Time for action: the Devil is in the policy detail

Will financial regulation support a move to a net zero financial system?

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Synopsis

The *Devil in is the policy detail*: provides a comprehensive description of the complex ecosystem of climate-related[1] financial regulation at UK, EU and international level (Part 1); evaluates, in detail, the potential effectiveness of the main climate-related financial policy and regulatory tools currently being developed in the UK (Part 2); and makes a series of policy and regulatory recommendations to align financial markets with climate and wider environmental goals (Part 3).

A reminder of what's at stake

The UK is failing to meet its ambitious[2] climate goals,[3] and the government's plans for net zero do not include enough information to allow for proper scrutiny of those plans.[4] Reforming financial markets is a key part of greening the UK economy and, given the influence of the UK financial markets, the global economy. Much more needs to be done to ensure UK financial institutions take climate responsibilities seriously.[5] Banks continue to lend to, insurers continue to insure, asset managers and pension funds continue to invest at scale in corporate and sovereign assets[6] that cause serious harm to the environment.

Even from a 'selfish' national interest perspective, financial market reform should be a priority for the UK as its heavily financialised economy is particularly exposed to climate risks.[7] However, people living in nations with the lowest incomes, poorest health, and weakest infrastructures are most at risk.[8] Financial services is one of the UK's leading export sectors. The carbon emissions associated with the UK financial sector were estimated to be nearly twice (1.8 times) the emissions produced domestically by other UK economic activities.[9]

Much more needs to be done to ensure financial institutions take climate change seriously

Financial policy and regulation will not align with climate goals

To move towards a net zero financial system, financial policy and regulation must:

- Reduce the ***stock*** of environment-damaging assets held by financial institutions.
- Direct the ***flow*** of new money away from environment-damaging economic activities and towards environment-supportive economic activities.
- Hold financial institutions to account for harm caused to the environment.

1 We tend to use the terms climate and environment interchangeably. But, throughout the report whichever term we use we mean climate and wider environmental issues (such as biodiversity)
2 The Climate Change Act 2008 was amended to commit the UK government by law to reduce greenhouse gas emissions by at least 100 percent of 1990 levels (in other words, 'net zero') by 2050. The previous goal was 80 percent of 1990 levels.
3 Current programmes will not deliver Net Zero - Climate Change Committee (theccc.org.uk)
4 We've won our case against the UK Government's inadequate net zero strategy | ClientEarth
5 See for example: 51% of major global energy companies are still failing to disclose their decarbonisation strategy - Grantham Research Institute on climate change and the environment (lse.ac.uk); Climate Action 100+ Net Zero Company Benchmark shows an increase in company net zero commitments, but much more urgent action is needed to align with a 1.5°C future | Climate Action 100+
6 E.g., bonds issued by national governments and agencies
7 See: People in the US and UK face a huge financial hit if fossil fuels lose value, study shows | Fossil fuels | The Guardian
Stranded fossil-fuel assets translate to major losses for investors in advanced economies | Nature Climate Change
8 Climate change and health (who.int)
9 The-Big-Smoke-the-global-emissions-of-the-UK-financial-sector.pdf (greenpeace.org.uk) Note that the analysts conclude that this is likely to be a significant underestimate due to lack of publicly available data in key areas such as insurance.

We conclude from our assessment that the UK does not have: the appropriate high-level policy and regulatory framework and architecture; effective regulatory objectives and tools; and regulatory culture to align finance with sustainability goals and to hold financial institutions to account.

Financial markets are regulated to prevent: finance from wrecking the economy as with the 2008 crisis; money laundering and insider trading; the financing of terrorism; and consumers being missold and ripped off. Yet, even the most basic assessment of financial regulation shows that preventing finance from harming the environment does not have anywhere near the same status or priority as those other objectives in the work of the Bank of England, Prudential Regulation Authority (PRA), and Financial Conduct Authority (FCA).

The report makes a set of recommendations to help move us towards a net zero financial system. The recommendations may seem radical, but they are not when compared to existing regulations already used to maintain financial stability, ensure market integrity and protect consumers. If adopted, the recommendations would accord the environment equal status in financial regulation. This is not much to ask for. Indeed, there is a strong case to be made that the environment should be given priority status in financial regulation.

The regulatory tools needed will depend on the financial activity, e.g., bank and shadow bank lending/finance, insurance and reinsurance, asset management, pension funds, financial intermediaries, and information providers. The main categories of regulatory intervention that can be used to align market behaviours are prudential; information, reporting and disclosure based; conduct of business regulation; and direct market interventions aimed at changing behaviours of financial institutions. We analysed each category and concluded that moving towards a net zero financial system needs a very different approach in each of those categories.

Prudential Regulation

The main prudential regulators, the Bank of England and PRA, have started to think about the impact of climate change on the financial institutions they regulate, but not the impact of those financial institutions have on the environment - in other words, the *consequences* of climate change not the *causes* of climate change. Prudential tools are not being directly deployed to change the behaviours of banks/shadow banks and insurers that finance climate damaging activities.

Information, reporting and disclosure-based regulation

This has been where most of the regulatory activity has been at UK, EU and global level. The UK lags behind the EU. The FCA should be commended for its attempts to develop a sustainable investment labelling regime to help investors make informed decisions. However, this report concludes that the FCA's proposals are confusing and unlikely to prevent greenwashing and 'impact washing'[10].

Generally, the conventional approach to financial regulation based on tackling information asymmetries[11] does not have a great record in preventing market failure in financial services. Our view is that financing climate harm is set to become *the* major market failure if it is not already so. More direct interventions will be needed to change financial institutional behaviours.

[10] This report focuses on environment-related finance – the 'E' part of ESG. But this has to be considered alongside corporate responsibility and social impact – the 'S' part of ESG – which considers the impact of corporate behaviours on employees, human rights, and so on.
[11] The theory is that better information allows market participants to make more effective decisions and choices and thereby indirectly improve markets by rewarding good behaviours and penalising bad behaviours. This is different to direct financial regulation where financial regulators use policy tools to directly constrain financial institutions' behaviours.

Meaningful, trustworthy ESG data and ratings of both underlying economic entities and financial institutions is critical to target policy and regulatory interventions. There is significant risk of conflicts of interest in the use of ESG data and ratings and a confusing plethora of methodologies deployed by data providers. It is not possible to judge whether current methodologies provide a meaningful assessment of financial institutions' impact on the environment. There are concerns that ESG ratings providers primarily focus on the risks financial institutions face from climate change, not the risks these institutions pose to the environment.[12]

We are far from having comprehensive, usable environmental performance data published in the reports and accounts of major economic entities.

A green taxonomy is also important to allow stakeholders to distinguish clearly between those economic activities which harm the environment and those which make a positive contribution.[13] The UK government had committed to legislate for a UK green taxonomy (similar to the EU's sustainable finance taxonomy[14]) by January 1st, 2023. Disappointingly, the UK government recently announced that the UK taxonomy would be delayed.[15]

The Financial Reporting Council and auditing and accountancy bodies have undertaken welcome work on improving the disclosure of climate risks in company report and accounts. However, disclosures are too reliant on narrative reporting. We are far from having comprehensive, usable environmental performance data published in the reports and accounts of major economic entities.

Cost of business regulation, and direct market behavioural interventions

There has been little active consideration of how to deploy robust conduct of business and direct market behavioural interventions to divert existing pools of assets and the flow of new money away from climate damaging activities. The emphasis has been on encouraging a market-led transition. This light-touch approach towards the continued financing of climate-damaging activities is at odds with the hard line taken against financial institutions that enable practices such as misselling, insider trading, market abuse, money laundering, financing terrorism, or breaking economic sanctions.

The regulatory interventions currently on the table do not reflect the gravity of the challenge. We need a rethink by the main financial regulators on how to deploy prudential, disclosure and reporting, conduct of business, and market behaviour regulation across the key financial sectors and throughout the supply chain (from wholesale through institutional markets to retail financial services and ordinary consumers).

It remains to be seen how the UK will compete as a global centre of green finance. Will it be a beacon of high standards or establish a lighter regime and risk a regulatory race to the bottom?

Avoiding regulatory arbitrage within different sectors of the UK financial system is important, but there are wider potential implications. Post Brexit, the UK financial sector remains hugely influential at EU and international level. The government is developing a Green Finance Strategy with the aim of making the UK a Global Centre of Green Finance (GCGF). It remains to be seen whether the UK intends to make the UK competitive through deregulation or as a beacon of high standards on green finance. The signs are not good.

[12] ESG Ratings: A Compass without Direction (harvard.edu)
[13] An agreed classification system intended to help stakeholders identify which economic activities which can be considered environmentally sustainable
[14] EU taxonomy for sustainable activities (europa.eu)
[15] Written statements - Written questions, answers and statements - UK Parliament

Key recommendations

The recommendations apply to UK financial policymakers and regulators. Obviously, given the global nature of the challenge, it would be ideal if there was a consistently robust approach to climate-related financial regulation at international, EU and UK national level. We hope that UK civil society recognises the need to continue to try to influence financial regulation at EU and international level, *and* domestically. What happens at international and EU level will continue to influence domestic regulation; and if we follow a path of lowering UK domestic standards, this could undermine the goal of creating universally high standards of environment-related financial regulation.

High-level policy recommendations

Global Centre for Green Finance - In our view, the government's plans for the GCGF will not make the UK a leading, trustworthy centre of socially useful green finance. Indeed, the government's deregulatory agenda evidenced by the reforms to Solvency II and pension charge caps, and its intention to give financial regulators secondary competitiveness and growth objectives, runs counter to that aim. The GCGF should be built with the following principles and goals in mind. It should: foster genuine green financial innovation; aim to be systemically robust and stable; prize integrity and trustworthiness; and establish a reputation for being well regulated, accountable, and transparent.

The recommendations, below, would help the UK create a GCGF built on high standards and integrity -

A Net Zero funding strategy and plan - The UK government should produce a detailed Net Zero Funding Strategy and Plan which sets out: how the government intends to implement the most sustainable, fairest, and economically efficient means of funding the green transition; and how, where, and when to best deploy available (public and private) funding to different sectors of the economy. We need a funding strategy because the two sources of funding net zero do not operate independently of each other. The scale of private financial resources available for the climate challenge and the terms on which those resources are made available will be affected by the availability of state resources and vice versa. Objectively determining the optimal balance between private and public funding of net zero is critical, yet this has not been analysed in any real depth.

A new status for environmental financial regulation - Environment-related financial regulation should be given at least equal status to financial stability, prudential regulation, financial market integrity, and consumer protection. Therefore, the Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to environmental sustainability. The FCA, PRA, TPR, and FRC should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objective.[16]

Financial Conduct Authority high-level responsibility - The FCA should have responsibility for overseeing how financial institutions, listed companies and larger private companies, and employers' pension schemes disclose compliance with environmental goals to investors and other financial users. The FCA should be given responsibility for regulating ESG ratings and ratings providers.

[16] There is a very strong case for establishing a dedicated agency charged with monitoring and reporting on the environmental harm caused by corporates and financial institutions, maintaining an environmental harms register, and regulating ESG ratings providers. But, for now, we recommend that these functions be carried out by existing regulatory authorities.

Financial Reporting Council high-level responsibility - The FRC should retain responsibility for ensuring that the auditing of underlying economic activities meets regulatory requirements. Reporting on ESG compliance should urgently be made a statutory requirement, with tough sanctions for non-compliance with reporting standards.

A new Financial Sustainability Committee - The government and Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate-related risks.

FSC Annual Report - The proposed FSC should publish an annual report on its activities plus a wider triennial review on progress. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

An environmental harm audit of the financial sector - Financial regulators should produce a baseline audit of the environmental harm caused by each of the major financial sectors. This should be done on a preliminary basis using data on emissions generated by underlying economic entities which financial institutions finance/lend to, invest in, and insure.[17] Once better data and a UK Taxonomy is available, a more comprehensive environmental audit should be undertaken.

Sectoral de-risking transition plans - Financial regulators should develop climate de-risking transition plans for each of the main financial sectors. These plans should have clear milestones and timeframes for climate de-risking each sector.

Public register of environment-critical financial institutions/Institutional de-risking plans - Financial regulators should establish a public register of environment-critical financial institutions based on their impact on the climate and wider environment. Regulators should develop environment de-risking plans for each environment-critical financial institution within their remits.

Risk-based approach to climate-related financial regulation - The FCA and PRA already operate a risk-based approach to their existing statutory objectives. They should adopt a similar approach to environment-related financial regulation and produce a list of financial institutions which present the greatest risk to the environment and robustly deploy the appropriate regulatory interventions. The FCA and PRA should incorporate climate risk into their respective board risk committees and report annually on progress made on sectoral and institutional de-risking plans.

Economic and financial supply chains - The FRC and FCA should increase their focus on improving the standards of auditing and reporting on compliance with environmental goals in supply chains.[18]

Pre-emptive and precautionary financial regulation - Historically, progress in financial regulation happened in response to financial crises and market failure. With climate risk, we do not have the luxury of relying on markets to 'signal' the true cost of failure so that financial institutions respond properly. We urge the financial regulators to adopt a more robust, pre-emptive, and precautionary approach to environment-related financial regulation.

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[17] The EU securities regulator ESMA has already produced an analysis which quantifies the 'greenness' of a large sample of 3,000 European investment funds. UK regulators could adopt and adapt this approach for the UK. See Table 1, p29

[18] The supply chain accounts for more than 90% of most consumer goods companies' environmental impact. For more detail see: [Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre]

Prudential Regulation

Change of focus for financial regulators - The Bank of England/PRA focus too much on the *consequences* of climate change not the *causes*. The regulators should reconsider this approach. We urge the Bank of England and other regulators to send a strong, positive signal to Parliament and government that they recognise the need for financial regulation to actively support climate goals.

Solvency II and insurers - The government's intended deregulation of Solvency II to 'encourage' insurers to invest in green assets will reduce consumer protection and undermine the security of people's pensions. It is unlikely to cause insurers to invest in green assets or disinvest from climate-damaging assets. Regulators should require insurers/reinsurers to have credible, demanding climate de-risking transition plans with clear targets and timeframes to both protect insurance policyholders from climate-related risks and reduce the harm caused to the environment by insurance companies.

Specific policy tools for insurers - Specific policy tools will be needed to implement transition plans. Prudential regulators should adopt the 'One for One' Rule. That is, for each £ of funds that finances new climate-damaging activities, insurers should hold a £ of their own-funds against potential losses. If government insists on retaining the use of the Matching Adjustment (MA) technical provision in Solvency II which benefits shareholders at the expense of policyholders (see Annex A), then assets which contribute to climate damage should not be eligible for MA portfolios. To address the stock of climate-damaging assets, insurers should have to hold a proportion of own-funds, ratcheted up over an appropriate time frame to compel insurers to divest these assets in line with the transition plans described above. This should apply to assets already held in MA portfolios.

Banks - Banks (and shadow banks) should be required to have similar credible, demanding climate de-risking transition plans in place. The 'One for One' Rule and treatment of existing climate damaging assets should also apply to banks and shadow banks.

Other Bank of England interventions - We support in principle the proposals, outlined by Positive Money and others, for the Bank of England to establish a Green Term Funding Scheme and Green collateral frameworks to directly influence financial market behaviours.

Defined benefit (DB) pension schemes - The Pensions Regulator (TPR) should require DB schemes to have credible, demanding climate de-risking transition plans. A version of the 'One for One' Rule for banks and insurers outlined above should be developed for DB pension schemes. The value of additional funds needed to comply with the 'One-for-One' rule should be added to the scheme's liabilities and the sponsoring employer required to fund the scheme's climate-risk funding deficit.

Prudential regulation of defined benefit pension schemes - We recommend the prudential regulation of DB schemes be transferred to the Bank of England/PRA. The core principles of prudential regulation are similar for banks, insurers, and DB pension schemes. This would allow for a more consistent approach to systemic risk and prudential regulation, and specifically to environment-related financial regulation.

Conduct of business, reporting and disclosure, and other policy tools

The need for a clear fund rating system and climate health warnings - The FCA is developing a sustainable investment labelling regime to be used by investment funds. 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). 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' i.e., 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 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 should 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). To help investors identify how well investment funds meet green goals, there should be a clear rating system based on, say, 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 poor ratings should carry a clear environment health warning. We have provided examples of how an alternative green label would work in the report. The approach we set out could work for all types of collective fund/portfolio and indeed for bank loan books.

Other measures - The FCA's label proposals fall well short in a number of areas. Particularly worrying are the weak proposals on oversight and governance; the 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 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 coverage of products adopted by the EU. The FCA should bring all investment-based products within the label. 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 won't be covered by the labelling regime, they should be required to perform due diligence on the green compliance of those funds. If that is not possible, they should not be allowed to recommend those funds.

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).[19] It must be reasonable to assume there is a significant risk that greenwashing[20] 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.

Recommendations on defined contribution (DC) pension schemes - Sponsoring employers and scheme trustees should be required to submit DC schemes to be green rated by an independent rating agency and compared to an appropriate market benchmark to promote accountability to pension scheme members. Sponsoring employers and trustees should be required to explain poor ratings to scheme members and produce an improvement plan. Scheme trustees should be required to produce climate de-risking transition plans (see above) approved by scheme members.

[19] It is interesting that searching the FOS website for 'greenwashing' or 'ESG' at the time of writing turned up no results.
[20] 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

Other measures 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.

An Environmental Harm Register - Government should establish an independently operated, publicly accessible Environmental Harm Register.[21] 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.[22] This data should be audited with the auditing overseen by the FRC. The Environmental Harm Register and Sanctions List would 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.

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.[23] 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.[24] 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.

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[21] Ideally, an international register would be created by a relevant international agency

[22] 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.

[23] Senior Managers and Certification Regime | FCA

[24] 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

Data, rating and reporting/the role of the FRC

Environment responsibility statements - If stewardship means creating sustainable benefits for the environment, then we need evidence of progress. The FRC should ensure that independent, objective evidence on the degree to which underlying economic entities[25] 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.

ESG voluntary Code of Conduct - Until regulation happens, the FCA has created the ESG Data and Ratings Code of Conduct Working Group (DRWG), to develop a voluntary Code of Conduct for ESG data and ratings providers.[26] 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/intermediaries to use ESG ratings and the Code responsibly.

Code governance - The governance of the DRWG is very weak and dominated by industry representatives.[27] 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. ESG

[25] The real economy entities which financial institutions finance in different forms
[26] Code of Conduct for ESG data and ratings providers | FCA

[27] 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.

ratings and providers may not yet be regulated. But the FCA already requires financial promotions and communications to be clear, fair, and not misleading and misuse of ESG data and ratings obviously has the potential to mislead. So, 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 inconsistency - Worryingly, the FCA does not seem to think the low correlation between the ESG ratings provided by different agencies is a problem.[28] It is not reasonable to expect end-users to compare and contrast underlying methodologies. The FCA should: investigate and publish urgently 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.

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

Introduction and background

As part of its work on the impact of finance on the environment, the Financial Inclusion Centre (FIC) undertook a new project called ***The Devil is in the policy detail – will financial regulation support a move to a net zero financial system?*** This followed on from *Time for Action – greening the financial system*[29] which made over 40 high-level policy recommendations to overcome the barriers to greening the financial system and markets.

The *Devil in is the policy detail* takes the analysis to the next level and evaluates, in detail, the main financial policy and regulatory tools available to green the financial system. There is a complex ecosystem of climate-related financial policymaking and regulation. This project spans regulation aimed at financial institutions such as banks and shadow banks, insurers, asset managers, and pension funds, and reporting and disclosure standards aimed at businesses in the real economy. It also considers the critical role of data, data assurance, and environmental ratings.

As well as providing a much-needed comprehensive assessment of environment-related financial regulation, we hope this report will become a useful resource and reference material for civil society groups who want to understand the complex ecosystem of financial regulation.

We are very grateful to Friends Provident Foundation for supporting this follow up project, and indeed for supporting our first report.

A fork in the road

The UK is at a fork in the road in terms of which direction it takes on climate-related financial regulation. Decisions made now won't just have domestic implications, they will have consequences for efforts to establish high standards at a global level.

Post Brexit, there is much to consider and major political decisions to take. The future of specific UK environment-related financial regulation will be influenced by developments at international and EU, not just domestic considerations. The UK government intends to make the UK a global green finance centre. Will the UK develop world leading standards on green financial regulation, or instead establish a lighter regime than the EU and other regions and risk a regulatory race to the bottom?

UK financial services remain one of the most important in the world. The UK can play a positive role in supporting the global transition to a net zero financial system. Even though the UK has left the EU, the EU still matters to the UK financial sector, and vice versa, so the UK can still play an important role in influencing financial regulation for good at EU level. Conversely, if UK policymakers take the wrong approach, and embark on a strategy of regulatory arbitrage, this could significantly harm efforts to create universally high standards of environment-related financial regulation.

Within the UK, there are concerns that finance industry lobbies are using the need to fund the green transition and economic recovery as 'Trojan Horses' to push for financial deregulation. They argue that current financial regulations limit their ability to finance green technology/infrastructure. We believe this is disingenuous to say the least. Deregulation will weaken consumer protection in financial services but is unlikely to support the goal of moving towards a net zero financial system. There are better ways to ensure the financial sector supports net zero goals as we set out in the report.

[29] Time for Action – Greening the Financial System | The Financial Inclusion Centre

Structure of the report

Following the Summary and Introduction, Part 1 provides a reminder of what is at stake and what financial regulatory reform must do to support climate goals. It also describes in much detail the current legislative and regulatory landscape at UK, EU, and international level.

Part 2, the main part of the report: assesses the role of the main regulators - the Bank of England, Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), The Pensions Regulator (TPR), and the Financial Reporting Council (FRC). It examines in detail the potential impact of the main categories of legislation and regulation, and the specific policy tools regulators might use to influence financial markets, institutions, and consumers. Specifically, the team considered:

- **Financial stability/prudential regulation -** The balance sheet/risk management policy tools that the Bank of England and PRA intend to use to address systemic and prudential risks in the financial system created by climate change. We assess whether these tools will also align behaviours of banks and insurers with climate goals. TPR also has an interest as climate risks will affect the soundness of pension schemes.
- **Conduct of business/disclosure -** This focuses mainly on the role of the policy tools that the FCA, as the lead conduct regulator, plans to use to align financial market behaviours with climate goals. The FCA's main intervention is to develop a sustainable investment label[30] to help investors make better choices. Any effective disclosure or label must be built on relevant and trustworthy reporting and data. TPR will also have an influence on the behaviour of employers' pension schemes who are significant investors in the economy.
- **Financial reporting -** While we are primarily interested in the work of financial regulators, the work of the FRC is critical. Financial institutions invest in or lend to businesses in the real economy. How 'green' financial markets and institutions prove to be ultimately depends on how well the underlying businesses they invest in, lend to, or insure comply with climate goals. Trustworthy reporting and disclosure including in company report and accounts will be important.
- **Data, data assurance, and ratings -** Access to quality, trustworthy data and objective ratings on how well markets, financial institutions, and firms in the real economy comply with climate goals will be critical. To be useful, data has to be gathered, processed, analysed, and converted into objective, meaningful information and ratings. The regulation of the ratings agencies which perform this role is also important.
- **Other non-financial regulators -** We briefly cover the role of The Competition and Markets Authority (CMA) and Advertising Standards Authority (ASA) which are reviewing potentially misleading green claims (greenwashing) and advertisements made by businesses in the real economy about the products and services sold to consumers.
- **International and EU regulations and standards -** The nature of the climate crisis requires a global response from financial policymakers and regulators. UK legislation and regulation cannot be considered in isolation. So, we must also consider the approach being adopted by EU and international policymakers, regulatory authorities, and standards setters. These will continue to influence what happens in the UK and vice versa. Rather than have a separate section on international and EU standards, we have covered how those might affect UK national policy and regulation within each of the main sections.

The Summary contains a synopsis of the policy recommendations. Part 3 brings together, in more detail, the main recommendations from each of the relevant sections. The annexes contain more

[30] Note that the assessment and recommendations in this report focuses primarily on how financial regulation relates to climate and wider environmental issues. But these have to sit within a wider framework of ESG regulation so we do make reference to the 'S' and 'G' aspects of ESG.

detail on the key aspects of financial regulation considered in the report – Solvency II which covers insurers, bank prudential regulation, and the FCA's sustainable investment labels.

To accompany the work, we hosted and published a series of podcasts with each focusing on a specific project theme. These podcasts can be found on the following link: Podcasts: The Devil is in the policy detail – will financial regulation align financial market behaviours with climate goals? | The Financial Inclusion Centre

Finally, a word about what the report does not cover. It does not cover the disruption caused to the global energy markets by the war in Ukraine. The war is likely to affect the attitudes of policymakers towards energy security and green transition. Therefore, it is likely to have an impact on financial regulation. But, as it stands, it is unclear what the impact will be. If we can, we will return to this issue if we get any sense of the direction of travel.

There are other policy interventions designed to influence the behaviour of markets such as carbon offsets and various industry self-regulatory initiatives including a number of green codes. Unfortunately, we cannot cover all these interventions. This report focuses on regulatory policy and interventions – which is a huge challenge in its own right.

We hope this latest report is helpful and interesting.

Malcolm Hurlston CBE
Chairman
The Financial Inclusion Centre

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Part 1:
A reminder of the challenge, the policy landscape

What is at stake and what needs to be done

The ultimate goal of policy and regulatory interventions across the whole economy is to prevent climate catastrophe. Reforming financial markets is a means to that end. When signing up to the 2015 Paris Agreement, countries[31] agreed to cut greenhouse gas emissions to limit the increase in global average temperatures to well below 2°C above pre-industrial levels and to make efforts to limit the increase to 1.5°C above pre-industrial levels.

In the UK, the Climate Change Act 2008 was amended to commit the UK government by law to reduce greenhouse gas emissions by at least 100 percent of 1990 levels or, in other words, 'net zero' by 2050.[32] The previous goal was 80 percent of 1990 levels.[33]

It is one thing setting more ambitious goals, quite another to deliver on them. The UK is failing, so far, to meet those goals,[34] and the government's plans for net zero do not include enough information to allow Parliament and civil society to scrutinise those plans.[35]

*One of the main themes of this report is the need to deal with the **stock** of existing climate damaging assets as well as the **flow** of new financial resources.*

There has undoubtedly been an improvement in corporate behaviours towards climate responsibilities. Yet, it is also clear that much more needs to be done to ensure financial markets and institutions take their climate responsibilities seriously.[36] The conclusion from one major report was stark: '*The past decade saw growing momentum, where public and private climate finance almost doubled between 2011 and 2020. However, reaching climate objectives will require climate investment to increase at least seven times by the end of this decade as well as the alignment of all other financial flows with the objectives of the Paris Agreement.*'[37]

One of the main themes of this report is the need to deal with the *stock* of existing climate damaging assets as well as the *flow* of new financial resources. It has been estimated that the 60 largest global banks have around $1.35 trillion of credit exposure to fossil fuel assets through loans.[38] The five biggest UK banks have $72 billion exposure.[39]

Companies listed on global stock markets are on track to warm the planet by 2.9° C by the end of the century. Just 16 percent of listed companies align with keeping global warming at or below 1.5°C, with one-third aligned with keeping global warming at or below 2°C. Fifty one percent of listed

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[31] Almost all countries signed up to The Paris Agreement. Only a handful refused to do so.
[32] A legal duty to act - Climate Change Committee (theccc.org.uk)
[33] Climate change targets: the road to net zero? - House of Lords Library (parliament.uk)
[34] Current programmes will not deliver Net Zero - Climate Change Committee (theccc.org.uk)
[35] We've won our case against the UK Government's inadequate net zero strategy | ClientEarth
[36] See for example: 51% of major global energy companies are still failing to disclose their decarbonisation strategy - Grantham Research Institute on climate change and the environment (lse.ac.uk); Climate Action 100+ Net Zero Company Benchmark shows an increase in company net zero commitments, but much more urgent action is needed to align with a 1.5°C future | Climate Action 100+
[37] Fast track to a low-carbon, climate resilient economy (d1bf23g64f8xve.cloudfront.net)
[38] Report – A safer transition for fossil banking: Quantifying capital needed to reflect transition risk | Finance Watch (finance-watch.org)
[39] Tackling-financial-risks-related-to-the-fossil-fuel-financing-of-British-banks.pdf (finance-watch.org)

companies align with future warming of greater than 2°C.[40] Remember, these are listed companies which financial institutions such as pension funds, insurance companies, and asset managers invest in and banks lend to.

Climate change not only creates economic risks. It has been described as the greatest health threat facing humanity. It is also the case that the effects of climate change are not being experienced equally across the globe. Increased extreme heat is one of the most obvious impacts of global warming. People living in nations with the poorest health and infrastructures are most at risk.[41] Similarly, lower income nations have seen disproportionately bigger effects on economic output due to increased extreme heat. Recent analysis estimated that the total cumulative losses globally due to extreme heat between 1992 and 2013 were between $5 trillion and $29.3 trillion. Losses for regions in the bottom decile of incomes amounted to 6.7 percent of GDP per capita annually, compared to just 1.5 percent for those regions in the top income decile.[42]

As outlined in Time for Action, if we are to tackle the climate crisis, we need to change the way:

- **We live:** the choices we make about how and what we consume.
- **We work and produce:** the nature of economic activity and the corporate behaviours society expects.
- **The financial system works:** the allocation of resources by financial institutions, and the choices we make about how our money is used.
- **Global markets are governed and regulated:** the climate crisis is a truly global issue and so requires a global, collaborative approach to governance and regulation.

The UK has to do more in each of those areas to live up to its commitments on climate change. Reforming our powerful and influential financial system and markets will be central to that challenge. But, even from a 'selfish' national interest perspective, financial market reform should be a priority the UK as its heavily financialised economic system is particularly exposed to climate-related financial risks.[43]

The role of the state

The financial resources available to tackle climate change can come from:

- the state and its agents such as the Bank of England, and local government; and
- the private sector which includes financial institutions (including banks and other lenders, insurers, asset management, pension funds, private equity and so on) and individuals (savers, investors, policyholders, pension scheme members).

These two sources do not operate independently of each other. The scale of private financial resources available for the climate challenge (and the terms on which those resources are made available) will be affected by the availability of state resources – and vice versa. These are major political economy decisions.

[40] MSCI-Net-ZeroTracker-October.pdf
[41] Climate change and health (who.int)
[42] Globally unequal effect of extreme heat on economic growth | Science Advances
[43] See: People in US and UK face huge financial hit if fossil fuels lose value, study shows | Fossil fuels | The Guardian
Stranded fossil-fuel assets translate to major losses for investors in advanced economies | Nature Climate Change

Apart from the private finance sector arguing for the state to underwrite early-stage risks of investing in green infrastructure, there has been surprisingly little discussion and even less analysis of how state financial resources can be used to support climate goals.

The state can channel lower-cost funding than the private sector. It can take a different view on priorities and where to target funding decisions, take different risks than private sector institutions, and operate to different time horizons. However, this report focuses on private sector financial institutions and consumers and how regulation can be applied to modify their behaviours. Nevertheless, a full debate on the respective roles of the state and private finance is urgently needed.

What climate-related financial regulation has to achieve

The ultimate goal of the proposals on financial regulation described in this report is to align financial markets (and behaviours and activities of institutions and individuals within those markets) with climate goals.[44] This challenge can be simply stated as ensuring financial regulation directs the necessary financial resources (savings and investment, lending, and insurance):

- *away* from economic activities which harm the environment; and
- *towards* climate-positive activities that contribute to climate goals.

To achieve that goal, financial policy and regulation must:

- Reduce the ***stock*** of existing climate damaging assets already held in the form of loans, shareholdings and bond holdings. These assets tend to be held in listed[45] tradeable company shares or larger privately owned companies. The challenge here is getting financial institutions and households to disinvest their existing climate damaging holdings. A related challenge is identifying with more precision where those climate damaging assets are held within the financial system – that is, how much is held in the banking, insurance, asset management, and pensions sectors. It is difficult to know how much progress needs to be made, or where to target regulatory interventions, without first knowing where the greatest harm is being caused. This suggests the need for an audit of how much climate damage each of those sectors is contributing to.[46]
- Direct the ***flow*** of new money. Policymakers and regulators need 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.

Reducing the stock of assets already held in climate damaging activities requires a different set of policy interventions and regulatory tools to those needed to direct money into new/early-stage

[44] In Time for Action, we talked about SRI Finance – **S**ustainable, **R**esponsible, and Social **I**mpact finance. This report focuses mainly on the sustainability/climate related aspects. But it is worth noting that many of the issues covered here will be relevant to the debate on Social Impact. For example, parts of the finance lobby have been pushing for reforms to pensions and insurance legislation/regulation arguing that this would enable them to contribute to the funding of the green transition and levelling up.

[45] That is, with shares/bonds listed and tradeable on recognised financial exchanges.

[46] There are a number of analyses published on the level of emissions created by companies listed on global stock markets. See, for example: MSCI-Net-ZeroTracker-October.pdf
Although there has been a small shift in asset allocation towards private companies, UK financial institutions (asset managers, pension funds, and insurers) continue to invest the bulk of their assets in government bonds and bonds and equity of listed companies for which useful data on emissions is available. It should be possible to produce at least a preliminary audit of the concentration of high emissions-creating assets in each of the main sectors.

ventures. The policy and regulatory tools will differ depending on the source of funding – for example, regulations aimed at bank lending or insurers will be different to those aimed at asset managers.

Prudential regulators can directly influence the behaviours of banks and insurers, and to a lesser degree asset managers, by requiring them to hold capital on their balance sheets against the risk of future financial losses. So, they could apply this approach to climate risks. They could penalise the financing of climate damaging activities by requiring banks and insurers to hold capital on their balance sheets against the risks of future financial losses created by climate change. The Pensions Regulator (TPR) could apply the same approach to defined benefit schemes (see below).

The FCA has not considered more direct interventions to compel financial institutions to change their climate related behaviours.

The main conduct regulator, the FCA, sets conduct of business rules and guidance to regulate the behaviours of the firms within its remit. So far, with regards to climate change, the FCA has focused on enhancing transparency and disclosure in the hope that this will encourage financial markets and institutions to behave more responsibly towards climate goals. For example, a key intervention being developed by the FCA is a sustainable investment label intended to help investors identify sustainable funds and products. We analyse this initiative in some detail later in this report.

The FCA has not considered more direct interventions to compel financial institutions to change their climate related behaviours. This is in contrast to the tough consumer protection rules it has in place to require financial firms to treat consumers fairly. As we discuss later, a 'market-led' approach to encourage financial markets to align with climate goals is unlikely to deliver the necessary change.

Investment funds, insurance funds, and bank loan books consist of real economy assets. So, effective climate-related financial regulation (prudential and conduct of business) will need to be underpinned by a meaningful green 'taxonomy'[47] and trustworthy, meaningful data, ratings, and corporate reporting.

The FRC and other standards setting bodies will need to play an important role in ensuring corporate reporting on climate issues is usable and trustworthy. So far, most of the work has focused on narrative reporting. This, of course, will be helpful. But truly effective climate-related financial regulation will need hard ***data*** and ***evidence.*** We cannot measure to what degree financial markets and institutions are contributing to environmental harm, or measure progress against climate goals, without hard data. Narrative reporting cannot do that.

It is worrying that the UK has made so little progress on developing its own version of a Green Taxonomy.[48] Nor has the decision been made whether to bring the regulation of ESG ratings agencies within the FCA's remit. A meaningful taxonomy, robust trustworthy data and reporting are the building blocks of effective climate-related prudential and conduct regulation. Work on these issues need to be sped up if climate-related financial regulation is to work. This is covered in more detail in the sections on specific regulatory tools later in the report.

[47] Basically, a classification system to allow financial institutions and consumers to identify those economic activities which are environmentally sustainable and damaging.

[48] UK Green Taxonomy - Hansard - UK Parliament

We must also consider the role of a range of intermediaries who exercise significant influence over the behaviours of, and decisions made by financial institutions and financial consumers. These intermediaries include financial advisers, investment consultants, information providers, and ratings agencies. Again, important decisions on how to regulate these intermediaries have not yet been made.

The UK regulatory organisations and agencies involved

Before going on to evaluate the policies being applied by the government and various regulatory agencies, it is worth reminding ourselves of the number of organisations and agencies involved in the challenge of aligning financial markets with climate goals. It is a very complex ecosystem and this report can only provide a summary.

Parliament and government

At UK national level, Parliament and government is responsible for the overall high-level policy framework needed to address climate change including how much funding is needed, where that funding comes from, and so on. With regards to the financial sector, it sets the legislation which determines the roles and responsibilities of the main regulators.

The government has developed a Green Finance Strategy aimed at making the UK a leading global centre of green finance. This strategy will not only determine whether the UK becomes attractive as a global centre of green finance but will have an impact on the domestic approach to policy, legislation, and regulation.

We previously analysed the government's Green Finance Strategy and, indeed, supported the objectives set out in the strategy. However, we, are concerned that the legislative and regulatory framework, and specific regulations, rules, and guidance are not fit for purpose and will not drive the necessary change in the financial system and markets. A different approach is needed if UK financial markets are to support climate goals and if the UK is to be a leading effective, trusted, and reputable global centre of green finance.[49]

The government has recently placed a great deal of emphasis on making the UK financial sector 'competitive', post Brexit. Indeed, as part of the Future Regulatory Framework Review[50] and now in the Financial Services and Markets Bill[51] it is giving regulators a secondary objective to promote growth and competitiveness.

It remains to be seen whether the UK government intends to make the sector competitive as a global centre of green finance by becoming a beacon of good practice in green finance or by reducing regulatory standards in an effort to reduce costs for the financial sector. We obviously hope for the former.

Reducing regulatory standards in the UK creates the risk of 'regulatory arbitrage' as global firms could set up in the UK to take advantage of weaker legal and regulatory systems. It would increase the risk of greenwashing and damage to the UK's reputation as a trusted centre of green finance.

Furthermore, given the sheer size of the UK financial sector, this regulatory arbitrage would risk dragging down regulatory standards in other parts of the global financial system. The climate crisis is a truly global issue and so requires a global, collaborative approach to governance and regulation. If

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[49] HM Government: Update to the Green Finance Strategy – Call for Evidence | The Financial Inclusion Centre

[50] Future Regulatory Framework (FRF) Review: Proposals for Reform - GOV.UK (www.gov.uk)

[51] Financial Services and Markets Bill - Parliamentary Bills - UK Parliament At the time of writing the FSMB was receiving its Second Reading in the House of Lords

the UK facilitates regulatory arbitrage, this will harm global attempts to make sure financial market behaviours support climate goals.

Under the rules announced by the then Chancellor of the Exchequer Rishi Sunak at COP26, the government is requiring large companies and certain financial sector firms to publish, by 2023, a transition plan to decarbonise their operations and reach net zero emissions. The Transition Plan Taskforce (TPT) has been mandated by the government to develop a 'gold standard' for transition plans.

Government departments and regulators are working together to introduce new Sustainability Disclosure Requirements (SDR). This will require businesses in the real economy, asset managers, asset owners (e.g., pension funds), and investment funds and products to disclose more fully their management of sustainability risks, impacts and opportunities. Implementation of SDR is being led by HM Treasury (HMT) with different elements introduced by relevant regulators and government bodies - for example, the Department for Work and Pensions (DWP), the Department for Business, Energy and Industrial Strategy (BEIS), and the Financial Conduct Authority (FCA).

Transition plans and SDRs are welcome but again the effectiveness will depend on the quality of data used to monitor progress against the plans and robust supervision of disclosure by financial regulators.

The UK financial regulators

The Bank of England, the PRA, the FCA, TPR, and FRC are involved in addressing climate change to varying degrees.

The Bank of England and PRA

The Bank of England and Prudential Regulation Authority (the PRA sits within the Bank's overarching structure) are in a position to use balance sheet and risk management regulatory tools to address the financial stability/systemic and prudential risks in the financial system created by climate change.

Systemic risk means risk to the stability of the wider financial system. Prudential regulation relates to the soundness of individual financial institutions such as banks, building societies, credit unions, insurance companies and certain major asset managers. The PRA prudentially regulates around 1,500 firms.

As part of their work, the Bank of England/PRA stress test the resilience of the current business models of the largest banks and insurers, and the UK financial system, against the physical and transition risks associated with different possible climate scenarios. The regulators point out that, under the current prudential framework, firms are already required to ensure they have sufficient capital to be resilient against all material risks including those stemming from climate change. But they also highlight that current capital regimes likely do not yet capture the full extent of climate-related financial risks. The materiality of these gaps is not yet clear. The PRA is contributing to international efforts to understand the size of the risks and identify ways to mitigate those risks. It is also exploring improvements to the parts of the capital framework that are specific to the UK.

Post Brexit, the government and Bank of England/PRA have to consider how to apply two major pieces of EU prudential legislation and regulation – the Capital Requirements Directive/Regulation and Solvency II. These determine how much capital banks, building societies, investment firms, and insurers hold against the risk of financial loss. Reformed versions of the regulations could play an important role in aligning institutional behaviours with climate goals, if deployed effectively.

Solvency II has proved particularly contentious. Both the government and the insurance lobby have been pushing for the rules to be weakened to 'free up' resources for investing in the green transition. Government plans to reform the directive were confirmed by the Chancellor Jeremy Hunt in the Autumn Statement delivered in late 2022 and published in the form of final consultation feedback response.[52]

Capital tools can and should be deployed to change financial market behaviours

As we explain in Part Two, the Solvency II reform will be risky, could undermine the security of peoples' pensions and will not be an efficient way to channel resources into the green transition.

Even if the Bank of England/PRA are considering climate risks, it is very important to recognise that, as of yet, they approach climate change primarily from the perspective of prudential regulation. They are interested in the consequences of climate change for the system and firms they regulate, not the financial causes of environmental damage. They are not required by legislation to prioritise assessing what risks financial institutions create for the climate nor to prevent financial markets contributing to climate damage. The regulators are adamant that capital is not the right tool to address the causes of climate change, but that it should be used to provide resilience against its effects. As we go on to explain, we fundamentally disagree. Capital tools can and should be deployed to change financial market behaviours to stop financial institutions financing environment-damaging activities.

The Financial Conduct Authority

The FCA also has a critical role to play in trying to align financial markets with climate goals. The FCA is the lead UK 'conduct' regulator. That means it regulates the behaviours of financial institutions and sets standards of market conduct. The FCA has a lot on its plate. It regulates the conduct of around 50,000 firms and prudentially supervises 48,000 firms.[53] It has primary statutory objectives to protect consumers, to protect and enhance the integrity of the UK financial system and promote effective competition in the interests of consumers.

The FCA also has a very important role as the UK's securities regulator. The UK is a global centre for the issuance of shares and bonds by companies. These bonds and shares are first issued and sold on the primary market before being traded on the secondary market and bought and sold by financial institutions and retail investors.

The FCA monitors disclosures by issuers and financial firms, enforces compliance with rules on disclosures, reviews and approves the prospectuses and circulars used to promote the issuance, and oversees compliance with the Listings Rules.[54] Climate-related issues will play an increasingly bigger role in the promotional material used by companies and their agents. This is different to the role of the FRC which oversees how information is disclosed in company reports and accounts as we discuss later.

[52] Consultation_Response_-_Review_of_Solvency_II_.pdf (publishing.service.gov.uk)

[53] Note that it regulates many of those firms for conduct and prudential. The PRA prudentially regulates the larger or systemically important firms.

[54] The Listing Rules are a set of regulations which a company listed on a UK stockk exchange must comply with. These are overseen by the FCA. Mandatory standards apply to aspects such as reporting on compliance with the UK Corporate Governance Code and the information to be included in a prospectus when companies are being listed.

The growth in climate finance has implications for the FCA statutory objectives. For example, greenwashing could lead to consumers being misled and the integrity of the UK's markets undermined. It could also lead to unfair competition if more unscrupulous financial institutions were more willing to misrepresent their products to customers than their more scrupulous competitors.

The FCA contributes to the work of the Government's Transition Plan Taskforce on the disclosure of transition plans by listed companies and regulated firms. It is considering matters such as the governance of listed companies' and regulated firms' transition plans, as well as their content and how they are communicated.

As part of the decision to require the publication of transition plans, the FCA is requiring certain financial firms and listed companies to publish plans from 2023 using the reporting framework developed by the Task Force on Climate-Related Financial Disclosures (TCFD).[55]

The FCA has developed its own strategy on climate change.[56] Its work is based on a number of core themes. The themes that are most relevant for this project in the FCA's own words are:

- Transparency - promoting transparency on climate change and wider sustainability along the financial markets value chain.
- Trust - building trust and integrity in ESG-labelled instruments, products and the supporting ecosystem.
- Tools - working with others to enhance industry capabilities and support firms' management of climate-related and wider sustainability risks, opportunities and impacts.
- Transition - supporting the role of finance in delivering a market-led transition to a more sustainable economy.

The FCA focuses on how financial institutions disclose compliance with climate goals. It wants consumers/investors to have the appropriate information to make informed choices about green financial products. To support this, it is implementing a green taxonomy and has published proposals for a sustainable investment labelling regime in the UK. It also aims to mitigate the risk of 'greenwashing' although it is not clear how it intends to enforce the regulations where firms do engage in greenwashing.

The FCA has just published a consultation document setting out its proposals for the investment product sustainability labels and restrictions on how terms like 'ESG', 'green' or 'sustainable' can be used.[57] We examine these in more detail, later in the report.

The FCA works with the other regulators that have a role to play in changing institutional behaviours. The FCA/Bank of England/PRA are developing Technical Screening Criteria to define what economic activities are environmentally sustainable. This will clearly set out the criteria which specific economic activities must meet in order to be considered environmentally sustainable and therefore 'Taxonomy-aligned'.

The approach to climate-related financial regulation is very different to the direct approach it adopts on consumer protection. For example, it sets rules and standards for financial firms to make sure

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[55] Task Force on Climate-Related Financial Disclosures | TCFD) (fsb-tcfd.org)
[56] A strategy for positive change: our ESG priorities | FCA
[57] FCA proposes new rules to tackle greenwashing | FCA

they: treat their customers fairly; deliver appropriate products and services; and put customer protection above their own profits or income.[58]

These rules and standards aimed at protecting consumers can be very direct. For example, the FCA sets rules and standards on how firms should treat consumers who are in financial difficulty, or on dealing with conflicts of interest. It has recently decided to bring in a new Consumer Duty 'that will set higher and clearer standards of consumer protection across financial services and require firms to put their customers' needs first'.[59]

With climate finance, the FCA is focusing on supporting a 'market-led' transition relying on greater transparency and improving disclosure to *indirectly* influence the behaviour of financial institutions such as insurers and asset managers.[60] After all, they invest money in the shares and bonds of real economy firms on behalf of clients such as pension schemes and ordinary investors. Thus, the idea is that greater disclosure will cause those who actually own assets (e.g., pension schemes and their beneficiaries, and ordinary investors) to put pressure on financial institutions to disinvest from climate damaging assets. It also wants to protect financial consumers from greenwashing by financial firms.

However, it is important to note that, as with the Bank of England/PRA, the FCA does not have a statutory objective or duty to proactively promote climate positive financial behaviours, cause financial institutions to disinvest from climate damaging assets, or have a legal target to achieve a certain 'greening' of the financial system.

So far, there appears to be no intention on the part of the government to give the FCA the powers and duties to directly influence the behaviour of financial institutions by applying sanctions for holding climate damaging assets. This is interesting considering the comprehensive set of rules in place in the UK overseen by the FCA, The National Crime Agency (NCA),[61] and Office for Financial Sanctions Implementation (OFSI)[62] relating to market abuse, financial crime, fraud, money laundering, terrorist financing, politically exposed persons, and evading sanctions. These activities harm the national interest and, given the role the UK financial sector plays in the global economic and financial system, the interests of other nations and their citizens. However, financing climate damaging activities also harms the national interests of the UK and other countries – indeed there is a case for saying that climate change is the greatest harm that must be addressed.

The Pensions Regulator

TPR is the public body whose role it is to protect workplace/employers' pension schemes in the UK, including protecting people's savings held in those pension schemes.[63] Obviously, given the scale of the assets held by employers' pension schemes, the behaviours and attitudes of those schemes (and the trustees who oversee schemes) will have an influence over the direction of financial markets. Pension scheme members could also influence their schemes given the right opportunities and support.

[58] Protecting consumers | FCA
[59] PS22/9: A new Consumer Duty | FCA
[60] Climate change and sustainable finance | FCA
[61] Money laundering and illicit finance - National Crime Agency
[62] Office of Financial Sanctions Implementation - GOV.UK (www.gov.uk)
[63] TPR can be thought of as being the equivalent of the PRA for ensuring the security of employers' defined benefit pension schemes; and the equivalent of the FCA for ensuring that employers' pension scheme members get good value for money and are treated fairly by employers. Note that the FCA regulates the conduct of the asset managers and insurance companies who manage the pension assets, and it regulates personal pensions.

TPR, in a way, has a dual prudential and conduct of business role depending on the type of pension scheme involved. As described elsewhere, there is an important distinction between what are known as defined benefit (DB) pension schemes and defined contribution (DC) schemes.

DB schemes, like banks and insurers have to worry about 'prudential' risks – that is, not having enough assets in schemes to honour 'promises' made to depositors or policyholders. TPR recognises that climate change is systemically significant for pensions and its own statutory objectives. It says that if trustees fail to consider risks and opportunities from climate change or fail to exercise effective stewardship, they face the risk that investment performance will suffer. Moreover, defined benefit (DB) schemes are sponsored by employers whose future prospects are also affected by climate change. So, part of TPR's work is similar to that of the PRA's work in the banking and insurance sector.

But the value of the pension generated from a DC scheme depends on the amount of the employer and employee contributes to the pension and the returns achieved by the scheme. DC schemes do not make 'promises' in the sense of a DB scheme.

However, TPR will have an important role to play in ensuring pension schemes are transparent about climate risks especially if we want pension scheme members to be informed and engaged. Thus, TPR plays a similar role to the FCA and FRC on how pension schemes (DB and DC) disclosure and reporting performance.

TPR has contributed to the National Adaptation Programme (NAP).[64] This assesses a range of evidence and analysis on the challenges of climate change in the UK and proposes actions that could be adopted by the UK government and other organisations to respond to those challenges.

As with the PRA, TPR approaches climate change primarily from the perspective of how exposure to climate risks might affect the security and value of pensions rather than how, as the regulator, it can proactively direct the pension fund sector to support climate goals.

The Department for Work and Pensions (DWP) and the TPR introduced statutory guidance for pension schemes[65] and for pension scheme trustees[66] on governance and reporting of climate-related risks and opportunities.

Pension scheme trustees, subject to requirements set out in recent legislation[67], must take steps to identify, assess and manage climate-related risks and opportunities in a proportionate way and report on what they have done. These reporting requirements align with the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD), something we address later in the report.

The Financial Reporting Council

The FRC regulates auditors, accountants and actuaries, and deals with issues relating to accounting, audit, assurance and actuarial standards and guidance. It also sets and oversees the UK's Corporate Governance and Stewardship Codes. Its work is aimed at investors and others who rely on company reports, audits, and high-quality risk management.

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[64] Second national adaptation programme 2018 to 2023
[65] Climate change governance guidance | The Pensions Regulator
[66] Governance and reporting of climate change risk: guidance for trustees of occupational schemes (publishing.service.gov.uk)
[67] The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 and the Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021

As with the FCA, the FRC will play a major role in applying the disclosures developed by the Taskforce on Climate-related Financial Disclosures (TCFD) to the UK. It is responsible the implementation of integrated Sustainability Disclosures Requirements (SDR).

The work of the FRC is important as the green performance of financial markets ultimately depends on how well the underlying businesses which financial institutions and consumers/ordinary investors lend to or invest in comply with climate goals. The inclusion of trustworthy, meaningful and usable reporting and disclosure in company reports and accounts is critical.

The UK Stewardship Code sets standards for those involved in investing money on behalf of savers, investors, and pensioners. It defines stewardship as the responsible allocation, management, and oversight of capital to create long term value leading to sustainable benefits for the economy, the environment, and society. The code applies to asset owners including pension schemes, insurers, foundations, endowments, local government pension pools and sovereign wealth funds. It encompasses asset managers who manage assets on behalf of UK clients or invest in UK assets; and other intermediaries such as investment consultants, data and research providers that support asset owners and asset managers to exercise their stewardship responsibilities. The FRC is also working with the FCA on creating a new regulatory framework for investor stewardship.

A significant development is that the FRC is transitioning to become the Audit, Reporting and Governance Authority (ARGA). As part of that reform, it is proposed that it will have a revised remit is 'to protect and promote the interests of investors, other users of corporate reporting and the wider public interest'.

The FRC says that, under this new remit, it intends to leverage its role and responsibilities to help support a framework that enables the growth of sustainable businesses. Importantly, this involves understanding how the actions of companies affect the societies in which they operate; how they report on this; and how they are addressing this impact.[68]

Note that other regulatory authorities see their main role as understanding and dealing with the *consequences* of climate change, not the *causes*. In other words, how the climate affects firms they regulate not how firms affect the environment. If the new ARGA adopts a different approach, it has the potential to play an important role helping us understand how companies affect the environment.

Non-financial regulators

While we focus on financial regulators, other regulators will play a role in meeting the challenge. The Competition and Markets Authority (CMA) is reviewing potentially misleading green claims (greenwashing) made by businesses in the 'real economy' about the products and services sold to consumers. It has developed a code of practice on green claims. This is relevant because, as with financial reporting described above, financial institutions cannot claim to offer climate-aligned financial products if the underlying businesses whose shares they hold in their investment, insurance, or lending portfolios are not selling compliant products.

The Advertising Standards Authority

The ASA has also issued guidance designed to complement the CMA's code. The Committee of Advertising Practice (CAP) offers guidance on non-broadcast and marketing activities while The Broadcast Committee of Advertising Practice (BCAP) covers broadcast advertising.[69] Both codes state

[68] FRC-LAB-ESG-Paper_2021.pdf
[69] CAP-guidance-on-misleading-environmental-claims-and-social-responsibility.pdf (asa.org.uk)

the following: 'The basis of environmental claims must be clear. Unqualified claims could mislead if they omit significant information.' They state that absolute claims must be supported by a high level of substantiation and that all terms much be clear to consumers.

Among other things, the BCAP code says that marketers should not assume a high level of knowledge particularly if ads are not targeted and that ads must make clear if any advertised environmental benefit will only result from specific consumer action or behavioural change. It also recommends that for claims about recycling any limits to recycling must be stated.

The powers of the ASA are relatively light touch, but it can make referrals to Trading Standards and Ofcom, the communications regulator.

International and EU developments

As mentioned in the introduction, the nature of the climate crisis requires an international response from financial policymakers and regulators. There is certainly a lot of activity at the global level in an attempt to develop consistent standards on climate finance. Post Brexit, what happens at EU level is still relevant to UK financial markets simply because the EU markets remain important to UK financial services businesses.

Rather than have a separate section analysing those international and EU policies and standards, we cover the implications for UK national policy and regulation within each of the main sections. We have summarised the key points of the main international and EU developments below for ease of reference.

International developments

A range of international regulators and reporting bodies are trying to harmonise the plethora of standards and fragmented rules relating to assessment and disclosure of climate-related risks[70]. This includes The Basel Committee on Banking Supervision,[71] the International Organisation of Securities Commissions (IOSCO),[72] the International Association of Insurance Supervisors (IAIS),[73] the International Standards Organisation (ISO),[74] the International Financial Reporting Standards Foundation (IFRS)[75], and the International Capital Markets Association (ICMA).[76]

One of the most influential international initiatives is the Taskforce on Climate-related Financial Disclosures (TCFD) created in 2015 by The Financial Stability Board (FSB).[77] The TCFD develops recommendations concerning the types of information which companies should disclose to allow investors, lenders, and insurance underwriters to assess and price climate-related risks.

The UK government and main UK regulators work within the framework created by the TCFD. The UK government made the implementation of the TCFD's recommendations a core part of its Green Finance Strategy published in 2019. For example, in the Green Finance Strategy, the government said it expected large asset owners to disclose in line with the TCFD by 2022. In November 2020, a

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70 Climate-related financial risks: a survey on current initiatives (bis.org)
71 Press release: Basel Committee clarifies how climate-related financial risks may be captured in the existing Basel Framework (bis.org) Climate-related financial risks: a survey on current initiatives (bis.org)
72 Global regulatory body to harmonise 'plethora' of ESG standards | Financial Times (ft.com)
73 www.iaisweb.org
74 The world's official standards body has begun writing sustainable finance rules (responsible-investor.com)
75 The IFRS Foundation Launches Consultation on Sustainability Reporting | Environment, Land & Resources (globalelr.com)
76 Sustainable finance (icmagroup.org)
77 https://www.fsb-tcfd.org/about/

cross-government department/regulator taskforce (including the FCA) published a Roadmap[78] charting a path towards mandatory TCFD-aligned disclosure obligations across the UK economy, with the intention that most of the measures would be introduced by 2023.

The FCA and FRC have conducted a review into what degree larger listed companies are complying with the TCFD framework and made recommendations for improvement.[79] As mentioned, the reporting requirements set out by TPR, align with the recommendations of the TCFD.

On the company reporting side, the International Financial Reporting Standards (IFRS) Foundation announced the setting up of the International Sustainability Standards Board (ISSB)[80], at COP26 in November 2021.

The UK government and various UK regulatory authorities that form the TCFD Taskforce[81] are working on the most effective way to approach climate-related financial disclosures. Reflecting the need for SRI to be regulated at the international as well as national level, the same authorities are working on international financial reporting standards and have proposed a new standard setting body for sustainability disclosures. More details about these international and EU initiatives can be found below.

The role of the EU and European Commission

The various policymaking and regulatory institutions of the EU have been very active in the field of sustainable finance. The European Commission (EC) has developed a sustainable finance strategy and an action plan on sustainable finance.[82] The strategy contains three main sets of actions –

Reorienting capital flows towards a more sustainable economy - This includes developing a clear and detailed taxonomy for sustainable activities; creating a green bond standard and label for financial products; fostering investment in sustainable projects; incorporating sustainability in financial advice; and developing sustainable benchmarks.

Mainstreaming sustainability into risk management - This includes better integrating sustainability in ratings and market research; clarifying asset managers' and institutional investors' duties regarding sustainability; and considering how to introduce a 'green supporting factor' in the EU prudential rules for banks and insurance companies with the aim of incentivising banks and insurers to invest in climate supporting activities.

Fostering transparency and long-termism - This includes strengthening sustainability disclosure and accounting rulemaking; and fostering sustainable corporate governance and attenuating short-termism in capital markets.

In 2021, the EC announced a Banking Package to review the key banking rules, the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV), to implement the final Basel reforms. A core part of this new banking package will be new rules requiring relevant banks to systematically identify, disclose and manage sustainability risks (environmental, social and

[78] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf
[79] Review of TCFD-aligned disclosures by premium listed commercial companies | FCA
[80] IFRS - International Sustainability Standards Board
[81] Bank of England, Financial Conduct Authority, Financial Reporting Council, The Pensions Regulator, Department of Work and Pensions, and Department for Business, Energy, and Industrial Strategy
[82] Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth (europa.eu)

governance or ESG risks) as part of their risk management. The Basel timetable had called for these changes to be implemented by 1st January 2023, but it looks as if the EU will not achieve this until 1st January 2025.

The EC is also reviewing Solvency II. As with the UK, the EC is reforming the rules to 'encourage' insurers to release capital to fund the green transition. The reforms are also intended to improve the way climate risks are identified, calibrated, and managed.

The main EU regulators belonging to the system of European Supervisory Authorities (ESAs) are also involved in supporting the Commission's overall strategy.

The European Occupational Pensions and Insurance Authority (EIOPA) has undertaken climate-related stress tests of pension schemes and insurance companies.[83] It will also play a central role in the review of Solvency II and implanting any technical changes.

The European Securities Markets Authority (ESMA) takes into account sustainable business models and the integration of ESG factors in its work across its four main activity areas – developing a single rulebook, supervisory convergence, direct supervision and risk assessment.[84] ESMA has developed its own sustainable finance road map with three priorities: tackling greenwashing and promoting transparency; building regulatory capacity; and monitoring, assessing, and analysing ESG markets and risks.[85]

ESMA has recently produced some powerful analysis which tested whether a large sample of EU investment funds (3,000) would meet three key criteria for the proposed EU Ecolabel.[86] The Ecolabel actually has six criteria but the first three are quantitative criteria that can be measured.

Criterion 1 imposes a minimum portfolio 'greenness threshold' of 50%, as measured by alignment with the EU Taxonomy. Criterion 2 requires that fund portfolios do not include equities issued by companies deriving more than 5% of their turnover from environmentally harmful activities. Criterion 3 requires that financial products invest in companies that comply with minimum social and governance safeguards and exclude companies deriving any revenue from socially harmful activities. Only 16 of the 3,000 funds (0.5% of the sample) were found to meet the proposed minimum portfolio greenness threshold of 50 percent and the additional exclusion requirements. This is a helpful methodology for quantifying the greenness of portfolios rather than relying on narrative descriptions. A method for quantifying degrees of greenness is necessary if we are to have a meaningful comparative rating system. We use a similar approach in our proposed rating system considered later in this report.

The European Banking Authority – as the European banking regulator - has an important role in supporting the European banking sector in transitioning to a more sustainable economy and mitigating risks stemming from climate change and broader environmental, social and governance (ESG) factors.[87] The EBA will play a central role in implementation.

83 EIOPA launches climate stress test for the European occupational pension sector | Eiopa (europa.eu) 2021 Insurance stress test report | Eiopa (europa.eu)

84 Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth (europa.eu)

85 ESMA'S ROLE (europa.eu)

86 The EU Ecolabel is an EU-wide label awarded to green products and services. A version of the label for retail financial products has been considered as an option to help retail investors make informed investment decision on the sustainability features of investment products. ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)

87 The EBA publishes its roadmap on sustainable finance | European Banking Authority (europa.eu)

On the reporting side, the EU and relevant EU agencies have also been very active. In February 2022 the EC adopted a proposal for a Directive on corporate sustainability due diligence. [88] The aim of the Directive is to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance.

The EU has set up a new European Financial Reporting Advisory Group (EFRAG)[89] sustainability reporting body responsible for developing draft standards. This is similar to the procedure for IFRS in the EU. Interim draft standards were published in November 2022. Final standards will be produced following adoption by the EC, expected in June 2023.

Table 1: Ecolabel criteria for UCITS equity funds, taxonomy and exclusions

Criteria	Name	Description
1	Investments in environmentally sustainable economic activities	Portfolio greenness based on companies' green turnover and capital expenditure (capex), as defined in the EU Taxonomy
2	Exclusions based on environmental aspects	Cut-off threshold for economic activities deemed to be detrimental or opposed to environmental policy aims
3	Exclusions based on social aspects and governance practices	Address social concerns potentially associated with investments and corporate governance practices

Source: Table 1: ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)

EU Sustainable Finance Disclosure Regulation (SFDR)/Green Taxonomy - The SDFR is now in place, but the regulatory technical standards that asset managers will have to follow will come into effect in early 2023.[90] The SDFR sets down sustainability disclosure obligations that manufacturers of financial products (product providers/fund managers) and financial advisers have towards end investors**.** The standards require market participants to disclose more information relating to their approach to ESG, sustainability risks, and impact. The reporting requirements apply at both product and entity level.

As part of the SDFR, fund managers are being required to classify EU-based funds according to one of three categories. Article 6, Article 8, and Article 9 funds as defined in the relevant articles in the SDFR. Article 9 and 8 funds are referred to by the market and media as 'dark green' and 'light green' funds reflecting their degree of sustainability. Article 6 funds are all other funds. All funds will be required to provide some ESG disclosure. The Article 8 and 9 funds will be subject to more detailed disclosure.

The EU is more advanced than the UK when it comes to disclosure and development of a taxonomy. EU action has already caused a change in market behaviour as firms voluntarily reclassified funds in advance of the detailed standards coming into force.

Fund managers must disclose how they factor in sustainability risks into the investment process, the metrics they use to assess ESG factors, and how they consider investment decisions that might have

[88] Corporate sustainability due diligence (europa.eu)
[89] EFRAG Today - EFRAG
[90] https://www.esma.europa.eu/press-news/esma-news/esas-provide-clarifications-key-areas-rts-under-sfdr

a negative impact on environmental and social sustainability factors - what the SDFR describes as 'Principal Adverse Impacts' (PAIs).

Disclosure of PAIs is to be done on a comply or explain basis on the website of Financial Market Participants (FMPs). The disclosure takes the form of a statement on due diligence policies with respect to the adverse impacts of investment decisions. Where an FMP does not consider adverse impacts of investment decisions on sustainability factors, it must publish and maintain on its website clear reasons for why it does not do so, and, where relevant, information as to whether and when it intends to do so.

PAI indicators are central to the goals of the SFDR and are key to understanding its objectives. There are over 60 mandatory and optional indicators. Specific indicators are used to assess investments in corporate issuers, sovereign assets, and real estate assets. For example, for corporate investments, there are nine mandatory and 16 environmental PAI indicators, and five mandatory and 17 optional, social PAI indicators.

To classify a product as 'sustainable' as envisaged by the SFDR, certain minimum requirements must be met. Products must: explain how they consider the PAIs; and 'do no significant harm'. The EU approach sets a higher bar than the UK FCA's sustainable investment label proposals. The 'do no significant harm' principle relates more to the social or responsible aspect of ESG and is linked to EU Taxonomy Minimum Safeguards which include: OECD Guidelines for Multinational Enterprises; UN Guiding Principles on Business and Human Rights; International Labour Organisation on Fundamental Principles and Rights at Work; International Bill of Human Rights.

As with the FCA's approach (addressed later in this report), the EU SFDR incorporates environmental or social characteristics; there isn't a separate regime for environmental and social impact funds. But, the EU asset management industry has focused on environmental aspects and, as mentioned, the market and media has termed Article 8 and 9 funds as 'light green' and 'dark green' funds.

The SDFR applies to FMPs, financial advisers, and financial products. FMPs encompass a wide range of financial institutions: insurance undertakings making available Insurance-Based Investment Products (IBIPs); Institutions for Occupational Retirement Provision (IORPs); manufacturers of pension products and Pan-European Personal Pension Product (PEPP) providers; Alternative Investment Fund Managers (AIFMs); Undertakings for Collective Investment in Transferable Securities (UCITS) management; and investment firms or credit institutions providing portfolio management. This is much more comprehensive that the UK FCA's approach.

The ESAs have already developed mandatory reporting templates covering the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts.

The approach is on a 'comply or explain' basis. Funds that invest in environmentally sustainable activities, as defined in the EU Taxonomy, can state this and do not need to explain how they consider PAIs or the 'do no significant harm' principle..

The EU Taxonomy Regulation is integral to initiatives such as the SDFR.[91] It covers: financial market participants offering financial products in the EU (including occupational pension providers); and large companies who are already required to provide a non-financial statement under the Non-

[91] And to other initiatives such as the EU Ecolabel, Green Bond Standards, and the amendments made to MiFID II

Financial Reporting Directive (NFRD). It also applies to the EU itself and Member States, when they develop standards or labels for green financial products or green corporate bonds.

The Taxonomy Regulation is a classification tool designed to help investors and policymakers identify economic activities that make substantial contributions to environmental goals. Technical screening criteria are used to help users identify environmentally positive activities. Economic activities are assessed on three main principles to assess the degree of alignment with the Taxonomy objectives. To be classified as sustainable, an activity must: substantially contribute to at least one of six environmental objectives[92]; 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. Activities can either substantially contribute to environmental performance of industry *directly,* or act as an *enabling* or *transition* activity.

It is worth noting that civil society groups in the EU have expressed concerns that the European Commission has approved the inclusion of fossil gas and nuclear energy into the EU taxonomy.[93] Indeed, a number of EU NGOs have walked out of the Platform on Sustainable Finance, an expert Taxonomy group, over fears about its independence. The groups said the Commission has interfered politically in the group and acted against evidence on gas-fired power and nuclear power despite its legal obligation to follow scientific advice.[94]

The Task Force on Climate-Related Financial Disclosures (TCFD) - The TCFD was established by the Financial Stability Board (FSB) to help identify the information needed by investors, lenders, and insurance underwriters to appropriately assess and price climate-related risks and opportunities. The TCFD made recommendations on how organisations should disclose information on climate related risks in four key areas:

1. Governance: the organisation's governance around climate-related risks and opportunities.
2. Strategy: the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.
3. Risk Management: the processes used by the organisation to identify, assess, and manage climate-related risks.
4. Metrics and Targets: the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The recommendations apply to non-financial businesses and financial institutions. The TCFD recommended that this framework should apply to organisations that have public debt or equity. For non-financial organisations and industries, the TCFD has issued specific guidance for those sectors which are most likely to be affected by climate impacts. While the TCFD recommendations provide a framework, it says that organisations should make financial disclosures in accordance with their own national disclosure requirements. This information should be included in financial filings and annual reports.

Basel Committee on Banking Supervision (**BCBS**) - The Basel Committee is the leading committee of international banking supervisory authorities.[95] It develops global standards for supervising major banks such as capital adequacy standards (see Prudential Regulation, below). With regards to climate risks, at the global level, the Basel Committee has issued 18 *principles for the effective*

[92] 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
[93] 92 civil society organizations call on financial institutions to avoid taxonomy-aligned greenwashing - Reclaim Finance
[94] NGOs walk out of expert Taxonomy group over lack of independence | WWF
[95] The Basel Committee

management and supervision of climate related financial risks.[96] The Basel Committee follows a principles-based approach designed to improve how banks manage and supervisors deal with climate-related risks. The principles cover corporate governance, internal controls, risk assessment, management and reporting and are intended to provide a common baseline for international banks.

International Organization of Securities Commissions (IOSCO) - IOSCO is the international body that brings together the securities regulators across global financial markets. It sets and promotes adherence to global standards for the securities sector and works with the G20 and the Financial Stability Board (FSB) on global regulatory reform. It has developed its own plan on sustainable finance. The recommendations in the plan include introducing disclosures consistent with the TCFD's recommendations as well as disclosures to help investors better understand sustainability-related products; promoting consistency, comparability and reliability in disclosure; and helping to prevent greenwashing.[97]

International Association of Insurance Supervisors (IAIS) - The IAIS is the membership organisation of 200 global insurance supervisors and regulators. It is the global standard-setting body for the supervision of the insurance sector. With regards to climate change, it has a role in assessing the risks facing the global insurance sector and provides a baseline of climate risk data.[98] It has made some changes to its Insurance Core Principles (ICPs) to address the risks from climate change to make it more explicit that insurance supervisors should require insurers to incorporate climate-related risks into their operations, specifically on governance, enterprise risk management and disclosures. The IAIS also aims to promote globally consistent supervisory practices to help supervisors' response to climate change including how to monitor, assess, and respond to climate-related risks. It is also assessing how supervisors undertake climate scenario analysis and whether new guidance will be needed to help supervisors.

International Financial Reporting Standards (IFRS) Foundation[99] - The IFRS Foundation is a not-for-profit, public interest organisation established to develop high-quality, understandable, enforceable and globally accepted accounting and sustainability disclosure standards. The standards are developed by two boards, the International Accounting Standards Board (IASB) and International Sustainability Standards Board (ISSB). The ISSB is the most relevant for this project.

International Sustainability Standards Board (ISSB)/Sustainability Accounting Standards Board (SASB) - The ISSB was established by the IFRS to produce a comprehensive global baseline of sustainability related disclosure standards. The ISSB will sit alongside the IFRS Board. The ISSB standards cover climate and other environmental, social, and governance (ESG) matters; and are intended to provide investors and other capital market participants with information on companies' sustainability-related risks, and improve the quality, reliability, and transparency of company reporting. The ISSB standards build on the standards developed by the SASB.[100]

Data, data assurance and ratings

Central to all types of climate-related regulation will be access to quality, trustworthy data on how well markets, financial institutions, and firms in the 'real economy' comply with climate goals. Good data will be necessary at all parts of the finance 'supply chain'. We will need data on the underlying

[96] Press release: Basel Committee issues principles for the effective management and supervision of climate-related financial risks (bis.org)
[97] For more detail see: IOSCO's 2022 Sustainable Finance work plan strengthens the organization's commitment to increasing transparency and mitigating greenwashing
[98] Climate risk - International Association of Insurance Supervisors (iaisweb.org)
[99] IFRS - Sustainability-related Reporting
[100] Standards Overview - SASB

firms, and the aggregate performance of financial institutions and the funds/products they manage and sell.

As such, the role of ratings providers will be critical. The FCA has already said that it would welcome taking over the regulation of ESG ratings providers. But it is in the gift of the Treasury to extend the FCA perimeter and without it the FCA cannot press ahead with regulation of ESG ratings providers. Our view is that without statutory force, which the regulator itself has asked for, this may not deliver the required changes. The credibility of data is essential in harnessing investors in the drive towards the climate transition. The FCA has now announced the formation of a working group to develop a Code of Conduct for Environmental Social and Governance (ESG) data and ratings providers on a voluntary basis.[101] The group is to be known as the ESG Data and Ratings Code of Conduct Working Group (DRWG) . A critique of this DRWG which is very industry dominated can be found below.

There are other developments in terms of data assurance. In one of our podcasts, we interviewed the Open Data Institute (ODI), available on the following link **-** The Devil is in the policy detail-the role of data and data assurance in greening the financial system.

The ODI suggests that data assurance will have an important role to play particularly if an asset manager or pension fund seeks to gain an advantage by using an agency that takes a looser, less rigorous approach. This chimes with our concern that we could see some agencies inside the regulatory perimeter and some outside just covered by a voluntary code.

The ODI does suggest that data institutions can go some way to address the issue of proprietary versus open data. It generally supports open data but adds that data institutions can offer a halfway house. We would note that there are around 900 data assurance organisations in the UK as well though not all operate in the sustainability area. We may be at the stage where lots of consultancies proliferate due to the business opportunity, but it underlines the importance of establishing firm regulations. We would firmly support extending the regulatory perimeter to the most significant ratings agencies as opposed to a voluntary code as you can see from our recommendations later in the report.

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

Part 2:

Assessment of environment-related financial legislation, policy and regulation

What does an effective legislative and regulatory framework like?

Before going on to assess the approach to legislation and regulation being adopted in the UK, it is worth setting out what an effective framework might look like. To align financial markets with climate goals we need the following:

- A comprehensive, high-level policy framework which: recognises the scale and nature of the climate crisis and the role the financial sector plays in contributing to that crisis; establishes the necessary scale and appropriate mix of financial resources (investment, loans, and insurance, state and private sector) needed to finance the green transition; sets the appropriate policy goals; and provides the necessary direction and impetus at national level to align financial markets with climate goals.
- An effective legislative and regulatory architecture and framework to provide the direction, objectives, powers, duties and resources for financial regulators and other agencies responsible for implementing high-level policy goals.
- Effective regulations, rules, and guidance to implement the high-level policy objectives and to change financial market behaviours – objectives and goals cannot be translated into actual behavioural change in financial markets without the right policy and regulatory tools.
- The right regulatory culture and approach to drive the necessary behavioural change in financial markets. Parliament and government might provide the legislative framework and give regulators their objectives and powers. However, much will depend on how regulators interpret their roles and apply their powers.

The role of Parliament and government

Greening the economy and financial system is one of the great economic and public policy challenges of our time. Parliament and government determine the high-level legislative and regulatory framework within which regulators operate, and the objectives given to regulators.

The need for Parliament and government to reform financial markets is all the more pressing in light of the latest report from the UN's Intergovernmental Panel on Climate Change (IPCC) published recently.[102] It concluded that climate change risks are greater than previously thought and we have a brief and rapidly closing window of opportunity to adapt. This is not a time for half-hearted measures.

As we explain below in our suggestion for *an effective legislative and regulatory framework*, the role Parliament and government intends for the main UK financial regulators is limited. It does not match the scale of the challenges ahead.

[102] Press release | Climate Change 2022: Impacts, Adaptation and Vulnerability (ipcc.ch)

The government has developed a Green Finance Strategy aimed at making the UK a leading global centre of green finance. This strategy will not only determine whether the UK becomes attractive as a global centre. It will have an impact on the domestic approach to policy, legislation, and regulation – and, given the influence the UK as a financial centre continues to wield, international standards.

The government is updating the Green Finance Strategy and recently issued a Call for Evidence.[103] The strategy has three objectives:

- Greening finance by supporting the financial services sector to align with the UK's net zero commitment and wider environmental goals.
- Mobilising private investment at scale to support clean and resilient growth.
- Supporting financial services to capture the opportunity presented by the transition to a net zero and nature-positive economy, cementing UK leadership in green finance and ensuring that businesses can benefit.

While it is good that the government has a strategy, we concluded in our submission[104] to the Call for Evidence that the legislative and regulatory framework, and specific regulations, rules, and guidance are not fit-for-purpose and will not drive the necessary change in the financial system and markets. We did not agree that the UK's green finance regulatory framework is world class and argued that a different approach will be needed if the UK is to be a leading effective, trusted, and reputable global centre of green finance.

The success of the UK as a green finance centre should not just be judged on how fast or large it grows. The ***quality*** of green finance and the business the UK attracts is just as important, if not more, important as the ***quantity***. The green finance developed in the UK must be effective in driving climate-positive behaviours in the real economy, at UK national and international level.

There is an apparent tension between being a true green financial centre and narrow, short term national economic interests. There may be a temptation to lower standards to make the UK financial services industry more 'competitive' to attract global business. But there will be a long term cost to this. We would hope that the government would recognise the benefit of attracting business by being a beacon of high standards.

The activities of any financial centre claiming to be green must be meaningfully aligned with climate goals and net zero commitments. Recent research found that global stock markets are funding companies with three times more coal, oil and gas reserves than can be burned without breaking the 1.5°C Paris climate target. In the UK, The London Stock Exchange holds 47 $GtCO_2$ of embedded emissions. This is 30 times more than those of the UK's own fossil fuel reserves (1.5 $GtCO_2$) and ten times more than its 15-year carbon budget from 2023-37 (4.7 $GtCO_2$).[105]

We argue that if the UK is to be a leading global centre for green finance (GCGF) it should be built on the following principles and values:

Effectiveness, efficiency, and neutrality - The green finance strategy creating the GCGF should be neutral and promote the most effective, efficient forms of climate funding, not accord preferred status to any particular form. Greening the financial system and the underlying real economy will require sustained efforts over the long term. Therefore, green finance must be sustainable and

[103] Update to Green Finance Strategy: call for evidence - GOV.UK (www.gov.uk)
[104] HM Government: Update to the Green Finance Strategy – Call for Evidence | The Financial Inclusion Centre
[105] Exchanges carrying three times more carbon reserves than can be burned under Paris – Carbon Tracker Initiative

aligned with the long-term nature of climate goals. This will be a challenge given the short-termism prevalent in UK financial markets generally.

Genuine financial innovation - Financial products and instruments produced by the UK financial sector should make a real, measurable contribution to climate objectives. Growth in new 'green branded' products or financial market activity should not necessarily be taken as evidence of environmental, economic and social utility or success of the UK as a GCGF *per se*.

Systemically robust and stable - There is now a better understanding of the link between climate change and i. systemic risks in the financial system and ii. risks to specific financial institutions. A successful GCGF should promote financial system and market behaviours that contribute to environmental, economic, and financial system stability in the UK and, given the importance of the UK financial sector, globally. In our view the current proposals for climate-related financial regulation do not fully recognise or address those risks. We look at this below in the section on prudential regulation.

Integrity and trustworthiness - A reputable green finance centre should be a beacon of integrity, transparency, and good corporate governance. It should compete by operating to the highest standards, not by promoting a race to the bottom on regulation. Users, both domestic and global, of a UK centre of green finance should be able to have a high degree of confidence and trust in UK financial system, markets, and financial institutions – and that confidence and trust should be justified.

Well regulated, accountable and transparent - A world-class GCGF will require world-class, climate-related financial regulation encompassing financial stability, prudential, market, and conduct of business rules, and the highest standards of corporate accountability. Yet the current proposals for climate-related financial regulation are not fit for purpose (this is covered in more detail later in the report). Crucial to effective regulation will be regulatory independence. We are very concerned that the direction of travel evident in the proposed reforms of the UK financial regulatory system post Brexit would compromise regulatory independence. Regulators should be free to ensure that quality of business takes precedence over quantity of business. The principles of transparency and openness should be embedded into the operations of a GCGF. This requires moving away from prevalent regulatory culture in the UK which limits transparency to protect commercial interests. The government has recently placed a great deal of emphasis on making the UK financial sector 'competitive'. Indeed, as part of the Future Regulatory Framework Review[106] and subsequent Financial Services and Markets Bill[107], it intends to give regulators a secondary objective to promote growth and competitiveness. It remains to be seen whether the UK government intends to make the sector competitive by becoming a beacon of good practice in green finance or by reducing standards in an effort to reduce costs for the sector. As we explain elsewhere, the UK is already lagging behind other jurisdictions such as the EU in the development of ESG taxonomies.

Funding the green transition

With regards to funding the necessary green transition, there have been a number of attempts to model the level of funding needed for the UK to meet its net zero goals.[108] Moreover, The Committee on Climate Change (CCC) has undertaken detailed analysis of the level of funding needed within specific economic sectors.[109]

[106] Future Regulatory Framework (FRF) Review: Proposals for Reform - GOV.UK (www.gov.uk)
[107] Financial Services and Markets Bill Committee stage - Parliamentary Bills - UK Parliament
[108] The OBR estimated that £1.4 trillion in additional investment would be needed between 2020 and 2050 for the UK to meet its domestic net zero emissions targets. How much will it cost the UK to reach net zero? | Financial Times (ft.com)
[109] Sixth Carbon Budget - Climate Change Committee (theccc.org.uk)

So, we have reasonable estimates about how ***much*** is needed. We do not have the political structures and high-level policy mechanisms to ensure the necessary level of funding occurs. The UK, despite the stated commitments of government, is falling behind in terms of the level of funding needed.[110]

There has been little detailed analysis on how ***best*** to fund the transition. That is: what is the most sustainable and economically efficient means of funding the transition; how to achieve a just and fair transition; and how, where, and when to best deploy available funding to different sectors of the economy (public and private).

There are big decisions to be made such as on the balance between public and private sources of funding and direct charges, current taxation, and borrowing. There are difficult choices to be made about intergenerational fairness. The timing of funding decisions is also important. There are decisions to be made about which type of funding is most appropriate for specific sectors of the economy including the public and private sectors and the balance between central and local government funding.

We need a detailed government Climate Funding strategy and plan which sets out: how the government intends to implement the most sustainable and economically efficient means of funding the green transition

We do not have the appropriate policy framework in place to allow us to answer those critical political economy questions in the national interest. So far, the government's attention seems to have been focused on incentivising private finance in its various forms (e.g., pension funds, insurance funds, private equity and so on) even though private finance is a more costly form of funding than collective funding through the state. These decisions are important. Defaulting to more costly forms of funding has real world consequences. It feeds through to higher costs for households.[111]

These issues are outside the scope of this project as we are focusing on the role of private sector financial markets, institutions, and households. But, to reiterate, the role the private sector plays in funding the green transition cannot be considered in isolation. We need a full and proper debate about these big political economy questions at some stage.

We need a detailed government Climate Funding strategy and plan which sets out: how the government intends to implement the most sustainable and economically efficient means of funding the green transition; how it will ensure the transition is just and fair transition; and how, where, and when to best deploy available funding to different sectors of the economy (public and private). The strategy and plan should contain details on:

- How the funding required to achieve the UK's aggregate net zero targets will be met, broken down by major economic sector
- The timing of the deployment of funding with clear targets
- The optimal mix of funding, the balance between current spending (direct charges, current taxation) and investment/borrowing

[110] Climate: WWF warns UK spending is lagging behind targets - BBC News
[111] Private finance demands a return above the 'risk free rate' namely government bonds (gilts). Higher charges need to be extracted from households to pay for the higher returns expected.

- Which government departments and other agencies (e.g., non-departmental public bodies, regulators, local authorities) will be responsible for coordinating the implementation of the funding strategy and plans
- The expected balance between public and private sources of funding with justifications as to why one form of funding is being preferred over another (e.g. why more costly private finance is being relied on instead of more economically efficient collective state funding sources)
- How it intends to achieve a just and fair transition including how it will address regional and inter/intra generational fairness

We must also consider the impact of *economic* policy decisions made by policymakers on green transition policies. For example, decisions by the MPC to raise interest rates to tackle inflation has consequences for the funding of green tech which becomes more expensive.[112]

There is a tremendous amount of coordination, and public involvement and approval, required if we are to fund the green transition in the fairest, most equitable, and economically efficient and sustainable way. Parliament and government, rightly, should be responsible for addressing those issues and coordinating the overall approach to the green transition.

An effective legislative and regulatory framework that puts environmental sustainability at the heart of financial regulation

Aligning financial market with climate goals also requires a serious amount of direction and coordination by financial regulators. This is why the limited role for financial regulators envisaged by government is so disappointing, an issue we address later in the report.

Ensuring environmental sustainability is at the heart of financial regulatory policy and operations does not detract from the importance of other regulatory objectives such as financial stability, prudential regulation, financial market integrity, and consumer protection. But, at the very least, the environment should be given equal status.

Given the seriousness of the challenge, we need to deploy whatever interventions it takes to ensure financial institutions (and those who run those financial institutions) are deterred from financing climate and environmental harm and are held to account if they do so.

This requires the application of coordinated and sustained interventions by prudential and conduct of business regulators in all the main financial sectors (banking, insurance/reinsurance, asset management, pensions and so on) and throughout the financial services supply chain (from wholesale markets through institutional markets to retail financial services and ordinary consumers).

Yet, it is not clear that policymakers and regulators recognise the financial risks associated with climate change in the policies they propose – particularly the impact on households. The UK, with its heavily financialised economic system is particularly exposed to climate-related financial risks. [113]

With regards to the overarching legislative and regulatory framework, we highlighted in our first report, Time for Action, that the absence of clear, primary statutory objectives for financial

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[112] Can we avoid green collateral damage from rising interest rates? | by UCL Institute for Innovation and Public Purpose | UCL IIPP Blog | Jun, 2022 | Medium

[113] See: People in US and UK face huge financial hit if fossil fuels lose value, study shows | Fossil fuels | The Guardian
Stranded fossil-fuel assets translate to major losses for investors in advanced economies | Nature Climate Change

regulators in relation to climate change is a major barrier to greening the financial sector, and therefore greening the economy.[114]

The current high-level, post Brexit reform of financial regulation, currently being legislated for in the Financial Services and Markets Bill, and specific reforms such as that of Solvency II, are a missed once-in-a-generation opportunity to reform UK financial regulation so that it causes the necessary behavioural change in the UK financial system and markets.

The Financial Services and Markets Bill (FSMB)[115] implements the outcomes of The Future Regulatory Framework (FRF) Review.[116] The latest proposal in the FSMB is limited in its ambitions for climate-related financial regulation. The role of regulators is limited to having regard to a regulatory principle defined as 'the need to contribute towards achieving compliance with section 1 of the Climate Change Act 2008 (UK net zero emissions target)'.

The Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability.

Politics is sometimes described as the art of prioritisation. It is the same with financial regulation. Financial regulators have to prioritise many competing priorities. There is a real risk that financial regulators will not give climate change, and the contribution financial markets and institutions make to climate change, the same priority as other objectives unless Parliament mandates them to do so.

Therefore, we argue that the Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability. Specifically, we support other civil society organisations in their view that regulators should have a statutory objective which ***positively*** requires them to take action to help achieve the UK's emissions reduction targets and Paris Agreement commitments of limiting global warming to 1.5 degrees.[117] The FCA, PRA, TPR, and FRC should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objectives.

The FCA should be given responsibility for overseeing how financial institutions, listed companies and larger private companies, and employers' pension schemes disclose compliance with sustainable, responsible, and social impact (SRI) criteria. The FCA should be given responsibility for regulating ESG ratings and ratings providers.

The FRC should retain responsibility for ensuring the auditing of underlying economic activities meets regulatory requirements. Reporting on SRI compliance should be made a statutory requirement rather than voluntary, with tough sanctions for non-compliance with reporting standards.

The government and the Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate related risks.

[114] Time for Action – Greening the Financial System | The Financial Inclusion Centre
[115] Financial Services and Markets Bill 2022-23 - House of Commons Library (parliament.uk)
[116] Future Regulatory Framework (FRF) Review: Proposals for Reform - GOV.UK (www.gov.uk)

[117] Civil Society responds to Treasury's proposed financial sector reforms - The Finance Innovation Lab

The proposed FSC should develop ***climate de-risking transition plans*** for each of the main financial sectors – banking, shadow banking, insurance and reinsurance, and asset management/pensions. These plans should have clear milestones and timeframes for climate de-risking each sector.

As a priority, the FSC and FCA should produce an audit of the climate harm caused by each of the major financial sectors. It will be difficult to develop transition plans and to allow stakeholders to identify where policy interventions without should be targeted without audits to provide a baseline against which to measure progress.

The relevant regulators should establish a public register of climate-critical financial institutions within their remits based on the impact of these institutions on the climate and wider environment. Regulators should set climate de-risking plans for each climate-critical financial institution within their remits.

The FCA and PRA already operate a risk-based approach to financial regulation. That is, they identify financial institutions which present the greatest risk to their statutory objectives and prioritise their supervision and enforcement activities accordingly. The regulators should adopt a similar approach to climate-related financial regulation. They should identify financial institutions which present the greatest risk to the environment and robustly deploy the appropriate regulatory interventions – see prudential regulation, conduct of business, reporting and disclosure, and sanctions policy tools in the sections below.

The FSC should publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

There needs to be greater focus on supply chains in the economy.[118] The FRC and FCA should collaborate and increase their work on improving the standards of auditing in and reporting on compliance with climate goals in supply chains.

Effective regulations, rules and guidance

High-level policy principles, objectives and goals set out in legislation need to be codified in regulations, rules, and guidance to have the desired effect on financial market behaviours. Financial market participants need to know what is expected of them. Financial regulators need policy levers to force through changes in behaviours. That requires setting the rules and standards which market participants are expected to comply with. These rules and standards can then be monitored and, if not complied with, potentially following warnings, form the basis for enforcement action.

If the detailed regulations and rules don't have enough 'bite', this can undermine the intent of high-level objectives and goals. This is why we emphasise 'the Devil is in the policy detail'. Below, we analyse, in more detail, the main financial regulations in place or being proposed to align financial markets with climate goals. We conclude that the main policy tools being adopted by the government and relevant prudential and conduct financial regulators do not go far enough.

Regulatory culture and approach

The dominant culture and attitudes within the UK regulatory system are a cause for concern. Looking at the strategy set out by the UK regulators, there is too much of a reliance placed on

[118] The supply chain accounts for more than 90% of most consumer goods companies' environmental impact. For more detail see: [Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre]

disclosure, transparency, and 'encouraging' the market to achieve the necessary realignment of market behaviours and activities.

As outlined below, the FCA intends to introduce a general anti-greenwashing rule. This could be a powerful deterrent against greenwashing if it is enforced robustly and tough sanctions used to penalise firms that set out to mislead. This all depends on the culture and attitude of the regulator.

Every major UK misselling scandal (such as PPI, personal pensions, mortgage endowments) featured a significant growth in the sales activity in a market that was poorly regulated. These conditions now exist in the ESG sector.

There has been a significant growth in interest in ESG amongst UK investment firms and, when trying to identify potential detriment, campaigners adopt the principle of 'follow the money'. The FCA has already signalled its concern about the poor quality of applications submitted by investment firms to get *new* ESG funds authorised by the regulator.[119] The FCA can do much to prevent greenwashing at the point where new funds are being authorised.

However, the other part of the question is: what has been happening with *existing* funds? In 2020, analysts identified a 'surge' in the number of funds that had rebranded as sustainable.[120] Since then, the same analysts removed more than 1,000 of funds in its European fund database from its 'sustainable' list after conducting more extensive examination of the funds' disclosure and having tightened its criteria for inclusion on the sustainable list.[121] This suggests that some investment firms have been overclaiming on the sustainability alignment of their ESG funds.

It could be argued that a firm which rebrands an existing investment fund as 'green' for marketing purposes without significantly changing the underlying portfolio by removing climate damaging assets and/or adding climate aligned assets is misleading investors. It seems reasonable to assume that similar behaviour has been happening in the UK ESG sector. If this is the case, there is a strong argument for the FCA to have taken action using its existing rules relating to the need for information to be clear, fair, and not misleading.

On the climate crisis, we do not have the luxury of waiting for climate-related financial regulation to fail before learning the lessons

The FCA says it is 'actively monitoring' the market but it does not appear to have undertaken any systematic analysis of the UK ESG fund industry to check whether existing funds are potentially misleading investors and has no active greenwashing investigations (or to have conducted any previously).[122]

The proposed dedicated anti-greenwashing rule should help the FCA to enforce against greenwashing. However, it remains a cause for concern that the regulator appears not to have already conducted and published investigations into such a fast-growing market. It needs to send a clear message to the financial services industry that it intends to regulate robustly. Therefore, we recommend that the FCA should conduct an investigation into existing funds claiming/claimed to be 'ESG' or 'ESG-aligned'.

119 Authorised ESG and sustainable investment funds: improving quality and clarity (fca.org.uk)
120 Surge in Funds Rebranding as Sustainable | Morningstar, April 2020
121 Morningstar cuts 1,200 funds from 'sustainable' list | Financial Times (ft.com)
122 UK's FCA has met with asset managers on ESG but is yet to conduct greenwashing investigations (responsible-investor.com)

Historically, UK financial regulators have tended to follow a permissive approach to regulation, intervening only when there is evidence of harm that cannot be ignored. Progress in financial regulation has tended to happen as a result of prior attempts at regulation failing to prevent financial crises and major market failures. For example, the 2008 systemic financial crises resulted in better financial stability and prudential regulation. The major misselling scandals led to much improved conduct of business and consumer protection regulation. Insider dealing and money laundering scandals forced policymakers and regulators to tighten up on market regulation to stop market abuse and fraudulent practices. But, on the climate crisis, we do not have the luxury of waiting for climate-related financial regulation to fail before learning the lessons. If we get this wrong, it will not be possible to unwind the damage caused.

It will require ***direction*** from policymakers through the appropriate legislative framework, statutory objectives provided to regulators, and robust ***pre-emptive*** and ***precautionary*** interventions on the part of regulators that ***deter*** climate-damaging financial activities.

The need for a consistent approach to regulation

The policy interventions outlined below are aimed at specific types of institutions such as insurers and reinsurers, banks, asset managers, and pension schemes. A consistent approach to financial regulation will be needed to avoid regulatory arbitrage.

There are justified concerns that clamping down on climate-damaging finance in some UK financial sectors could just cause a transfer of that finance to shadow banking institutions that facilitate the provision of non-bank credit/finance to the economy. So, it is important that prudential interventions are applied consistently and robustly across all mainstream banking and shadow banking institutions that provide non-bank credit/finance.[123]

Similarly, care must be taken to ensure that if effective prudential regulation were introduced, it does not just encourage financial institutions to switch business to financial activities covered by potentially weaker conduct of business regulations. So, we need to ensure prudential, conduct of business and other forms of regulations produce consistently high outcomes across all business areas.

What bank and insurance prudential regulation have in common is that policy tools are designed to ensure that policyholders and depositors have a high degree of certainty about the return they can expect. For example, savers want to know that if they deposit, say, £1,000 they will get £1,000 back if they ask to withdraw that amount.

Insurance policyholders want to be sure that if they have a policy that says it will pay out a certain sum assured that it will then pay out that amount if they make a claim. A pensioner who has bought an annuity promising £1,000 a month, wants to be sure that the insurer will be able to pay that amount each month.

The same principle applies to defined benefit pension schemes. A pension scheme member who has paid into his/her employer's defined benefit scheme will want to be sure that the scheme will pay out the benefits promised. This has been the source of much concern and debate about the security of these schemes during the recent gilt/DB pension schemes' mini crisis.

The common theme connecting the above institutions is that financial regulators (PRA for banks and insurers, TPR for defined benefit schemes) can directly influence the behaviours of institutions they

[123] See, for example: kedward_gabor_ryan-collins_aligning_finance_with_the_green_transition_from_a_risk-based_to_allocative_green_credit_policy_regime.pdf (ucl.ac.uk)

regulate through prudential regulation tools They can require institutions to try to quantify the risks of promises not being met or of losses occurring, and hold certain types of assets to try to reduce the risk that promises will be not honoured/expectations not met. Prudential regulators could use these direct policy tools to require firms to factor in climate risks and, more relevantly from the perspective of this report, compel firms to stop financing climate-damaging activities.

On a separate, but connected, issue we recommend that the prudential regulation of DB schemes be transferred to the Bank of England/PRA. The core principles of prudential regulation are similar for banks, insurers, and DB pension schemes. This would allow for a more consistent approach to systemic risk and prudential regulation generally (see the LDI crisis) and specifically to climate-related financial regulation.

A different approach will be needed for institutions such as asset managers that sell investment funds/products or defined contribution pension schemes. In this case, the amount an investor/pension scheme member gets back will depend on how much they invest and how the value of the underlying assets held in the fund/scheme perform. In other words, the value of the assets held, and the financial outcome produced is ***variable***. The asset/pension fund manager will buy shares and bonds in companies held within portfolios. Of course, the fund manager will try to deliver a decent return. However, the fund/DC scheme does not have to hold 'reserves' to pay out a promised amount. Prudential regulatory tools will not be appropriate.

Nevertheless, even if the policy tools may differ, policy needs to be consistently applied across all financial sectors to avoid regulatory arbitrage. For example, if prudential regulators adopt a suitably tough approach to bank/shadow bank financing of businesses that are still engaging in climate damaging activities, then the cost of financing for the business will rise and returns earned by the bank/shadow bank sectors will fall. That should be the intention – to deter financing of climate damaging activities. But what if this causes real-economy businesses to make even greater use of borrowing by issuing bonds to be bought by investors/asset managers/pension funds rather than traditional borrowing from banks? Bonds and equity are held by asset managers, pension schemes, and retail investors.[124] Conventional prudential regulatory tools will not be appropriate. Other tools will be needed to change the behaviours of these financial institutions.

In the following sections, we consider the role of prudential regulation, conduct of business regulation, and other regulatory interventions which could apply across the financial sector.

Prudential regulation: the role of the Bank of England, PRA and TPR

The Bank of England describes its objective as playing a leading role in ensuring the macroeconomy and financial system are resilient to the risks from climate change and being supportive of the transition to a net zero economy.

The PRA sits within the Bank of England and is responsible for the prudential regulation of important financial institutions that make up the financial system. The PRA mitigates the risk of critical financial institutions like banks going bust and of insurers failing to honour commitments to their policyholders. Just as the Bank's tries to ensure the financial system is resilient to climate shocks, the PRA seeks to make systemically important financial institutions resilient to climate shocks.

[124] Insurers are also major holders of corporate bonds and equity, but insurers are covered by Solvency II prudential regulation

The Bank of England/PRA are asking the firms they regulate to embed climate-related financial risk into their business strategies and are working on how to embed climate-related financial risk into their own approach to financial supervision.

As part of their work, Bank of England/PRA are stress testing the resilience of the current business models of the largest banks and insurers, and the UK financial system, against the physical and transition risks associated with different possible climate scenarios. The Bank of England has been undertaking a number of major data gathering and financial modelling exercises to help it understand the implications of climate risks. A key exercise is the Climate Biennial Exploratory Scenario (CBES). The CBES was designed to: quantify the financial exposure of financial institutions, and the financial system more broadly to climate-related risks; improve firms' management of the financial risks created by climate change; assess how climate risks might affect financial institutions' business models and gauge their likely responses; and understand the implications for the provision of financial services. It published the results of its latest CBES in May 2022.[125]

The results of the exercise found that an 'early action' scenario, where policies are introduced in a timely manner to deliver an orderly transition to net zero by 2050, resulted in the lowest costs and greatest opportunities for the financial sector. Other scenarios where climate risks are higher brought greater costs for the financial sector and greater potential costs for the real economy, including through the withdrawal or increase in the price of financial services to certain businesses and households.

The results will now influence the way the Bank and PRA manage climate-related risks in the financial system, and the choice of specific policy interventions to mitigate the risks to financial institutions.

The PRA has also undertaken a thematic review of how financial institutions are embedding the management of climate risks into their activities.

Following this review and the CBES, the Bank of England/PRA recently wrote to the CEOs of the major financial institutions they supervise. From a risk management perspective, there has been progress. However, the Bank of England/PRA conclude that more progress on managing climate risks is needed. Firms that are deemed to be falling short of what supervisors expect will be asked to provide a roadmap setting out what they intend to do to address this. The PRA may use wider supervisory tools to make sure those climate risks are being properly managed. [126] It is welcome that some progress is being made even if it is unclear how the Bank of England/PRA will respond to firms that lag behind.

When they consider climate change, we are concerned that the Bank of England and PRA are too focused on the potential impact on their financial stability and prudential regulation objectives and how these risks apply to the firms within their remit. We believe this is too narrow an approach.

The Bank of England/PRA do not see their role as proactively preventing financial institutions damaging the environment or intervening to change financial market behaviours so markets are aligned with climate goals. In other words, they focus on the *consequences* of climate change not the *causes.* This is an important distinction to remember.

[125] Results of the 2021 Climate Biennial Exploratory Scenario (CBES) | Bank of England
[126] Thematic feedback on the PRA's supervision of climate-related financial risk and the Bank of England's Climate Biennial Exploratory Scenario exercise

The Bank of England maintains that the matter of *how* to address the causes of climate change is a decision for governments and parliaments, not financial regulators.[127] To be fair, as we emphasise above, it is the role of Parliament and government to set the high-level objectives for financial regulators, not for regulators to decide for themselves. That is why we argue that financial regulators will not play the necessary role in tackling climate change unless and until they are provided with the right statutory objectives and direction from Parliament and government. Nevertheless, if the Bank of England and other regulators sent a strong, positive signal to Parliament and government that they recognise the need for financial regulation to support climate goals, this would be very welcome.

While the Bank of England/PRA are the main systemic risk and prudential regulators, The Pensions Regulator (TPR) also has an important prudential regulation role to play given the size of the UK defined benefit (DB) pension scheme sector

TPR has a dual prudential and conduct of business role depending on the type of pension scheme involved. As described elsewhere, there is an important distinction between what are known as defined benefit (DB) pension schemes and defined contribution (DC) schemes.

DB pension schemes face similar issues to insurance companies. They both have to identify and manage risks that might affect their ability to meet expectations of, and commitments made to, scheme members and policyholders. In other words, they face prudential regulation risks. So, TPR has to act as the 'prudential regulator' for DB schemes. This has implications for how TPR manages the climate related risks facing DB schemes – and, in turn, the role TPR could have in ensuring DB schemes contribute to climate goals.

Until now, TPR's role in addressing climate related risks has focused on disclosure and reporting, and governance and management of climate risks as set out in The Pensions Schemes Act 2021[128] and TPR's Climate Change Strategy[129] rather than using direct prudential regulation tools to advance climate goals.

Specific prudential regulations

Insurers and Solvency II

The most relevant piece of insurance regulation is Solvency II. This was developed at EU-level and came into force across the EU (including in the UK) in 2016. The UK government and insurance industry were very influential in determining the content of Solvency II. The UK insurance sector has taken more advantage of the flexibility contained in Solvency II than any of its major (now-former) EU competitors (see Annex 1 for details of Solvency II).

Post Brexit, the government, the Bank of England and the PRA have consulted on further reforms to Solvency II. The UK insurance lobby, supported by the UK government claim that reforming Solvency II will free up capital for investing in the green transition and 'levelling up', and had been pushing the Bank of England/PRA to change the rules.[130] In the most recent autumn statement, Chancellor Jeremy Hunt backed reform of the Solvency II, accepting the insurers' arguments.

Reform is not confined to the UK. The European Commission is now reviewing Solvency II.[131] The aim of the review is to make the insurance and reinsurance sector more resilient and to 'free up' more

[127] Climate capital – speech by Sam Woods | Bank of England
[128] Pension Schemes Act 2021 (legislation.gov.uk)
[129] Climate change strategy | The Pensions Regulator
[130] Post-Brexit reforms to financial regulations could release £95bn to boost the UK economy and tackle climate change | ABI
[131] Solvency II review (europa.eu)

insurance funds to be channelled towards the European Green Deal – similar to the arguments made by the UK government.

Solvency II aims to protect consumers by making sure insurers have enough assets to pay claims (for example, to pay pension annuities in retirement) and hold enough money on their balance sheets to withstand financial shocks. As we explain in detail in Annex 1, the reforms the government is pushing through represent a significant reduction in consumer protection and will undermine the security of people's pensions.

More relevantly for this project, the Solvency II deregulation will not encourage significant *flows* of resources *to* climate positive activities, and *away from* climate damaging activities. At best, the proposals might make a marginal contribution to channelling flows of assets but at a potentially serious cost to the consumer protection available to insurance policyholders and pension savers. The proposals do not contain robust measures that would cause insurance companies to meaningfully divest or disinvest from their existing stock of climate damaging assets.

The insurance industry has been vocal in asserting that the current design and implementation of Solvency II stops them from investing in green technology/infrastructure and that reform is needed to enable such investment. Solvency II does ***not*** prevent insurers from investing in green assets or levelling up. Our view is these arguments are being used as Trojan Horses for deregulation which would allow insurers to extract more value from higher risk assets, transfer risk to policyholders, and to provide shareholders with windfalls.

There is also the important point that private finance (including insurance and pension funds) is a much more costly way to finance green goals and levelling up compared to state-financing mechanisms. We also note that the finance industry is lobbying for the state to 'de-risk' green assets such as new green technologies or green infrastructure by underwriting the associated early-stage risks. This is what is known as 'privatising the rewards, socialising the risks'. Or, 'heads they win, tails we lose'. Again, it does not seem to be an economically sensible approach.

We would understand the dilemma facing policymakers and regulators if weakening prudential regulation was the only option to encourage investment in green assets/levelling up. Yet this is not the case. There are more effective ways of directing the financial resources of financial institutions to productive uses without compromising consumer protection and undermining long-term trust and confidence in the insurance industry and pensions.

A much more effective means to incentivise insurers to invest in productive assets would be to penalise the holding of or directing of new funds to unproductive or climate-damaging assets. This would provide the necessary incentive by making productive assets more attractive, in economic and regulatory terms, and would be a better way of achieving the twin goals of dealing with the flow and stock of assets.

To redirect resources from climate-damaging assets, financial regulators should require insurers and reinsurers to have credible and demanding ***climate de-risking transition plans*** in place, with clear targets and timeframes. These de-risking plans are intended to both protect insurance policyholders from climate-related risks and to reduce the harm caused to the environment by investment decisions made by insurance companies.

Once transition plans have been approved, specific policy tools will be needed to implement these plans. We very much support the idea that policymakers and prudential regulators should adopt the "One for One" Rule. That is, for each £ of resource that finances ***new*** climate damaging activities, insurers should hold a £ of their own-funds to be held as liability for potential losses.[132] An alternative would be to adjust the 'own-funds requirement' by reference to an independent assessment of the climate damage caused by an economic activity.[133]

If government and Bank of England/PRA insist on retaining the use of the Matching Adjustment (MA) technical provision (see Annex 1), then assets which contribute to climate damage should be excluded from assets eligible for MA portfolios.

That would address the ***flow*** of new funds. We would still need to deal with the ***stock*** of existing climate-damaging assets. This could be done by requiring insurers to hold a proportion of own-funds against existing holdings with the proportion ratcheted up over an appropriate time frame to compel insurers to divest these assets in line with the transition plans described above. This should apply to assets already held in MA portfolios.

Prudential regulation of banks

Similar issues arise with regards to the banks. Making sure banks and the wider financial system are resilient against climate risks is, of course, important. However, we are primarily interested in how financial regulators can ensure that banks and other financial institutions such as the shadow banking sector[134] support climate goals by not financing climate damaging activities.

We have to try to break out of the 'doom loop' in which the financial system and financial institutions are at risk from climate change, yet the same system and institutions finance climate damaging activities.

Climate-related prudential regulation certainly has a significant role to play in aligning financial market behaviours with climate goals. It can allow financial regulators to deploy some very direct mechanisms to change the behaviours of financial institutions – regulators can directly influence the cost of financing certain economic activities using 'balance sheet' tools.

The essence of prudential regulation for banks (as with insurers) is that firms should hold enough capital on their balance sheets to be able to absorb financial losses – and the level and type of capital to be held depends on the level of financial risks they are exposed to (an explanation of how bank prudential regulation works can be found in Annex 2). Banks and certain other institutions also have to worry about the risk of customers withdrawing their money *en masse* if there is a crisis of confidence in that institution such as run on a bank.

Increasingly, the function of credit intermediation in the financial system is undertaken by shadow banking institutions. These institutions are not covered by the same prudential regulation standards as conventional bank lenders. But, some of these institutions are susceptible to bank style runs.

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[132] https://www.finance-watch.org/the-one-for-one-rule-a-way-for-cop26-ambitions-to-manifest-in-policy/

[133] So, if an economic activity was rated as 4 out of 5 in terms of its climate impact, insurers would hold 80p in the £ and so on. But this would require a robust foundational taxonomy which we do not yet have.

[134] The shadow banking sector is now huge, and any policy interventions must address behaviours in that sector. It is sometimes referred to as market-based finance, non-bank financial intermediation, or non-bank financial companies. There is some overlap between shadow banking and the insurance sector and certain types of asset management/collective investment funds which are covered in other sections. But, for the purpose of the categorisation we use in this report (and the regulatory tools to be deployed) we refer to institutions that are involved in credit intermediation, some of which may be susceptible to bank type runs. For more information on the size and nature of the sector. See: Global Monitoring Report on Non-Bank Financial Intermediation 2021 - Financial Stability Board (fsb.org) and Shadow Banking | Finance Watch (finance-watch.org)

Therefore, care has to be taken to ensure regulatory policy is applied consistently across the different sectors to prevent regulatory arbitrage.

Traditionally, the way that the size of financial risks has been assessed has been to analyse historic data on the losses caused by exposure to economic assets. That may be appropriate for assets where large amounts of historical data exists to be modelled. The same amount of data is not available on climate risks so historical data is not as useful in this context. A more forward looking, precautionary approach is needed.

It would be wrong to suggest that prudential regulators (at UK and global level) are not thinking about climate change. They certainly are but there are concerns that bank regulation does not properly factor in the risks arising from climate change. It has been estimated that the 60 largest global banks have around $1.35 trillion of credit exposure to fossil fuel assets through loans.[135] The five biggest UK banks alone have $72 billion exposure.[136] More relevantly for this project, there are concerns that prudential regulators do not fully consider the impact of the behaviours of the firms they regulate on the environment.

The Bank of England/PRA are concerned with two main types of climate-related risks that may create financial risks – physical and transition risks. Physical risks include events such as rises in sea levels, floods, or more frequent storms that may damage property, or affect economic output. These events can create transition risks such as lower profits for companies, asset values falling causing loses for investors, insurance costs rising, or lenders making losses on loans. While we have not yet seen many cases, in future, financial institutions may also face legal risks if businesses or individuals take action to obtain redress or compensation for losses related to climate risks.

The Bank of England/PRA are stress testing the resilience of the biggest banks against climate risks. Firms are being asked to embed climate-related financial risk into their business strategies. The Bank of England/PRA will expect firms that are falling short on managing climate risks to provide a roadmap to address failings. The Bank of England is working on how to embed climate-related financial risk into its own approach to financial supervision. The PRA has also undertaken a 'thematic review' of how financial institutions are embedding the management of climate risks into their activities. The PRA may use wider supervisory tools to make sure those climate risks are being properly managed. [137]

It is worth noting that, so far, the Bank of England/PRA have not deployed the type of capital requirements used to manage other prudential risks outlined above to manage the risks associated with climate change.

At the global level, the Basel Committee has issued 18 *principles for the effective management and supervision of climate related financial risks*.[138] The Basel Committee follows a principles-based approach designed to improve how banks manage and supervisors deal with climate related risks.

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[135] Report – A safer transition for fossil banking: Quantifying capital needed to reflect transition risk | Finance Watch (finance-watch.org)

[136] Tackling-financial-risks-related-to-the-fossil-fuel-financing-of-British-banks.pdf (finance-watch.org)

[137] Thematic feedback on the PRA's supervision of climate-related financial risk and the Bank of England's Climate Biennial Exploratory Scenario exercise

[138] Press release: Basel Committee issues principles for the effective management and supervision of climate-related financial risks (bis.org)

The principles cover corporate governance, internal controls, risk assessment, management and reporting and are intended to provide a common baseline for international banks.

Yet it is important to note that the Basel Committee recommendations do not cover capital requirements. Instead, it focuses on supervisory tools. Under the Basel framework, as it stands, assets exposed to fossil fuels are not treated as higher risk. This means they are not given a high-risk weighting, unlike other assets such as loans to higher risk businesses. As a result, banks do not have to hold higher capital against these climate risks. From a prudential regulation perspective, this means there is less of a deterrent to banks to building up further exposures to fossil fuel assets from a prudential regulatory perspective.

While the Bank of England/PRA also uses a supervisory approach for now, it is in the process of considering whether capital requirement tools might be used and in what way.[139] The Bank of England/PRA recognises there are challenges including the absence of historical data to model the risks associated with climate change. The Bank of England/PRA had originally said they would decide whether or not to include capital requirements for climate risk management by the end of 2022, but that date has started to slip.[140]

The PRA is previously on record said that it does not think that capital requirements tools – in particular what are known as green supporting factors (GSF) - should be used to tackle the climate crisis. In other words, capital requirement tools should be used to address the consequences of climate change, not the causes.[141]

The idea behind green supporting factors is that green assets are treated as less risky than other assets. This means banks would have to hold less capital to absorb losses so incentivising greater financing of green assets. However, the Bank of England argues that there is little evidence to support the effectiveness of GSF as a means of incentivising green finance. The Bank of England fears that reducing capital requirements could undermine its prudential regulation and even its financial stability objectives.[142]

We share the views of the Bank of England/PRA and other civil society organisations[143] that a GSF is unlikely to significantly change bank behaviours (or indeed the behaviour of insurers) and incentivise major financing of green assets *without other accompanying interventions*. Instead, we support the view that it would be more efficient to use direct interventions to deter banks and insurers from financing climate damaging activities.

The Bank of England recognises that there are risks associated with climate change. So, there is surely a prudential regulatory case for using capital requirements to compel banks and other financial institutions to reduce their exposure to climate damaging activities. Indeed, there is a moral hazard argument. Only a minority of around 18% of bank deposits are backed by actual reserves, with 82 percent backed by mortgages and other loans which can be risky and illiquid.[144] Of course, there is the Financial Services Compensation Scheme (FSCS) which guarantees up to £85,000 of consumers deposits and savings in event of a bank, building society, or credit union failing. The FSCS

[139] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021.pdf, p29
[140] Although recent statements by the Deputy Governor of the Bank of England have cast doubt on that timetable. See: Four key takeaways from the BoE's climate and capital conference - Green Central Banking
[141] Climate-related financial risk management and the role of capital requirements (bankofengland.co.uk)
[142] Climate change adds to risk for banks, but EU lending proposals will do more harm than good (bruegel.org) and 2dii_The-Green-Supporting-Factor.pdf (2degrees-investing.org)
[143] To better understand UK banks we have to follow the money - Positive Money
[144] Banking sector regulatory capital - 2022 Q1 | Bank of England

is funded by a levy on financial institutions [145] – so the customers, members, and shareholders of other financial institutions have to fund banks that fail.

There are also wider social, environmental and, indeed, ethical arguments for stronger interventions. Banks and other financial institutions have a direct role in financing climate-damaging activities which affect us all. The effects of climate change are not being felt evenly. Poorer nations are bearing the brunt in terms of health and economic impacts. The sheer scale and interconnectivity of the UK's financial markets means this country plays a disproportionate role in financing economic activities that create climate damage across the globe. The UK is a major exporter of climate-damaging finance. The carbon emissions associated with the UK financial sector were nearly twice (1.8 times) the emissions produced domestically by other UK economic activities.[146]

Financial institutions and executives can face tough criminal and civil sanctions for enabling the financing of terrorism, money laundering or for the breaking of economic sanctions. So, why do policymakers and regulators allow them to continue to finance climate damaging activities? There is a strong case for arguing that the harm caused by financing climate damaging activities is actually greater than that caused by enabling those other activities and therefore that it requires a proportionate response.

Some might argue that there is little point in UK policymakers and regulators taking a tough line against climate damaging finance, if all it does is encourage that finance to relocate to other jurisdictions around the world. We believe that this is not a justification for going easy on climate change. We do not use that excuse to justify going easy on money laundering or funding terrorism. We should not tolerate hosting climate damaging finance in the UK.

In 2021, the International Energy Agency (IEA) produced a road map to achieve net zero by 2050. One of the key requirements for this to work is that there should no investment in new fossil fuel supply projects and no further final investment decisions for new unabated coal plants.[147] However, in 2021, five UK banks together invested £35 billion of *new* money into fossil fuels.[148]

Of course, bringing to a stop immediately the financing of economic activities that are linked to or depend on fossil fuels would have significant economic consequences. Therefore, as with insurers, we argue that financial regulators should require banks (and other types of financial institution including those in the 'shadow banking' sector that finance climate damaging activities) to have credible and demanding ***climate de-risking transition plans*** in place, with clear targets and timeframes, to reduce the financial system's exposure to climate-related risks and reduce the harm caused to the environment by banks and other financial institutions.

Once transition plans have been approved, specific policy tools will be needed to implement these plans. As with insurers, policymakers and prudential regulators should adopt the "One for One" Rule for banks and financial institutions in the shadow banking sector. That is, for each £1 of resource that finances ***new*** climate damaging activities, banks (and shadow banking institutions) should hold £1 of their own-funds with a resulting liability for potential losses or even as a climate harm

[145] How FSCS is funded | Financial services firms levy | FSCS

[146] The-Big-Smoke-the-global-emissions-of-the-UK-financial-sector.pdf (greenpeace.org.uk) Note that this is likely to be an underestimate. Due to lack of publicly available data the report authors were unable to include estimates for the emissions associated with the UK insurance sector which is one of the biggest in the world.
[147] Pathway to critical and formidable goal of net-zero emissions by 2050 is narrow but brings huge benefits, according to IEA special report - News - IEA
[148] Banking-on-Climate-Chaos-2022.pdf (priceofoil.org)

penalty.[149] An alternative would be to adjust the 'own-funds requirement' by reference to an independent assessment of the climate damage caused by an economic activity.[150]

To deal with the ***stock*** of existing climate damaging assets, banks and shadow banks should hold a proportion of own-funds against existing holdings of climate-damaging activities. This proportion would be ratcheted up over an appropriate time frame to compel institutions to disinvest these assets in line with the transition plans described above.

There are some positive interventions which could be deployed to generate climate supporting financial behaviours. For example, we support in principle the proposals outlined by Positive Money for the Bank of England to adapt green monetary policy and macro prudential regulation to influence market behaviours.

Green Term Funding Scheme: Despite the Bank of England's reticence, the UK should use the framework of preferential interest rates to incentivise green lending.[151] A Green Term Funding Scheme would enable financial institutions with green lending activities to borrow money from the Bank at a lower rate and support longer term green projects. However, for this to work, we would need to establish a foundational UK green taxonomy.

Green collateral frameworks: the Bank of England should deter financial institutions from holding climate-damaging assets. This could be done by reducing the value of these assets by excluding them as collateral or subjecting them to haircuts in terms of their valuations. The Bank could also increase the value of green assets by requiring a minimum quota of sustainable sectors to be held in credit portfolios.

The Pensions Regulator, prudential regulation of defined benefit (DB) schemes

Until now, TPR's role in addressing climate related risks has focused on disclosure and reporting, and governance and management of climate risks as set out in The Pensions Schemes Act 2021 and TPR's Climate Change Strategy. There appears to have been no real consideration as to how TPR might use prudential regulation tools to direct DB pension schemes to advance climate goals.

Much of TPR's work is driven by the Government's Green Finance Strategy and recommendations contained in the work of the TCFD – these are discussed in detail above. For qualifying employers' pension schemes, the Green Finance Strategy and implementation of TCFD recommendations is being taking forward through the new Pensions Scheme Act 2021 which writes climate change into UK pensions legislation.

Proposed new regulations will adapt the TFCD recommendations so that they are relevant and usable for pension trustees' decision-making processes. For example, in the TFCD recommendations, the heading 'governance' is being translated into a requirement for pension trustees to have oversight of climate-related risks and opportunities. Under the heading 'metrics and targets', trustees will be expected to evaluate the pension scheme's carbon footprint by calculating the greenhouse gas emissions of the investments held in the pension fund portfolio. Trustees will have to publish a report on these issues.

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149 https://www.finance-watch.org/the-one-for-one-rule-a-way-for-cop26-ambitions-to-manifest-in-policy/

150 So, if an economic activity was rated as 4 out of 5 in terms of its climate impact, insurers would hold 80p in the £ and so on. But this would require a robust foundational taxonomy which we do not yet have.

151 https://www.bankofengland.co.uk/markets/market-notices/2020/term-funding-scheme-market-notice-mar-2020

Mandatory disclosure of climate risks in line with the TCFD recommendations initially applies to larger schemes and all master trust and collective DC schemes' although all schemes are subject to some duties relating to disclosure on how they manage climate-related risks.

As with the Bank of England/PRA, TPR will carry out thematic reviews on pension scheme resilience to climate-related scenarios and examine whether scheme reports recognise the risks involved. It may use these findings to inform any revisions to the guidance given to pension schemes in relation to climate-related risks.

It is of course good that TPR is playing a role in improving disclosure of climate-related risks and promoting better risk management. But, it is far from clear what TPR actually intends to do to ensure that pension scheme trustees take action to reduce i. the climate-related risks their scheme is exposed to and ii. the climate-related harm their scheme contributes to.

As explained, TPR is the prudential regulator for DB pension schemes. If it looks as if there is a risk that a scheme has a deficit (i.e. there are too few assets to meet the scheme's liabilities), it can require the scheme to produce a recovery plan.[152]

The same principle should apply to climate-related risks. As with banks and insurers, DB pension schemes should be required to have credible and demanding ***climate de-risking transition plans*** in place, with clear targets and timeframes, to reduce the scheme's exposure to climate-related risks and reduce the harm caused to the environment by the scheme's investments. Versions of the 'One for One' Rule for banks and insurers outlined above should be developed for DB pension schemes. To ensure this has an effect, the value of additional funds needed to comply with the 'One-for-One' rule should be added to the scheme's liabilities and the sponsoring employer required to fund the scheme's ***climate-risk funding deficit***.

Conduct of business, reporting and disclosure and other policy tools

In this section, we look at financial policy tools aimed at financial institutions where the value of the assets held, and the financial outcome expected and produced, is ***variable***. Remember, prudential regulation tools which allow regulators to directly influence the types of assets institutions should hold are not available here.

The main options are regulatory tools covering conduct of business, disclosure and reporting, and other less widely discussed sanctions-based approaches. As with prudential regulation tools, regardless of which type of policy tool is deployed, the goal is the same – to change behaviours in the financial system, to deter climate-damaging finance and promote climate-positive finance. The regulators with the primary roles here are the FCA, TPR, and FRC.

The role of the FCA/Sustainable investment labels

FCA's role

The FCA is the lead UK conduct regulator. It regulates the behaviours of financial institutions and sets standards of market conduct. Therefore, it could have a major role to play in aligning financial market behaviours with climate goals. The FCA is particularly important with regards to financial institutions such as asset managers and pension providers.

[152] DB pension recovery plans | The Pensions Regulator

To promote climate-positive behaviours, the FCA has developed a strategy on climate change.[153] The FCA focuses on how financial institutions disclose compliance with climate goals. It wants consumers and institutions such as pension schemes to have the appropriate information to make informed choices about green financial products and to mitigate the risk of 'greenwashing'.

The FCA works with the other regulators including the PRA and TPR that have a role to play in changing institutional behaviours. The FCA is also working with the FRC on creating a new regulatory framework for investor stewardship.

One of the FCA's major initiatives relates to Sustainability Disclosure Requirements (SDR) and investment labels. Recently, the FCA issued an important Discussion Paper DP21/4 [154] followed by a Consultation Paper CP22/20[155] setting out proposals on how investment firms should classify assets and disclose compliance with climate goals and for an investment label to help retail investors make informed choices.

We were very disappointed with the FCA's initial proposals on classifying assets and disclosure set out in the Discussion Paper.[156] We argued that the proposals could lead to consumers being misled as to the green credentials of assets held within financial products and enable greenwashing. The FCA has revised its approach in the Consultation Paper.

The FCA's proposals are intended to align with the recommendations of the Task Force on Climate related Financial Disclosures (TCFD) and will build on these proposals in line with the international reporting standards developed by the International Sustainability Standards Board (ISSB). The FCA recognises that many investment firms and products which could be covered by its proposals also operate internationally. It has tried, as far as possible, to be consistent with other initiatives, particularly: the EU's Sustainable Finance Disclosure Regulation (SFDR); the International Organisation of Securities Commissions' (IOSCO) Recommendations on Sustainability-Related Practices, Policies, Procedures, and Disclosure in Asset Management; and proposals by the main US financial regulator the Securities and Exchange Commission (SEC).

The FCA's proposals on disclosure cover:

- **Sustainable investment labels** to help consumers navigate the investment product market and enhance consumer trust.
- **Consumer facing disclosures** to help consumers understand the key sustainability-related features of products.
- **Detailed disclosures** targeted at a wider audience such as institutional investors and retail consumers seeking more detailed information including:
  - **Pre-contractual disclosures** covering the sustainability-related features of investment products.
  - **Ongoing sustainability-related performance information** including performance indicators and metrics in a sustainability product report.
  - **A sustainability entity report** covering how firms manage sustainability-related risks and opportunities.
- **Naming and marketing rules** limiting the use of certain sustainability-related terms in product names and marketing materials unless the product uses a sustainable investment label.

153 A strategy for positive change: our ESG priorities | FCA
154 DP21/4: Sustainability Disclosure Requirements and investment labels | FCA
155 CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels | FCA
156 FCA Discussion Paper DP21-4 Sustainability Disclosure Requirements and Investment Labels | The Financial Inclusion Centre

- **Requirements for investment product distributors** to ensure product-level information and labels are made available to consumers.
- **A general anti-greenwashing rule** which would apply to all regulated firms and reinforce existing rules to clarify that sustainability-related claims must be clear, fair, and not misleading.

Sustainable investment labels

The FCA has reduced the number of labels it intended to use from five to three. Originally the FCA had proposed the following labels: 1. Not promoted as sustainable; 2. Responsible (may have some sustainable investments); and three 'Sustainable' blocks 3. Transitioning (low allocation to Taxonomy-aligned sustainable activities); 4. Aligned (high allocation to Taxonomy-aligned sustainable activities); and 5. Impact (objective of delivering positive environmental or social impact, a category in its own right).

The three labels it is now proposing to use are: 'Sustainable Focus', 'Sustainable Improvers', and 'Sustainable Impact'. The classification and labelling of the products is based on the 'intentionality' behind that product. The FCA is developing qualifying criteria for each label.

Sustainable Focus: invests in assets that are environmentally and/or socially sustainable.

Sustainable Improvers: invests in assets that aim to improve the environmental and/or social sustainability of assets over time, including in response to the stewardship influence of the firm.

Sustainable Impact: invests in solutions to environmental or social problems, to achieve positive, real-world impacts.

Table 2: Criteria for each label

Sustainable Focus	Sustainable Improvers	Sustainable Impact
The firm must ensure that at least 70% of the product's assets either meet a credible standard of environmental and/or social sustainability or align with a specified environmental and/or social sustainability theme. The FCA states that a credible standard is one that is robust, independently assessed, evidence based and transparent.	The firm must ensure that the product is invested in assets that have the potential to become more environmentally and/or socially sustainable over time, including in response to active investor stewardship.	The sustainability objective must be to achieve a predefined, positive, measurable real-world environmental and/or social outcome. The firm must specify: a theory of change, in line with the product's sustainability objective, emphasising how its investment process aims to contribute to addressing either environmental and/or social problems; a robust method to measure and demonstrate that its investment activities have had a positive environmental and/or social sustainability impact; its escalation plan should the real-world outcome no longer plausibly be achievable, including potential divestment of assets.

The FCA intends to require firms to specify credible, relevant, rigorous and evidence based KPIs that measure a sustainable investment product's ongoing performance towards achieving its sustainability objective; and monitor the product's performance against its sustainability objective on an ongoing basis with reference to the specified KPIs. There are other requirements relating to: governance and due diligence, and stewardship; and communicating to consumers. The full details of the FCA's proposals can be found in Annex C.

However, the key to the proposals is the system of classification, labelling and related criteria. The critical point to note is that the sustainable definition can be applied to funds with both green and/or social impact goals. The FCA proposals would not require separate labels for funds with different goals.

A general anti-greenwashing rule

Potentially, the most powerful proposal is the intention to introduce a general anti-greenwashing rule for all FCA-regulated firms. This would require all regulated firms to ensure that the naming and marketing of financial products and services in the UK is clear, fair, and not misleading. The naming and marketing should be consistent with the sustainability profile of the product or service. The application of this proposal to all regulated firms is also intended to capture firms that approve financial promotions for unauthorised persons.

There are already rules in place relating to information being clear, fair, and not misleading. Yet rather than rely on these general rules, the FCA concluded that a specific rule relating to sustainability claims was necessary to allow it challenge firms on potential greenwashing. This could be a very effective tool but only if enforced robustly with sanctions for breaching rules.

Pensions and other products

The FCA has decided not to apply the above proposals to pensions and other products such as exchange traded funds at this stage. It is still considering how it might bring those vehicles into the scope of the new regime. This is in contrast to the approach adopted by the EU which covers a much more comprehensive set of financial products and activities.

The FCA's future work

The FCA intends to undertake much further work in this field, particularly as other UK and global initiatives are developed – see Annex C. The proposals outlined above apply to a particular set of products sold under certain circumstances and are limited to retail investors.

ESG data and rating providers

As it stands, the FCA does not regulate ESG data and ratings providers. This would require HM Treasury to extend the regulatory perimeter to bring providers within the regulator's remit. If this does happen, the FCA would develop and consult on a regulatory regime with a focus on outcomes in areas highlighted in IOSCO's recommendations including transparency, good governance, management of conflicts of interest, and systems and controls.

Yet even if HM Treasury does agree to extend the perimeter, it will take some time before any new regime would take effect. In the meantime, the FCA intends to work with HM Treasury to support and encourage industry participants to develop and follow a voluntary Code of Conduct on ESG ratings.[157] There is the danger that a voluntary Code of Conduct could be used as an excuse not to

[157] ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk)

bring providers within statutory regulation. Details of the industry-led voluntary code have now been published. We have serious concerns about the proposed objectives of the Code and the governance relating to development of the Code. We can see lots of opportunity for industry participants with commercial relationships to effectively mark their own homework – see below.

Critique of the FCA's proposals

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.

However, as ever, the devil is in the detail – the theme of this 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 project.

Producing a *usable* label or marker for collective structures[158] does present a challenge. 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, e.g., 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

[158] 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 (e.g., bonds, equities etc) within a single portfolio/fund.

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 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 seeking 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.[159] The FCA refers to research showing there are more than 800 funds having responsible, sustainable or ethical characteristics.[160] 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-

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

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 'green-ness' 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 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. [161]

Sustainability metrics and KPIs - The FCA is not mandating the type of sustainability metrics that firms should use.[162] 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

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

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.

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.[163] The FCA's rules currently say that only one quarter of the members of a firm's governing body have to be independent.[164] 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.[165] 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.[166] 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

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

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

interest which may give rise to poor outcomes. The recent crisis involving complex Liability Driven Investment strategies is a case in point.[167]

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.

What if the adviser offers a mix of funds some of which are climate-transition supporting while others are climate-damaging?

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. 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.[168] 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. 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.

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

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.[169]

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, e.g., 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, i.e., 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 i.e. 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'[170] 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?

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[169] What You Need to Know about Impact Investing | The GIIN
[170] '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

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.

The Financial Inclusion Centre framework proposals for disclosure and labels

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.

This particular report focuses 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.

We have not included proposals relating to the governance aspect in this report as there are organisations such PIRC[171] which cover corporate governance issues. However, the framework we outline below could accommodate governance ratings if necessary.

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.

In the FIC model, the label and accompanying data helps end-users see clearly:

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

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[172], e.g., 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 (e.g., 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). Non qualifying funds would carry a clear, strong 'climate health warning'.
3. **The approach adopted by the fund** 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 (i.e., 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 3: 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 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, e.g., 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

[172] 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.

	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, e.g., 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 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 mixing up 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, i.e., 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[173] 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, e.g., 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 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% of this fund's assets are held in shares and bonds of companies that have a low green rating as certified by ABC rating

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

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.[174]

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.

Whichever rating system is used, it is important that providers cannot evade scrutiny by choosing not to submit funds for rating.

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, e.g., 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 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% of its overall investments in shares of company A1, which generates 60% 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

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[174] 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.

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;[175]
- 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.[176] 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.[177]

Table 4: Outline of green star/globe, colour coding and label approach

Fund A				**Fund B**				**Fund C**			
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				

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[175] 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

[176] 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)

[177] 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)

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% 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 table below.

Table 5: 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 6: 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 subcategories. 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.

The role of TPR and regulation of defined contribution schemes

As outlined above, there is a significant structural difference between defined benefit (DB) schemes and defined contribution (DC) schemes. DB schemes face prudential risks. With DC schemes, the value of the assets held, and the financial outcome produced is ***variable***. The asset/pension fund manager will buy shares and bonds in companies held within portfolios. Of course, the fund manager will try to deliver a decent return. However, the fund/DC scheme does not have to hold reserves to pay out a promised amount. Prudential regulatory tools will not be appropriate. The main regulatory tools will be conduct of business and disclosure/reporting regulations.

As with DB schemes, DC schemes will be subject to proposed new regulations which will adapt the TFCD recommendations, so they are relevant and usable for pension trustees' decision-making processes. For example, trustees will be expected to evaluate the pension scheme's carbon footprint by calculating the greenhouse gas emissions of the investments held in the pension fund portfolio. Trustees will have to publish a report on these issues. This is welcome.

But more is needed. We make the following recommendations for DC schemes:

- Sponsoring employers and scheme trustees should be required to submit their scheme(s) to be green rated by an independent ESG rating agency based on the model outlined above for investment funds.
- The scheme's green rating should be published and compared to an appropriate market benchmark to promote accountability to pension scheme members. If the scheme has a poor green rating, the sponsoring employer and scheme trustees should be required to explain that poor rating and plans for improving the scheme's green performance.
- Scheme trustees should be required to produce ***climate de-risking transition plans.***
- Pension scheme members should be consulted on these transition plans and these plans subject to approval by scheme members.

Workplace pensions and the charge cap

Another important issue relating to pensions is the charge cap on workplace pensions. In simple terms, the cap on charges on a default workplace scheme is 0.75% per annum.[178] It was intended to stop high investment charges extracting value from schemes and reducing the returns achieved on the assets held in the pension portfolio. It was recognised that competition and market forces were not effective at keeping charges at reasonable levels and that a mandated cap was needed to stop pension scheme members from being exploited by high investment fees.

Even at this late stage we recommend that the charge cap be left unchanged.

Now, using similar arguments deployed by the insurance lobby for deregulation of Solvency II (see above), certain sections of the investment industry lobby have been pushing government to relax the charge cap to 'facilitate' investment in green finance infrastructure and levelling up. Again, we believe these arguments are disingenuous and that the real aim here is allow private finance institutions to generate higher returns and higher fees and will lead to greater value extraction from pension schemes.

This deregulation was supported by the Productive Finance Working Group convened by the Bank of England. Yet, there are major concerns about how independent this group is from the asset

[178] Value for members | DC pension schemes | The Pensions Regulator

management and private finance industry that dominates its membership.[179] Unfortunately, the government has agreed with this recommendation and indeed has brought forward the draft regulations that would allow this.[180]

There is no guarantee that this deregulation will ensure that pension schemes invest more in green infrastructure or levelling up. Instead, there is a risk that the private finance industry will use the opportunity to target pension scheme trustees to promote more costly, complex, less liquid investment strategies that generate higher fees.

If pension schemes did actually use the deregulation to finance green infrastructure, as explained elsewhere this is a costly form of financing the green transition.

Even at this late stage we recommend that the charge cap be left unchanged. Undermining an important consumer protection measure to facilitate a more costly form of funding does not make sense.

Other behavioural interventions to ensure firms take environmental harm seriously

As mentioned, given the seriousness of the challenge, we need to deploy whatever interventions it takes to ensure financial institutions, and those who run those financial institutions, are deterred from financing climate and environmental harm, and are held to account if they do so.

This requires the application of coordinated and sustained interventions by prudential and conduct of business regulators in all the main financial sectors and throughout the financial services supply chain (from wholesale markets through institutional markets to retail financial services and ordinary consumers).

Prudential regulation tools could be adapted to ***directly*** change the behaviours of banks, insurers, and DB pension schemes in relation to funding climate damaging activities. But prudential regulators have so far focused on how climate risks might affect the firms they regulate, not the other way round. The approach adopted by prudential regulators needs to change if we are to address the climate harm caused by financial institutions.

So far, most of the discussion about financial institutions not covered by prudential regulations, has been based on the belief that disclosure and better reporting will ***indirectly*** drive behavioural change. The theory is that investors (both institutional and retail) will be able to use better reporting and clear, consistent labels to identify and distinguish between climate-positive and climate-damaging funds and reallocate assets accordingly.

That's the theory, anyway. It has to be said that disclosure and greater transparency, or enlightened market self-interest, does not have a great track record in driving out adverse behaviours in financial markets. It has often taken direct regulatory interventions to control or constrain the behaviours of financial institutions.

A key challenge is changing the behaviours of institutions, not covered by prudential regulation, who are not concerned about reputational damage or peer group pressure especially if the financial rewards for funding climate damaging activities remain attractive. Alternative direct interventions

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[179] There are 24 members of the Working Group. When it was set up, all the members of the Working Group were from the financial sector – asset managers, insurers, banks, private equity and venture capital, and pension funds. The Working Group even includes seven trade bodies as well as many individual firms, so duplicating the representation of financial sector interests. See [Working Group to facilitate investment in productive finance – Members list (bankofengland.co.uk)]

[180] [Broadening the investment opportunities of defined contribution pension schemes (publishing.service.gov.uk)]

are needed. These interventions would need to have the same impact as direct prudential regulation tools to avoid regulatory arbitrage. Otherwise, firms whose business activities attracted tough prudential regulation could shift to less well-regulated activities.

So far, there appears to be no intention on the part of the government to give the FCA the powers and duties to directly deter financial institutions from holding climate damaging assets. This is in contrast to the approach taken towards market abuse, financial crime, fraud, money laundering, terrorist financing, politically exposed persons, and evading sanctions. These activities clearly harm the national interest and, given the role the UK financial sector plays in the global economic and financial system, the interests of other nations and their citizens. There are comprehensive set of rules in place in the UK overseen by the FCA, the National Crime Agency (NCA),[181] and Office for Financial Sanctions Implementation (OFSI).[182]

So far, there appears to be no intention on the part of the government to give the FCA the powers and duties to directly deter financial institutions from holding climate damaging assets.

Surely the same case can be made that financing climate damaging activities also harms the national interests of the UK and other countries – indeed there is a case for saying that climate change is the greatest harm that must be addressed.

What might be the equivalent powers for conduct of business and financial market regulators such as the FCA? The key is to make sure there is a price to pay for continuing to finance climate damaging activities, so the rewards are no longer attractive. There are number of potential options. The nature of some of these interventions means they would either need to be deployed by the government itself or powers given to the regulators to act on behalf of the government. These interventions would apply to all types of financial institutions including those covered by prudential regulations.

A publicly accessible Climate Harm Register

Central to effective interventions is the existence of centralised, trustworthy data on the level of environmental harm caused by companies in the real economy. The government has already committed to requiring large companies and certain financial sector firms to publish, by 2023, a transition plan to decarbonise their operations and reach net zero emissions.

We recommend the government establish an independently operated, publicly accessible Climate Harm Register

For this to work, will require public, trustworthy independently audited data on the level of emissions produced by major publicly listed and private companies, and sovereign countries. Remember, the portfolios of bank loans, investment funds, pension funds, and insurance companies are constructed in the main from loans to these companies, insurance of these companies' economic activities, or investments in the equity and bonds of these companies.

Therefore, we recommend the government establish an independently operated, publicly accessible Climate Harm Register. The Register would contain: the details of the level of emissions generated

[181] Money laundering and illicit finance - National Crime Agency
[182] Office of Financial Sanctions Implementation - GOV.UK (www.gov.uk)

by publicly listed and larger private companies, and sovereign countries; the source of those emissions (i.e., which activities of the company generate the emissions); and the geographical location of those emissions. This data should be audited with the auditing overseen by the FRC.

Companies should be required to publish milestones, in terms of reductions in emissions, in their net zero transition plans.

The worst performing entities should be listed on an Environmental Sanctions List. The Climate Harm Register and Sanctions List would be maintained by the FCA. There are a number of analyses published on the level of emissions created by companies listed on global stock markets which could be adapted and improved.[183]

As well as enabling the other interventions listed below, a public register would help facilitate meaningful and trustworthy ratings schemes. Companies should be required to publish milestones, in terms of reductions in emissions, in their net zero transition plans. Therefore, the Register would also enable progress against transition plans to be monitored and reported on allowing government and relevant regulators to implement remedial action.

A fund climate-penalty

With this intervention, investment funds and pension funds would be required to pay a penalty for investing in or continuing to hold assets in companies that damage the climate and wider environment. Reference would be made to the Climate Harm Register and Sanctions List outlined above. This is intended to play the same role as climate-related prudential regulation tools outlined above. For example, if a company which scored a poor rating on emissions issued a bond with a return set above market averages to attract new finance, then a fund which invested in that bond would pay a climate-penalty to reduce the net return received.

similarly, if a fund continued to hold shares in companies with poor emission ratings, then if those shares outperformed a benchmark index over a defined period (say three years), then a windfall penalty would be paid.

This penalty would be based on the difference between the return generated by shares held in companies with high levels of emissions and the benchmark portfolio return. These penalties would be paid to government or to finance other activities to support efforts to green the financial system, e.g., independent research agencies.

Direct fines and sanctions

The other version of the above measure would be to apply direct fines and sanctions (for example, by removing certain regulatory permissions) to financial institutions that continue to provide or arrange finance for companies or bonds of sovereign countries that have the worst ratings on emissions. Again, the Register and Sanctions List would allow for government to specify a list of prohibited companies and sovereigns which would attract fines and sanctions. As with the prudential regulation interventions outlined above, financial institutions could be required to have transition plans and given time, perhaps five years, to divest from the highest risk/prohibited companies and sovereigns.

[183] See, for example: MSCI-Net-ZeroTracker-October.pdf

Board level/senior management responsibilities and remuneration

Financial institutions do not run themselves; they are run by boards and senior managers who guide the organisation, make the key business decisions, and set the culture of the organisation. So, if we want to address the climate harm caused by climate-critical financial institutions, there must be professional and financial consequences for the people who continue to allow the financial institutions they run to damage the environment. To do this, we make the following recommendations:

- The Senior Managers and Certification Regime (SMCR) should apply to a financial institution's climate-related financial activities including sanctions for failing to comply with a new climate-related responsibility.[184]
- A new responsibility for those covered by the SMCR should be introduced to consider the impact of a firm's activities on environmental sustainability and to take reasonable steps to reduce that impact. [185]
- A nominated non-executive director (NED) should be responsible for ensuring oversight of the firm's climate-related financial activities including ensuring that climate de-risking transition plans are executed within the agreed timeframes.
- For those covered by the SMCR, the performance in respect of complying with the proposed climate responsibility should be considered when individuals require approval to work at senior level in the financial services industry.
- Information about any enforcement decisions made against an individual covered by the SMCR for failing to comply with the new climate responsibility should be included in the directory of certified and assessed persons on the Financial Services Register.[186]
- When considering remuneration of boards and senior management, it should be mandatory for independent assessment of performance against climate responsibility and climate de-risking plans to be included in the calculation of the remuneration.

The role of the FRC and the regulation of ESG ratings providers

The final part of our analysis relates to the foundational data, ratings, and reporting which will be needed to underpin the main regulatory interventions discussed in this report. This covers ESG ratings and ratings providers/agencies. We also make some brief additional points about the role of the FRC given its important role it will need to play in ensuring that foundational data and reporting is trustworthy and relevant.

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184 Senior Managers and Certification Regime | FCA

185 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

186 Financial Services Register | FCA

The importance of data, ratings, and reporting

It is helpful first to summarise the role of data, ratings, and reporting in the financial services supply chain and in effective regulation to reinforce just how important it is to get this right. Figure 1, below, summarises where data, ratings, and reporting are needed in the financial services supply chain and what is required to ensure that data and ratings are meaningful and trustworthy.

Figure 1: The financial services supply chain – stages at where regulation on data, reporting, and ratings needs to be deployed to green the financial system

Foundational data and information

Economic entity: listed and private companies, sovereign states, local government and other agencies e.g., transport/housing authorities that use finance provided by financial markets and institutions
Types of financing used: equity, bonds, insurance, loans, finance, and other financial instruments.
Requires: green taxonomy, trustworthy audited consolidated data on emissions generated by entity, audited reporting to facilitate independent measurement of the 'green-ness' of the entity (or financial instrument used for specific purpose), a central Climate Harm Register
Regulation: needs regulation and oversight of green taxonomy, data, reporting, central register, ratings agencies with FCA and FRC (on reporting by economic entity) taking the lead

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Financial institutions that provide or facilitate finance/activities and products

Financial institutions: Banks, insurers/reinsurers, asset managers (fund managers), investment trusts, pension funds/schemes, investment consultants, investment platforms/advisers
Products/funds/activities: loans/loan books, savings products, insurance/insurance funds, investment funds, investment strategies/management services, financial advice, institutional pension funds, personal pension products e.g. annuities
Requires: consolidated assessment of the financial institution's green performance ***and*** portfolio/loan book/fund/product/platform green performance plus a usable, trustworthy 'marker' that synthesises performance built from foundational data relating to economic entities
Regulation: needs regulation and oversight of i. reporting by financial entity; ii. ratings, labels and other 'markers' intended to help end-users make decisions and choices; and iii. ratings providers, and how ratings are used by intermediaries. FCA should have primary responsibility for regulating data/ratings/labels and providers and users of data/ratings/labels.

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Uses/end-users of reporting, data and ratings

Financial institutions: to provide finance, make investment decisions, manage risk, build portfolios, manufacture and sell products
Financial intermediaries: financial advisers, investment consultants, investment platforms, comparative information providers use data and ratings to promote products, make recommendations and provide advice
Pension scheme/charity trustees, retail fund/direct investors: data and ratings used to make choices and decisions
Civil society organisations/media: reporting, data, and ratings used to hold financial sector to account
Policymakers and regulators: should be using data and ratings to understand which financial sectors and institutions are causing the most climate and environmental harm; supervise markets and enforce regulations; understand how, where, and when to deploy different types of policy and regulatory interventions e.g. prudential, conduct of business, disclosure based, direct interventions such as penalties and sanctions; and measure progress against goals (this requires baseline audits of each major financial sector and activity)

Any collective investment fund/product, insurance fund, pension fund, and bank loan book regardless of the legal or corporate form, is comprised of individual securities (mostly bonds and equities), deposits with specific financial institutions, and other assets such as direct property, and private equity. The green performance of financial institutions ultimately depends on the extent to which the underlying businesses which financial institutions and consumers/ordinary investors lend to, insure, or invest in comply with climate goals.

Narrative reporting or explanations of governance and how economic entities manage climate risks will be helpful for those who want more information. However, narrative styles of reporting can allow for obfuscation and do not allow for objective measurement of progress against climate goals.

If we are to be able to measure progress, we need hard data on climate performance that can be quantified, that can be consistently measured and presented.

The foundational data and information relating to the constituent assets needs to be of the highest quality and integrity. If that data and information (and how that data and information is presented and reported) is flawed, biased, not relevant, or hard to access and use then it will undermine the ability of end-users to make effective decisions and choices. The utility of any representative marker such as a rating scheme will depend on the quality and integrity of that foundational data and information.

Moreover, better data is needed to ensure policymakers and regulators deploy regulatory interventions (whether prudential, conduct of business, market, sanctions aimed at different parts of the financial system) to greatest effect. Regulators cannot do that without access to robust, comprehensive data on which financial sectors and activities are causing the greatest harm. Data is needed to know which sectors and activities to prioritise, which regulatory tools to deploy, and how to calibrate those interventions.

Yet, we do not know which specific financial sectors and activities are causing the greatest harm to the environment. We recommend, as a priority, the main regulators should plan to undertake a comprehensive audit of which financial sectors are causing the greatest harm. This should be done on a preliminary basis using existing data on emissions generated by underlying economic entities which financial institutions finance/lend to, invest in, and insure. Once better data and a UK Taxonomy is available, this audit should be more comprehensive. This audit should provide the baseline for regulator reporting to measure progress towards climate de-risking the financial sector.

The role of the FRC

Trustworthy, meaningful and usable reporting and disclosure included in company reports and accounts is critical. The FRC has a potentially significant role to play in ensuring this happens. The FRC is already responsible for oversight of the audit and corporate reporting relating to underlying economic entities. As with the FCA, the FRC will play a major role in applying the disclosures developed by the Taskforce on Climate-related Financial Disclosures (TCFD) to the UK. It is responsible the implementation of integrated Sustainability Disclosures Requirements (SDR).

It is also working with the FCA on the UK Stewardship Code which sets standards for those involved in investing money on behalf of savers, investors, and pensioners. Stewardship is defined as the responsible allocation, management, and oversight of capital to create long term value leading to sustainable benefits for the economy, the environment, and society.

The FRC is transitioning to become the Audit, Reporting and Governance Authority (ARGA). As part of that reform, it is proposed that it will have a revised remit is 'to protect and promote the interests of investors, other users of corporate reporting and the wider public interest'. The FRC says that, under this new remit, it intends to leverage its role and responsibilities to help support a framework that enables the growth of sustainable businesses. Importantly, this involves understanding how the actions of companies affect the societies in which they operate; how they report on this; and how they are addressing this impact.[187]

One of the criticisms we have of the attitude of other regulatory authorities covered in the report is that they tend to see their main role as understanding and dealing with the *consequences* of climate change (how the climate affects firms they regulate), not the *causes* of climate change (how firms

[187] FRC-LAB-ESG-Paper_2021.pdf

affect the environment). The new ARGA could play an important role helping us understand how companies affect the environment.

These are all powerful statements of intent. But, these need to be translated into action and, most importantly, cause behavioural changes in underlying economic entities and in the financial institutions that provide and arrange finance for those entities.

If stewardship means creating sustainable benefits for the environment, then we need evidence that this happening. There are a number of recommendations we would make to improve the evidence base and quality of data on the green performance of economic entities within the remit of the FRC/ARGA to ensure disclosure and reporting contributes as much as possible to the challenge.

None of this negates the arguments for implementing the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) in the UK, or integrated Sustainability Disclosures Requirements (SDR). Information in relation to governance, strategy, risk management, and metrics and targets should help investors and others take a more informed view of a company's climate-related risks. But we are primarily concerned about the impact of company behaviours on the climate and wider environment.

Many of the key initiatives relating to disclosure are still in the development phase with further detail needed before these can be used to any real effect. However, it is important that these initiatives do not become overly complex and too narrative based as this will dilute the impact. If reporting and disclosure is to have maximum impact, the information and data contained within reports must be clear and minimise the chances of misinterpretation and/or obfuscation.

We recommend that economic entities be required to produce new Climate and Environmental Responsibility Statements. These statements should be independently verified and set out clearly and prominently the following:

- independently audited data on emissions generated by the company's activities
- independent assessment of the degree to which the company's activities are aligned with the definitions in the UK Green Taxonomy (when finalised)
- a comparative assessment of the company's performance against an appropriate benchmark
- data should be published at a consolidated economy entity level and at geographical/regional/division level to allow for assessment of the contribution the company's different activities make to its overall performance
- explanations of how the company's activities are contributing to climate and wider environmental harms
- a risk assessment of which of the company's activities is making the greatest contribution to climate and environmental harm with the actions the company is taking to address those risks

With regard to financial matters, auditors can 'qualify' a company's report and accounts. This means the auditor has reservations about whether the accounts represent a true and fair view of the company's financial position. This principle should also apply to reporting and disclosure on climate and wider environmental issues. We recommend auditors should also have to state whether they: i. stand by their view that statements in a company's report and accounts relating to the environment are true, fair, and not misleading; or ii. the report and accounts should be qualified because they do not stand by those statements either because they disagree with the conclusions or there is insufficient independent information to allow judgment to be made.

The FRC and relevant industry representative bodies for auditors, accountants, and actuaries should urgently develop meaningful, new professional standards with regards to identifying, quantifying, and reporting on climate related risks. The FRC should incorporate these standards in assessments of whether enforcement action should be brought for breach of professional standards.

The role of ESG ratings and ratings providers agencies

Financial regulators must begin to assess financial institutions' performance on the basis of the impact of their behaviours and decisions on the environment, rather than the impact of climate change on financial institutions. The same approach needs to be applied to ESG data, ratings, and ratings providers. Others have raised similar concerns. According to the FCA, MSCI is the most widely used ratings agency.[188] Yet, its ratings measure the impact of external events on a company's prospects not a company's impact on the environment.[189]

There have been many criticisms of the role of ratings agencies in the financial crisis of 2008.[190] One of the main criticisms is that there was an inherent conflict of interest in the credit ratings system itself. Those institutions who were being rated also paid for the rating. Moreover, users of ratings such as banks, insurers, and pension funds had an incentive to select ratings that presented a flattering view of the companies they invested in or lent money to. Banks and insurers had to hold less capital if the companies were given a better credit rating. Investors such as pension funds were able to invest in assets that were over-rated which enhanced the investment return generated – that is, until the market woke up to the true risk involved. Overall, there was an incentive for ratings agencies to inflate credit ratings and downplay credit risks.

Similar conflicts of interest exist in the ESG ratings market. Indeed, conflicts of interest in the ESG sector may be more embedded. With credit ratings, there at least was some financial incentive for some users to avoid credit ratings that were inflated and not a true measure of the credit risk associated with an asset.

With ESG ratings there is a strong incentive for financial institutions to actively select a ratings provider that produces inflated ESG ratings. As the old saying goes, 'follow the money'. As the level of interest and investment in ESG grows, there is a real incentive for financial institutions to misrepresent the compliance of a fund/product with climate goals.

Even where ratings agencies do not set out explicitly to mislead, if the system has embedded biases or allows some ratings providers to adopt a light touch approach, then it will not deliver the necessary transparency and could actually be detrimental.

There is a simultaneous risk of both a proliferation of providers leading to confusion *and* overconcentration in the market. KPMG estimated there were over 150 major ESG data providers worldwide. More recently, the International Regulatory Strategy Group (IRSG) reported there are around 30 significant ESG rating and data providers globally. The top three providers accounted for around 60% of the market in 2021.[191]

It cannot be reiterated enough that the utility of any labelling system or disclosure system generally depends on the quality, consistency, and integrity of the foundational data and reporting provided by real economy companies and ESG ratings produced by providers. Allowing financial institutions to select from a proliferation of ratings providers, with very different methodologies, obviously

188 See ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk), Fig 3
189 ESG Ratings: A Compass without Direction (harvard.edu)
190 See for example: Credit rating agency reform is incomplete (brookings.edu)
191 See ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk), paras 2.16/17

undermines the ability of end-users such as pension funds and retail investors to compare and contrast the climate performance of financial institutions.

The FCA has already said that it would welcome taking over the regulation of ESG ratings providers. However, it is in the gift of HM Treasury to extend the FCA perimeter and without it the FCA cannot press ahead with regulation. We urge HM Treasury to give the FCA the powers to regulate ESG ratings and ratings providers as quickly as is possible.

The FCA has now announced the formation of a group to develop a Code of Conduct for Environmental Social and Governance (ESG) data and ratings providers on a voluntary basis.[192] The group is to be known as the ESG Data and Ratings Code of Conduct Working Group (DRWG) .

The objectives of the DRWG are to develop (i) a comprehensive, proportionate and globally consistent voluntary Code of Conduct for ESG data and ratings providers, and (ii) a recommendation on ownership of the Code.

The FCA says the work of the DRWG is built around four outcomes (a standard regulatory term for what the regulator wants to see happen). The outcomes are: transparency; good governance; robust systems and controls; and sound management of conflicts of interest.

In our view, these are not ***outcomes***. These are inputs and processes which if followed might create the right outcomes. We argue that these outcomes do not get to grips with the challenge of assisting and informing trustees, financial intermediaries and other investors. We therefore argue that the following are a much better set of objectives and outcomes. The Code should ensure:

- The production of ESG ratings that are trustworthy and meaningful, and of a consistently high standard, analysed by providers that operate to the highest standards of integrity and not subject to conflicts of interest
- Investors are able to make effective, informed decisions relating to ESG factors
- Positive behaviours and practices are promoted and climate damaging activities are deterred and punished
- Financial institutions and intermediaries use ESG ratings responsibly

It is difficult to see how relying on greater transparency on methodologies or the management of conflicts of interest will deliver the outcomes we seek. It is not reasonable to expect end-users such as pension fund trustees or ordinary investors to first investigate the specific methodologies employed by different ratings agencies and then select funds based on those ratings. Nor is it sensible to think that competition will drive up quality and integrity of ratings. Indeed, if anything the fiercer the competition, the greater the risk of ratings inflation. The FCA must actively drive up the quality and relevance of ESG ratings, not leave it to the market to evolve.

There may be benefits in increased coordination but even at this planning stage the voluntary code working group has very poor civil society representation and is dominated by industry representatives. The Terms of Reference of the DRWG[193] state that two industry groups, the International Capital Market Association (ICMA) and the International Regulatory Strategy Group (IRSG), will serve as the Secretariat. This Secretariat will appoint the members of the DRWG.

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

[193] ESG Data and Ratings Code of Conduct Working Group: Terms of Reference (fca.org.uk)

The DRWG will be co-chaired by M&G, Moody's, the London Stock Exchange Group (LSEG) and Slaughter and May, and composed of stakeholders including investors, ESG data and ratings providers, and rated entities. The FCA envisages that the group will consist of between 15-18 members. Yet only three of the positions are to be reserved for academics and civil society representatives. The FCA, HM Treasury, the Bank of England, the Financial Reporting Council, and other relevant financial regulators and government departments will be in the FCA's words 'active observers, offering their views, where deemed appropriate'.

The FCA intends that meetings will be conducted under the Chatham House rule. Comments, dialogue and feedback within the DRWG's meetings will not be attributable to individuals or the organisations they represent or with which they are associated. The Chatham House rule will also apply in any situation where a formal conversation occurs relating to the work of the DRWG.

The FCA says that the DRWG should seek to publish a draft of the voluntary Code of Conduct for consultation approximately within six months of the group's first meeting, with the final version of the Code within approximately four months of the start of the consultation. The FCA also says the DRWG should set out its recommendation on the ownership of the Code – the body responsible for hosting and maintaining the Code, as appropriate – when the final version of the Code is published – at the latest.

Developing a meaningful code of practice on ESG ratings while we wait for statutory regulation is critical. Yet we are very concerned about the ability of a DRWG, so heavily dominated by industry representatives, to deliver a meaningful Code of Conduct.

The terms of reference of the DRWG are too weak. And it is unacceptable that such a group is dominated to such an extent by industry vested interests. The whole set up comes across as all a little too cosy and could even furnish ministers with an excuse not to require full regulation.

In our view, the FCA must be more than observers on this group. It must take the lead to ensure this DRWG acts in the public interest. The FCA should chair this group. If not, it should ensure that it is chaired by an independent person not industry representatives. It cannot allow a Secretariat run by the industry also appoint the members of the DRWG. The FCA should appoint the members and also ensure that half of the DRWG members is made up of independent civil society representatives.

Moreover, the FCA cannot allow this DRWG, as constituted, to determine ownership of the Code. At the very least, the regulator must approve the recommendation of Code ownership. To build trust in the DRWG, and ultimately in any code of practice, the workings of the group should be open to public interest representatives. The Chatham House Rule should *not* apply except when there are genuine issues of commercial confidentiality being discussed. The Secretariat should publish the agenda of forthcoming meetings and actively invite public interest representatives to make written contributions and oral representations at meetings. Minutes of the meetings should be approved by the FCA and published on the FCA website.

Furthermore, the FCA appears to say nothing about what happens if ESG data and ratings providers fail to comply with the Code or indeed fail to sign up to the Code. We must consider how ESG data and ratings are used as well as produced. The FCA does not discuss what might happen if end-users of ESG data and ratings such as asset managers/investment funds abuse the intention of any Code.

Obviously, this is a voluntary, not statutory code so the FCA itself does not have the powers to enforce compliance or sanction breaches. However, some form of sanction will be needed to ensure this voluntary code is not abused. Therefore, the DRWG should be required to consider appropriate deterrents and sanctions for abusing the spirit and letter of the Code.

In addition, the FCA should require end-users of ESG data and ratings to consider whether a provider complies with the Code and disclose this upfront to investors. Of course, this would all depend on whether the Code itself was of a sufficiently high standard. Allowing an ESG data/ratings provider to publicise that it complies with a flawed code would mislead investors. Similarly, allowing asset managers/investment funds to use the fact that the ratings supplier complied with a flawed code in marketing and promotions would mislead investors. Therefore, the FCA should prepare guidance for issuance on the use of ESG data and ratings alongside the development of the new Code.

It will also be important to test what the FCA means when it suggests that if it does get full powers to regulate some ratings providers, the code could cover those firms that fall outside its remit.

The FCA does not seem to think that the low correlation between the ESG ratings provided by different agencies is a problem.[194] Yet, surely there is a risk that, if different agencies reach very different conclusions about the ESG rating of the same asset, this will cause confusion and make it harder for investors to make effective, informed choices. It also makes it easier for financial institutions and underlying economic entity to select the most favourable rating.

The low correlation may be something that is addressed as the broad regulatory architecture and taxonomies become better established. In the meantime, the FCA should be conducting its own research so it is better informed on what should be a crucial issue.

The FCA should:

- Investigate urgently why there is such a low correlation between ESG ratings and publish the results of that analysis.
- Identify the potential detrimental impacts on investor decision making created by the low correlation between ESG ratings.
- Assess the potential for conflicts of interest created by users being able to select favourable ESG ratings methodologies.
- Promote consistent methodologies for ESG ratings.

[194] ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk) Risk of harm, p13

Part 3:
Conclusion and summary of recommendations

Conclusions

We conclude from our assessment that we do not yet have in place the necessary policy and regulatory framework and architecture, and regulatory objectives, tools, and culture to align financial market behaviours with climate goals. Specifically, we lack:

- A comprehensive, high-level policy framework which: fully recognises the role the financial sector plays in contributing to the climate crisis; establishes the necessary scale and appropriate mix of financial resources needed to finance the green transition; sets the appropriate policy goals; and provides the necessary direction and impetus at national level to align financial markets with climate goals.
- An effective legislative and regulatory architecture and framework to provide the direction, objectives, powers, duties and resources for financial regulators and other agencies responsible for implementing high-level policy goals.
- The specific regulatory tools that would effectively implement the high-level policy objectives and change financial market behaviours.
- The right regulatory culture and approach to drive the necessary behavioural change in financial markets. Parliament and government might provide the legislative framework and give regulators their objectives and powers. However, much will depend on how regulators interpret their roles and apply their powers.

Climate-related regulatory policy must address two separate yet 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. A related challenge is that policymakers and regulators do not know the scale of climate damaging assets held in each of the main financial sectors. To help target regulatory interventions, we first need an audit of the climate harm caused by the main financial sectors.

- Directing the ***flow*** of new money. The challenge for policymakers and regulators 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?

Reducing the stock of assets already held in climate damaging financial activities and directing new money into climate-supporting financial activities require specific policy and regulatory tools. The main categories of regulatory intervention that can be used to align market behaviours are:

prudential; conduct of business; reporting and disclosure based; and other more direct market behavioural interventions.

The appropriate regulatory tool to be deployed will depend on the financial sector and activity, e.g., bank and shadow bank lending, insurance and reinsurance, asset management, pension funds, financial intermediaries, and information providers. Our assessment has led us to conclude that the specific policy tools being used or considered by regulators will not cause the necessary behavioural change in financial markets. The interventions on the table do not reflect the gravity of the challenge or recognise the root causes of climate damaging financial activities. The current approach does not provide the necessary deterrence against continuing to finance climate damaging activities. There are concerns about the prevailing regulatory culture. Regulators do not seem minded to adopt the robust approach needed to change market behaviours and green the financial system.

We need a rethink by the main financial regulators on how to deploy prudential, conduct of business, disclosure and reporting, and market behaviour regulation across the key financial sectors and throughout the financial services supply chain from wholesale markets through institutional markets to retail financial services and ordinary consumers. Regulatory interventions should be deployed consistently across the sectors to avoid regulatory arbitrage.

Avoiding regulatory arbitrage is not just an important national UK issue. Post Brexit, the UK financial sector remains hugely influential at EU and international level. The government is developing a Green Finance Strategy to make the UK a leading Global Centre of Green Finance (GCGF). It remains to be seen whether the UK intends to make the UK competitive by deregulating and lowering standards or becoming a beacon of high standards on green finance. Will the UK drive up or drag down global standards?

Summary of FIC recommendations

The recommendations are intended to create the appropriate high-level framework, set the appropriate objectives for financial regulators, introduce effective policy and regulatory tools, and develop the right regulatory culture to change market behaviours.

High level policy recommendations

Global Centre for Green Finance - The government's plans for the GCGF will not make the UK a leading, trustworthy centre of socially useful green finance. The GCGF should be built on the following principles: foster genuine green financial innovation; ensure the financial system is systemically robust, stable, and protected against climate risks; promotes integrity and trustworthiness amongst its constituent financial institutions; and meets the highest standards of regulation, accountability, and transparency.

A Climate Funding Strategy and Plan - The government should produce a detailed government Climate Funding strategy and plan which sets out: how the government intends to implement the most sustainable and economically efficient means of funding the green transition; how it will ensure the transition is just and fair transition; and how, where, and when to best deploy available funding (public and private) to different sectors of the economy. The strategy and plan should contain details on: how the funding required to achieve the UK's aggregate net zero targets will be met, broken down by major economic sector; the timing of the deployment of funding with clear targets; the optimal mix of funding, the balance between current spending (direct charges, current taxation) and investment/borrowing; which government departments and other agencies (e.g. non-departmental public bodies, regulators, local authorities) will be responsible for coordinating the implementation of the funding strategy and plans; the expected balance between public and private sources of funding with justifications as to why one form of funding is being preferred over another (e.g. why more costly private finance is being relied on instead of more economically efficient collective state funding sources); how it intends to achieve a just and fair transition including how it will address regional and inter/intra generational fairness.

Equal status for climate related financial regulation - Climate related financial regulation should be given at least equal status to the other regulatory objectives such as financial stability, prudential regulation, financial market integrity, and consumer protection.

A new statutory environmental objective for the Bank of England - Given the seriousness of the challenge, we need to deploy whatever interventions it takes to ensure financial institutions (and those who run those financial institutions) are deterred from financing climate and environmental harm and are held to account if they do so. Therefore, we argue that the Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability. Regulators should have a statutory objective that ***positively*** requires them to take action to help achieve the UK's emissions reduction targets and Paris Agreement commitments of limiting global warming to 1.5 degrees.[195] The FCA, PRA, TPR, and FRC should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objectives.

Financial Conduct Authority high level responsibility - The FCA should be given responsibility for overseeing how financial institutions, listed companies and larger private companies, and employers' pension schemes disclose compliance with sustainable, responsible, and social impact (SRI) criteria. The FCA should be given responsibility for regulating ESG ratings and ratings providers.

Financial Reporting Council high level responsibility - The FRC should retain responsibility for ensuring the auditing of underlying economic activities meets regulatory requirements. Reporting on ESG compliance should be made a statutory requirement rather than voluntary, with appropriate sanctions for non-compliance with reporting standards.

Financial Sustainability Committee - The government and the Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate-related risks.

Sectoral climate de-risking transition plans - The proposed FSC should develop ***climate de-risking transition plans*** for each of the main financial sectors – banking, shadow banking, insurance and reinsurance, and asset management/pensions. These plans should have clear milestones and timeframes for climate de-risking each sector.

Public register of climate-critical financial institutions - The relevant regulators should establish a public register of climate-critical financial institutions within their remits based on the impact of these institutions on the climate and wider environment. Regulators should set climate de-risking plans for each climate-critical financial institution within their remits.

Risk based approach to climate related financial regulation - The FCA and PRA already operate a risk-based approach to financial regulation. That is, they identify financial institutions which present the greatest risk to their statutory objectives and prioritise their supervision and enforcement activities accordingly. The regulators should adopt a similar approach to climate-related financial

[195] Civil Society responds to Treasury's proposed financial sector reforms - The Finance Innovation Lab

regulation. They should identify financial institutions which present the greatest risk to the environment and robustly deploy the appropriate regulatory interventions.

FSC Annual Report - The FSC should publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

Economic and financial supply chains - There needs to be greater focus on supply chains in the economy.[196] The FRC and FCA should collaborate and increase their work on improving the standards of auditing in and reporting on compliance with climate goals in supply chains.

Pre-emptive and precautionary financial regulation - Historically, UK financial regulators have tended to follow a permissive approach to regulation, intervening only when there is evidence of harm that cannot be ignored. Progress in financial regulation tends to happen in response to crises and market failure. This is not the appropriate approach to climate risk. We do not have the luxury of waiting for events to reach the point of no return. We cannot rely on market dynamics to reveal and 'signal' the true cost of climate-related market failure or compel financial institutions to respond. Financial market behaviours will only align with climate goals if financial institutions are made to fully appreciate and recognise the cost of failing to do so. Therefore, we urge the financial regulators to adopt a more robust, and pre-emptive and precautionary approach to climate-related financial regulation.

Consistently applied climate related financial regulation - Specific sets of policy tools will be needed for banks/shadow banks, insurers, and asset managers/pension funds. Regulatory interventions must be deployed consistently across the board to avoid regulatory arbitrage.

Prudential regulation

Change of focus for financial regulators - The Bank of England/PRA focus on the *consequences* of climate change not the *causes*. This cannot be optimal given the role financial markets and institutions play in enabling climate-damaging activities. The regulators should reconsider this approach. It is for Parliament and government to set the appropriate objectives for regulators. Nevertheless, we urge the Bank of England and other regulators to send a strong, positive signal to Parliament and government that they recognise the need for financial regulation to support climate goals.

Solvency II and insurers - The government's intended deregulation of Solvency II to 'encourage' insurers to invest in green assets and levelling up will result in a reduction in consumer protection and undermine the security of people's pensions. This deregulation is unlikely to result in insurers investing in productive assets or stopping funding climate-damaging assets. We need a different approach. To redirect resources from climate-damaging assets, financial regulators should require insurers and reinsurers to have credible and demanding climate de-risking transition plans in place, with clear targets and timeframes. These de-risking plans are intended to both protect insurance policyholders from climate-related risks and to reduce the harm caused to the environment by investment decisions made by insurance companies.

Specific policy tools for insurers - Specific policy tools will be needed to implement transition plans. We very much support the idea that policymakers and prudential regulators should adopt the "One

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[196] The supply chain accounts for more than 90% of most consumer goods companies' environmental impact. For more detail see: [Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre]

for One" Rule. For each £ of resource that finances new climate damaging activities, insurers should hold a £ of their own-funds to be held as liability for potential losses. An alternative would be to adjust the 'own-funds requirement' by reference to an independent assessment of the climate damage caused by an economic activity. If government insists on retaining the use of the Matching Adjustment (MA) technical provision (see Annex A), then assets which contribute to climate damage should be excluded from assets eligible for MA portfolios. To deal with the stock of existing climate-damaging assets, insurers should be required to hold a proportion of own-funds against existing holdings. This proportion would be ratcheted up over an appropriate time frame to compel insurers to divest these assets in line with the transition plans described above. This should apply to assets already held in MA portfolios.

Banks and climate related financial regulation - Banks will need to be deterred from financing climate damage. So as with insurers, financial regulators should require banks (and other financial institution in the shadow banking sector) to have credible and demanding climate de-risking transition plans in place, with clear targets and timeframes, to reduce the financial system's exposure to climate-related risks and reduce the harm caused to the environment by banks and other financial institutions. The "One for One" Rule and treatment of existing climate damaging assets should also be applied to banks and financial institutions in the shadow banking sector.

Other Bank of England interventions - We support in principle the proposals outlined by Positive Money for the Bank of England to use its market influence including the use of a Green Term Funding Scheme and Green collateral frameworks.

Defined benefit pension schemes - TPR should require DB schemes to have credible and demanding climate de-risking transition plans in place, with clear targets and timeframes, to reduce the scheme's exposure to climate-related risks and reduce the harm caused to the environment by the scheme's investments. Versions of the 'One for One' Rule for banks and insurers outlined above should be developed for DB pension schemes. To ensure this has an effect, the value of additional funds needed to comply with the 'One-for-One' rule should be added to the scheme's liabilities and the sponsoring employer required to fund the scheme's climate-risk funding deficit.

Prudential regulation of defined benefit pension schemes - On a separate, but connected, issue we recommend that the prudential regulation of DB schemes be transferred to the Bank of England/PRA. The core principles of prudential regulation are similar for banks, insurers, and DB pension schemes. This would allow for a more consistent approach to systemic risk and prudential regulation generally (see the LDI crisis) and specifically to climate-related financial regulation.

Conduct of business, reporting and disclosure, and other policy tools

FCA's sustainable investment label proposals - The FCA's key initiative in this space is its proposals for a sustainable investment label for asset managers/investment funds. The principle behind a label is good. But we are concerned that the FCA's proposals will not help investors make effective decisions and choices, will not hold financial institutions to account for continuing to invest in climate damaging activities, or be effective at preventing greenwashing. 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; and potential inclusion of fossil fuels within funds that qualify for a sustainable label.

Confusion over funds with a green purpose/goals and social purpose/goals - The FCA's proposals for sustainable labelling conflate the different elements of ESG (green, responsible corporate behaviours, and social impact), confuse the purpose/goal of a fund with the approach the fund is following to meet those goals, and do not allow investors to see clearly how well funds are complying with stated goals. The FCA should rethink the architecture of its proposals to allow investors to distinguish more clearly fund with different goals.

Standardised template for disclosure - The FCA is not requiring asset managers to use a consistent, standardised template when disclosing climate related information at this stage. Instead, it is 'encouraging' the industry to 'consider developing a market-led template'. 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. The FCA must rethink that decision and take the lead in developing a standardised template which all asset managers must use.

Need for independent verification - The FCA is making a mistake in not requiring firms to obtain independent verification of their fund labelling. There is a risk that firms will end up marking their own homework. In addition, 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. The FCA must rethink this decision and require firms to obtain independent verification of labels.

Sustainability performance KPIs - Firms will be required to have sustainability KPIs which the FCA says must be credible, rigorous, and evidence based. But the FCA is not mandating the type of KPIs that firms must use. Firms will still be able to choose the KPIs they use to back up claims of sustainability performance. Firms can also monitor KPIs internally. As with the label itself, there is no requirement for independent verification. This is risky given the potential for conflicts of interest and the sheer proliferation of data and approaches available in the market. The FCA should mandate the type of KPIs to be used, and how these KPIs should be overseen and verified.

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.[197] The FCA's rules currently say that only one quarter of the members of a firm's governing body have to be independent. [198] 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. The rules on fund governance bodies should be changed to require at least half of the members to be independent.

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 and falls short of the approach adopted by the EU. Leaving large parts of the product market not covered by the proposals creates obvious risks. Therefore, the FCA should bring all other products within the labelling proposals.

Institutional investors/pension scheme trustees - The FCA is not mandating that firms use labels when marketing to institutional clients such as pension schemes. This is misguided. Pension scheme trustees do not receive the same protection from the FCA's Conduct of Business Rules because they

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

are treated as sophisticated clients. 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.[199] 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.

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. Including alerts when a product is based overseas is necessary but not sufficient. The FCA should require distributors and intermediaries to undertake due diligence on overseas products to be able to disclose to investors fund's climate alignment. If distributors and intermediaries are unable to perform due diligence, these funds should not be distributed.

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.[200] 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. But allowing fossil fuels to be included in a fund marketed as green cannot make sense. Any fund promoted as sustainable should not be allowed to include fossil fuel assets within its portfolio.

Market Impact and Social Impact - We are concerned that the FCA's proposals on Sustainable Impact labelling would enable 'impact washing' to occur. Therefore, we argue that a fund marketed as social impact which also seeks to produce market returns cannot be classified as a genuine social impact fund. For example, funds could invest in Low Middle-Income Countries (LMICs) and buy up assets cheaply and make a huge return but still claim it is making an impact. This is clearly different to a fund that is willing to make a financial sacrifice in pursuit of social goals.

There should be a clear distinction between what we term Market Impact funds and Social Impact funds even though both intend to deliver a social impact. We define a Market Impact fund as one which invests for social impact but still expects to make a market return. A Social Impact fund is one which seeks to address social issues that would not be addressed by the market or issues which the state is unwilling to address and is willing to make a financial sacrifice in the form of forgoing returns.

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.

A clear fund rating system and climate health warnings - The FCA's approach to labelling is confusing. The FCA should introduce a clear system which allows investor to clearly distinguish funds

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

that have a green goal from those that have a social goal (e.g., around fair treatment of workers). To help investors identify how well investment funds meet those goals, there should be a clear rating system using, say, a colour coded symbol or star ratings. Asset managers should have to disclose a green rating for all funds. Any fund which contains certain assets such as fossil fuels should not be allowed to be marketed as green. Funds claiming to be 'transitioning' should set clear targets and publish independently verified progress against those targets. Funds with a poor rating should carry a clear climate health warning.

If the FCA insists on allowing asset managers to choose whether to submit a fund for rating, the regulator should at least require those funds not submitted to carry this climate health warning. Worked examples of how an FIC label would be constructed can be found in the report. Note that this approach could work for all types of investment fund/portfolio and for bank loan books.

Existing ESG funds - The FCA's proposals on labelling, if significantly improved, could help prevent greenwashing going forward. But they do not deal with the risk that greenwashing may have already been happening in the UK. There has been a significant growth in the number of funds in the ESG sector yet the sector has not so far been directly supervised. Detriment tends to 'follow the money' in financial services. So, it is reasonable to expect that in these conditions, there is a significant risk that greenwashing has already happened. 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 or thematic review of existing funds that claim to be 'ESG' or 'ESG-aligned'. The FCA should assess whether the rise in interest in ESG funds has resulted in firms rebranding funds as ESG aligned or unreasonably emphasising a fund's 'greenness' without significantly changing the fund's assets.

Recommendations on defined contribution (DC) pension schemes - Specific interventions are needed for DC schemes. Sponsoring employers and scheme trustees should be required to submit their scheme(s) to be green rated by an independent ESG rating agency based on the model outlined above for investment funds. The scheme's green rating should be published and compared to an appropriate market benchmark to promote accountability to pension scheme members. If the scheme has a poor green rating, the sponsoring employer and scheme trustees should be required to explain that poor rating to scheme members and produce a plan for improving the scheme's green performance. Scheme trustees should be required to produce climate de-risking transition plans. Pension scheme members should be consulted on these transition plans with these plans subject to approval by scheme members.

Other interventions to ensure financial institutions take climate change seriously -

The scale of the climate crisis facing us means we need to deploy whatever interventions it takes to ensure financial institutions, and those who run those financial institutions, are deterred from financing climate and environmental harm, and are held to account if they do so. Even if prudential regulations do work, we need to avoid regulatory arbitrage. Disclosure-based regulatory interventions do not have a good track record in financial markets and services. So, we need additional regulatory interventions to close regulatory gaps and bolster disclosure-based interventions.

There is a clear contrast between the attitudes adopted by policymakers and regulators towards issues such as market abuse, financial crime, fraud, money laundering, terrorist financing, politically exposed persons, and evading sanctions, and financing climate damage. Climate harm must be given at least equal status. The key is to make sure there is a price to pay for continuing to finance climate damaging activities, so the rewards are no longer attractive. There are number of potential options.

These interventions would apply to all types of financial institutions including those covered by prudential regulations.

A publicly accessible Climate Harm Register - Central to effective interventions is the existence of centralised, trustworthy data on the level of environmental harm caused by companies in the real economy. We recommend the government establish an independently operated, publicly accessible Climate Harm Register. The Register would contain: the details of the level of emissions generated by publicly listed and larger private companies, and sovereign countries; the source of those emissions (i.e. which activities of the company generate the emissions); and the geographical location of those emissions. This should be complemented with information on wider environmental harm. This data should be audited with the auditing overseen by the FRC. The worst performing economic entities on the Register should be included on an Environment Sanctions List.[201] The Environmental Harm Register and Sanctions List would be maintained by the FCA. The Register would allow for better prudential regulation and for meaningful labels to be created. It would also enable progress against transition plans to be monitored and reported on allowing government and relevant regulators to implement remedial action.

A fund climate-penalty - With this intervention, investment funds and pension funds (not covered by prudential regulation) would be required to pay a penalty for investing in or continuing to hold assets in companies that damage the climate and wider environment. Reference would be made to the public Climate Harm Register and Sanctions List. If a company which scored a poor rating on emissions issued a corporate bond (with a return set above market averages to attract new finance), then a fund which invested in that bond would pay a climate-penalty to reduce the net return received. Similarly, if a fund continued to hold shares in companies with poor emission ratings and those shares outperformed a benchmark index over a defined period (say three years), then a climate penalty would be paid. These penalties would be paid to government or to finance other activities to support efforts to green the financial system, e.g., independent research agencies.

Direct fines and sanctions - Another approach would be to apply direct fines and sanctions to financial institutions that continue to provide and arrange finance for companies or bonds of sovereign countries that have the worst ratings on emissions. Sanctions could involve the removal of regulatory permissions. The public Register and Sanctions List would enable government and FCA to specify a list of companies and sovereigns which would attract fines and sanctions.

Board level/senior management responsibilities and remuneration - Financial institutions do not run themselves; they are run by boards and senior managers who guide the organisation, make the key business decisions, and set the culture of the organisation. So, if we want to address the climate harm caused by climate-critical financial institutions, there must be professional and financial consequences for the people who continue to allow the financial institutions they run to damage the environment. To do this, we make the following recommendations:

- The Senior Managers and Certification Regime (SMCR) should apply to a financial institution's climate-related financial activities including sanctions for failing to comply with a new climate-related responsibility.[202]

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[201] 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.

[202] Senior Managers and Certification Regime | FCA

- A new responsibility for those covered by the SMCR should be introduced to consider the impact of a firm's activities on environmental sustainability and to take reasonable steps to reduce that impact.[203]
- A nominated non-executive director (NED) should be responsible for ensuring oversight of the firm's climate-related financial activities including ensuring that climate de-risking transition plans are executed within the agreed timeframes.
- For those covered by the SMCR, the performance in respect of complying with the proposed climate responsibility should be considered when individuals require approval to work at senior level in the financial services industry.
- Information about any enforcement decisions made against an individual covered by the SMCR for failing to comply with the new climate responsibility should be included in the directory of certified and assessed persons on the Financial Services Register.[204]
- When considering remuneration of boards and senior management, it should be mandatory for independent assessment of performance against climate responsibility and climate de-risking plans to be included in the calculation of the remuneration.

Data, ratings, and reporting and the role of the FRC

The final set of recommendations relate to the need for robust foundational data and reporting on the underlying economic entities which financial institutions finance and the role of ESG data and ratings agencies.

Climate Harm Audit - Currently, we do not know which specific financial sectors and activities are enabling the greatest harm to the environment. As a priority, the FSC and FCA should produce an audit of the climate harm caused by each of the major financial sectors. This should be done on a preliminary basis using existing data on emissions generated by underlying economic entities which financial institutions finance/lend to, invest in, and insure. Once better data and a UK Taxonomy is available, this audit should be more comprehensive. This audit should provide the baseline for the FSC and regulators to measure and report against progress towards climate de-risking the financial sector.

The role of the FRC

Climate and environmental responsibility statements - Trustworthy, meaningful and usable climate reporting and disclosure included in company reports and accounts will be critical. The FRC will play a major role in meeting this challenge. If stewardship means creating sustainable benefits for the environment, then we need evidence that this happening. The FRC needs to ensure that independent, objective evidence on the degree to which economic entities are contributing to the environment or harming the environment is put into the public domain. If reporting and disclosure is to have maximum impact, the information and data contained within reports must be clear and minimise the chances of misinterpretation and/or obfuscation. This will require new climate and environmental responsibility statements. These statements should set out clearly and prominently the following, with sources of verification:

- independently audited data on emissions generated by the company's activities

[203] 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
[204] Financial Services Register | FCA

- independent assessment of the degree to which the company's activities are aligned with the definitions in the UK Green Taxonomy (when finalised)
- a comparative assessment of the company's performance against an appropriate benchmark
- data should be published at a consolidated economy entity level and at geographical/regional/division level to allow for assessment of the contribution the company's different activities make to its overall performance
- explanations of how the company's activities are contributing to climate and wider environmental harms
- a risk assessment of which of the company's activities is making the greatest contribution to climate and environmental harm and the actions the company is taking to address those risks

Qualifying company accounts - Auditors should have to state whether they: i. stand by their view that statements in a company's report and accounts relating to the environment are true, fair, and not misleading; or ii. do not stand by those statements either because they disagree with the conclusions or that there is insufficient independent information to allow that judgment to be made. If it is the latter, the report and accounts should be qualified.

New professional standards on climate reporting - The FRC and relevant industry representative bodies for auditors, accountants, and actuaries should urgently develop meaningful, new professional standards with regards to identifying, quantifying, and reporting on climate related risks. The FRC should incorporate these standards in assessments of whether enforcement action should be brought for breach of professional standards.

The role of ESG ratings and ratings providers agencies

It is important that financial regulators begin to assess financial institutions' performance on the basis of the impact of their behaviours and decisions on the environment, rather than the impact of climate change on financial institutions. Independent, objective ratings are critical. Regulators need to address conflicts of interest exist in the ESG ratings market. With ESG ratings there is a strong incentive for financial institutions to actively select a ratings provider that produces inflated ESG ratings. It is not reasonable to expect retail investors or pension fund trustees to be able to challenge the methods used by individual ratings providers. Nor is it sensible to think that competition will drive up quality and integrity of ratings. Indeed, if anything the fiercer the competition, the greater the risk of ratings inflation.

Statutory regulation of ESG ratings and ratings providers - The FCA has already said that it would welcome taking over the regulation of ESG ratings providers. But it is in the gift of HM Treasury to extend the FCA perimeter and without it the FCA cannot press ahead with regulation. We urge HM Treasury to give the FCA the powers to regulate ESG ratings and ratings providers as quickly as is possible.

ESG voluntary Code of Conduct - The FCA has announced the formation of a group to develop a Code of Conduct for Environmental Social and Governance (ESG) data and ratings providers on a voluntary basis.[205] The group is to be known as the ESG Data and Ratings Code of Conduct Working Group (DRWG). The objectives of the DRWG are to develop (i) a comprehensive, proportionate and

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

globally consistent voluntary Code of Conduct for ESG data and ratings providers, and (ii) a recommendation on ownership of the Code. The FCA says the work of the DRWG is built around four outcomes. These are: 1. Transparency; 2. Good governance; 3. Robust systems and controls; and 4. Sound management of conflicts of interest.

But, in our view, these are not outcomes. These are inputs and processes which, if followed, might create the right outcomes. We argue that these outcomes do not get to grips with the challenge of assisting and informing trustees, financial intermediaries and other investors. We therefore argue that the following are a much better set of objectives and outcomes. The Code should ensure:

- The production of ESG ratings that are trustworthy and meaningful, and of a consistently high standard, analysed by providers that operate to the highest standards of integrity and not subject to conflicts of interest
- Investors are able to make effective, informed decisions relating to ESG factors
- Positive behaviours and practices are promoted and climate damaging activities are deterred and punished
- Financial institutions and financial intermediaries use ESG ratings and the Code responsibly

Governance of the Code of Conduct - The Terms of Reference of the DRWG[206] state that two industry groups, the International Capital Market Association (ICMA) and the International Regulatory Strategy Group (IRSG), will serve as the Secretariat. This Secretariat will appoint the members of the DRWG. The DRWG will be co-chaired by industry representatives, and composed of stakeholders including investors, ESG data and ratings providers, and rated entities. The FCA envisages that the group will consist of between 15-18 members. Yet only three of the positions are to be reserved for academics and civil society representatives. The FCA, HM Treasury, the Bank of England, the Financial Reporting Council, and other relevant financial regulators and government departments will be in the FCA's words 'active observers, offering their views, where deemed appropriate'.

The FCA intends that meetings will be conducted under the Chatham House rule. Comments, dialogue and feedback within the DRWG's meetings will not be attributable to individuals or the organisations they represent or with which they are associated. The Chatham House rule will also apply in any situation where a formal conversation occurs relating to the work of the DRWG.

The FCA also says the DRWG should set out its recommendation on the ownership of the Code. So, the industry dominated DRWG will be able to recommend which body should be responsible for hosting and maintaining a voluntary Code.

Developing a meaningful code of practice on ESG ratings while we wait for statutory regulation is critical. However, we remain very sceptical about the ability of the DRWG, so heavily dominated by industry representatives, to deliver a meaningful Code of Conduct.

The terms of reference of the DRWG are too weak. It is unacceptable that such a group is dominated to such an extent by industry vested interests. The whole set up comes across as all a little too cosy and could even furnish government ministers with an excuse not to require full regulation. We propose a different approach.

- The FCA must be more than observers on this group. It must take the lead to ensure this DRWG acts in the public interest. The FCA should chair this group or ensure that it is chaired

[206] ESG Data and Ratings Code of Conduct Working Group: Terms of Reference (fca.org.uk)

by an independent person, not industry representatives. It cannot be right that a Secretariat run by the industry also appoint the members of the DRWG. The FCA should appoint the members and ensure that half of the DRWG members are independent civil society representatives.

- The FCA cannot allow this DRWG, as constituted, to determine ownership of the Code. The regulator must approve the recommendation of Code ownership.
- To build trust in the DRWG, and ultimately in any code of practice, the workings of the group should be open to public interest representatives. The Chatham House Rule should *not* apply except when there are genuine issues of commercial confidentiality being discussed. The Secretariat should publish in advance the agenda of forthcoming meetings and actively invite public interest representatives to make written contributions and oral representations at meetings. Minutes of the meetings should be approved by the FCA and published on the FCA website.
- The FCA appears to be silent on what happens if ESG data and ratings providers fail to comply with the Code, or indeed fail to sign up to the Code. We must consider how ESG data and ratings are used as well as produced. The FCA does not discuss what might happen if end-users of ESG data and ratings such as asset managers/investment funds abuse the intention of any Code.
- Obviously, this is a voluntary, not statutory code so the FCA itself does not have the powers to enforce compliance or sanction breaches. However, some form of sanction will be needed to ensure this voluntary code is not abused. Therefore, the DRWG should be required to consider appropriate deterrents and sanctions for abusing the spirit and letter of the Code.
- In addition, the FCA needs to make it clear that end-users of ESG data and ratings should consider whether the provider they use complies with the Code and disclose upfront to investors whether the provider complies with the Code.
- Of course, this would all depend on whether the Code itself was of a sufficiently high standard. Allowing a ESG data/ratings provider to publicise that it complies with a flawed code would mislead investors. Similarly, allowing asset managers/investment funds to use the fact that the ratings supplier complied with a flawed code in marketing and promotions would mislead investors. Therefore, the FCA should urgently prepare guidance for issuance on the use of ESG data and ratings alongside the development of the new Code of Conduct.
- In addition, it is worrying that the FCA does not seem to think that the low correlation between the ESG ratings provided by different agencies is a problem.[207] The FCA should: investigate urgently why there is such a low correlation between ESG ratings and publish the results of that analysis; and identify the potential detrimental impacts on investor decision making created by the low correlation between ESG ratings. It should assess the potential for conflicts of interest created by users being able to select favourable ESG ratings methodologies. The regulator should promote consistent methodologies for ESG ratings. It is not reasonable to expect end-users to compare and contrast underlying methodologies or sensible to rely on competition between ESG providers to drive up standards. This needs direct regulatory intervention.

Financial Inclusion Centre
February 2023

[207] ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk) Risk of harm, p13

Glossary

Institutions

Prudential Regulation Authority (PRA) – As part of the Bank of England, the PRA is responsible for the prudential regulation and supervision of around 1,500 banks, credit unions, building societies, insurers, and major investment firms. The PRA creates policies which require financial firms to maintain sufficient capital and adequate risk controls. (Bank of England, 2022)

Financial Conduct Authority (FCA) – The FCA works alongside the PRA to regulate the conduct of 50,000 firms in the UK. Firms and individuals are authorised or registered with the FCA, allowing the authority to ensure financial markets are honest, competitive, and fair. (FCA, 2022)

The Pensions Regulator (TPR) – TPR is a public body sponsored by the DWP that aims to protect workplace pensions in the UK. This is achieved, for example, by making sure employers put their staff into a pension scheme (automatic enrolment) or that decisions made on behalf of savers are in their best interests. (TPR, 2022)

Financial Reporting Council (FRC) – The FRC promotes transparency and integrity by regulating auditors, accountants, and actuaries so investors who rely on company reports know they are not being misled. (FRC, 2022)

The Competition and Markets Authority (CMA) – The CMA is an independent non-ministerial department that promotes competition, ensuring only the most consumer-focused and innovative businesses succeed. This is done by investigating mergers and entire markets to ensure there is enough competition. If there is not, the CMA will act against anti-competitive behaviour to ensure the protection of consumers from unfair trading practices. (GOV.UK, 2022)

HM Treasury (HMT) – HM Treasury is the government's economic and finance ministry. The HMT maintains control over public spending and is responsible for developing and executing economic and public finance policies. (GOV.UK, 2022)

Department for Work and Pensions (DWP) – The DWP is a ministerial department responsible for welfare, pensions, and child maintenance policy. For example, the DWP is responsible for ensuring safe working conditions and providing a decent income for people of pension age. (GOV.UK, 2022)

Department for Business, Energy, and Industrial Strategy (BEIS) – BEIS is a ministerial department which backs enterprise and long-term growth to encourage economy-wide transformation. This is to generate cheaper, cleaner, homegrown energy. (GOV.UK, 2022)

Bank of International Settlements (BIS) – Established in 1930, The BIS acts as a bank for central banks by supporting the pursuit of monetary and financial stability through international cooperation. (BIS, 2022)

Basel Committee on Banking Supervision (BCBS) – The BCBS is the primary global standard setter for the prudential regulation of banks. BCBS provides a forum for cooperation on banking supervisory. (BIS, 2022)

International Organisation of Securities Commissions (IOSCO) – The IOSCO, established in 1983, is the international body, recognised as the global standard setter for the securities sector. This commission develops, implements, and promotes adherence to internationally recognised standards for regulation. (IOSCO, 2022)

The International Association of Insurance Supervisors (IAIS) – IAIS, established in 1994, is the global standard-setting body which develops and assists the implementation of principles, standards, guidance, and materials for insurance sector supervision. (IAIS, 2022)

The International Standards Organisation (ISO) – The ISO, established in 1946, is an independent, non-governmental international organisation. To support innovation, this organisation brings together experts to develop voluntary, consensus-based, market-relevant international standards. (ISO, 2022)

The International Reporting Standards Foundation (IFRS) – The IFRS is a not-for-profit organisation established to develop high-quality, understandable, enforceable, and globally accepted accounting and sustainability disclosure standards (IFRS Standards). (IFRS, 2022)

The International Capital Markets Association (ICMA) – ICMA works to promote the development of the international capital and securities markets with principles, rules, and recommendations for successful operation. (GOV.UK, 2022)

The International Sustainability Standards Board (ISSB) – The ISSB is one of the two-standard setting boards for the IFRS, which sets IFRS Sustainability Disclosure Standards. These standards provide investors and capital market participants with information about sustainability-related risks and opportunities. (IFRS, 2022)

European Commission (EC) – Established in 1958, the EC is politically independent of the EU. The European Commission promotes the general interests of the EU by implementing policies and proposing and enforcing legislation. (European Commission, 2022)

European Supervisory Authorities (ESAs) – The ESAs are comprised of three authorities, EBA, EIOPA, and ESMA. These authorities work on harmonising financial supervision by developing a single set of prudential standards for financial institutions in the EU. (European Central Bank, 2022)

The European Occupational Pensions and Insurance Authority (EIOPA) – The EIOPA is an EU financial regulatory institution which contributes to the effectiveness and stability of the financial system to protect the public interest. This is done by promoting a regulatory framework. (EIOPA, 2021)

The European Securities Markets Authority (ESMA) – The ESMA is an independent EU authority that contributes to safeguarding the stability of the EU's financial system by protecting investors and promoting stable and orderly financial markets. This is achieved by assessing risks, providing a rulebook, and supervising credit rating agencies. (ESMA, 2022)

The European Banking Authority (EBA) – The EBA is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision. This is achieved by providing a rulebook, promoting convergence of supervisory practices, and assessing risks in the EU banking sector. (EBA, 2022)

European Financial Reporting Advisory Group (EFRAG) – EFRAG, established in 2001 as a private association, serves the European public interest in both financial and sustainability reporting. This is achieved by ensuring IASB's standard setting process considers European views. (EFRAG, 2022)

The Financial Stability Board (FSB) – FSB is an international body that monitors and makes recommendations about the global financial system. The board coordinates national fiscal authorities and international standard-setting bodies to develop strong regulatory and supervisory policies. (FSB, 2022)

Initiatives and regulation

Capital Requirements Regulation (Directive) – The CRD is an EU legislation that covers rules for the prudential regulation of authorised banks (credit institutions). (Bank of England, 2022)

Solvency II regime – The Solvency II regime, implemented in 2016, sets out regulatory requirements for insurance firms, covering: financial resources, governance and accountability, risk assessment and management, supervision, and reporting. (Bank of England, 2022)

2015 Paris Agreement – The Paris Agreement is an international treaty on climate change adopted at COP21 in 2015. This Agreement set out to limit global warming to below 2 degrees Celsius. (United Nations, 2022)

The Climate Change Act 2008 – This act set a target to reduce the emissions of carbon dioxide and other greenhouse gases by 2050. This approach ensures that climate change risks are adapted to. (Climate Change Act, 2022)

Green Finance Strategy – This strategy was set out in 2019 to provide a comprehensive approach to greening financial systems, mobilising finance for clean and resilient growth. (GOV.UK, 2022)

Future Regulatory Framework (FRF) Review – FRF was established to consider how the financial services regulatory framework should adapt to the UK's position outside of the EU, ensuring framework is fit for the future. (GOV.UK, 2022)

COP26 – Conference of the Parties (COP)26 is the most recent annual UN climate change conference. This conference is used to discuss and establish climate change targets. The main goal was to achieve global net zero by 2050 and keep global warming at a maximum of 1.5 degrees Celsius.

National Adaptation Programme (NAP) – The NAP sets the actions the government will take to adapt to challenges of climate change. This programme covers: natural environment, industry, infrastructure, people and the built environment, and local government sectors. (GOV.UK, 2022)

Integrated Sustainability Disclosure Requirements (SDR) – SDR intends to create an integrated, streamlined framework requiring real economy companies to report their sustainability risks, opportunities, and impacts. (FCA, 2021)

Task Force on Climate-Related Financial Disclosures (TCFD) – The TCFD was created by the FSB to develop recommendations on the types of information that companies should disclose to support investors, lenders, and insurance underwriters. (TCFD, 2022)

Transition Plan Taskforce (TPT) – The UK Government mandated the TPT to develop a gold standard for transition plans. The initiative should help drive decarbonisation as it ensures companies and financial institutions prepare thorough plans to achieve net zero and tackle greenwashing. (TPT, 2022)

Terms of art

Socially Responsible Investment (SRI) – Strategy that considers the environmental, ethical, and social impact of investments as well as the financial return available.

Taxonomy – Set of criteria used to evaluate whether a financial asset will support given sustainability goals. (Ehlers et al., 2021)

Green Finance – This type of financing consists of a loan or investment that supports environmentally-friendly activity, for example, purchasing environmentally-friendly goods, services, or infrastructure.

Prudential regulation – Legal framework dedicated to financial stability and safety of institutions and broader financial systems. (APRA, 2022)

Systemic risk – The risk of collapse of an entire financial system or market as one event in a market triggers a more severe event elsewhere.

Regulatory arbitrage – A practice that firms use to capitalise on loopholes in regulatory systems to by-pass unfavourable regulations.

ESG – ESG stands for environmental, social, and corporate governance.

Greenwashing – Greenwashing is a form of misleading advertising or a claim which aims to persuade customers that the company's products, aims, or policies are environmentally friendly.

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Annexes

Annex A - Solvency II

Solvency II aims to protect consumers by making sure insurers have enough assets to pay claims (for example, to pay pension annuities in retirement) and hold enough money on their balance sheets to withstand financial shocks. The reforms the government is pushing through represent a significant reduction in consumer protection and will undermine the security of peoples' pensions.

As with banking prudential regulation, the Solvency II regulatory framework is built on a three-pillar structure:

Pillar I: this sets the *quantitative* requirements i.e., the valuation of the assets and liabilities held by firms and capital requirements to manage risks and absorb losses.

Pillar II: this sets the *qualitative* requirements, including governance and risk management of the firm's activities and the Own Risk and solvency Assessment (ORSA).

Pillar III: deals with *supervisory* reporting and public disclosure.

The core of Solvency II is that insurers should hold the appropriate amount and type of risk-based capital to protect against losses and protect consumers' interests. There are two key capital requirements – the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR) – which act as trigger points for interventions by regulators.[208] If insurers stay above the SCR, then regulators will not intervene for financial reasons. If insurers fall below the MCR, regulators may take the strongest actions, for example, the removal of the insurer's authorisation.

We have two primary concerns in relation to the proposed reforms of Solvency II and wider financial market reform.

- The prudential regulation of UK insurers and therefore consumer protection available to policyholders should be robust and maintain trust and confidence in the sector over the long term; and
- Market, prudential, and conduct of business regulation should align UK financial market behaviours with climate goals.

There are concerns that, post Brexit and post Covid, industry lobbies are using climate change and the need for economic recovery as 'Trojan Horses' to push for deregulation and they appear to be winning the argument. The core assertion is that current prudential regulation requirements inhibit their ability to finance green technology and infrastructure given how risks are currently defined.

The key area of concern on consumer protection relates to specific parts of Solvency II called the Risk Margin (RM) and the Matching Adjustment (MA).[209] The RM is an additional capital buffer which insurers are supposed to hold against the risk of financial loss. The government and insurers new plans reduce this capital buffer.

The MA allows insurers to 'bring forward' future returns on assets (often high-risk assets) held in their portfolios. Insurers are allowed to assume that expected returns on MA assets will be achieved and include these future returns as capital on their balance sheets. Because insurers can create this

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[208] For more details on the SCR and MCR see: [Solvency II GI 2016 (actuaries.org.uk)]

[209] For FIC submission to government and Bank of England/PRA consultation on Solvency II see here: [Submission to HM Treasury Review of Solvency II consultation | The Financial Inclusion Centre]

artificial capital, it means they have to hold less 'real' capital on their balance sheets against the risk of financial losses. This benefits shareholders at the expense of policyholders who are exposed to the risk that these higher returns do not materialise over time.

Due to this financial conjuring trick, the UK insurance sector looks stronger than it really is.[210] The current approach to regulation may be masking the true position of insurers – even before any reforms.[211] The scale of MA assets involved is already worrying. Total assets held in MA portfolios amounts to around £380bn. It delivers a capital benefit to insurers of £80bn – an increase of £20bn from £60bn when first introduced. That £80bn is more than two-thirds of the entire capital base of the life insurance industry of £112bn. For some specific insurers, the MA makes up the bulk of their capital.[212]

The inclusion of illiquid assets in MA portfolios can heighten the risk to policyholders. The proportion of assets in illiquid assets has already grown from 31 percent in 2018 to 41 percent in 2021.[213]

The widespread use of the MA to artificially create capital means there is an illusion of balance sheet strength in some of our major insurers. The UK approach to prudential regulation has already allowed the UK insurance sector to make far greater use of this artificial capital creating mechanism than its major EU competitor markets.

Yet government and insurers pushed regulators to allow to make even greater use of the MA with a wider range of assets to be eligible for inclusion in these MA portfolios. The Bank of England/PRA did push back on the demands for some elements of reform. The Bank was actually content to cede on the Risk Margin element of the proposed reforms but wanted to tighten up on the use of the MA.

But, the consultation feedback and various analyses suggest this quid pro quo sought by the Bank of England has been rejected by the government which has backed industry lobbying.[214] The government has supported the insurance lobby argument that if it was not allowed to take further advantage of the MA (as well as get the benefit from the RM), insurers would not invest in green assets/levelling up.[215]

The deregulation will mean a greater reliance on this artificial capital. It is not just traditional personal pensions/annuities that we need to consider. Employers have been transferring pension liabilities to insurers in very large volumes. In total, the Bank of England/PRA estimates that more than eight million policyholders are served by this sector. Pension transfers from employers to insurers are expected to grow even further as a result of the recent crisis in the gilts market and pensions sector. We are very concerned the reforms will undermine the long-term security of people's pensions.

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[210] A former Bank of England official described the Matching Adjustment as akin to allowing punters at a horse race to demand some of their winnings just before the race has started, on the grounds that the claimed winnings can be deemed to be certain. Capital created by matching adjustment is entirely artificial | Financial Times (ft.com)
[211] There are concerns that the use of the Matching Adjustment already artificially inflates the strength of the balance sheets of a number of major UK insurers. See: Regulation is masking the true condition of insurers | Financial Times (ft.com)
[212] Sam Woods Solvency II: Striking the balance – speech by Sam Woods | Bank of England and Regulation is masking the true condition of insurers | Financial Times (ft.com)
[213] HM Treasury, Review of Solvency II, Consultation, April 2022, para 3.6
[214] See: Consultation_Response_-_Review_of_Solvency_II_.pdf (publishing.service.gov.uk)
[215] Solvency II reform proposals need further work to meet objectives | ABI and Aviva explores using shareholder money to fund infrastructure projects | Financial Times (ft.com)

However, this project is not focused on consumer protection issues. We are interested in the impact of financial regulation on addressing the climate crisis. The connection with climate crisis is that a key reason the government and insurers give for amending the Solvency II rules is that this would ‘free up’ insurance company resources to invest in green assets and levelling up.[216]

Solvency II does not prevent insurers investing in the green transition or levelling. We believe the insurance industry claims about why they want reform of Solvency II are disingenuous and their demands are driven more by the desire to benefit shareholders rather than unlock capital for productive uses such as financing the green transition or levelling up.

We wish the government had called the insurance lobby’s bluff. Indeed, far from weakening Solvency II, we argue the state of the insurance sector warrants a toughening up of prudential regulation. The Bank of England/PRA should require those insurers who are heavily dependent on the MA to develop ***financial resilience transition*** plans to reduce reliance on the MA over a reasonable period.

It is not sensible to deregulate and weaken consumer protection in an attempt to encourage insurers to provide capital for the green transition – capital that is also much more costly than state funding. There are better ways to ensure insurers disinvest from climate-damaging assets and invest in climate-positive activities as we explain in the report.

[216] UK rewrite of insurance rules to ‘free up billions for investment’ | Financial Times (ft.com)

Annex B - Bank prudential regulation

The prudential regulation regime relating to banks is complex. At the international level, the Basel Committee on Banking Supervision (BCBS) set internationally agreed standards on the capital which banks should hold to absorb financial losses and manage risks. These Basel standards were implemented in the EU through the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD). However, since Brexit, the UK has had to implement the Basel standards through its own policy measures.[217]

Core to prudential regulation is the concept of 'regulatory capital'. This is a source of bank funding mostly in the form of equity that can absorb financial losses. The prudential regime sets minimum capital requirements based on the ratio of a bank's capital to its risk-weighted assets (RWAs). In this case, assets are the loans and other finance arrangements that generate revenue for banks. Given that different types of lending will be riskier than others, the RWAs are calculated by assigning different 'risk weights' to a bank's assets. A bank's liabilities are items such as the deposits held by consumers and businesses with the bank. Unlike, say, an investment fund where the value of an investor's holdings will fluctuate as the value of the underlying assets fluctuate, depositors do not expect to see the capital value of their savings fall below the amount they deposited.

According to internationally agreed standards set by the Basel Committee described above, banks must hold 'minimum capital requirements' and additional capital buffers or cushions so they can absorb losses in times of stress without breaching the minimum requirements.

In essence, the approach to bank prudential regulation is based on three 'pillars.[218] In the UK, the minimum capital requirements are covered by Pillar 1 and Pillar 2A. Pillar 1 is the core of this system and includes capital requirements to deal with credit, market, and operational risks. The capital requirements are calculated using models, stress testing and ratings. The PRA also sets Pillar 2 minimum capital requirements (known as Pillar 2A) to deal with material risks that are not fully covered under Pillar 1.

The PRA also sets a PRA buffer which is determined as part of the supervision process and is used to mitigate against external risk factors and/or where the regulator concludes that a firm's risk management and/or governance systems is significantly weak. This PRA buffer is known as Pillar 2B and is specific to the UK.

The third pillar relates to disclosure. Currently, banks and insurers have to publish information on material risks within their Pillar 3 disclosures and on principal risks and uncertainties in their Strategic Report as required under the UK Companies Act.

The way prudential regulation is structured means that regulators could influence banks' appetites for financing environment damaging assets by adjusting the amount of capital banks have to hold for doing so. For example, this could be done by applying the one-for-one rule described in the main report. This would help protect the financial system from climate risks and the environment from financial institutions' behaviours.

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217 PS22/21 'Implementation of Basel standards: Final rules' (bankofengland.co.uk)

218 For more details see: Climate-related financial risk management and the role of capital requirements (bankofengland.co.uk)

ANNEX C – FCA'S proposals on disclosure and sustainable investment labels

The FCA's proposals on disclosure cover:

- **Sustainable investment labels** to help consumers navigate the investment product market and enhance consumer trust.
- **Consumer facing disclosures** to help consumers understand the key sustainability-related features of products.
- **Detailed disclosures** targeted at a wider audience such as institutional investors and retail consumers seeking more detailed information including:
  - **Pre-contractual disclosures** covering the sustainability-related features of investment products.
  - **Ongoing sustainability-related performance information** including performance indicators and metrics in a sustainability product report.
  - **A sustainability entity report** covering how firms manage sustainability-related risks and opportunities.
- **Naming and marketing rules** limiting the use of certain sustainability-related terms in product names and marketing materials unless the product uses a sustainable investment label.
- **Requirements for investment product distributors** to ensure product-level information and labels is made available to consumers.
- **A general anti-greenwashing rule** this applies to all regulated firms and reiterates existing rules to clarify that sustainability-related claims must be clear, fair, and not misleading.

Sustainable investment labels

The FCA has reduced the number of labels it intended to use from five to three. Originally the FCA had proposed the following labels: 1. Not promoted as sustainable; 2. Responsible (may have some sustainable investments); and three 'Sustainable' blocks 3. Transitioning (low allocation to Taxonomy aligned sustainable activities); 4. Aligned (high allocation to Taxonomy aligned sustainable activities); and 5. Impact (objective of delivering positive environmental or social impact, a category in its own right).

The three labels it is now proposing to use are: 'Sustainable Focus', 'Sustainable Improvers', and 'Sustainable Impact'. The classification and labelling of the products is based on the 'intentionality' behind that product. The FCA is developing qualifying criteria for each label.

Sustainable Focus: invests in assets that are environmentally and/or socially sustainable

Sustainable Improvers: invests in assets that aim to improve the environmental and/or social sustainability of assets over time, including in response to the stewardship influence of the firm

Sustainable Impact: invests in solutions to environmental or social problems, to achieve positive, real-world impacts.

Table 7: Criteria for each label

Sustainable Focus	Sustainable Improvers	Sustainable Impact
The firm must ensure that at least 70% of the product's assets either meet a ***credible*** standard of environmental and/or social sustainability or align with a specified environmental and/or social sustainability theme. The FCA states that a credible standard is one that is robust, independently assessed, evidence based and transparent.	The firm must ensure that the product is invested in assets that have the potential to become more environmentally and/or socially sustainable over time, including in response to active investor stewardship.	The sustainability objective must be to achieve a predefined, positive, measurable real-world environmental and/or social outcome. The firm must specify: a theory of change, in line with the product's sustainability objective, emphasising how its investment process aims to contribute to addressing either environmental and/or social problems; a robust method to measure and demonstrate that its investment activities have had a positive environmental and/or social sustainability impact; its escalation plan should the real-world outcome no longer plausibly be achievable, including potential divestment of assets.

The FCA intends to require firms to specify credible, relevant, rigorous and evidence based KPIs that measure a sustainable investment product's ongoing performance towards achieving its sustainability objective; and monitor the product's performance against its sustainability objective on an ongoing basis with reference to the specified KPIs.

There are other requirements relating to: governance and due diligence, and stewardship; and communicating to consumers. However, the key to the proposals is the system of classification, labelling and related criteria.

Disclosures

The government intends to introduce SDR across all sectors of the economy as part of its Roadmap to Sustainable Investing. A key part of the FCA's proposals in the consultation paper relate to disclosure requirements applying to asset managers. The government's Roadmap also set out plans for SDR to include disclosures measured against the UK Green Taxonomy. The UK Green Taxonomy has not yet been developed. Advice is being provided to the government by the Green Technical Advisory Group (GTAG). GTAG has only just provided the first tranche of advice so it may be some time before the UK Taxonomy is ready to be used. Once the UK Taxonomy has been developed, the FCA has said that it intends to consider how it might update its rules to include disclosures relating to the Taxonomy.

The FCA proposes to introduce two levels of disclosure: consumer-facing disclosure and more detailed disclosure requirements to help inform other market participants.

Consumer-facing disclosures will provide a summary of a product's key sustainability-related features. These disclosures are intended to complement the labels described above and help consumers compare similar products or the same product over time and hold the provider to account for its sustainability claims.

The consumer-facing disclosures are meant to summarise the information disclosed in the detailed product-level disclosures. The FCA is proposing that firms must include the following categories of disclosures: basic information about the firm and product; the product label with a brief description of what it means; the sustainability goal; the sustainability approach; 'unexpected investments' – information about investments that the firm would 'reasonably expect' consumers of the product to find surprising to be included in the product; information on the sustainability metrics/KPIs; and signposting to other relevant disclosures.

It is worth noting that the FCA is not intending to specify a particular template for firms to use as it does not want to be too prescriptive. Instead, it 'encourages industry to consider developing a market-led template'.

Detailed disclosures will provide more granular information and will be aimed at institutional investors and a broader range of stakeholders. These will be located in pre-contractual disclosures, a sustainability *product* report, and a sustainability *entity* report. There is a lot of detail contained in these proposals.[219]

The FCA intends that detailed product-level disclosures will be made in two forms of existing documentation, depending on the information being disclosed:

- Pre-contractual disclosures: fund prospectus, prior information document
- Sustainability product report (this builds from the TCFD product report)

A significant issue to note is that the FCA intends that the pre-contractual disclosures and sustainable product report will apply only to products that qualify for a sustainable investment label. This means that firms that continue to sell investment products that might be contributing to climate harmful activities will not have to explain themselves to the public.

The FCA does not intend to include requirements that are aligned with the EU SFDR's 'Do No Significant Harm' approach which requires disclosure on how a sustainable investment does not significantly harm the sustainability objective. Again, the FCA considers that this may be too restrictive.

The FCA proposes that firms produce ongoing, dedicated sustainability product reports on the sustainability-related performance of products. This builds from the TCFD product report. The key elements are details of the investment policy and strategy, and the product's performance against its specified KPIs.

Asset managers who are in scope of the FCA's proposals will be required to produce detailed *entity-level* reports. These reports will build on the four-pillar structure of the TCFD recommendations with detailed disclosure requirements on governance, strategy, risk management, and metrics and targets. We look at these in more detail below.

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

The FCA says its proposals at this stage are a starting point for sustainability-related disclosure. As the ISSB develops further standards on additional sustainability topics, the regulator intends to build on its initial requirements, adding sustainability metrics at product level and more specificity to disclosure requirements at entity level. The FCA says it has also taken into account other sustainability-related disclosure requirements such as the EU SFDR and proposals from the SEC in the US to support international coherence to the extent appropriate.

Naming and marketing

The FCA is also proposing to introduce restrictions around names and marketing of investment products aimed at retail investors, that do not qualify for one of the sustainability labels outlined above. There are many products currently promoted as 'ESG integrated' or which employ strategies such as exclusion/negative screening or 'tilt' towards ESG. The regulator is concerned that these products would not necessarily qualify for the proposed new labels and if firms were allowed to continue to market products as being ESG-aligned or sustainable, this could mislead consumers and undermine the value of the new labels.

To address this risk, the FCA is proposing to prevent firms selling in-scope products to retail investors that do not qualify for and use one of the sustainable labels from using terms such as 'ESG' (or 'environmental', 'social' or 'governance'), 'climate', 'impact', 'sustainable' or 'sustainability', 'responsible', 'green', 'SDG' (referring to the UN's sustainable development goals), 'Paris-aligned' or 'net zero' in their product names and marketing. Note that these prohibitions do not apply to products sold to institutional investors as the regulator does not think this is proportionate at this stage.

A general anti-greenwashing rule

Potentially, the most powerful proposal is the intention to introduce a general anti-greenwashing rule for all FCA-regulated firms. This would require all regulated firms to ensure that the naming and marketing of financial products and services in the UK is clear, fair, and not misleading. The naming and marketing should be consistent with the sustainability profile of the product or service. The application of this proposal to all regulated firms is also intended to capture firms that approve financial promotions for unauthorised persons.

There are already rules in place relating to information being clear, fair, and not misleading. Yet rather than rely on these general rules, the FCA concluded that a specific rule relating to sustainability claims was necessary to allow it challenge firms on potential greenwashing. This could be a very effective tool but only if enforced robustly with sanctions for breaching rules.

The role of distributors

The last part of the FCA's proposals relate to the role of distributors in financial services. Distributors are defined as those who offer, sell, recommend, advise on, arrange, deal, propose or provide a product or service. This includes financial advisers and investment platforms that allow retail investors to compare and invest in multiple investment products.

The FCA is proposing that for in scope products, distributors should display the relevant sustainable investment label. Where products do not use a sustainable label, distributors will still have to provide retail investors with access to the consumer-facing disclosures.

For now, the FCA key proposals apply to products based in the UK. They do not apply to overseas products which may be sold to UK retail investors. The FCA intends to publish separate proposals for dealing with overseas products at some stage in the future. For now, the FCA intends to rely on warnings to retail investors. The FCA intends to prohibit the use of certain sustainability-related terms in the naming and marketing of in-scope UK products. UK retail investors may still be sold overseas products using those terms. The FCA intends to require distributors to place a notice on those products to alert retail investors that the product is based overseas and is not subject to the labelling and disclosure requirements, with a hyperlink to the FCA's webpage which explains the labelling and disclosure requirements.

Pensions and other products

It is worth noting that the FCA has decided not to apply the above proposals to pensions and other products such as exchange traded funds at this stage. It is still considering how it might bring those vehicles into the scope of the new regime. This is in contrast to the approach adopted by the EU which covers a much more comprehensive set of financial products and activities.

The FCA's future work

The FCA intends to undertake much further work in this field, particularly as other UK and global initiatives are developed. The proposals outlined above apply to a particular set of products sold under certain circumstances and are limited to retail investors.

The regulator is seeking to expand the regime in the following areas:

Overseas products - The FCA is working with HM Treasury to consider options for how to treat overseas products and intends to follow with a separate consultation on how the proposals outlined above might apply to those products.

Financial advisers - Intermediaries such as financial advisers could play a potentially significant role in influencing consumer and market behaviour. The FCA is exploring how to introduce rules for financial advisers aimed at confirming that they should take sustainability matters into account when giving investment advice to consumers and understand consumers' preferences on sustainability to ensure the advice is suitable. A separate consultation is promised though with no date specified as yet.

Institutional investors - The FCA says that its proposed labels are primarily aimed at helping consumers navigate the market and protecting them from greenwashing. It also says that firms ***may also choose*** to label products offered to institutional investors.[220]

Listed issuers - Listed issuers are companies which list securities – in this case on the London markets. The FCA intends to consult on adapting its TCFD-aligned disclosure rules for listed issuers to reference the ISSB's standards once those standards have been finalised and made available for use in the UK. This is consistent with the Government's expectation that the ISSB standards will form the 'backbone' of the corporate reporting element of SDR. More generally, as well as proposing interventions aimed at the retail investment market, the FCA is considering how to integrate environmental, social and governance (ESG) into UK capital markets. A key part of its ESG Strategy is to promote integrity in the market for ESG-labelled securities supported by the growth of service providers – which would include providers of ESG data, ratings, assurance, and verification services. This would be an important building block of any system to help investors and other users such as pension schemes check the claims made by issuers and financial institutions with regards to sustainability performance. As outlined above, loan portfolios, investment funds/products, insurance products, and pension funds are made up of loans to/holdings in individual company bonds and shares. The integrity of any rating or labelling system intended for end-users such as savers, investors, insurance policyholders, or pension scheme members ultimately depends on the integrity

[220] CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), para 3.2

of the data relating to individual companies within those portfolios. The old adage 'rubbish in in, rubbish out' is very apt.

ESG data and rating providers - As it stands, the FCA does not regulate ESG data and ratings providers. This would require HM Treasury to extend the regulatory perimeter to bring providers within the regulator's remit. If this does happen, the FCA would develop and consult on a regulatory regime with a focus on outcomes in areas highlighted in IOSCO's recommendations including transparency, good governance, management of conflicts of interest, and systems and controls.

Yet even if HM Treasury does agree to extend the perimeter, it will take some time before any new regime would take effect. In the meantime, the FCA intends to work with HM Treasury to support and encourage industry participants to develop and follow a voluntary Code of Conduct to address the type of issue outlined above. [221] There is the danger that a voluntary Code of Conduct could be used as an excuse not to bring providers within statutory regulation. We now have details of the industry-led voluntary code and can see lots of opportunity for industry participants with commercial relationships to effectively mark their own homework.

Disclosure of transition plans - The FCA intends to build on its TCFD-aligned disclosure rules, which refer to the TCFD's guidance on transition plans. In doing so it will draw on the outputs of the Government's Transition Plan Taskforce (TPT).

Taxonomy-related disclosure requirements - The FCA will consider how to update the product-level disclosure requirements to include relevant disclosures once the UK Green Taxonomy has been developed.

Sustainability-related metrics - The FCA will build on the product-level disclosure requirements and add a baseline of core sustainability-related metrics for firms to disclose in relation to all products. This will evolve further as ISSB sustainability disclosure standards are developed.

Entity-level disclosures - The regulator also intends to build on the entity-level disclosure requirements. It will add more specificity and granularity to disclosure requirements for different sustainability topics in line with the development of future ISSB standards.

[221] ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk)

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