# FINANCIAL INCLUSION CENTRE DISCUSSION PAPER

# PREVENTING SOCIAL IMPACT WASHING

**Summary**
As part of its work on the environmental, economic, and social utility of finance, the Financial Inclusion Centre recently published a major report called *The Devil is in the policy detail – will financial regulation support a move to a net zero financial system?*[1] We concluded that current climate-related financial regulation would not align financial markets with net zero goals. The FCA's Sustainability Disclosure Requirements (SDR) and sustainable investment label initiative[2] is confused and confusing. It is unlikely to be effective at exposing funds that finance climate harm or preventing greenwashing.[3] We also highlighted the weaknesses in ESG ratings.

That report focused on environmental issues. However, we were also concerned that *social impact washing*[4] has not received the same degree of scrutiny as its 'twin', greenwashing. The FCA's proposals on SDR and sustainable investment labels are nowhere near robust or clear enough to prevent social impact washing.

The whole approach to ESG ratings promoted by policymakers, regulators, and the industry is fragmented and inconsistent. It is too narrative based which allows for obfuscation on the part of funds and asset managers. ESG ratings providers are not regulated and ratings methodologies can produce very different results for the same financial institutions/products. There are too many opportunities to game the ESG ratings market to overstate how ESG compliant products are.

For too long, policymakers and regulators have let the market determine the evolution of sustainable finance and ESG products and ratings. Is it too late to get at least part way 'back to basics', and to introduce some discipline and rigour? Let's hope not.

On the environmental side, the focus should be on hard data (independently verified) on the amount of climate damage financial institutions are enabling, with a clear data-based, rating system.[5] This is crucial if the financial sector is to be held to account for enabling climate harm.

On social sustainability, the goal should be to expose the degree of 'social harm' enabled by funds and identify funds that make a genuinely positive social impact. The FCA should apply strict criteria to prevent social impact washing. For example, we argue that only financial institutions willing to sacrifice financial returns in pursuit of social goals should be allowed to describe their funds and products as socially sustainable. Similarly, funds investing in companies that treat workers fairly or pursue progressive polices on gender pay equality should not expect any special praise. Doing what is expected should be the norm.

This paper sets out our concerns about social impact washing using illustrative case studies and proposes an alternative disclosure and rating system to hold financial institutions to account.

[1] The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre
[2] FCA updates on its Sustainability Disclosure Requirements (SDR) and investment labels consultation | FCA
[3] In simple terms greenwashing refers to organisations making misleading claims about the positive contribution a fund/ product makes to the environment, or indeed downplaying the negative impacts on the environment.
[4] Social impact washing relates to organisations making misleading claims about the positive contribution a fund/ product makes to social goals (improving workers' rights, tackling gender inequality etc), or downplaying the negative impact.
[5] For example, a colour coded system or 1 – 5 stars based on the degree of climate harm being financed. The Portfolio Greenness Ratio outlined by the European Securities and Markets Authority (ESMA) provides a useful template ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu) The FCA's own analysis shows that objective grading systems influence investors' decisions In this case, a medal based system – bronze, silver, gold – was tested. See: Sustainable investing: objective gradings, greenwashing and consumer choice | FCA Insight.

**Introduction**
One of the key initiatives in the field of sustainable finance relates to FCA's Sustainability Disclosure Requirements (SDR) and investment labels. Sustainable finance in this case refers to finance that takes environmental or social factors into consideration when decisions are being made. Recently, the FCA issued a Discussion Paper DP21/4 [6] followed by a Consultation Paper CP22/20[7] setting out proposals on how investment firms should classify assets and disclose compliance with sustainability goals, and for a sustainable investment label to help retail investors make informed choices. A detailed critique of the FCA's proposals can be found in *The Devil is in the policy detail* report and in our submission to the FCA's consultation document.[8]

We would also note that one matter identified in our paper was the FCA's focus on funds rather than the wide array of products underpinned by funds or portfolios which can range from huge life funds, pension mandates, pension products of many sorts, multi-asset portfolios and indeed Exchange Traded Funds. Any system should not be restricted to funds, but we refer to funds subsequently for ease of reading. It does require clarification or a wide range of products, vehicles, strategies, portfolios and products including many which contain funds could be accidentally applying labels, come under a different regime or indeed be left out altogether.

**FCA's sustainable investment label proposals are confused and confusing**
The FCA is proposing to use three labels: 'Sustainable Focus', 'Sustainable Improvers', and 'Sustainable Impact'. The classification and labelling of the products is based on the intentionality behind that product rather than the ***objective*** or ***goal***[9] of the product. The FCA has proposed qualifying criteria for each label.

**Sustainable Focus** Invests in assets that are environmentally and/or socially sustainable. The firm must ensure that at least 70 percent 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.

**Sustainable Improvers**: 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.

**Sustainable Impact**: Invests in solutions to environmental or social problems, to achieve positive, real-world impacts. The sustainability objective must be to achieve a predefined, positive, measurable real-world environmental and/or social outcome.

As we explain in the *Devil is in the policy detail* report, funds branded as being sustainable might contain investments with green goals and/or social goals. The FCA is not proposing to have separate labels for funds with green goals and funds with social goals. We think this is a major mistake and will cause confusion. The FCA's proposals would make it harder for investors to clearly identify those funds/products with green goals and those which aim to tackle social issues.

[6] DP21/4: Sustainability Disclosure Requirements and investment labels | FCA
[7] CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels | FCA
[8] Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre
[9] For example, to have a positive impact on the environment, or on social issues.

The FCA is clear that its proposals do not suggest any hierarchy between the labels. This is a very strange attitude. It is precisely the opposite to what is needed. To ensure meaningful corporate accountability, society should be able to see the degree to which financial institutions are responsible for financing climate and social harm, and financial institutions ranked on that degree of harm. This is in line with investor preferences. The FCA's own analysis shows that objective grading systems influence investors' decisions.[10] It is almost as if the FCA is unwilling to require financial institutions to disclose objective data on how much harm they enable to the planet and people.

Similarly, the terms Sustainable *Focus, Improvers, and Impact* are unlikely to carry much meaning and be effective in helping investors make decisions that reflect their preferences and values. To be fair, with the Focus label, there is at least a minimum threshold of 70 percent qualifying assets. This could help those investors who insist on a high degree of compliance with green or social goals. Yet the way the FCA proposes to implement the sustainable label conflates green and social goals. Requiring a fund/product to contain 70 percent of assets that meet what is a vague definition of environmental or socially sustainable isn't much help, especially given that the FCA is not requiring financial institutions to obtain independent verification of claims.

The Improver and Impact categories are especially vague and practically meaningless. With the Improver category, how can an investor be expected to know whether the assets held in a fund/product have the potential to become more environmentally and/or socially sustainable over time, or if stewardship will cause a company's management to change its mind? It will have to rely on the financial institution that provides the fund/product for reassurance. This will be very difficult given that the FCA is not requiring independent verification of the sustainability 'performance'.[11]

With the Impact category, surely any fund that invests in environmentally or socially sustainable assets that fund is already aiming to make an impact? It is difficult to see what this category adds to what the Focus category means to convey.

The FCA does not appear to require minimum thresholds for the Improver and Impact labels. A minimum threshold system would require that X percent of the assets in a fund/product must be considered 'improver assets' or 'impact assets' for the fund/product to qualify for a Sustainable Improver or Sustainable Impact label.

It would be clearer and much easier to understand if there was a quantitative, data-based rating system that ranked funds according to the degree of climate or social harm they were financing. As mentioned above, the FCA's own analysis shows that objective grading systems influence investors' decisions.[12]

Some investors will only want to choose funds that already have a high degree of compliance with green or social goals and intend to maintain that level of compliance. The Focus label could be useful to those investors if it was separated into green and social categories, and the methods for verifying

[10] See: Sustainable investing: objective gradings, greenwashing and consumer choice | FCA Insight In this case, a medal based system – bronze, silver, gold – was tested.

[11] At least with financial performance the investment returns generated by the assets in a portfolio can be measured with a degree of certainty as prices are quoted on various established stockmarkets.

[12] In this case, a medal based system – bronze, silver, gold – was tested. See: Sustainable investing: objective gradings, greenwashing and consumer choice | FCA Insight.

compliance claims was significantly improved. However, a rating system would still be better than a single Focus category.

Other investors will be willing to take a gradual approach, building up their investment in environmentally or socially sustainable assets over time. Or they might be content with a 'blended' approach holding funds with a proportion invested in environmentally or socially sustainable assets. The split between compliant and non-compliant assets would depend on investors' preferences. A rating system would allow 'improver' investors to see clearly which funds are actually improving over time. A rating system would enable 'blended' investors to spot funds that most closely matched their preferences. The FCA's approach would not allow for that.

Of course, there is something of 'a rose by any other name'[13] to fund category names. It is not the name of the fund categories that matters most, it is the substance. But, it is important that the definitions are consistent and reflect how investors consider their own preferences and make decisions. Clear definitions are needed to 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 – the opposite of what they are ostensibly trying to achieve.

**FCA's approach would not address social impact washing**

As mentioned, social impact washing has not received as much attention as greenwashing. When we refer to social sustainability, we mean funds or products that aim to tackle social issues such as workers' rights in supply chains, gender inequality, economic regeneration, financial inclusion and so on, not environmental issues.

We are concerned that the FCA's proposals are not drawn tightly enough to prevent social impact washing. The conditions for allowing funds and products to be described as socially sustainable must be more specific.

We would argue that certain specific and interrelated criteria should be met before a fund (or the activities of the underlying entity the fund invests in) can be described as socially sustainable. The fund (underlying entity) should:

- Be willing to sacrifice financial returns in pursuit of social goals.
- Exceed expected standards of corporate behaviour – financial institutions and underlying economic entities should not get credit for merely doing what society expects of them.
- Substitute the role of the state in a way that enhances aggregate social utility, and without state subsidies.
- Comply with the 'do-no-harm' principle. That is, it should ensure that activities aimed at benefiting one community do not result in harm to other vulnerable communities. This is particularly relevant for funds that invest in companies that may be located in one region, say the UK, but which sell products or services in other countries around the world.

[13] '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

Below, we explain in more detail what these criteria entail, illustrated with case studies to challenge the FCA's proposed approach. As outlined above, we do not think the FCA's approach to SDR and the use of the sustainable Focus, Improver, and Impact categories will be effective at helping investors make informed decisions and holding financial institutions to account for enabling environmental and social harm. We set out an alternative approach, below. However, the criteria for qualifying as socially sustainable set out in this paper would also improve the meaning and efficacy of the FCA's Focus, Improver, and Impact categories.

**Sacrificing financial returns**
A key question is whether funds that qualify for a social sustainability label should be allowed to generate market or above market returns, or aim for a below market financial return.[14]

We would argue there is a fundamental difference between funds that are content, or even expect, to sacrifice financial returns in pursuit of social goals and those which seek to make a market return while complying with social expectations regarding corporate behaviours. With the former, the fund is clearly prioritising addressing social issues and is willing to make a financial sacrifice to do so. In the latter case, the fund expects to make at least a market return while doing no more than is expected by society.

By way of illustration, let's take the case of how to help non-profit lenders improve access to affordable loans to take on loan sharks, or address problem debt in a community. One approach might be for a social impact fund to provide grants or no-interest loans to non-profit community organisations to provide emergency support to the most vulnerable members of a community or to cross subsidise affordable loans. For these social impact investors, the main concern is the impact they are having on communities – the financial return is a secondary consideration.

This is different to investors who expect at least market returns alongside having an impact. There is the argument that these investors did not have to commit investment to this particular asset class and that they could have generated returns by investing in other activities. However, if they thought they would not have generated at least market returns, then it is unlikely they would have been willing to invest. Social impact is not the dominant motivation.

What about investors who invest in new technology that claims to change how credit risk is assessed and would make lenders more willing to provide credit on market terms to hitherto underserved households? This investment can certainly be said to be having a market impact, but can it be said to be having a significant social impact?

There is no doubt that some consumers would now be included in a market where previously they were excluded. So, it can be said to be having a social impact of some sort. But, this technology would not change the principles underpinning market-provided consumer credit. If technology such as this did genuinely change risk assessment models, market return seeking investors would still want it to be deployed to maximise financial returns. They would still want to target those households which offered the best combination of high profits and low risk. Again, in this case, maximising the risk adjusted return is the priority.

[14] For a description of impact investing and different attitudes to returns see: [What You Need to Know about Impact Investing | The GIIN]

Looking at the FCA's proposals, would the regulator allow funds that provided capital to non-profit community organisations on *market* terms, or invested in new credit risk assessment technology to use the label sustainable Impact?

There is a more fundamental point here. Many technological innovations that have generated huge profits for investors can also be said to have had a social impact eg. innovations in telecommunications or pharmaceuticals. In some cases, the initial innovators and entrepreneurs may well have been driven by a social purpose. Yet would we really classify subsequent investments by financial institutions to bring these innovations to the mass market as driven by a social impact motive rather than the profit motive?

Allowing a definition of social sustainability that doesn't require sacrificing of financial returns would allow financial institutions far too much leeway to camouflage conventional return-seeking investment decisions as socially sustainable and encourage impact washing.

As another example, let's take a fund that invests in low-middle income countries (LMICs) where assets can be bought cheaply, but the asset managers believe prospects for economic growth and investment returns are good? The fund provider could argue that this investment is having a social impact as it creates jobs. But, can it really be said that social impact is the primary motivation here rather than spotting potentially undervalued assets to generate high returns for investors? Would the FCA allow this fund to be classified as sustainable Impact?

Similarly, what about an investment fund or insurance company that invests in building social or private rented accommodation but also aimed to generate a market-matching or market-beating returns? In this case, financial institutions are able to exploit the fact that the state is no longer meeting a social need (to ensure there is sufficient affordable housing for citizens) to generate market returns for investors. Would the FCA allow this investment to be called social Impact?

**Exceeding expectations of corporate behaviour**

Linked to the above point about attitudes to financial returns is society's expectations of corporate and market behaviour. Should financial institutions expect to be rewarded just for complying with the standards of behaviour expected by society for example on gender pay equality or fair treatment of workers?

To use a simple analogy, as citizens we do not expect special treatment or rewards/awards for complying with the basic standards of behaviour expected by society or required by the law. Society does reward citizens who do go beyond what is expected of them. Society penalises or sanctions citizens who fall short of those standards.

How should this apply to financial institutions? If a financial institution invests in companies that do treat workers fairly or have policies in place to address gender pay gaps, while aiming for a market or above market return, that is to be welcomed. But does the financial institution deserve special praise or reward for just doing what is expected? Not doing harm is not the same as doing good. We would argue that doing what is expected should be the norm, not the basis for reward. Would the FCA allow a fund that invests in companies that meet societal expectations and also seeks a market returns to be branded as a sustainable Impact fund?

**Substituting the role of the state, attitudes to risk**

The third criteria we think should apply before a fund[15] can use the label sustainable relates to risk taking and the role of the state.

Let's take for example a regeneration fund that invests in companies which set up business in economically deprived areas of the country and also wants to deliver market rates of returns for investors. The investee companies will often only set up business in deprived areas if the state underwrites the risk or subsidises development costs. The fund managers might claim that this is a socially sustainable investment activity. But is economic and social impact really the motive rather than state supported financial returns? Would the company itself have invested without state support? Would the fund have invested in those companies without state support to underwrite the risk of market returns not being delivered to shareholders? Would the FCA allow this type of 'regeneration' fund to be branded as sustainable Impact?

For various reasons, the state has reduced the provision of core public and social services in certain areas. Charities and other non-profits have tried to fill the gap or services have been 'outsourced' by central and local government. Increasingly, private investors have shown an interest in working in 'partnership' with non-profits to deliver services once provided by the state or see direct investment opportunities in providing those services.

Can we really describe a fund that makes a market return for investors as a result of the state withdrawing from the provision of services as having a social impact? Is the fund adding to overall social utility? We would argue not, especially if the private investors expect to receive some form of cross subsidy or tax advantage, if the cost of financing those services is higher using private finance[16], or if the private investors make returns by exploiting vulnerable workers.

Would the FCA allow a fund set up to invest in care homes with the aim of matching or beating market returns to be classified as sustainable Impact? This fund would seek to generate market returns for investors by taking advantage of the fact that the activity is 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. Moreover, there are real concerns about the treatment of workers in the social care sector. [17]

Looking at financial services products, financial institutions use risk-based pricing to determine whether consumers can access consumer affordable credit or insurance. Those consumers who do not meet these risk-based criteria will be forced to use high cost credit or insurance, priced out of the market, or just denied access altogether. Moreover, the state may be unwilling to fill the gap by providing the affordable products consumers need. Of course, the market will supply products – at a price. Would the FCA allow a fund that expected to make market returns by investing in consumer credit providers who were willing to supply high-cost credit to hitherto excluded consumers to be classified as social impact?

[15] Or whether individual assets within a fund can be classified as sustainable

[16] Remember, the state can finance services at lower cost than private finance. Private finance expects returns in excess of the risk free rate. These higher returns have to be paid for somehow.

[17] See for example, Exploitation of migrants is rising as care homes struggle to fill jobs | Financial Times (ft.com)

**The 'do-no-harm' principle**
We would also argue that funds claiming to be socially sustainable should ensure that their financial activities aimed at benefiting one community do not result in harm to other vulnerable communities. This condition can apply to funds that invest in the UK. The example of investing in care homes is a case in point. An asset manager might claim a fund which invests to provide social care is social impact. But, can it really be called that if it makes returns by exploiting workers?

However, the 'do no harm' principle is particularly relevant for funds investing in companies that many be located in one region, say the UK, but which sell products and services for use in other countries around the world.

For example, how would the FCA's approach accommodate a fund which invested in shares in an arms manufacturing company which decided to set up in a deprived region of the UK but sold those arms to oppressive regimes in other parts of the world? Or a technology company that set up in a UK deprived region but sold their technology to oppressive regimes to spy on citizens? The fund might be said to be having a positive social impact by financing job creation in deprived regions. Yet those companies' revenues are generated by activities which clearly harm other vulnerable people.

**A better approach to SDR and investment labels**
As outlined above, we think the FCA's approach to SDR and investment labels is confused and is confusing. It is unlikely to hold financial institutions to account for continuing to finance climate damaging activities, or be effective at preventing greenwashing.

On the social sustainability side, the FCA's proposals are too vague to allow investors to distinguish clearly between those financial institutions who genuinely prioritise making a social impact by enhancing social utility and those who want to wrap conventional return-seeking financial activities in a social impact 'flag of convenience'. We doubt very much if the FCA's proposals will be effective at preventing social impact washing.

What can be done? For too long, policymakers and regulators have let the market determine the evolution of sustainable finance and ESG products and ratings. Is it too late to get at least part way 'back to basics', and in introduce some discipline and rigour? Let's hope not.

On the environment side, the priority now should be on producing hard data (independently verified) on the amount of climate damage financial institutions are enabling, with a clear data-based, rating system.[18] This is crucial if the financial sector is to be held to account for enabling climate harm. Note that an objective rating system could be applied more widely to bank loan books and insurance funds, not just investment funds. At a later stage, if a meaningful UK taxonomy ever does emerge, a rating system could accommodate other wider environmental factors such as preserving biodiversity.

On the social sustainability side, the goal is to identify and expose funds that enable social harm (eg. investing in companies that exploit supply chain workers) and identify funds that make a genuinely

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[18] For example, a colour coded system or 1 – 5 stars based on the degree of climate harm being financed. The Portfolio Greenness Ratio outlined by the European Securities and Markets Authority (ESMA) provides a useful template ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu) The FCA's own analysis shows that objective grading systems influence investors' decisions In this case, a medal based system – bronze, silver, gold – was tested. See: Sustainable investing: objective gradings, greenwashing and consumer choice | FCA Insight.

positive social impact, thereby improving the social utility of finance. The definition of social sustainability needs to be drawn much more tightly with rigorous screening criteria used to distinguish genuinely social impact financial activities from social impact washing activities.

To reiterate, to be categorised as ‘socially sustainable’, the fund (underlying entity) should:

- Be willing to sacrifice financial returns in pursuit of social goals.
- Exceed expected standards of corporate behaviour – financial institutions and underlying economic entities should not get credit for merely doing what society expects of them.
- Substitute the role of the state in a way that enhances aggregate social utility, and without state subsidies.
- Comply with the ‘do-no-harm’ principle. That is, it should ensure that activities aimed at benefiting one community do not result in harm to other vulnerable communities. This is particularly relevant for funds that invest in companies that may be located in one region, say the UK, but which sell products or services in other countries around the world.

In terms of rating funds, there are two possible approaches. One approach would be to use a rating system similar to the environmental rating system with a positive and negative scale. Funds which held a high proportion of assets in entities which meet strict qualifying criteria on social sustainability would receive a positive rating. Funds with a high proportion of assets in entities (corporate and sovereign assets) which do not comply with meaningful standards on social sustainability would attract a negative rating. The input data eg. the size of the gender pay gap, policies on paying a real living wage, and compliance with international labour standards would need to be independently verified and disclosed in reports and accounts of the investee entities.

The alternative would be to use a more limited approach and only allow funds which meet a high threshold of compliance with the qualifying social sustainability criteria to use the social sustainability label. For example, 70 percent of a fund’s assets would need to meet the criteria. This would align with the FCA’s sustainable Focus category.

Of course, civil society organisations could still investigate and expose financial institutions that invest in or finance companies that, for example, abuse supply chains or fail to address gender pay inequality.

The system we propose isn’t perfect. There will be funds and activities that cannot be accommodated by the social impact framework criteria we set out in this paper. The criteria and their application would need revision. But, the current system the FCA is developing is unlikely to work. It is confused and confusing and will enable social impact washing. We hope this short paper at least prompts a debate and some rethinking on a crucial issue.

**Financial Inclusion Centre**
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