internally or by an external ratings agency) and then marketed and promoted. The layers include underlying constituents (securities/ assets/ funds), investment portfolios, and products/ funds aimed at end-users (retail investors, insurance policyholders, pension scheme members)
- Ensure that relevant fund governance bodies (or pension scheme trustees) oversee and report to end-users on the integrity of any assessment and ratings approach, and performance against goals.
- Supervise closely the practices of external ratings agencies. In an ideal world, assessment and ratings of each of the layers would be undertaken by a non-profit, public interest organisation. This would avoid the conflicts of interest inherent in the provision of ratings by commercial organisations. But, that is not going to happen, so it is important that commercial agencies are regulated very closely.
- Supervise fund manager/ product provider compliance with regulations and rules at authorisation stage and on an ongoing basis, and use sanctions for non-compliance.

If this happens, any third party verification is likely to be superfluous and may indeed add to the confusion. Of course, there would be nothing to stop independent civil society organisations undertaking their own investigations and research to expose misleading practices.

**Q20: What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machine readable format to better enable data collection and analysis?**
We have set out what we consider to be the objectives and goals of policy and regulatory interventions – see Introduction, p2. Interventions will be judged a success if they result in:

- an increase in environmentally **S**ustainable financial activities and reduction in environmentally damaging activities;
- an increase in **R**esponsible corporate behaviours (treatment of workers, supply chains etc) and reduction in irresponsible corporate behaviours; and
- an increase in financial activities that have a positive social **I**mpact (on local economy and communities, financial and social inclusion etc) and a reduction in financial activities that are detrimental to the interests of households and communities.

The only realistic way of measuring the impact of interventions is through the publication of independent data which measures progress against those objectives and goals. Narrative or qualitative assessments will not shed much light on market behaviours and activities. We would urge the FCA to develop a framework, similar to the grid set out in Q4, to report publicly against those objectives and goals. This will mean requiring regulated firms, funds, and schemes to report publicly on compliance with these goals *and* to report to the FCA so the regulator can publish overall market performance reports.

**This marks the end of The Financial Inclusion Centre submission**

**January 2022**