FCA Discussion Paper DP23/1

Finance for positive sustainable change: governance, incentives, and competence in regulated firms

Submission by The Financial Inclusion Centre

About The Financial Inclusion Centre

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

Promoting system level change

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

Ensuring households' core financial services needs are met

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

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Introduction

The Financial Inclusion Centre is pleased to submit a response to this important Discussion Paper. As we argue in our major policy report, The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre the current approach to financial regulation will not be sufficient to align financial market behaviours with environmental and social goals. The UK financial sector continues to finance, at scale, economic activities which harm 'people and the planet'. Financial institutions which do so are not being held to account.

The main issue on the environmental side is that protecting the environment from finance is not given anywhere near the same status in regulation as other objectives such as protecting consumers, maintaining financial stability, market integrity, preventing money laundering or the financing of terrorism. We argue that financial regulators should be given a primary statutory objective in relation to climate change underpinned by a comprehensive robust set of policies to change the behaviours of financial institutions.

On the social impact side, much stricter criteria on the definition of social impact or social sustainability are urgently needed to prevent social impact washing. Preventing social impact washing | The Financial Inclusion Centre

There is a significant amount of work needed to align financial markets with environmental and social goals. Addressing governance, incentives, and competence in regulated firms could play an important role. But, it is very important that the FCA and other regulators do not rely on a market led approach or try to incentivise change. Regulatory interventions aimed at *encouraging* positive behaviours and cultural change do not have a good track record in other areas of financial markets. There is little reason to expect that this approach will be that effective in realigning financial market behaviours with respect to environmental and social goals. Disclosure aimed at exposing adverse behaviours and practices along with tough regulatory interventions will be needed to constrain market practices that continue to cause environmental and social harm.

Responses to specific questions

Q1: Should all financial services firms be expected to embed sustainability-related considerations in their business objectives and strategies? If so, what should be the scope of such expectations? Please explain your views.

Yes. For the very simple reason that UK financial services continue to finance at scale economic activities that cause harm to the environment and social goals.

On the environment side, it is difficult to see how the UK can achieve the transition to net zero unless financial market behaviours are aligned with green goals. Financial markets are made up of individual financial firms, so stopping the financing of climate damaging activities requires addressing the behaviours of individual firms.

Similarly, on the social impact side, financial institutions continue to finance and reward economic actors which do not comply with the standards society expects on issues such as fair treatment of

workers (either direct employees or in the supply chain). Moreover, if financial institutions are to drive positive behavioural change in investee companies then those financial institutions have to also demonstrate that they are committed to and complying with the same standards.

Q2: Beyond the FCA's ongoing work on diversity and inclusion, and introduction of the Consumer Duty, should we consider setting regulatory expectations or guidance on how firms' culture and behaviours can support positive sustainable change? Please explain your views.

Good culture and behaviours will only be embedded across the market if the regulator ensures that boards of individual financial institutions understand clearly there will be a penalty for not having a good corporate culture or enabling financial behaviours and practices, and business models that harm the planet and people. The regulator needs to ensure that institutions who continue to behave irresponsibly do not gain a competitive advantage from doing so.

Therefore, if the FCA wants to drive positive sustainable change, it should adopt an approach which penalises adverse behaviours. Deterrence is much more effective than encouragement or incentives. If the market knows there is a penalty for adverse behaviours, then positive cultures will emerge from that.

Q3: What steps can firms take to ensure that they have the right skills and knowledge relating to material climate- and sustainability-related risks, opportunities and impacts on their boards? Should we consider setting any regulatory expectations or guidance in this area? If so, what should be the scope of such expectations?

It is a matter for the boards of individual firms to determine where the specific skill and knowledge gaps are. But, yes, the FCA should set regulatory expectations and requirements on these issues. These are specialist issues and, as with any other complex issue, it is important that the right expertise and knowledge exists at board level.

The best way to require firms to take these obligations seriously is for the FCA to make sure there is a penalty for failing to do so. A robust approach to deterrence will focus the minds of boards and ensure they prioritise acquiring the right skills and knowledge.

Q4: What are likely to be the most effective strategies in embedding climate- and sustainability-related considerations across a firm's operations? What is the potential benefit of initiatives such as the appointment of functional 'champions', or the creation of dedicated working groups or forums? And how can the value of such initiatives be enhanced?

Initiatives such as 'champions', working groups, and forums will be helpful in operationalising enhanced and meaningful standards throughout firms. But, of course, the most effective way to ensure climate and sustainability-related considerations are embedded across a firm's operations is to make it clear that this is a board level responsibility.

Q5: What management information does senior management use to monitor and oversee climate- and sustainability-related developments, and to monitor progress against public commitments? Should we set expectations or guidance for decision-making processes, including systems and controls, audit trails and the flow of management information to key decision-makers? If so, what should be the scope of such expectations?

Yes, the FCA should introduce requirements, not just set expectations, as to the type of data and information collected and analysed, how this is reported to the board, and the actions required by the board in response to failures to meet targets revealed by the data.

There is always the risk of data and information being sanitised as it makes its way up the management chain to the board. Therefore, the FCA should make it clear that it is the board's responsibility to ensure that the right information is collected and to take responsibility for the integrity and relevance of data and information.

But, there is a much bigger challenge in relation to data and monitoring. A rethink of the approach to market monitoring and disclosure is required. In our *Devil is in the policy detail* report referred to above, we make a series of recommendations on meaningful disclosure and transparency on environmental and social issues including:

- The FCA and other financial regulators should produce a baseline audit and subsequent regular audits 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.[1] This baseline audit is needed to monitor progress against transition plans at a market and sectoral level. But, it would also provide benchmarks for boards of individual firms to assess their performance on environmental and social goals.
- Boards of individual financial institutions should be required to conduct and publish audits of their own environmental harm performance using the same approach outlined above. Once better data and a UK Taxonomy is available, a more comprehensive environmental audit should be undertaken. But, we should not wait for a UK Taxonomy to introduce enhanced disclosure on portfolio emissions. This should be a priority.
- 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. Boards of individual financial firms should be required to produce climate de-risking plans and report publicly against those 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 climate de risking plans for each environment-critical financial institution within their remits.
- 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

[1] The Portfolio Greenness Ratio approach adopted by ESMA provides a very useful template [ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)]

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.

- For social issues, a meaningful equivalent to the portfolio greenness ratio is not available. However, it is still possible and desirable to require firms to measure and disclose what proportion of the assets contained in investment funds, pension and insurance funds, and loan books comply with high social standards. For example, it would be possible to identify the proportion of underlying economic entities (corporate or sovereign) in portfolios that sign up to meaningful codes of practice on supply chain practices or adhere to standards on human rights, gender pay equality, real living wage and so on. But, of course, it is important that financial firms are not allowed to select metrics that paint their compliance with social goals in a favourable light. The reference data used to measure levels of compliance, the use of that data by boards of financial firms, and the producers of that data needs to be overseen by the FCA.
- The Sustainability Label being developed by the FCA could also provide a useful benchmark for boards of individual firms to assess their performance on environmental and social goals. But, the approach to the label needs to be reconsidered if it is to be useful. As we set out in Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre the FCA should: require independent verification of sustainability 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.
- The role of ESG ratings and ratings providers will be critical for allowing boards to measure performance and for holding boards to account for that performance. It is encouraging that the FCA wants to take on responsibility for regulating ratings and providers. Until this happens, as an interim measure, the FCA is establishing a working group, the ESG Data and Ratings Code of Conduct Working Group (DRWG), to develop a voluntary code of conduct on ESG ratings. We have serious concerns about the limited remit of this DRWG. 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.
- The governance of the DRWG is very weak and dominated by industry representatives. 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 FCA should require institutional users to disclose upfront to investors whether the ESG ratings provider they use complies with the Code. 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.

- Worryingly, the FCA does not seem to think the low correlation between the ESG ratings provided by different agencies is a problem. 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.

Q6: Should we consider setting new regulatory expectations or guidance on senior management responsibilities for a firm's sustainability-related strategy, including the delivery of the firm's climate transition plan? If so, which existing SMF(s) would be the most suitable to assume these responsibilities? Please explain your views.

Yes, the FCA should set regulatory requirements on transition plans. As mentioned above, in addition to the FCA developing sectoral transition plans, boards of individual financial firms should be required to develop and publish transition plans. Executing these transition plans should be a board responsibility.

Q7: Should we consider introducing specific regulatory expectations and/or guidance on the governance and oversight of products with sustainability characteristics, or that make sustainability claims – for example to clarify the roles and expectations of governing bodies such as Fund Boards? If so, which matters in particular would benefit from clarification?

Yes. Regulatory requirements should be introduced in relation to independent verification of labels, mandatory disclosure and formats for reporting templates and KPIs, and independent verification of claims of progress against transition plans. Rules should be amended to ensure half of fund governance body members are independent.

Q8: What matters should firms take into consideration when designing remuneration and incentive plans linked to their sustainability-related objectives? In particular, we welcome views on the following: a. the case for linking pay to sustainability-related objectives b. whether firms should break down their sustainability-related commitments into different factors, allocating specific weightings to each c. whether short-term or long-term measures are more appropriate, or a combination of both d. whether sustainability-related incentives should be considered for senior management only, or a wider cohort of employees e. how firms could consider remuneration and incentive plans in the design and delivery of their transition plans f. remuneration adjustments where sustainability-related targets (at either the firm level or individual level) have not been met. Please explain your views.

Q9: Should we consider additional regulatory expectations or guidance in any of the areas considered in Q8? Please explain your views.

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. 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. Sanctions for failing to comply with the new climate-related responsibility should be applied.

It should be mandatory for independent assessment of performance against climate de-risking plans to be included in the calculation of remuneration for boards and senior management. Failure to meet targets set out in FCA approved transition plans should affect remuneration. We do not agree with the idea of incentives. Deterrence is a more effective way of ensuring that good practice is embedded across the whole market.

Q10: Should we consider additional regulatory measures to encourage effective stewardship, particularly in relation to firms' governance and resourcing of stewardship, and associated incentive mechanisms and conflict of interest policies? Are there regulatory barriers that we should consider? Please explain your views.

The stewardship approach, particularly using a comply or explain basis, is not equal to the challenges we face trying to align financial market behaviours with environmental and social goals. The theoretical basis underpinning the stewardship approach assumes that there is some sort of natural alignment between the interests of financial markets and environmental and social goals. This is clearly not the case. That alignment has to be caused by regulatory interventions.

If we are to align financial markets with climate goals, board of firms need to understand there is a regulatory price to pay for continuing to finance climate damaging activities. In terms of social goals, it needs to be clear there is a reputational price to pay for continuing to finance economic activities that harm people.

The principles contained in the FRC Stewardship Code are all well and good. But, these are far too qualitative and reporting is too narrative based. To produce change, effective sanctions (whether in

the form of regulatory sanctions or reputational impacts) are needed to improve behaviours and practices. Hard, independently verified data, not narrative reporting, on compliance with environmental and social goals is needed to monitor and provide assurance on whether progress is being made.

Q11: What additional measures would encourage firms to identify and respond to market-wide and systemic risks to promote a well-functioning financial system? How can the collective stewardship efforts of asset owners and asset managers best be directed towards the most pressing systemic issues? And how can remaining barriers best be reduced? Please explain your views.

We have nothing much to add on stewardship expect to reiterate that significant regulatory reform is needed if financial market behaviours (and the behaviours of underlying investee corporates) are to be aligned with environmental goals.

We argue that protecting the environment from climate damaging finance needs to be given at least equal status in the objectives of financial regulators. A more interventionist approach on the part of the financial regulators along with a set of robust regulatory interventions are needed to implement this objective.

This is set out in some detail in our *Devil is in the policy detail* report mentioned above.

Q12: What do you consider to be the main sustainability-related knowledge gaps across the financial sector and how can these best be addressed? What do you consider to be the potential harms to market integrity, consumer protection or competition arising from these knowledge gaps?

The primary knowledge gap relates to the degree of environmental harm being financed by UK financial markets. Moreover, we do not know which sectors of financial services or climate-critical financial institutions are responsible for the greatest harm.[2] Similarly, we have limited information on the extent of greenwashing in the market although on the 'follow the money principle' it is surely sensible to presume that this has been widespread. This lack of meaningful data means that policy interventions are not being deployed effectively to stop the continued financing of climate damaging activities.

With regards to market integrity, consumer protection, and competition the obvious harms are: undermining the reputation and integrity of the UK financial sector (particularly relevant given the government wants the UK to be global centre of green finance); consumers being misled and missold to due to greenwashing; and greenwashing and poor data allowing less scrupulous firms to mislead consumers and gain market share as a result.

[2] The parallel here is with systemically important financial institutions.

Q13: Do you think there is a need for additional training and competence expectations within our existing rules or guidance? If so, in which specific areas do you consider further rules and/or guidance are required? Please explain your views.

No comment.

Q14: Which aspects of the training and capability-building initiatives discussed above, or any others, would be particularly useful to consider (for example in identifying which skills and/or training is needed) and how best should we engage with them?

No comment.

Q15: Have you seen misrepresentation of ESG credentials among ESG professionals and, if so, what are the potential harms? Have you seen any consistent training metrics that can help compare firms' knowledge/capabilities? Please describe.

We do not have the resources to monitor and investigate ESG credentials. But, as outlined above, on the basis of the 'follow the money' principle, we think it is reasonable to presume that as with greenwashing, misrepresentation of ESG credentials is happening.

This marks the end of the Financial Inclusion Centre's submission.
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