FINANCIAL CONDUCT AUTHORITY (FCA): SUSTAINABILITY DISCLOSURE REQUIREMENTS (SDR) AND INVESTMENT LABELS CP22/20

SUBMISSION BY THE FINANCIAL INCLUSION CENTRE

JANUARY 2023

About The Financial Inclusion Centre

The Financial Inclusion Centre (FIC) 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. We focus on households who are excluded from, face discrimination in, or are underserved by financial markets and services.

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INTRODUCTION

We are pleased to make a submission to such an important consultation. Our submission is structured in three sections. Following this introduction, we summarise our submission. We then provide answers to the FCA's specific questions. As can be seen from our submission, we do not think the FCA's proposals for a sustainable label will be effective at helping end-users[1] of that label make informed decisions about the degree to which financial institutions contribute to climate goals or continue to finance economic activities that damage the environment. The Annexes contain a detailed critique of the FCA's proposals contained in CP22/20 and The Financial Inclusion Centre's alternative proposals for a ratings regime.

SUMMARY OF FINANCIAL INCLUSION CENTRE SUBMISSION ON PROPOSALS IN CP22/20

The idea behind a sustainable investment label is good. However, the FCA's proposals conflate and confuse different ESG ***goals*** (environmental, responsible corporate behaviours, and social impact) into a single sustainable label and conflates ESG goals with the ***approach*** adopted by funds.

The first stage of categorisation suggested in the FCA's proposed categories, Focus, Improver, and Impact, reflect the approach adopted by financial institutions and the way the market has evolved. The approach is not designed to reflect the way end-users think about sustainable goals: is a product green; does a fund follow principles of corporate responsibility; or does it seek to make an impact on social policy goals? This will make it more difficult for investors to identify funds which meet their goals.

The FCA says that its system does not imply a 'hierarchy' ie. that some funds are better than others. Nor does the FCA intend to mandate that all funds be subject to a rating. The label is voluntary. So, the FCA's approach is not a proper rating system that would allow investors to easily identify the degree to which funds comply with stated goals or provide transparency on how much environmental harm is caused by those funds without a label. With the FCA's proposals, financial institutions that continue to finance economic entities that damage the environment will not be held to account.

We urge the FCA to rethink the architecture of its proposals and introduce a naming and labelling system which allows end-users to:

- Distinguish funds according to the goal or purpose ie. funds with a green goal from those that have a social goal (eg. around fair treatment of workers or tackling a social policy goal such as financial inclusion) or, if preferred, products with a balanced set of sustainability goals. If the FCA insists on retaining the single sustainable label, it would be better to at least require these to be branded as 'Sustainable (Green)' or 'Sustainable (Impact)'. Those funds which meet the qualifying criteria across each of the categories should be allowed to use the label Sustainable (Balanced).
- Easily identify the degree to which a product complies with those stated goals through a meaningful rating system.

[1] We define end-users as retail investors and others such as pension fund trustees, charity trustees, and local government. We think any proposals should apply to more than retail investors.

- Understand the approach adopted by the product eg. does it aim to transition or improve to a higher rating.
- Easily identify funds which continue to cause harm to climate and environmental goals. A voluntary labelling system which applies only to financial institutions which are behaving well is not sufficient to move us towards a net zero financial system.

To help end-users identify how well investment funds meet green goals, there should be a clear rating system based on, say, a colour-coded symbol or 1-5 star ratings. For products with green goals, the rating should be determined by the proportion of a fund/ product portfolio's assets which meet a green standard. This degree of compliance could be determined using a quantitative measurement such as a Portfolio Greenness Ratio.[2] Funds claiming to be 'transitioning' should set clear targets and publish independently verified progress reports.

Any fund promoted as green in any form should not be allowed to include fossil fuel assets within its portfolio and exclude other activities which do significant harm to environmental goals. Funds with a poor green rating should carry a clear environment health warning.

We have provided examples of how an alternative green label would work in Annex B. We believe the approach we set out could work for all types of collective fund/portfolio and indeed for bank loan books. It could also be adapted to allow for rating of funds according to their compliance with corporate social responsibility standards (eg. investing in companies which pay a real living wage or aim for gender pay equality). But, our focus is on climate and environmental goals.

The FCA's label proposals fall well short in a number of other areas. Particularly worrying are: the weak proposals on oversight and governance; the amount of leeway firms will have to mark their own homework on compliance with green goals; and the lack of consistency on disclosure which will cause investor confusion. Oversight of a fund's objectives could be done by an investment fund governance body, yet FCA rules say only one quarter of the members of this body have to be independent.

The FCA should: require investment firms to obtain independent verification of labels; take the lead on developing a standardised template for disclosure rather than encourage the market to develop one, and mandate its use by all funds; and mandate the use of standardised green finance KPIs to allow for meaningful comparison of sustainability performance and progress towards green goals. Rules should be amended to ensure half of fund governance body members are independent.

The proposals fall well short of the comprehensive coverage of products adopted by the EU. The FCA should bring all investment based products within the label proposals. The proposals should apply to clients such as pension scheme trustees, charities, and local government clients not just retail investors.

If distributors and intermediaries recommend overseas funds which claim to be green yet aren't covered by the UK labelling regime, they should be required to perform due diligence on the green compliance of those funds. They should be required to certify to clients if a fund complies with UK standards. If that is not possible, they should not be allowed to recommend those funds.

[2] ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)

There has been a significant growth in the number of funds in the ESG sector. Detriment tends to 'follow the money' in financial services and the ESG fund market has not been directly supervised by the FCA or addressed by the Financial Ombudsman Service (FOS).[3] It must be reasonable to assume there is a significant risk that greenwashing[4] has already occurred. There are already rules in place requiring regulated firms to be clear, fair, and not misleading in the way they promote and market funds. Therefore, we urge the FCA to conduct an investigation into existing funds that claim(ed) to be 'ESG' or 'ESG-aligned'. This will help inform the FCA's preparations for introducing its welcome proposal for a new anti-greenwashing rule.

Other interventions to ensure financial institutions take environmental harm seriously
The scale of the climate crisis facing us means we need to deploy robust interventions to ensure financial institutions, and their directors and senior managers are deterred from financing climate and environmental harm, and are held to account if they do so. Protecting the environment should be given at least equal status in regulation as objectives such as protecting consumers, preventing money laundering and financing terrorism, and maintaining market integrity. Additional interventions will be needed to complement any rating or disclosure based intervention. These recommendations are taken from a forthcoming Financial Inclusion Centre report called '*The Devil is in the policy detail: will financial regulation support a move to a net zero financial system?*'

An Environmental Harm Register Government should establish an independently operated, publicly accessible Environmental Harm Register.[5] The Register would contain details on the level and source of emissions generated by publicly listed and larger private companies and sovereign state agencies. This should be complemented with information on wider environmental harm. The worst performing economic entities on the Register should be included on an Environment Sanctions List.[6] This data should be audited with the auditing overseen by the Financial Reporting Council (FRC). The Environmental Harm Register and Sanctions List should be maintained by the FCA. The Register would allow for better targeted regulation and provide the foundational data to build up meaningful sustainability labels. It would also enable progress against transition plans to be monitored thereby allowing government and relevant regulators to consider and require the appropriate remedial action at entity and sector level.

An environmental-harm penalty for funds In time, allowing for a suitable transition period, penalties should be introduced for financial institutions that continue to fund economic entities which seriously damage the climate and wider environment. Reference would be made to the public Environmental Harm Register and Sanctions List outlined above. For example, if a company, which scored a poor rating on emissions, issued a corporate bond, then any fund which invested in that bond should pay a climate penalty to reduce the net yield received. Gains from equity type investments would also need to be addressed. A global carbon tax on economic entities is desirable. An alternative would be to create a climate harm 'windfall tax' to be applied to investment funds which make above market returns from holding environmental damaging assets.

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[3] It is interesting that searching the FOS website for 'greenwashing' or 'ESG' at the time of writing turned up no results.
[4] In the sense that funds have been promoted as being ESG compatible to gain a marketing advantage without fundamental changes being made to the underlying investments
[5] Ideally, an international register would be created by a relevant international agency
[6] The government maintains a UK Sanctions List under the Sanctions and Anti-Money Laundering Act 2018 [The UK Sanctions List - GOV.UK (www.gov.uk)] We argue the same robust approach should be applied to economic entities which cause the worst damage to the environment.

Direct fines and sanctions In time, direct fines and sanctions (for example, by removing certain regulatory permissions), should be imposed on financial institutions that continue to finance or provide access to finance for the most harmful environmental activities as designated on the Sanctions List.

Board level/senior management responsibilities and remuneration: There should be professional and financial consequences for the people who run financial institutions that continue to damage the environment. The Senior Managers and Certification Regime (SMCR) should apply to a climate-related financial activities including sanctions for failing to comply with a new climate-related responsibility.[7] For individuals covered by the SMCR, a new responsibility should be introduced to consider the impact of a firm's activities on environmental sustainability and to take reasonable steps to reduce that impact.[8] It should be mandatory for independent assessment of performance against climate responsibility and climate de-risking plans to be included in the calculation of remuneration for boards and senior management.

Environment responsibility statements If stewardship means creating sustainable benefits for the environment, then we need evidence of progress. The FRC, with the FCA, should ensure that independent, objective evidence on the degree to which underlying economic entities[9] benefit or harm the environment is put into the public domain. Information must be clear and minimise the risk of misinterpretation and obfuscation. Economic entities should produce an environment responsibility statement setting out: independent, audited data on emissions generated by the entity's activities and the degree to which activities align with the definitions in the UK Green Taxonomy (when finalised); and a risk assessment of which activities make the greatest contribution to climate and environmental harm with the actions taken to address those risks.

Qualifying company accounts/environment reporting standards Auditors should have to say whether statements in a company's report and accounts relating to the environment should be qualified either because they disagree with the conclusions, or there is insufficient independent information to allow for judgment. The FRC and professional bodies for auditors, accountants, and actuaries should urgently develop new standards on identifying, quantifying, and reporting on environment-related risks. These standards should be included in assessing whether enforcement action should be brought for breaching professional standards.

Statutory regulation of ESG ratings and ratings providers There is an incentive for financial institutions to select a ratings provider that produces inflated ESG ratings. Consumers or pension fund trustees cannot be expected to challenge the different methodologies used by such providers. Nor is it sensible to think that competition will drive up the quality and integrity of ratings. Indeed, if anything the fiercer the competition, the greater the risk of 'ratings inflation' where providers provide more favourable ratings to attract clients. We urge HM Treasury to give the FCA the powers to regulate ESG ratings and ratings providers as quickly as possible.

[7] Senior Managers and Certification Regime | FCA

[8] This would be seen as being similar in intent to the overall responsibility senior managers have for the *firm's* policies and procedures for countering the risk that the *firm* might be used to further *financial crime* See: SYSC 4.7 Senior management responsibilities for UK relevant authorised persons: allocation of responsibilities - FCA Handbook

[9] The real economy entities which financial institutions finance in different forms

ESG voluntary Code of Conduct Until regulation happens, the FCA has announced a working group, the ESG Data and Ratings Code of Conduct Working Group (DRWG), to develop a voluntary Code of Conduct for ESG data and ratings providers.[10] The DRWG objectives should be revised to produce a Code that: ensures the production of trustworthy, meaningful ESG ratings; requires ESG providers operate to the highest standards of integrity; enables investors to make effective decisions on ESG factors; and requires financial institutions and intermediaries to use ESG ratings and the Code responsibly.

Code governance The governance of the DRWG is very weak and dominated by industry representatives.[11] There is a real risk the DRWG will not deliver a meaningful Code of Conduct and could even furnish government with an excuse not to regulate ESG ratings providers. The FCA should chair the DRWG or ensure it has an independent chair. The FCA should appoint DRWG members and ensure half are independent civil society representatives. The FCA must approve ownership of the Code. To build trust in the Code, the workings of the DRWG should be open to public interest representatives to make representations at meetings. The Chatham House Rule should *not* apply except when there are genuine issues of commercial confidentiality being discussed. Minutes of the meetings should be published on the FCA website. The FCA should require institutional users to disclose upfront to investors whether the ESG ratings provider they use complies with the Code. Even though this is a voluntary code, the FCA should require the DRWG to consider appropriate deterrents and sanctions for providers and users that abuse the Code. The FCA should issue guidance on the use of ESG data and ratings by regulated firms and intermediaries. ESG ratings and providers may not yet be regulated. But, the FCA already requires financial promotions and communications to be clear, fair, and not misleading. Misuse of ESG data and ratings obviously has the potential to mislead.

ESG ratings inconsistency Worryingly, the FCA does not seem to think the low correlation between the ESG ratings provided by different agencies is a problem.[12] It is not reasonable to expect end-users to compare and contrast underlying methodologies. The FCA should: investigate and publish an assessment of why there is such a low correlation between ESG ratings; assess the potential for conflicts of interest created by users being able to select favourable ESG ratings methodologies; and promote consistent methodologies for ESG ratings. A fair and functioning system requires direct regulatory intervention.

[10] Code of Conduct for ESG data and ratings providers | FCA

[11] Two industry groups will serve as the Secretariat for the DRWG. This Secretariat, co-chaired by industry representatives, will appoint the DRWG members. The DRWG will be composed of between 15-18 members, with only three positions reserved for academics and civil society representatives.

[12] Where different ESG providers produce different ESG ratings on the same economic entity/financial product

RESPONSES TO SPECIFIC QUESTIONS IN THIS PAPER

Q1: Do you agree with the proposed scope of firms, products and distributors under our regime? If not, what alternative scope would you prefer, and why?

It is positive that the FCA intends to apply the anti-greenwashing rule to all firms. But, it is concerning that its proposals on labelling and classification, disclosure, naming and marketing and distribution are limited to investment funds (primarily those marketed to retail investors). This leaves significant gaps in the market not covered by the FCA's approach and falls short of the approach adopted by the EU.

It is not clear why the FCA chose not to include other products now given that the principles underpinning a label are the same for any collective[13] product. Many of the asset management firms covered by these proposals will sell the full range of products. Yet a range of products may contain the same constituent equities and bonds just within different legal or taxation wrappers.

Leaving large parts of the product market not covered by the proposals creates obvious risks. Therefore, we argue the FCA should bring all other products within the labelling proposals.

The FCA also intends to differentiate between the protections given to retail investors and other clients such as pension fund trustees. Pension fund trustees are treated as 'sophisticated' in financial regulation. Yet, they clearly are not. Given the size of assets held in pension schemes, the consequences of pension scheme trustees making poor decisions can be significant. Trustees are often 'laypeople' with little experience of investment markets and strategies. The scale of the assets involved and the lack of technical knowledge and experience means they can actually be more vulnerable than retail investors to conflicts of interest which may give rise to poor outcomes. The recent crisis involving complex Liability Driven Investment strategies is a case in point.[14] Identifying genuinely climate compliant investment managers and consultants or spotting greenwashing will not be easy for ordinary trustees. The labelling proposals should apply to clients such as pension scheme trustees, charities, and local government.

Q2: Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?

We are pleased with the timetable for the proposed general anti-greenwashing rule. We would urge the FCA to speed up as much as possible the introduction of the other proposals. It is important to remember that protecting the environment from the activities of financial markets and institutions is not treated with anywhere near the same status as the FCA's (and PRA's) other regulatory objectives. A functioning label and disclosure regime is an opportunity to, at least partially, rectify that gap. Waiting until mid 2025 to implement some of the key disclosure requirements is surely not optimal.

Note that, as we explain below, while we fully support the principle of a label and enhanced disclosure, we do not think the FCA's approach will help investors distinguish between funds with

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[13] Collective in the sense that a product or fund comprises of a number of individual assets eg. bonds, equities and so on

[14] See for example: [Failure to learn lessons of 2008 caused LDI pension blow-up | Financial Times (ft.com)]

different goals, the degree to which financial institutions are damaging the environment, or be that effective in preventing greenwashing. We urge the FCA to fundamentally rethink its approach. This may well involve additional work but is still achievable within a more ambitious timetable.

Q3: Do you agree with the proposed cost-benefit analysis set out in Annex 2. If not, we welcome feedback in relation to the one-off and ongoing costs you expect to incur and the potential benefits you envisage.

Unfortunately, we are unable to comment on the costs aspect of the CBA. But, we are firmly of the view that, sadly, the FCA's proposals as currently constructed will not deliver the expected benefits. We do not think that these proposals will help create a system of financial regulation that moves us towards a net zero financial system.

The idea behind a sustainable investment label is good. However, the FCA's proposals conflate different ESG goals (environmental, responsible corporate behaviours, and social impact) into a single sustainable label. The proposals also conflate and confuse a fund's goals with the approach followed by a fund. This will make it difficult for investors to identify funds which meet their preferences.

The FCA says that its system does not imply a 'hierarchy' ie. that some funds are better than others. This cannot be the case. There is a clear hierarchy in terms of the degree of positive and negative contribution a financial institution and/ or fund makes towards climate goals. If financial resources are to be channelled towards climate positive and away from climate damaging economic activities, then this hierarchy needs to be clearly disclosed.

Nor does the FCA intend to mandate that all funds be subject to a rating. The label is voluntary. So, the FCA's approach is not a proper rating system which would allow investors to easily identify how well funds comply with stated goals or provide transparency on how much environmental harm is caused by those funds without a label.

The FCA's label proposals fall short in other areas. Particularly worrying are: the weak proposals on oversight and governance; the amount of leeway firms will have to mark their own homework on compliance with green goals; and the lack of consistency on disclosure which will cause investor confusion.

It is difficult to know to what degree the proposals might reduce greenwashing and increase consumer protection without seeing more detail on how the FCA intends to supervise and enforce against greenwashing. This is why we are urging the FCA to conduct an investigation into existing greenwashing in the market. This would help inform the FCA's approach to supervision and enforcement.

The FCA says that its proposals should also give consumers better confidence that a sustainable-labelled product is meeting certain criteria, and enable consumers and other stakeholders (eg. NGOs) to hold firms to account for their sustainability-related claims. We disagree. The FCA's decision to use a general sustainable label rather than dedicated green, corporate responsibility, and social impact labels (which better reflect the actual goals and preferences of investors), will make it harder for consumers to distinguish between funds and recognise when funds meet criteria.

Moreover, the FCA's proposal to allow investment funds to choose whether or not to have a label will allow those funds (and institutions) which continue to cause significant damage to the environment and do not qualify for label, to escape scrutiny.

The FCA says that the labels and consumer-facing disclosures should also help consumers better navigate the market for sustainable investment products, identify products that meet their needs and preferences, and in turn build trust in the market. As mentioned, we do not think that the FCA's proposals, which conflate goals with approach and involve a single sustainable label, will help investors easily identify funds which meet their preferences.

Furthermore, the FCA is not mandating standardised KPIs or a standardised template on disclosure, and it is not requiring firms to obtain independent verification of claims about alignment with climate goals. Oversight of a fund's objectives could be done by an investment fund governance body, yet FCA rules say only one quarter of the members of this body have to be independent.

So, there are serious issues relating to the governance and oversight of the system the FCA proposes. The FCA also intends to allow a working group dominated by industry interests to develop a voluntary Code of Conduct on ESG ratings and providers. The FCA's overall approach is unlikely to promote an ESG market in which trust could be justified.

The FCA refers to better informed capital allocation and asset pricing. But, the proposals on labelling are unlikely to help investors distinguish clearly between funds that have high standards of compliance with environmental goals and those which do not.

The FCA talks about encouraging an ecosystem of service providers emerging, driving innovation and thought leadership to support high-quality sustainability-related disclosures. But, again, we think the FCA is not adopting a sufficiently robust approach to mandating how information should be disclosed. The history of financial services regulation shows us that encouraging diversity of approaches to disclosure will just enable firms to obfuscate and confuse end-users. Moreover, its proposals on the voluntary Code of Conduct on ESG ratings providers will encourage the development of a weak Code of Conduct.

So, it is difficult to see how an ecosystem of high quality sustainability disclosures will result. Rather than driving genuine innovation, we are likely to see a proliferation of variable quality disclosures, end-user confusion, and an ecosystem embedded with conflicts of interest.

Q4: Do you agree with our characterisation of what constitutes a sustainable investment, and our description of the channels by which positive sustainability outcomes may be pursued? If not, what alternatives do you suggest and why.

The description of the channels by which positive climate outcomes might be generated is fine. We would rephrase the challenge as: will the approach adopted by the FCA (and the Bank of England/ PRA) create a regulatory system that actively channels financial resources towards climate positive and away from climate damaging economic activities; will it drive the development of a net zero financial system?

To develop a net zero financial system, climate related regulatory policy must address two separate, connected challenges:

- Reducing the ***stock*** of existing climate damaging assets already held in the form of loans, shareholdings and bond holdings, and insured assets. The challenge here is to understand how policymakers and regulators can get financial institutions and households to disinvest their existing climate damaging holdings.
- Directing the ***flow*** of new money. The challenge for policymakers and regulators here is to: i) prevent new flows of money going to established economic ventures that cause climate harm and ii) direct new resources to established ventures and new, early-stage ventures that make a positive contribution to climate goals?

Sadly, we do not think the current FCA proposals (and the approach followed by the Bank of England/ PRA) will be effective in meeting those challenges. A much tougher set of regulatory interventions – prudential, conduct of business, direct sanction based interventions – will be needed alongside disclosure based interventions such as labels. We have included additional recommendations in the Summary above.

Looking specifically at the FCA's sustainable label proposals, we conclude that these will not be effective at helping investors identify funds which meet their goals or expose financial institutions and funds that continue to damage the environment. If a label is to make a useful contribution to the wider suite of regulatory interventions, the proposals need to be significantly improved.

The FCA asserts that its descriptive approach to labelling is *objective* and that a traffic light or rating system is *subjective*. This is patently not the case. Descriptions, by definition, are subjective as they are not based on hard data, on quantitative measurement. Whereas, a system based on ratings or traffic lights, which rank funds on the basis of measuring and rating degrees of compliance with climate goals, is clearly the more objective approach. The FCA's approach which rejects the idea of a hierarchy of compliance would simply allow the industry to evade proper scrutiny.

The most worrying aspect of the FCA's proposals is the decision to go with a single sustainable label rather than labels which would allow investors to clearly distinguish between funds with environmental, corporate responsibility, and social impact goals. These are very different goals and allowing them to be included within a single sustainable label will just result in obfuscation and confusion.

We have provided a detailed critique of the FCA's proposals in Annex A and details of our alternative proposals in Annex B.

Q5: Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?

No. We disagree with the basic approach the FCA is proposing. The FCA is mixing up the **purpose/goal** of a fund (eg. the 'green-ness' of a fund) with the ***approach*** taken by the fund (Focus, Improver, and Impact). We urge the FCA to rethink the architecture of its proposals and introduce a labelling system which allows investors to clearly distinguish funds that have a green goal from those that have a social goal (e.g. around fair treatment of workers or tackling social policy failures).

To help investors identify how well investment funds meet green goals, there should be a clear rating system based on, say, a colour-coded symbol or star ratings. Funds claiming to be ‘transitioning’ should set clear targets and publish independently verified progress reports. Any fund promoted as sustainable in any form should not be allowed to include fossil fuel assets within its portfolio. Funds with a poor green rating should carry a clear environment health warning.

We have provided examples of how an alternative green label would work in Annex B. We believe the approach we set out could work for all types of collective fund/portfolio and indeed for other financial activities such as bank loan books.

The alternative to a rating system would be to have a more binary system where only those funds meeting minimum thresholds would qualify for using a label. However, the difference between our proposals and the FCA’s is that with the system we propose would require those funds that do not qualify would still have to disclose the degree to which the portfolio contains climate damaging assets. The worst performing funds would be required to carry a prominent climate health warning.

Q6: Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? If not, what alternatives do you suggest and why? In particular, we welcome your views on: a. Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme? b. Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear? c. Sustainable Impact: whether ‘impact’ is the right term for this category or whether should we consider others such as ‘solutions’; and the extent to which financial additionality should be a key feature?

No. We disagree with a number of aspects of the FCA’s proposals. We fundamentally disagree with the intention to categorise funds according to Sustainable Focus, Sustainable Improvers, and Sustainable Impact. Those distinctions are based on the approach adopted by a fund, not the purpose or goal of a fund.

The FCA intends that, when choosing between the huge number of funds on the market, investors (and intermediaries and comparative information providers) should first sort funds between Focus, Improver, and Impact and only then identify whether the fund is green, or social impact. The FCA’s architecture does not reflect the decision making process. Instead, it is designed to accommodate the way the market is developing and suits the needs of firms.

An effective label should allow end-users to:

- Identify funds which meet their preferences by making it easy to distinguish between the purpose/ goal of funds (such as environmental, corporate responsibility, or social impact goals).
- Critically, understand the degree of compliance with those goals, the approach taken in pursuit of those goals.

- Obtain independent evidence of any progress towards complying with goals (allowing an investment fund provider to self-define a fund as an Improver clearly creates the potential for misleading investors).
- Identify funds which have low levels of compliance with preferred goals.

This requires independent hard *data* not descriptions. It requires quantitative measurement of the degree of compliance with goals, and explicit ratings based on clear bands which allow investors to easily see those degrees of compliance. Contrary to what the FCA says, there is a hierarchy of funds in terms of contribution to climate goals. Investors need to be able to see where funds sit in this hierarchy.

We support the use of the term Impact. But, it should be used in a different way. It is unclear what purpose the term Impact, as envisaged by the FCA in its proposals, serves. Surely, any fund which aims to change behaviours could be said to be having an impact? What matters is how much impact the fund is having. And this requires clear ratings to allow investors to identify how much impact the fund is having.

We have a particular concern about the category of Sustainable Impact in the FCA's proposals. The FCA is proposing that Sustainable Impact funds would invest in solutions to environmental or social problems, to achieve positive, real-world impacts. As explained above, we argue that there should be a separate label for green and social impact funds to help investors clearly distinguish between funds with different goals. With regards to making a social impact, the FCA proposals are silent on whether a sustainable impact fund should aim for a below market financial return.

We would argue there is a basic difference between what we call Market Impact funds and Social Impact funds even though both might claim to deliver a social impact. The crucial point is the attitude to return expectations.[15]

We would define a Market Impact fund as one which invests with the goal of ensuring that the economy (and businesses that make up the economy) operate to the standards expected by society (fair treatment of employees and supply chains, gender equality, and so on) but still operating within the principles of the market. Crucially, the fund would still expect to generate a market return (or higher) on those investments.

We would define a Social Impact fund as one which seeks to address social issues that would not be addressed by the market operating to market principles or issues which the state is unwilling to address. For example, this might include providing grants or no-interest loans to non-profit organisations to tackle problems faced by local communities eg. helping non-profit lenders take on loan sharks. For Social Impact investors the main concern is the impact they are having – the return is a secondary consideration. This is not the case with Market Impact investors. They still want market returns – alongside having an impact.

Impact as a designation or marketing label has also migrated from private markets, where it may well have been philanthropic, ie. not seeking a return or any capital preservation to seeking a less than market return with capital preservation. More recently, impact as a term has been applied to asset managers and funds seeking a market or even above-market return. This has also seen the

[15] What You Need to Know about Impact Investing | The GIIN

description of impact investing move from mostly private markets to public markets ie. adopted by closed or open funds and even some insurers. It can be social or environmental yet that shift in meaning is not sufficiently addressed by the FCA with this labelling regime. It could even be argued that the FCA should be trying to halt this shift in definition, at least until there is more research and information.

Of course, there is something of 'a rose by any other name'[16] to fund category names. In other words, it is not the name of the fund categories that matters most, but the substance. It is important that the definitions are consistent and reflect how investors consider their own preferences and make decisions, and communicate the motives of the fund managers selling these funds. As it stands, the FCA proposals do not do that. Rather, the current FCA proposals reflect the marketing strategies of the industry. Just as there is a major risk of greenwashing, we fear the FCA's Sustainable Impact label proposals could enable impact washing.

For example, how would the FCA's proposals deal with a fund that invests in companies that set up business in economically deprived areas of the country with support from state subsidies yet still want to deliver market rates of returns for shareholders? The fund managers might claim that this is an impact fund – but is impact really the motive rather than state supported financial returns?

Or what about a fund that invests in low-middle income countries (LMICs) where assets can be bought cheap but the fund believes prospects for economic growth (and therefore investment returns) are good? This fund could be said to have an impact if it creates jobs. But, can it really be said that impact rather than spotting potentially undervalued assets to generate high returns is the primary motivation here?

Would the FCA allow a fund set up to invest in children's care homes with the aim of matching or beating the market return to be classified as 'Sustainable Impact'? This fund would be aiming to generate market returns for investors from an activity no longer provided by the state. The market returns investors would expect means the cost of financing those care homes would be higher than if the resources were provided by the state. This would be a negative social impact.

Similarly, would a fund that claimed to build social or private rented accommodation but also aimed to generate a market-matching or market-beating return be allowed to be called Sustainable Impact even though the higher cost of financing would put upward pressure on rents?

Would it be possible for a financial institution to define a fund as sustainable if it invested in a factory making weapons or climate-damaging goods in an area of high economic deprivation on the grounds that it was boosting local wages and levelling up? These funds would be behaving no differently to conventional investors seeking to generate returns from economic activities. These investors would have likely to have been interested in investing in these activities regardless of whether or not the concept of impact investing existed.

We argue that it is difficult to justify allowing a fund to be marketed as social impact if it seeks to produce returns that would match returns generated by supposedly non-impact funds. If impact funds are allowed to generate market returns, then this would increase the risk of 'impact washing'.

[16] 'What's in a name? **That which we call a rose, by any other word would smell as sweet**.' Juliet in Shakespeare's Romeo and Juliet

Therefore, we argue the FCA labelling regime should clearly distinguish between Market Impact (which aim to make market or above market returns while also aiming to make a social impact) and Social Impact funds (which are willing to make a financial sacrifice in pursuit of social goals).

If the FCA insists on retaining its single Sustainable Impact label, then it should have two subcategories – Sustainable Impact (Market) and Sustainable Impact (Social). If it insists on having just one Sustainable Impact label then this should be restricted to funds that aim to make a below market return.

Q7: Do you agree with our proposal to only introduce labels for sustainable investment products (ie. to not require a label for 'non-sustainable' investment products)? If not, what alternative do you suggest and why?

No. We strongly disagree. If the regulatory regime is to drive a move towards a net zero financial system then finance which makes a positive contribution to climate goals has to be encouraged ***and*** finance which makes a negative contribution aggressively deterred. Financial institutions which continue to finance climate-damaging activities must be held to account. This means that any clear label system must be applied to funds which have a poor degree of compliance with climate goals. This is why a label system which allows for explicit ratings is needed – see above.

The FCA says that its approach does not imply a hierarchy of funds. But, this is surely the wrong approach. There is obviously a hierarchy in terms of degrees of compliance with goals (whether environmental, corporate responsibility, or social impact). Consumers by nature in financial services do rank products. And indeed, the FCA's own research found that consumers liked a rating system (see Box 2 of DP22/20). Of course, it is only natural that the industry would want to avoid the sort of objective assessment that would lead to funds being rated and placed in a hierarchy. But, the FCA should design a system around consumers needs and preferences, not the industry's.

Q8: Do you agree with our proposed qualifying criteria? If not, what alternatives do you suggest and why? In your response, please consider: • whether the criteria strike the right balance between principles and prescription • the different components to the criteria (including the implementing guidance in Appendix 2) • whether they sufficiently delineate the different label categories, and; • whether terms such as 'assets' are understood in this context?

The FCA says that clear, objective criteria for sustainable investment labels are essential to upholding the integrity of the regime and building trust in sustainability investment products. We fully agree. But, what the FCA is proposing is not clear and it is not based on measurement and assessment against objective criteria. The conflating of different goals such as environmental and social impact within a single sustainable label will result in confusion and make it more difficult for investors to identify easily funds which meet their preferences.

Moreover, firms will be able to choose whether to apply a label to their funds. This means that funds which continue to damage the environment will be able to evade scrutiny.

The FCA proposes that products qualifying for a sustainable investment label must meet:

- five overarching principles covering (1) sustainability objective; (2) investment policy and strategy; (3) KPIs; (4) resources and governance; and (5) investor stewardship

- a number of key ('cross-cutting') considerations associated with each of the overarching principles. The requirements that cover what firms must 'do' are set out in this chapter, and requirements covering what firms must 'disclose' are set out in Chapter 5
- certain category-specific key considerations relevant to their particular label

But, most of these principles and factors are actually secondary to the decision as to whether a fund should qualify for a label. The FCA is overcomplicating the issue. The most important questions are: does a fund meets meaningful conditions that would allow it to use a green label; and how well a fund rates according to its contribution to climate and environmental goals? And this requires clear thresholds and boundaries and objective measurement using hard data to determine to what degree a fund qualifies.

The idea of having a dedicated category of Sustainable Improver is not helpful and is a distraction. As explained, the investment decision process involves investors first identifying funds that meet their own preferences (green, corporate responsibility, or social impact), and then finding out to what degree funds comply with those goals. Some will want a 'pure' green fund, others will be content with a fund with a limited degree of compliance but which intends to transition to a higher degree of compliance. If this is the case, then the fund should have to disclose targets which are independently verified. But, the point is that the priority for a label is to first help investors identify funds that meet their preferences/ goals and then the approach adopted (pure green, transitioning etc).

The FCA also says that its proposals provide flexibility to accommodate different sustainability objectives for continued evolution and innovation in the market within clear guardrails. We disagree. The FCA's proposals do not provide clear guardrails. They are far too much based on subjectivity, very loose definitions and narrative descriptions rather than quantitative analysis. The history of the investment funds market in the UK is one characterised by spurious proliferation of funds dressed up as innovation. The FCA's sustainable label proposals will encourage spurious proliferation in the ESG funds market. To reiterate, we seriously doubt this entire initiative will work unless the FCA sets clear quantitative thresholds and boundaries to allow for objective measurement and ratings of funds.

So, overall, the FCA has not struck the right balance between prescription and flexibility. If a label system is to work and to be easily understood by investors, the FCA needs to be focus on the things that matter (the degree of compliance with goals) and be prescriptive on the use of objective qualifying criteria.

Moreover, as we explain elsewhere, we are very concerned at the degree to which asset managers and others will be able to mark their own homework on compliance with goals, and KPIs.

Q9: Do you agree with the category-specific criteria for: • The 'Sustainable focus' category, including the 70% threshold? • The 'Sustainable improvers' category? Is the role of the firm in promoting positive change appropriately reflected in the criteria? • The 'Sustainable impact' category, including expectations around the measurement of the product's environmental or social impact? Please consider whether there any other important aspects that we should consider adding.

The categories Sustainable Focus, Improver, and Impact as set out by the FCA are not categories which reflect investor goals or preferences. Rather, those categories set out the approach adopted by funds. If this is to work, we need a system based on categories which clearly communicate goals (green, corporate responsibility, social impact); a rating system that communicates the degree to which the fund complies with goals (despite what the FCA says any label system needs to communicate to investors that there is indeed a hierarchy of funds); and then a description of the approach adopted.

As explained above, having a standalone Improver category is unhelpful. Improver signifies an approach not the goal of a fund.

With regards to Impact category, again the way the FCA envisages this being used conflates the approach with a goal. Any fund whether it has a green, corporate responsibility, or social impact goal can be said to be making an impact. It would be much more helpful and relevant to the actual decision making process if the Impact label was used for funds that wanted to make a Market or Social Impact – see above.

Q10: Does our approach to firm requirements around categorisation and displaying labels, including not requiring independent verification at this stage, seem appropriate? If not, what alternative do you suggest and why?

We have serious concerns about the governance and transparency relating to the FCA's proposals.

One of the most striking features of the FCA's proposals is that firms will **not** be required to obtain independent verification of their labelling. We would argue this is a major mistake. In effect, firms would be allowed to mark their own homework. An important element of the FCA's approach is that the regulator says it does not imply any hierarchy between the proposed categories. In other words, the FCA labels are not intended to imply that products with one particular label are better than others. With no relative measurement implied, and no independent verification required, it is going to be difficult for the intended users to trust labels and determine the relative contribution, whether positive or negative, that funds are making to climate change.

Moreover, if the firm decides to apply enhanced impact measurement and reporting, the FCA just says that it *could*, not *must*, include independent verification of the results.[17]

But, it is not just lack of independent verification of labels which are concerning. The FCA is not mandating the type of sustainability metrics that firms should use.[18] Firms will be required to have KPIs which the FCA says must be credible, rigorous, and evidence based. However, firms will still be

[17] See: CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), Appendix 2, p124
[18] See: CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), p93

able to choose the KPIs they use to back up claims of sustainability performance. This is risky given the potential for conflicts of interest and the sheer proliferation of data and approaches available in the market. Firms will have to monitor the product's performance against its sustainability objective on an ongoing basis with reference to those KPIs. But, again, this monitoring can be done internally. As with the label itself, there is no requirement for independent verification.

Moreover, with regards to the delivery of the product's sustainability objective, the FCA proposes that, where appropriate, there should be oversight by a governing body. But, of course, a governing body could be the board or a management committee of the firm.[19] The FCA's rules currently say that only one quarter of the members of a firm's governing body have to be independent.[20] Again, this could give rise to clear conflicts of interest particularly as the FCA is not insisting on independent verification of a fund's sustainability performance.

So, we would argue that serious improvements to the governance and transparency proposals are needed. Independent verification and oversight is needed. The issue of costs is interesting. There could be noticeable costs involved if the FCA applies its proposals for a sustainable label. The FCA's proposals overcomplicate the issue. Many of the qualifying criteria the FCA sets out - see above – are too narrative based and descriptive and secondary to determining whether a fund should qualify for a label. Verifying compliance with these criteria would be challenging.

However, if the FCA adopted a more straightforward approach to measuring fund compliance with goals based on quantitative assessment and hard data, then the costs involved would be limited. For example, comprehensive databases already exist with data on emissions created by the underlying economic entities which comprise fund portfolios. This foundational data will improve. It is not difficult to calculate the aggregate emissions for individual portfolios. This calculation would then allow for fund portfolios to be allocated to ratings bands. A worked example can be found in Annex B.

Calculating the aggregate emissions for portfolios is a fairly mechanical process that could be independently verified at low cost, and signed off by fund governance bodies. This process would not be that different to the process used to calculate portfolio risk scores which is already common in the investment industry where risk scores are applied to individual assets and then a composite portfolio investment risk rating is calculated. Calculating a Portfolio Green Rating is not difficult. Trying to help end-users make informed decisions through narrative disclosures and descriptions is difficult and therefore costly.

Q11: Do you agree with our proposed approach to disclosures, including the tiered structure and the division of information to be disclosed in the consumer-facing and detailed disclosures as set out in Figure 7?

Yes, a tiered approach is appropriate. But, to reiterate, the most helpful thing the FCA could do is develop a clear label with rankings that allows end-users (retail investors, pension fund trustees etc) to easily identify degrees of compliance with goals (green, corporate responsibility, or social impact). The FCA's own research shows that consumers respond to ratings.

[19] governing body - FCA Handbook
[20] COLL 6.6 Powers and duties of the scheme, the authorised fund manager, and the depositary - FCA Handbook

We would also reiterate that the label/ ranking system should apply to end-users such as pension fund trustees, charity boards, and local government. These groups are not sophisticated clients even if they are defined as such in legislation and regulation.

Q12: Do you agree with our proposal to build from our TCFD-aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?

It depends on what the FCA means by 'building from'. Of course, the FCA should continue to influence various EU and global standards reporting and disclosure standards. National and international consistency will be important. But, we would be concerned if the FCA held back on implementing rules relating to disclosing hard data on levels of emissions and compliance with other because it wanted to wait to align with the evolution of TCFD and other standards.

Remember, certain aspects of the TCFD framework particularly those relating to governance, strategy, and risk management will not be that relevant for most ordinary end-users. What matters is that there is a reliable rating which communicates clearly the degree to which a fund is financing climate harmful activities. The FCA should prioritise this.

Q13: Do you agree with our proposals for consumer-facing disclosures, including location, scope, content and frequency of disclosure and updates? If not, what alternatives do you suggest and why?

Yes. But, to emphasise, much of the information the FCA proposes to require firms to disclose is unlikely to be read and absorbed by end-users. More important is to have a clear rating published in a prominent place which makes it easy for end-users to see the negative or positive contribution a fund makes to environmental goals. This clear rating should be the focus of the FCA's work in this field.

And, of course, as we explain elsewhere it is important that the FCA mandates the type of KPIs firms use and require independent verification of any rating/ label and KPIs.

Q14: Do you agree with the proposal that we should not mandate use of a template at this stage, but that industry may develop one if useful? If not, what alternative do you suggest and why?

No. We disagree very strongly with this approach. The FCA should mandate the use of a template and the format of that template. We are at a loss to understand why the FCA does not intend to mandate a template. The regulator even acknowledges the merits of a template 'to achieve better consistency and standardisation of information to help consumers compare products'. But, standing back and allowing the industry to develop a template means there will be a lack of consistency which will surely make it more difficult for consumers to compare across funds and products especially given the sheer number of investment funds available in the UK. Firms will use the opportunity to develop a template that presents their particular funds in a good light and downplay negative aspects.

The lack of a consistent template will also hinder the ability of independent analysts and civil society organisations to compare the positive and negative contribution that funds are making to climate and other goals.

Given the large number of funds claiming to be ESG aligned, end-users would benefit from having independent comparative information tables. But, the development of useful comparative information tables could be held back for two reasons:

- The basic structure of the FCA's proposed label regime. The logical thing would be to enable end-users to first filter funds by their purpose/ goal ie. green, corporate responsibility, social impact and balanced. Or green and corporate social responsibility (with two sub categories for market impact and social impact – see above). Instead, the FCA proposes that funds be first categorised by their approach ie. Focus, Improver, and Impact. This makes it harder for end-users to identify what matters – whether or not a fund meets their goals and preferences.
- The unwillingness of the FCA to mandate a disclosure template. If firms are allowed to design their own template this will result in consumer confusion, not encourage innovation as the FCA seems to expect. The lack of a standardised template will also make it harder to develop useful comparative information tables. Consistent, standardised templates would obviously make it easier for independent information providers to collect and process key data for inclusion in tables.

Q15: Do you agree with our proposals for pre-contractual disclosures? If not, what alternatives do you suggest and why. Please comment specifically on the scope, format, location, content and frequency of disclosure and updates.

We have no particular comment on the format, location, content and frequency of disclosure and updates. These seem sensible.

But, to reiterate, the type of disclosures the FCA envisages are unlikely to make much difference to end-user behaviours. What is needed is a rating system which makes it easy for end-users (and others such as civil society) to clearly see the degree to which the fund supports or damages climate goals.

We have concerns about the scope. The FCA says that firms providing portfolio management services will not be required to produce their own pre-contractual disclosures. However, they must provide retail investors with easy access (eg. by hyperlinking) to the relevant disclosures. We do not understand the rationale for this. Firms that provide portfolio management services should produce an aggregate green rating of any portfolio constructed. This, of course, will depend on the FCA ensuring that there are meaningful ratings for individual funds.

This is another problem created by the FCA's approach to sustainable labels. The FCA's approach, which categorises funds according to Sustainable Focus/ Improver/ Impact descriptions, is subjective. It categorises funds according to a fund's approach rather than goal/ purpose. A much better system would be to have objective ratings based on quantitative analysis of the degree of compliance with green, corporate responsibility, and social impact goals. This objective, quantitative system better reflects the investment decision making process and would also allow for aggregate ratings to be constructed. This would work for portfolio management services and indeed other collective structures such as pension funds.

The FCA also says that products that do not qualify for a label or adopt sustainability-related policies and strategies are not subject to the pre-contractual disclosure requirements. This cannot be right. If we are to see the necessary behavioural changes in financial markets, if regulation is to move us towards a net zero financial system, then those financial institutions which continue to finance climate damaging activities must be held to account. All funds should have to display an independently audited rating which shows investors the degree to which the fund's activities comply with climate goals.

The FCA also says that it is not proposing to include requirements that mirror the EU SFDR's 'Do No Significant Harm' approach arguing that this approach may be too restrictive at this stage. We do not understand this approach. The FCA is unwilling to be prescriptive on a number of issues – not requiring independent verification, or mandating KPIs and now on the 'do no significant harm' issue. End-users need to be able to see clearly which funds are causing harm to the environment and to be able to trust any disclosures. If the FCA does not want to introduce a 'Do No Significant Harm' rule, then funds which have a poor green rating should be required to carry a clear climate health warning so that end-users can see clearly that a fund is damaging the environment.

Q16: Do you agree with our proposals for ongoing sustainability-related performance disclosures in the sustainability product report? If not, what alternative do you suggest and why? In your response, please comment on our proposed scope, location, format, content and frequency of disclosure updates.

We agree there should be some form of sustainability-related performance report to allow investors to monitor performance against goals. But, the FCA should not overcomplicate this. The most direct, simplest, and effective approach is to require funds to publish a rating alongside a Portfolio Greenness Score.

The rating could either be in the form of a 1-5 star system or a colour coded system (a dark green through to red globe depending on the positive contribution or harm the fund makes to the environment). The Portfolio Greenness Rating would be used to attribute a rating to funds.

The product's rating would be based on the weighted average climate score of the component assets eg. corporate bonds and equities held within the portfolio. The climate score of component assets would be based on independently verified data and measurement. ESMA has recently produced a very helpful methodology for calculating a Portfolio Greenness Ratio.[21]

Only component assets for which there is independent data available would be included in the weighted average score and rating for the product. Products with a low rating, or where independent data is not available, should carry an 'environment health' warning.

All funds should be required to disclose the harm they are causing to the environment. For example, a fund holding fossil fuel related assets should be required to disclose that 'X percent of this fund's assets are held in shares and bonds of companies that have a low green rating as certified by ABC rating agency'. Where data on the green rating of specific companies is not available, the activities of

[21] ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)

those companies should not be allowed to make a positive contribution towards a fund's climate rating.[22]

The quantitative approach inherent in the Portfolio Greenness Ratio and green rating also allows for objective monitoring and reporting of a funds green performance. It would be easy to see whether a fund's Portfolio Greenness Ratio has improved or deteriorated. And if fund managers tried to market their funds as being green 'transitional' or 'improver', then they should be required to set a target for improving the Portfolio Greenness Ratio which could then be easily monitored.

The objective, quantitative methodology outlined by ESMA provides a much clearer way for end-users to see how green a fund is, and how much progress that fund is making, than the FCA's approach which is more subjective and narrative based.

The Portfolio Greenness Ratio also allows for regular reporting. Calculating a Portfolio Greenness Ratio is a fairly mechanical process. Once component data for the constituent assets of a fund is available the Portfolio Greenness Ratio could be automatically updated. As we point out elsewhere, we would urge that the FCA and FRC to prioritise ensuring that data on the greenness of constituent assets is made available. The success or failure of any rating or label system very much depends on the availability of foundational data. We would urge UK regulators to follow ESMA's lead on this.

The FCA says that, in the first instance, it proposes that a sustainability product report will only be required for products that qualify for a sustainable investment label. Surely, this cannot be right. If we are serious about moving towards a net zero financial system, financial institutions must be held to account for the climate damage they finance. All products should be required to produce a Portfolio Greenness Ratio.

The FCA also says that firms providing portfolio management services will not be required to produce their own sustainability product reports. Again, this cannot be right. Portfolio Greenness Ratios would allow for aggregate portfolio ratios to be calculated mechanically.

Q17: Do you agree with our proposals for an 'on demand' regime, including the types of products that would be subject to this regime? If not, what alternative do you suggest and why?

No. All products should be required to disclose a Portfolio Greenness Ratio which would be automatically updated as and when new information about the constituent assets is made available (for example, if the underlying economic entity improved its own greenness ratio).

If trustworthy data on underlying assets is not available, then funds/ products should be required to carry a warning. Only assets for which there is independent data available should be used in the calculation of an aggregate Portfolio Greenness Ratio.

Other detailed information could be made available on demand. But, it is important that the FCA ensures that the critical data relating to portfolio emissions and alignment with other environmental standards is made available up front to end-users and displayed in a prominent position. Funds with a poor Portfolio Greenness Ratio and Rating should be required to display a prominent climate

[22] There may be a case for applying this rule to medium-larger companies. Exceptions could be made for smaller companies if it becomes clear that data on environmental compliance is difficult to obtain. Or, proxy data based on the green performance of that particular industrial sub sector could be used.

health warning with a statement declaring whether or not the fund manager intends to reduce the climate harm financed by the fund.

As mentioned above, it is important that the FCA prioritises the production of hard data on emissions and compliance with other environmental standards, and a rating scheme that allows end-users to easily identify the degree to which funds are financing climate damaging activities. Other initiatives such as TCFD reporting can wait.

Q18: Do you agree with our proposals for sustainability entity report disclosures? If not, what alternatives do you suggest and why? In your response, please comment on our proposed scope, location, format, content, frequency of disclosures and updates.

Q19: Do you agree with how our proposals reflect the ISSB's standards, including referencing UK-adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?

The entity level disclosures will be important for those end-users who are interested in detail. For example, civil society organisations and media may want to know more about a fund's operations to hold financial institutions to account. However, these disclosures are likely to be of secondary interest and importance to most ordinary end-users.

It is deeply worrying to read that the FCA is waiting until the UK Taxonomy is developed before considering how it might update its rules to include disclosures relating to the Taxonomy. The UK is already lagging behind the EU in key areas relating to ESG regulation. We urge the FCA to develop the rules on how taxonomy related disclosure *alongside* the process of agreeing the Taxonomy, so that those rules are ready to be consulted on as soon as is possible.

The FCA says it proposes a phased approach to implementation of the entity-level disclosure requirements, with the first disclosures to be published by the largest in-scope firms provisionally by 30 June 2025.

The FCA also says that it proposes to build on the TCFD framework, extending disclosure requirements under the four pillars – governance, strategy, risk management and metrics and targets – on climate-related financial disclosures to sustainability-related risks and opportunities.

We support the FCA's intention to align with and build on the TCFD framework. But, as mentioned, most of the TCFD measures ie. governance, strategy, and risk management will be of little use or interest to most ordinary end-users of ESG information.

A degree of flexibility on how firms report on governance, strategy, and risk management may well be appropriate given that these are best explained though narrative based disclosures. However, there should be prescription on the use of templates which include ESG data. Moreover, metrics and targets and other quantitative measures should be independently verified.

The timetable for the FCA's work on ESG disclosure is worrying. We are already lagging behind the EU in ESG financial regulation generally. It is important that the FCA should not wait for the further development, agreement, and the implementation of the TCFD framework to introduce targeted rules in the UK that would make a difference to end-users.

To reiterate, what really matters is that end-users have:

- clear, independently verified hard data on the level of emissions caused by a portfolio's assets and compliance with other environmental standards; and
- an objective, independently audited rating or ranking that allows them to compare the green performance of a fund.

This should be pursued as a priority by the FCA. The ESMA approach described above provides a model for this. This should not have to wait while the FCA works on various TCFD or ISSB frameworks and standards.

Q20: Do you agree with our proposed general 'anti-greenwashing' rule? If not, what alternative do you suggest and why?

Yes, we strongly agree with a general anti-greenwashing rule. Of course, the effectiveness of this rule will depend on how the FCA supervises and enforces this rule. If firms are to be deterred from greenwashing, they need to know what the consequences are. We would very much welcome more detail on how the FCA plans to supervise and enforce this rule.

We do not think that the FCA's label proposals and the discretion given to firms to mark their own homework, will be effective at preventing greenwashing. Therefore, it is important that a clear deterrent is built into the regulations to police market behaviours.

We also urge the FCA to conduct an investigation into greenwashing in existing ESG funds. There has been a significant growth in the number of funds in the ESG sector. Detriment tends to 'follow the money' in financial services and the ESG fund market has not been directly supervised by the FCA or addressed by the Financial Ombudsman Service (FOS).[23] It must be reasonable to assume there is a significant risk that greenwashing[24] has already occurred. There are already rules in place requiring regulated firms to be clear, fair, and not misleading in the way they promote and market funds. Therefore, we recommend that the FCA should conduct an investigation into existing funds that claim(ed) to be 'ESG' or 'ESG-aligned'. This will help inform the FCA's preparations for introducing its welcome proposal for a new anti-greenwashing rule.

Q21: Do you agree with our proposed product naming rule and prohibited terms we have identified? If not, what alternative do you suggest and why?

Q22: Do you agree with the proposed marketing rule? If not, what alternative do you suggest and why?

Yes, we do agree the proposal to prohibit firms from using certain names and terms for products that do not meet qualifying conditions.

But, we disagree with the basic labelling system proposed by the FCA. As explained, the FCA proposals conflate and confuse the approach followed by a product (Focus, Improver, Impact) with the goal or purpose (green, corporate responsibility, social impact).

[23] It is interesting that searching the FOS website for 'greenwashing' or 'ESG' at the time of writing turned up no results.
[24] In the sense that funds have been promoted as being ESG compatible to gain a marketing advantage without fundamental changes being made to the underlying investments

End-users need to be able to first see which products meet their preferred goals and then the degree to which products comply with those goals (the approach). This is best achieved by a robust naming policy and clear rating system. Indeed, the FCA's own research confirms that consumers respond well to a rating system.

The FCA's terms Focus, Improver, and Impact have the potential to confuse and mislead end-users. For example, a green fund that qualifies for Focus under the FCA's proposals can surely be said to be having an impact.

In the Annex below, we have set out our proposals for a rating system. These ratings could either take the form of 1-5 stars or colour coding. The rating is determined by bands eg. >60%-80%, >80%-100% etc. The band into which a product/ fund is placed is, in turn, determined by a quantitative measurement of a fund's compliance with green goals such as a Portfolio Greenness Ratio.

This clear system would also allow the FCA to police its naming and prohibited terms rules. For example, the FCA could then restrict the use of a limited list of approved green terms (or corporate responsibility and social impact terms) to products with a Portfolio Greenness Ratio of greater than 80 percent and which contain no assets which do significant harm to the environment.

It is likely to be easier to manage the risks of end-users being misled by terms when it comes to green and environmental products. The FCA very helpfully includes a list of terms that end-users are likely to associate with products with a green purpose. However, it is more difficult when it comes to funds with corporate responsibility goals and social impact goals. There isn't such an obvious list of associated terms. To deal with this, as part of the Consumer Duty, firms that claim a fund is responsible or impact should be required to stress test consumer understanding of terms used in the name of the fund.

To reiterate, it is important that the FCA's ESG intervention applies not just to products that meet qualifying threshold conditions. All funds should be required to disclose a Portfolio Greenness Ratio and rating. Products which have a low ratio and rating should be required to carry a climate health warning with prominent disclosure of holdings in economic entities that do significant harm to the environment.

Q23: Are there additional approaches to marketing not covered by our proposals that could lead to greenwashing if unaddressed?

As explained, we are very concerned that the FCA's overall approach to sustainable labels will not be effective at preventing greenwashing. The conflation of product goals/ purpose with the approach adopted by a product will result in consumers being confused which will make it harder to identify greenwashing. Moreover, the FCA's intention to allow firms to mark their own homework on key issues, will also facilitate greenwashing.

There is also the very serious risk of impact washing where financial institutions brand their funds as investment with a 'social conscience' when in reality the primary purpose of the fund is to make market returns for investors. This is explained in more detail, with examples of impact washing, in the response to Q6. The Sustainable Impact label as proposed by the FCA does not address the risk of impact washing. Our proposal to distinguish between funds that are Market Impact and Social Impact would address the risk of impact washing.

Q24: Do you agree with our proposals for distributors? If not, what alternatives do you suggest and why?

No. If distributors and intermediaries recommend overseas funds which claim to be green yet are not covered by the UK labelling regime, then they should be required to: i. perform due diligence on those funds; and ii. certify to the client whether or not the fund meets UK standards. If distributors and intermediaries are unable to testify to the green compliance of an overseas product, then they clearly should not be allowed to recommend those funds.

Q25: What are your views on how labels should be applied to pension products? What would be an appropriate threshold for the overarching product to qualify for a label and why? How should we treat changes in the composition of the product over time?

As explained in the response to Q1, the best way to deal with the greenwashing risks associated with other products, is to bring pensions and other products into a proper regime from the outset. The principles that should apply to products regardless of the legal or corporate wrapper are the same. The different products within a financial institution's stable (which after all are often just differentiated by the legal or corporate wrapper) often contain the same underlying assets. We cannot see the justification for not including all products now. The FCA's proposals fall short of the approach adopted by the EU.

Moreover, the FCA proposals would leave end-users such as pension fund or charity trustees with a lower level of regulatory protection than retail investors, even though trustees can be even more vulnerable to misleading and aggressive selling practices than retail investors.

It is interesting that the FCA raises the issue of how to deal with the changing composition of products over time. The key thing to recognise here is that most of the financial products that need to be covered by a meaningful label and rating regime are collective[25] in nature. That is, the end-user may purchase a specific product or contribute to a specific pension fund but those products/ funds will usually be comprised of holdings of a number of investments in/ loans to specific economic entities (the assets). The greenness of those constituent assets and the overall portfolio need to be calculated and rated.

However, the structure envisaged in the FCA's proposals, which is too much based on narrative descriptions, will not make it easy to monitor the current greenness and changes in portfolio composition over time. Similarly, the FCA's proposals would make it difficult to implement the FCA's own idea for a Sustainable Improver category. Verifying that a fund/ product is improving will be very difficult without the use of hard data that has been independently verified.

Monitoring changes in composition requires a mechanism for quantitatively measuring the composition over time. This is why we advocate the use of objective measures such as a Portfolio Greenness Ratio and rating system. The system we set out in Annex B would automatically track the changes in composition over time. It would also help end-users verify whether funds that claim to be transitioning to a greener status are indeed doing that.

[25] Here we do not mean the narrow sense of collective as defined in the FCA Handbook

Q26: Do you consider the proposed naming and marketing rules set out in Chapter 6 to be appropriate for pension products (subject to a potentially lower threshold of constituent funds qualifying for a label). If not, why? What would be an appropriate threshold for the naming and marketing exemption to apply?

We think the approach we outlined in this response for quantifying degree of compliance with green and environmental goals and clear ratings should also apply to pension products. Consistency is important.

Q27: Are there challenges or practical considerations that we should take into account in developing a coherent regime for pension products, irrespective of whether they are offered by providers subject to our or DWP's requirements?

As explained, different products are often just differentiated by the legal or corporate wrapper. They will often contain the same underlying assets. The process for creating a clear rating regime for any collective product (which contains multiple holdings), built up from an assessment of a portfolio's constituent assets, is the same regardless of the legal or corporate wrapper. We cannot see the justification for not including all products now, and applying the same principles.

The FCA's general approach seems to be designed primarily to accommodate the needs and interests of the various different financial institutions which make up the financial system. We urge the FCA to approach this whole issue from the perspective of the end-user. With the FCA's approach, end-users could be left dealing with a regime in which some products are covered by the regime and some are not. If they have a portfolio of products, some products would be covered, others not. In terms of practicality, the FCA's approach will make it harder for end-users to get a holistic picture of how much harm their financial activities are causing the environment. Phasing in the regime for different products will also make it more confusing for end-users.

Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers ie. do you foresee any challenges or concerns in making consumer-facing disclosures, pre-contractual disclosures and building from the TCFD product and entity-level reports?

The approach for pension providers should be the same as for investment funds. Critically, there should be a clear rating regime built on quantitative assessment of the greenness of a pension product portfolio.

Q29: Do you agree that the approach under our TCFD-aligned product-level disclosure rules should not apply to products qualifying for a sustainable investment label and accompanying disclosures? Would it be appropriate to introduce this approach for disclosure of a baseline of sustainability-related metrics for all products in time?

No. See above. It is important in the interests of accountability that any product/ fund which does not qualify for a label should also have to disclose the damage caused to the environment.

Q30: What other considerations or practical challenges should we take into account when expanding the labelling and disclosures regime to pension products?

See above. The principles for investment products and pensions products (and indeed pension funds covered by The Pensions Regulator) are similar. It would be more difficult and confusing to phase in the regime.

Q31: Would the proposals set out in Chapters 4-7 of this CP be appropriate for other investment products marketed to retail investors such as IBIPs and ETPs. In your response, please include the type of product, challenges with the proposals, and suggest an alternative approach.

To reiterate, the principles underpinning the creation of a meaningful label and rating system are similar regardless of the legal or corporate form of products. All collective products/ funds including services such as portfolio management services should be included from the outset.

ANNEX A – DETAILED CRITIQUE OF THE FCA'S PROPOSALS

This section is taken from a forthcoming Financial Inclusion Centre report which assesses whether the approach adopted by the UK financial regulators (Bank of England, Prudential Regulation Authority, Financial Conduct Authority, The Pensions Regulator, and Financial Reporting Council) will help us move towards a net zero financial system.

To be judged a success, policy and regulatory interventions must drive major behavioural changes in the financial system. These, in turn, must drive major behavioural changes in the real economy.

As part of that assessment, we analysed the FCA's sustainable label proposals. We concluded that the FCA's proposals will result in end-user confusion, are unlikely to prevent greenwashing, and will not hold financial institutions which continue to finance climate damaging activities to account. The FCA's proposals also allow firms too much discretion and would allow them to mark their own homework.

We have developed alternative proposals for a rating regime which are better aligned with the decision making process and would allow progress against green goals to be monitored.

The forthcoming report focuses primarily on the impact of financial markets on climate and wider environmental issues (such as biodiversity). But, any 'green' label will have to work within a wider sustainability, impact and governance framework. Indeed, the FCA's own proposals incorporate environmental and social impact issues. Our proposed rating regime accommodates corporate responsibility and social impact issues.

We have not included proposals relating to the corporate governance aspect in the forthcoming report as there are organisations such PIRC[26] which cover corporate governance issues. However, the framework we outline below could accommodate governance ratings if necessary.

Critique of the FCA proposals

Any framework has to accommodate investor preferences with regards to environmental issues, corporate responsibility, and social impact. We contend that the FCA's framework proposals are not structured in a way that accommodates those different preferences in a coherent, easy-to-understand or easy-to-use way.

The FCA's proposals on disclosure and labelling, greenwashing and ESG ratings could be very important. Alongside the potential for the Bank of England/PRA to change financial market behaviours through capital requirements tools, the FCA has the greatest opportunity and responsibility to change market behaviours. The proposals on labelling and disclosure will be the regulator's main intervention so it is important it gets it right.

There are some very welcome measures proposed by the FCA. It is hard to disagree with the issues the FCA intends to address. It is important that consumers are given accurate, standardised information to be able to make comparisons and are not misled by false labels. It is essential that greenwashing is tackled.

[26] Mission and Values – www.pirc.co.uk

However, as ever, the devil is in the detail – the theme of our forthcoming report. We do not think the FCA's latest proposals will be effective in achieving the regulator's own objectives for protecting consumers and preventing greenwashing or the wider objective of achieving a major re-alignment of financial market behaviours with climate goals.

The FCA's proposals are designed to accommodate both climate-related and social impact issues. We have focused on the relevance for climate-related issues given the scope of this initiative.

Producing a *usable* label or marker for collective structures[27] does present a challenge, but is doable. Individual securities 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. In this case, these goals are around climate/environmental sustainability, responsible corporate behaviours and social impact).

There are a number of core principles which we argue should govern the development, construction, and use of a marker aimed at end-users whether they are retail investors, pension scheme trustees, small businesses, charities or other similar organisations:

- A marker should make it easy for investors to identify funds/products which meet their preferences/are aligned with their own goals such as environmental sustainability, high standards of corporate responsibility, making a social impact, or good corporate governance. Those specific goals form the different parts of what is currently termed ESG. Some investors will want a more holistic or balanced sustainability approach and invest in funds that score well across a number of goals eg. a fund/product that invests in businesses that are environmentally sustainable *and* treat employees well *and* operate to the highest standards of corporate governance. So, a marker should be able to accommodate investors who want to select just on, say, environmental concerns and those who want to select on a holistic/balanced basis.
- 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 make it very difficult for end users to make informed comparisons. There needs to be objective, quantitative measurement to allow for comparative ratings.
- A marker may take the form of label, symbols, 1-5 stars, or traffic light system and so on. But, regardless of which form it takes, any collective fund/product covered by that marker must be: 1. analysed for the degree of compliance with goals; and 2. undergo some form of comparison and rating process using objectively determined thresholds, ranges, or bands. Otherwise, end users cannot distinguish between good and bad collective funds/products.
- Value judgments, underpinned by robust and objective quantitative analysis, cannot be avoided. Any marker should communicate a hierarchy of compliance with goals. 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

[27] Collective structures/investment vehicles such as investment funds, insurance-based products, investment trusts, structured products, funds of funds, platform buy lists, pension funds, include a number of individual assets (eg. bonds, equities etc) within a single portfolio/fund.

measure the effectiveness of policy and regulatory interventions unless progress can be quantified through the use of meaningful data to measure progress against goals.
- Similarly, if collective funds/products are to be allowed to be marketed as ‘transitional’, or ‘Improvers’ then some form of quantitative or numerical based criteria will be needed to measure progress.
- A collective fund/product, regardless of the legal or corporate form, is comprised of individual securities, 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. The constituent assets within the collective structure must first be assessed for compliance. Only then can the overall collective fund/product structure be assessed at the aggregate level and accorded some form of comparative rating/label.

Taking into account those principles, our main concerns about the FCA’s proposals relate to:

- Lack of clarity and potential for confusion on the proposed labels
- Asset managers’ wide discretion over labelling choice
- Confusion over consumer-facing disclosure
- Lack of independent verification
- Poor governance and transparency standards
- Unclear role of advisers and intermediaries
- Weak minimum standards/inclusion of fossil fuels

Lack of clarity and potential for confusion ‘ESG’ as currently understood, is made up of different activities banded together under this catch-all term.

Some investors/asset owners such as pension scheme members are specifically interested in the environment. They want to support financial services that promote environmentally sustainable economic activities and avoid products that contribute to damaging the climate.

Others are more interested in how corporate behaviours affects social issues. This social impact or social sustainability might take two forms. One form relates to market economic impact. That is, investing in businesses that treat employees or workers in their supply chains fairly, that adhere to gender equality principles on wages and so on, while still seeing to make a market return on that investment. Investors might want to make an impact, but there is no financial sacrifice involved in the form of being willing to accept lower returns. The other form relates to direct, social-impact financial services. For example, supporting financial and social inclusion by supporting non-profit lenders such as credit unions but not expecting a market return on that funding – indeed being willing to accept a loss on funding.

Both approaches can be considered as impact but we would argue there is a clear difference between the philosophy underpinning funds that are willing to forgo returns in pursuit of goals and those funds that do not – see below for further discussion on the difference between Market Impact and Social Impact funds.

These environmental and social impact activities are included in the E and S in ESG. The fourth category relates to corporate governance. This relates to how companies are run and accountability to shareholders and bondholders. This is the same as the 'G' in 'ESG'. Some investors/asset owners will be interested in a combination of those activities.

Under the FCA's labelling proposals, firms would be able to brand their products as 'sustainable' if it invests in assets that are environmentally *and/or* socially sustainable. Of course, potential investors should be able to tell from the name of the product what the focus of the fund is. For example, a fund called ABC Clean Tech Fund would obviously have an environmental focus, a fund called XYZ Regeneration Fund a social impact focus.

Yet, there is still scope for confusion. We believe that there is an essential difference between the core purpose of 'green' and 'social' funds. Any labelling system should be designed to make it easy for investors to tell the difference. It should also make it easy for investors to tell the difference between funds which are Market Impact and Social Impact.

There are 4,000 investment funds for sale in the UK classified by The Investment Association.[28] The FCA refers to research showing there are more than 800 funds having responsible, sustainable or ethical characteristics.[29] The number of funds aligning to sustainable criteria is likely to grow. It would be helpful for investors to be able to use platforms to screen and compare the multitude of sustainable funds on offer. Some investors will prioritise green funds, others social impact funds. Allowing both types of funds, with very different goals, to use the same sustainable label will make it more difficult for independent platforms to present information to investors and for investors to screen and choose funds that meet their particular preferences.

It would be preferable to maintain separate, defined labels which clearly communicate the goals and philosophy of funds and products. Even if the FCA insists on retaining the single sustainable label, it would be better to at least require these to be branded as 'Sustainable (Green)' or 'Sustainable (Impact)'. Those funds which meet the qualifying criteria across each of the categories should be allowed to use the label Sustainable (Balanced).

Similarly, the FCA's proposals do not appear to make allowance for investors who are interested in good corporate governance as their main concern. However, corporate governance is not the subject of this report.

Another area for confusion is the proposal that there should be two categories called **Sustainable Focus** (which invest in assets that are environmentally and/or socially sustainable) and **Sustainable Impact** (which invest in solutions to environmental or social problems, to achieve positive, real-world impacts). It is not clear what the difference between these two categories would be. Surely, any fund that aims to be sustainably focused (whether environmental or social as in FCA's definition) would have an impact on environmental or social problems. This is not a helpful distinction. The FCA is mixing up the **purpose/goal** of the fund (the 'greenness' of a fund) with the ***approach*** taken by the fund (Focus, Improver, and Impact).

Asset managers' wide discretion over labelling choice It will be up to firms to decide for themselves if they want to apply the sustainable investment labels to their products and assess whether their products meet the FCA's qualifying criteria. In other words, firms that decide not to apply a

[28] Fund Sectors | The Investment Association (theia.org)
[29] See: DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), para 1.15

sustainability label will not be subject to mandatory assessment and disclosure of the impact their investment decisions have on the climate or, for that matter, social impacts. Put bluntly, asset managers will not be held accountable for the damage they are doing to the environment and the contribution they are making to the climate crisis. A clear system based on, say, star ratings would be more helpful in allowing investors to identify and differentiate between the relative contribution funds are making towards climate goals or just as importantly the damage these funds continue to cause to the environment. At the very least, the FCA should require asset managers which do not submit funds to an assessment to include a clear climate heath warning.

Confusion over consumer-facing disclosures In addition to the labels outlined above, the FCA is introducing consumer-facing disclosures to provide consumers with more detail on the funds and products. While there will be some prescription around the format and content, the FCA is not introducing a consistent, standardised template at this stage. This is despite the FCA recognising the merits of a template 'to achieve better consistency and standardisation of information to help consumers compare products'. It even encourages the industry to 'consider developing a market-led template based on the content and format used in our behavioural research and our rules, once finalised'. The lack of a template set by the regulator to ensure consistency will surely make it more difficult for consumers to compare across funds and products especially given the sheer number of investment funds available in the UK. The lack of a consistent template will also hinder the ability of independent analysts and civil society organisations to compare the positive and negative contribution that funds are making to climate and other goals.

Lack of independent verification One of the most striking features of the FCA's proposals is that firms will **not** be required to obtain independent verification of their labelling. We would argue this is a major mistake. In effect, firms would be allowed to mark their own homework. An important element of the FCA's approach is that it does not imply any hierarchy between the proposed categories. In other words, the FCA labels are not intended to imply that products with one particular label are better than others. With no relative measurement implied, and no independent verification required, it is going to be difficult for the intended users to trust labels and determine the relative contribution, whether positive or negative, that funds are making to climate change.

Moreover, if the firm decides to apply enhanced impact measurement and reporting, the FCA just says that it *could*, not *must*, include independent verification of the results. [30]

Sustainability metrics and KPIs The FCA is not mandating the type of sustainability metrics that firms should use.[31] Firms will be required to have KPIs which the FCA says must be credible, rigorous, and evidence based. Firms will still be able to choose the KPIs they use to back up claims of sustainability performance. This is risky given the potential for conflicts of interest and the sheer proliferation of data and approaches available in the market. Firms will have to monitor the product's performance against its sustainability objective on an ongoing basis with reference to those KPIs. But, again, this monitoring can be done internally. As with the label itself, there is no requirement for independent verification.

[30] See: CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), Appendix 2, p124
[31] See: CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), p93

Fund governance bodies With regards to the delivery of the product's sustainability objective, the FCA proposes that, where appropriate, there should be oversight by a governing body. But, of course, a governing body could be the board or a management committee of the firm.[32] The FCA's rules currently say that only one quarter of the members of a firm's governing body have to be independent.[33] Again, this could give rise to clear conflicts of interest particularly as the FCA is not insisting on independent verification of a fund's sustainability performance.

ESG data and rating providers The FCA hardly mentions data and ratings providers in its consultation paper. However, it has said elsewhere that it sees a clear rationale for regulatory oversight of certain ESG data and rating providers.[34] The lack of regulation of data and ratings providers is a real cause for concern. The FCA is limited in what it can do about data and ratings providers until the government includes such agencies within the regulator's perimeter. This reinforces our concerns about the amount of discretion which the FCA intends to give firms to mark their own homework. It could lead to weaker governance standards than are required to drive the necessary change in approach and thinking. As argued above a voluntary approach is surely not good enough, when disclosures and labels, even in their current flawed state will rely so heavily on data.

Not all products are covered The proposals do not cover pension and other products such as exchange traded vehicles at this stage. This leaves significant gaps in the market not covered by the FCA's approach. It is not clear why the FCA chose not to include these products now given that the principles are the same. Many of the asset management firms covered by these proposals will sell the full range of products. Yet a range of products may contain the same constituent equities and bonds just within different legal or taxation wrappers. The principles underpinning any labelling or disclosure regime will be the same regardless of that legal wrapper.

Institutional investors/pension scheme trustees Detailed disclosures will provide more granular information and will be aimed more at institutional investors such as pension scheme trustees. There will be a lot of detail contained in these disclosures.[35] The FCA is not mandating that firms use labels when marketing to institutional clients. This is in keeping with the general approach the regulator adopts to retail and institutional market participants. Pension scheme trustees do not receive the same protection from the FCA's Conduct of Business Rules because they are treated as sophisticated clients.

Applying weaker standards of climate disclosure to institutional clients such as pension scheme trustees seems misguided. Given the size of assets held in pension schemes, the consequences of pension scheme trustees making poor decisions can be significant.

It is not clear why policymakers and regulators continue to treat pension fund trustees to be sophisticated clients. Trustees are often 'laypeople' with little experience of investment markets and strategies. There is the argument that they have access to professional advice from investment consultants. This is true. Yet, the scale of the assets involved and the lack of technical knowledge and experience means they can actually be more vulnerable than retail investors to conflicts of interest

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[32] governing body - FCA Handbook
[33] COLL 6.6 Powers and duties of the scheme, the authorised fund manager, and the depositary - FCA Handbook
[34] See: ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk)

[35] Details of these can be found in paras 5.42 to 5.104 of CP22/20

which may give rise to poor outcomes. The recent crisis involving complex Liability Driven Investment strategies is a case in point.[36]

With regards to climate risks, pension scheme trustees are faced with a plethora of approaches to assessing compliance with climate goals. Among other things they need to understand complex methodologies underpinning assessment or ratings. They have to deal with the conflicts of interest in financial services which increase the risk of greenwashing and identify genuinely climate-compliant investment managers and investee companies. Spotting greenwashing will not be easy for ordinary trustees.

Distributors, intermediaries, and advisers The FCA intends to require distributors to place a notice to alert retail investors when a product is based overseas and is not subject to the labelling and disclosure requirements, and to include a hyperlink to the FCA's webpage which explains the labelling and disclosure requirements. Including alerts when a product is based overseas is necessary but not sufficient. The FCA should require distributors, intermediaries, and advisers to undertake due diligence on overseas products to be able to disclose to investors how climate-aligned these products are. If distributors and intermediaries are unable to perform due diligence, then the FCA should not allow these products to be distributed.

One final point is that advisers usually combine funds into portfolios or indeed outsource the creation of portfolios to others. These services could adopt and adapt the new labels, but what if the adviser offers a mix of funds some of which are climate-transition supporting while others are climate-damaging? It may be that the FCA will offer a view on this when it comes to issuing further requirements for advisers around suitability and sustainability. But, it remains unclear for now how advisers, such an influential segment of the financial services industry, should deal with their clients on this issue.

Fossil fuels Although it does not expressly say it in the consultation paper, the FCA briefed the media that fossil fuels including coal, oil, and natural gas and nuclear power will not be excluded from sustainable funds. The FCA says that the firm will have to provide clear explanations of how these assets are appropriate for sustainable funds.[37] This is in line with the European Commission's decision to allow fossil gas and nuclear energy into the EU taxonomy which caused NGOs to resign from climate expert groups. The FCA's decision to not explicitly exclude fossil fuel assets from any financial product which uses the label 'sustainable' may follow the EU example to a degree, but it may allow more categories of fossil fuel, notably oil and coal to be included.

Market Impact and Social Impact This report is concerned primarily with the environment. But, environmentally sustainable funds have to co-exist with the other aspects of ESG which fall under the FCA's proposed labelling regime. The whole labelling approach has to work.

The FCA is proposing that Sustainable Impact funds would invest in solutions to environmental or social problems, to achieve positive, real-world impacts. As explained above, we argue that there should be a separate label for green and social impact funds to help investors clearly distinguish.

[36] See for example: Failure to learn lessons of 2008 caused LDI pension blow-up | Financial Times (ft.com)
[37] Greenwashing faces fresh curbs in UK regulator's crackdown | Financial Times (ft.com)

With regards to making a social impact, the FCA proposals are silent on whether a sustainable impact fund should aim for a below market financial return.

We would argue there is a basic difference between what we call Market Impact funds and Social Impact funds even though both intend to deliver a social impact. The crucial point is the attitude to return expectations.[38]

We would define a Market Impact fund as one which invests with the goal of ensuring that the economy (and businesses that make up the economy) operate to the standards expected by society (fair treatment of employees and supply chains, gender equality, and so on) but still operating within the principles of the market. The fund would still expect to generate a market return on those investments.

We would define a Social Impact fund as one which seeks to address social issues that would not be addressed by the market operating to market principles or issues which the state is unwilling to address. For example, this might include providing grants or no-interest loans to non-profit organisations to tackle problems faced by local communities eg. helping non-profit lenders take on loan sharks. For Social Impact investors the main concern is the impact they are having – the return is a secondary consideration. This is not the case with Market Impact investors. They still want market returns – alongside having an impact.

Impact as a designation or marketing label has also migrated from private markets, where it may well have been philanthropic, ie. not seeking a return or any capital preservation to seeking a less than market return with capital preservation. More recently, impact as a term has been applied to asset managers and funds seeking a market or even above-market return. This has also seen the description of impact investing move from mostly private markets to public markets ie. adopted by closed or open funds and even some insurers. It can be social or environmental yet that shift in meaning is not sufficiently addressed by the FCA with this labelling regime. It could even be argued that the FCA should be trying to halt this shift in definition, at least until there is more research and information.

Of course, there is something of 'a rose by any other name'[39] to fund category names. In other words, it is not the name of the fund categories that matters most, but the substance. It is important that the definitions are consistent and reflect how investors consider their own preferences and make decisions, and communicate the motives of the fund managers selling these funds. As it stands, the FCA proposals do not do that. Rather, the current FCA proposals reflect the marketing strategies of the industry. Just as there is a major risk of greenwashing, we fear the FCA's Sustainable Impact label proposals could enable impact washing.

For example, how would the FCA's proposals deal with a fund that invests in companies that set up business in economically deprived areas of the country with support from state subsidies yet still want to deliver market rates of returns for shareholders? The fund managers might claim that this is an impact fund – but is impact really the motive rather than state supported financial returns?

[38] What You Need to Know about Impact Investing | The GIIN

[39] 'What's in a name? **That which we call a rose, by any other word would smell as sweet**.' Juliet in Shakespeare's Romeo and Juliet

Or what about a fund that invests in low-middle income countries (LMICs) where assets can be bought cheap but the fund believes prospects for economic growth (and therefore investment returns) are good? This fund could be said to have an impact if it creates jobs. But, can it really be said that impact rather than spotting potentially undervalued assets to generate high returns is the primary motivation here?

Would the FCA allow a fund set up to invest in children's care homes with the aim of matching or beating the market return to be classified as 'Sustainable Impact'? This fund would be aiming to generate market returns for investors from an activity no longer provided by the state. The market returns investors would expect means the cost of financing those care homes would be higher than if the resources were provided by the state.

Similarly, would a fund that claimed to build social or private rented accommodation but also aimed to generate a market-matching or market-beating return be allowed to be called Sustainable Impact?

Would it be possible for a financial institution to define a fund as sustainable if it invested in a factory making weapons or climate-damaging goods in an area of high economic deprivation on the grounds that it was boosting local wages and levelling up? These funds would be behaving no differently to conventional investors seeking to generate returns from economic activities. These investors would have likely to have been interested in investing in these activities regardless of whether or not the concept of impact investing existed.

We argue that it is difficult to justify allowing a fund to be marketed as social impact if it seeks to produce returns that would match returns generated by supposedly non-impact funds. If impact funds are allowed to generate market returns, then this would increase the risk of 'impact washing'.

Therefore, we argue the FCA labelling regime should clearly distinguish between Market Impact (which aim to make market or above market returns while also aiming to make a social impact) and Social Impact funds (which are willing to make a financial sacrifice in pursuit of social goals).

If the FCA insists on retaining its single Sustainable Impact label, then it should have two subcategories – Sustainable Impact (Market) and Sustainable Impact (Social). If it insists on having just one Sustainable Impact label then this should be restricted to funds that aim to make a below market return.

ANNEX B: FINANCIAL INCLUSION CENTRE ALTERNATIVE PROPOSALS FOR A RATING SYSTEM

In the Financial Inclusion Centre model, the label and accompanying data helps end-users see clearly:

1. **The sustainability purpose or goal of a fund** Does it promote i. climate/environmentally friendly (green), ii. corporate responsibility (market impact), or iii. social impact activities?
2. **The degree to which the fund complies with the relevant sustainability goal** This would be based on a rating system or minimum threshold system. For the rating approach a label based on stars, or colour coding would be used. The rating would be based on ***absolute*** scales[40] eg. 0%-20%, >20%-40%, >40%-60%, >60%-80%, and >80%-100%, of assets qualifying as meeting a fund's goals. For a minimum threshold system, only qualifying funds would be allowed to use a 'green' label. The threshold could be set very high (eg. >80% assets qualifying) so that only one label was achievable. Alternatively, the threshold could be set lower with the label having two forms - dark green (>80%-100% qualifying) or light green (>60%-80% qualifying). A qualifying fund should not be allowed to hold assets which caused significant harm to the environment. Non qualifying funds would carry a clear, strong 'climate health warning'.
3. **The approach adopted by the fund** This would include more narrative descriptions. The pertinent questions to answer include: is the fund focused, aligned, or designed to have a measurable impact on an issue; and does it intend to transition to a higher rating and, if so, to what rating and over what period? This would include the detailed data on the policies adopted by the fund to achieve its goals or purpose. The FIC approach seeks to distinguish clearly between the ***goal/purpose*** of a fund/product (ie. promoting climate friendly, corporate responsibility, or social impact activities) and the ***approach*** (the degree of alignment with goals/purpose, intention to transition, and level of active management involved). We believe this better reflects the way consumers make decisions.

There are two possible versions of the FIC model:

- **Version 1**: with three main categories – Green (contribution to climate and wider environmental goals), Responsible (corporate responsibility), and Impact (Social Impact)
- **Version 2**: with two main categories but with two sub categories for the Responsible category - that is, Green and Responsible (Market Impact and Social Impact)

Table 1: Summary of FIC model for a sustainable label

Version 1: Three categories

Label	**Meaning**
Green	Conveys a product's approach to and alignment with climate and wider environmental goals (such as biodiversity). A rating system would be used to communicate the *degree* to which the product is aligned with climate goals. The rating could either be in the form of a 1-5 star system or a colour coded system (a dark green

[40] A relative scale, where funds are compared to other funds, would not be appropriate as this would embed poor practice in the market. With a relative scale, a fund with say only 40% assets complying could achieve a top rating if other funds typically had 10% assets qualifying. A relative scale in this case would not drive up standards.

	through to red globe depending on the positive contribution or harm the fund makes to the environment). The product's rating would be based on the weighted average climate score of the component assets eg. corporate bonds and equities held within the portfolio. The climate score of component assets would be based on independently verified data and measurement. Only component assets for which there is independent data available would be included in the weighted average score and rating for the product. Products with a low rating, or where independent data is not available, should carry an 'environment health' warning. The other approach would be to set a minimum threshold to qualify for a green label (dark or light green), with non-qualifying funds being required to carry an 'environment health' warning. But, those non-qualifying funds would still disclose the extent of the negative impact they are having on the environment. For example, this could be done by requiring disclosure of the proportion of assets held which are considered to be damaging to climate goals.
Responsible/Market Impact	Conveys a fund's approach to and alignment with corporate responsibility standards eg. treatment of employees and supply chains, commitment to human rights, gender equality and so on. A rating system could be used to communicate the *degree* to which the product is aligned with meaningful, independently verified corporate responsibility standards. The rating process could be similar to the process for green label rating, above. These funds would not sacrifice financial returns in pursuit of goals.
Social Impact	Restricted to funds set up and managed to have *direct,* identifiable social impacts. This is to distinguish from funds with a general aim to promote corporate responsibility. To qualify for the impact label, these products should accept a below-market rate of return. A ratings system for impact funds is probably not needed. Funds should either be dedicated impact funds or not. But, if necessary, a rating could be awarded depending on much of a financial sacrifice is made to pursue impact goals. Independently verified disclosure of the financial rate of return produced and impact performance of funds would be needed.

Version 2: Two categories

Label	Meaning
Green	As above, the main purpose of the label is to conveys a product's approach to and alignment with climate and wider environmental goals.
Responsible (Market and Social Impact)	Responsible funds and Impact funds do have shared purposes and goals. Both are primarily concerned with

	improving the economic and/or social wellbeing of workers, households, or communities. So, there is a case for having a single Responsible category. However, the motives underpinning the two approaches are very different. One seeks to generate market or above market returns – alongside having an impact. The other is willing to sacrifice financial returns in pursuit of social impact goals. Having two distinct categories reduces the risk of impact washing, too. The criteria for determining whether a fund qualifies would be the same as above.

The decision tree
Any labelling system can really only work if it clearly conveys the purpose or goal of a fund to allow investors to identify choices that meet their preferences. It is helpful to think of a decision tree involving three key decisions and therefore three important sets of information. Investors have to know:

- What is the goal of the fund/product?
- To what degree does it align with its goal?
- What approach does the fund adopt towards achieving its goals?

But, with the FCA approach, the investor will be choosing a fund based on whether it has a sustainable *focus*, *improver, or impact* focus rather than on whether the fund has a green goal, corporate responsibility goal, or social impact goal. However, the focus, improver, or impact terms in the FCA's model signifies the approach not the goal. The FCA is conflating and confusing the *approach* for delivering on goals with the actual *purpose/goal*.

For example, a green fund might try to achieve its goals by tilting the portfolio to hold shares and bonds in companies with high green scores, or it might focus its investments on supporting new green tech to make a ***direct impact*** in this sector. These are clearly funds with a green purpose/goal but with a different approach to achieving that goal. But, with the FCA's model one fund would have a Sustainable Focus or Sustainable Improver label, the other a Sustainable Impact label. This is not helpful.

It is not helpful to require investors to screen or filter funds first according to approach (Sustainable *Focus* or *Impact*) and then look at whether it is a green or social impact fund. This is also important if comparative information services are to work effectively.

The FCA's proposals do not seem to accommodate more typical CSR funds ie. funds that invest in companies with high standards of employee and human rights, or adherence to high supply chain standards. These may share similar goals – to improve wellbeing – but use a different approach to pure social impact funds.

Similarly, the Sustainable Improver label as a first potential decision point is not very helpful. Are investors really going to look first at whether a fund has an Improver label and then look at whether it is green or social impact? Surely, investors would identify whether a fund has green goals and then decide whether to select a fund that is: i. already significantly compliant with green goals or ii. be satisfied with a fund that currently has a low level of compliance but intends to improve?

We would argue that the more logical approach would be to help investors screen funds to:

- Identify whether funds are claiming to be green, social impact, or responsible through a clear label
- Compare to what degree the fund is aligned with green, social impact, or responsible goals using a meaningful rating system including whether funds are intending to transition to a higher rating
- Understand the approach used to meeting the stated goals

In terms of a transitioning fund, if a fund was rated as a 2 star fund but had an intention to transition to a better score, then it could disclose this with a transition plan and targets. Independently verified data and a report would be published by a truly independent governance body[41] to allow monitoring of progress against targets.

As to what would happen if a fund portfolio had both green and responsible assets within the fund, there are different ways to accommodate this. Either the fund could present two labels eg. XYZ Sustainable Balanced Fund is a qualified Green and Responsible fund. Alternatively, an investment fund that contained a mix of green, market impact, and social impact assets could be called a Sustainable (Balanced) fund as long as it met minimum qualifying thresholds for each of the holdings of green, responsible, and impact assets. This would be similar to the EU's 'do no harm' principle. The third option would be to allow the product provider/fund manager to select which category it wanted to emphasise.

Ratings and eligibility thresholds

Any system needs clear thresholds to allow for rating. There are two ways of presenting ratings that would help ordinary consumers and other users such as pension trustees.

1. **Require all funds to have a rating.** For funds with green goals this could be a dark green, light green, amber, light red, dark red symbol, perhaps a globe to signify the earth. Another option would be to use a 1 to 5 green star system with 5 stars denoting the highest level of compliance with green standards. An alternative version of this would be to use 1 to 5 green stars to rate funds on their green-ness and 1 to 5 red stars for those funds that continue to cause climate harm. We are primarily interested in the green label. But, a similar marker could be agreed for Market Impact and Social Impact funds.
2. **Impose minimum qualifying threshold for green and responsible funds.** Only funds with a minimum proportion of assets meeting green or responsible standards would qualify to display the relevant label. For example, funds with a green goal would be allowed to use a dark green or light green symbol depending on what proportion of assets complied with green goals. A similar approach could be used for funds with corporate responsibility goals. All other funds which did not meet the minimum qualifying threshold would be required to

[41] See Lack of independent verification and fund governance bodies, above

carry a clear climate or corporate behaviour 'health warning'. This warning would state that these funds contain a significant proportion of shares and bonds in companies which operate to low standards of corporate behaviour in relation to the environment and/or corporate responsibility.

Whichever rating system is used, it is important that providers cannot evade scrutiny by choosing not to submit funds for rating. If fund managers/product providers fear that their funds would not qualify for a good rating, then they still must be held to account for damage caused to the environment.

All funds should be required to disclose the harm they are causing to the environment. For example, a fund holding fossil fuel related assets should be required to disclose that 'X percent of this fund's assets are held in shares and bonds of companies that have a low green rating as certified by ABC rating agency'. Where data on the green rating of specific companies is not available, the activities of those companies should not be allowed to make a positive contribution towards a fund's climate rating.[42]

Whatever rating system we end up with, it must be based on independently verified input data/ratings. Moreover, ratings agencies *and* the methodologies they use must be approved and regulated by the FCA.

Social Impact funds should be treated separately. To qualify for a Social Impact label, the fund should aim for a below market return to differentiate from Market Impact funds. Many funds could claim to have an impact. Allowing funds to aim for a market or above return invites impact washing.

In the model we propose, the Social Impact label would be reserved for funds with clear social impact purpose or goal eg. improving educational standards (but not making a market return out of setting up private schools or selling educational materials), providing funds for credit unions to lend on to excluded consumers, or regenerating a local economy.

For Social Impact funds, there are two options. Perhaps the clearest option would be to apply a strict binary approach with only funds that do not seek to make a market return allowed to use the Social Impact label. But, it would also be possible to have a rating system for Social Impact funds determined by how much market return the fund is willing to forgo in pursuit of its social impact goals.

How would a 5 star or colour coded system work?
A rating system for green funds could be based on a colour coded symbol such as a globe (dark green, light green, amber, light red, dark red) or a 1 to 5 green star system or green and red star system. To establish a rating or colour coded system, clear boundaries or ranges would be needed.

Below, we set out two models for summarising the contribution funds/products make towards climate goals. For illustration purposes, we have assumed the fund portfolio holds just five assets. This could be shares and bonds in companies, other financial products, sovereign bonds, and private

[42] There may be a case for applying this rule to medium-larger companies. Exceptions could be made for smaller companies if it becomes clear that data on environmental compliance is difficult to obtain. Or, proxy data based on the green performance of that particular industrial sub sector could be used.

equity. In reality, typical portfolios could have holdings in hundreds of different assets. Yet, the principle is the same and the calculations involved are not that much more difficult.

Perhaps the most important process step for any labelling model (whether it is the models proposed here, the FCA's, or the European Union's) is establishing how 'green compliant' the assets held within a portfolio are.

In the models outlined below, we have chosen to use the percentage of revenue the asset generates from *accredited* green activities. For example, Fund A below has 30 percent of its overall investments in shares of company A1, which generates 60 percent of its company revenues from economic activities that are accredited as being green.

The question is: how do we determine whether a constituent asset should be accredited as green? There are a number of options. The two main approaches are to: i. use some sort of reference benchmark; or ii. adopt a more explicit, quantitative approach which measures emissions generated by assets held within a fund/product portfolio.

In the approach adopted by the EU, to be classified as sustainable, an activity must:

- substantially contribute to at least one of six environmental objectives;[43]
- do no significant harm to any of the other environmental objectives; and
- comply with minimum safeguards created to avoid having a negative impact on social stakeholders.

With the EU approach, activities can either substantially contribute to environmental performance of industry *directly,* or act as an *enabling* or *transition* activity.

A UK version of the EU Taxonomy has not yet been developed. This is another area in which the UK is lagging the EU.[44] Once a UK version has been developed, this could be used to provide the basis for a rating scheme. For example, in the case of Asset 1 held within Fund A below, 60 percent of that company's economic activities would be verified by an independent body as qualifying as being sustainable with reference to that UK Taxonomy. This is similar to the approach adopted by ESMA in its assessment of the proportion of EU investment funds that would qualify for the proposed EU Ecolabel – see Table 1, above.

The alternative would be to use a more explicit measurement of a fund portfolio's total greenhouse gas emissions or the total revenue generated from fossil fuel activities.[45]

Table 2: Outline of green star/globe, colour coding, and label approach

Fund A	Fund B	Fund C

[43] Climate change mitigation; climate change adaption; sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and ion control; and protection of healthy ecosystems
[44] The EU and EC are well advanced in developing technical criteria to allow a Taxonomy to be used. See TEG final report on the EU taxonomy (europa.eu) and SFDR Templates (europa.eu)
[45] See for example the template set out in Table 1, Annex 1 of European Commission Delegated Regulation (EU) 2022/1288, April 2022, EUR-Lex - 32022R1288 - EN - EUR-Lex (europa.eu)

Asset	% revenue from accredited green economic activities	% share of portfolio	Green factor	Asset	% revenue from accredited green economic activities	% share of portfolio	Green factor	Asset	% revenue from accredited green economic activities	% share of portfolio	Green factor
A1	60%	30%	18.0%	A1	20%	15%	3.0%	A1	50%	30%	15.0%
A2	90%	25%	22.5%	A2	30%	10%	3.0%	A2	50%	25%	12.5%
A3	55%	15%	8.3%	A3	50%	40%	20.0%	A3	60%	15%	9.0%
A4	50%	20%	10.0%	A4	40%	15%	6.0%	A4	60%	20%	12.0%
A5	55%	10%	5.5%	A5	Unknown	20%	0.0%	A5	35%	10%	3.5%
Total green score			64%				32%				52%
Green star (or globe) rating			****				**				***
Colour coding											
Label							**Environment warning**				

With the above approach, a green factor is calculated for each of the constituent portfolio assets. A total green alignment score is calculated for the product/fund. In this example, Fund A above scores 64 percent which means it qualifies for a 4 star rating or light green globe.

If we used a system where only funds that met a minimum threshold qualified for a label, then Fund A would qualify for a light green label with Fund C qualifying for an amber label. Fund B would carry a prominent environment warning to signify that this fund contains a high proportion of investments in assets that cause damage to the environment.

The alternative way to summarise the data would be to 'penalise', more obviously, funds that continue to hold climate damaging assets. This could be done by awarding 1-5 green stars for funds that have net positive green assets and 1-5 red stars for funds that have net negative climate damaging assets – see below.

Table 3: Outline of green and red star system

Fund A

Asset	% revenue from climate +ve economic activities	% revenue from climate neutral economic activities	% revenue from climate -ve economic activities	% share of portfolio	Green factor
A1	50%	30%	20%	30%	9%
A2	10%	40%	50%	25%	-10%
A3	40%	50%	10%	15%	5%
A4	30%	30%	40%	20%	-2%
A5	90%	10%	0%	10%	9%
Weighted average/ total green score	38.5%	33.5%	28.0%		10.50%
Rating					*

Fund B

Asset	% revenue from climate +ve economic activities	% revenue from climate neutral economic activities	% revenue from climate -ve economic activities	% share of portfolio	Green factor
A1	80%	20%	0%	15%	12%
A2	90%	10%	0%	40%	36%
A3	75%	15%	10%	10%	7%
A4	80%	10%	10%	15%	11%
A5	80%	20%	0%	20%	16%
Weighted average/ total green score	83.5%	14.0%	2.5%		81.00%
Rating					*****

Fund C

Asset	% revenue from climate +ve economic activities	% revenue from climate neutral economic activities	% revenue from climate -ve economic activities	% share of portfolio	Green factor
Company 1	20%	20%	60%	30%	-12%
Company 2	15%	55%	30%	25%	-4%
Company 3	10%	30%	60%	15%	-8%
Company 4	15%	45%	40%	20%	-5%
Company 5	20%	40%	40%	10%	-2%
Weighted average/ total green score	16.3%	37.3%	46.5%		-30.25%
Rating					**

Note that the examples above relate specifically to compliance with climate and wider environmental goals given the focus of this project. The same model could be used for Market Impact and Social Impact goals. If necessary, a summary table could be created for particular funds covering each of the main goals.

Table 4: Example of summary sustainability/ESG matrix

	Green Rating	Market Impact Rating	Social Impact Rating	Sustainable (Balanced)
Fund A	****	***	n/a – no data	No
Fund B	**	**	*	No
Fund C	***	n/a – no data	****	No

A summary fourth column could be included to denote whether a fund qualifies for Sustainable (Balanced) status. This could work with the FCA's approach to the sustainable investment label which does not separate out the different elements of ESG. To qualify for this label, a fund would have to meet minimum qualifying thresholds for each of the three sub categories. In the table above, none of these funds would qualify for a Sustainable (Balanced) label – even though some scored a good green rating.

As well as making it easier for investors to identify funds which meet their preferred goals and funds to avoid, the above approach would also better accommodate the use of comparative information tables than the FCA's proposed approach. Investors could filter and rank funds according to the goal they are most interested in – for example, Green, Market Impact, or Social Impact.

Note that the approach we advocate above could also be used for any collective structure (not just investment funds) such as segregated pension funds (which may have a mix of direct holdings and investment fund holdings), funds of funds, or investment platform recommendations used to create a portfolio. Indeed, it could also be used to produce a rating for bank loan books which would allow bank customers to see clearly how green their bank is.

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.

This marks the end of The Financial Inclusion Centre submission.

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