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The Financial Inclusion Centre

Financial markets that work for society

A new approach to defining social impact and sustainable finance and identifying impact washing

Making a return or making an impact?

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Summary

It is hard to avoid the terms impact and sustainability in the world of finance nowadays. The financial sector constantly tells us it is no longer just about making profits or generating returns for owners and investors; it says it wants to make a positive social impact, too.

The financial sector claims that private finance[1] can be deployed more to: tackle social harms and enhance social good; invest in core infrastructure and levelling up so easing pressure on public finances; and improve standards of corporate behaviours on social issues such as diversity and inclusion, human rights, fair wages, ethnicity and gender pay gaps. Politicians champion a greater role for private finance in meeting social and public policy goals.

This report challenges the claims about social impact and examines whether making an impact is indeed given the same priority as making financial returns. The report concludes that it is far too easy for financial institutions to impact wash their activities. It is too easy for conventional return-prioritising finance to masquerade as social impact or sustainable finance.

We argue for a more robust approach to distinguish between finance that: prioritises making a measurable positive social impact; socially sustainable finance which makes a positive impact while making financial returns; socially neutral finance which at least does no harm; and finance that continues to cause social harm. We propose a set of six tests to enable that distinction.

Defining social sector assets, social impact and sustainable finance

Social impact or sustainable finance incorporates sustainable development goals (SDGs).[2] It is the S in ESG[3] and, along with environmental issues, it is referred to as 'people and planet'. Yet these constructs do not properly convey the extent to which finance has redefined its role in the economy and society and, in doing so, created new opportunities to generate financial returns while bolstering corporate reputations.

A whole new category of monetizable *social sector assets* has emerged because of the growing interest in ESG related concepts, and the financialisation of the economy and society. The state (central and local) is limiting its role in funding affordable housing, health, social care, specialist education, and other public services. Private finance seeks to fill that gap and also play a bigger role in funding core public infrastructure, regeneration and 'levelling up'. Financial sector trade bodies have successfully lobbied for financial deregulation[4] and pushed for corporate welfare[5] to make this social sector asset class even more commercially attractive.

Note that we do not comment on political decisions on public spending. That is outside the remit of our work. However, we do highlight the consequences of using private finance to fund policy goals.

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[1] This incorporates insurers, pension funds, banks, asset managers, private equity and so on – any provider of finance, or intermediary that influences the allocation of finance to companies, projects, and so on ventures (the assets).

[2] Take Action for the Sustainable Development Goals - United Nations Sustainable Development

[3] Environmental, social, governance

[4] The Solvency UK 'reforms' are undoubtedly a weakening on prudential rules for insurers. The main insurance lobby group, the ABI, welcomed these reforms claiming this would allow it to invest in levelling up, social infrastructure, and the green transition Solvency II reform welcomed by insurance and long-term savings industry | ABI Phoenix urges solvency reforms to unleash £50bn for UK economy (ft.com)

[5] Corporate welfare includes states or other non-market actors 'de-risking' financial commitments or providing financial incentives.

For this analysis, we use a broad definition of social asset finance that incorporates: finance claiming to influence corporate behaviours on social issues; finance linked to SDGs; development, catalytic, and blended finance; finance deployed to tackle social harms such as poverty, exclusion, lack of affordable housing, and ill-health; and private sector funding of public policy goals such as building core infrastructure, regional development, and levelling up.

Social impact washing

If the history of finance tells us anything, it is that 'harm follows the money'. We are concerned that, as the wider sustainable finance market grows, opportunities for impact washing have also grown. Yet, impact washing does not receive the same degree of scrutiny as its 'twin', greenwashing.

Social impact washing includes financial institutions: making misleading claims about the contribution made to social policy or sustainability goals; seeking reputational reward for just doing what is acceptable on social issues rather than going beyond expectations; and rebranding conventional return-seeking finance as social impact or sustainable finance.

For return-prioritising financial institutions, the social sector is just another asset class to be considered during the investment decision process. The primary goal is to generate market returns and/or obtain corporate welfare to protect commercial interests. It is no different to investing in, say, the construction, technology, or pharmaceutical sectors to generate financial returns for investors and shareholders.

This is not a criticism. Financial institutions are not charities. They exist to make returns for investors and shareholders. The difference with social impact washing is that financial institutions can obtain a double benefit – generating market returns (sometimes underwritten by corporate welfare) and obtaining a reputational and marketing benefit and further commercial advantage for doing so.

Impact washing can happen because conventional return-seeking finance can masquerade as social impact or sustainable finance; the supposed benefits of deploying private finance to meet social and public policy goals have not been properly scrutinised; and the standards used to assess financial institutions' influence on corporate behaviours are not robust and are inconsistently applied.

Worryingly, the Financial Conduct Authority (FCA) flagship sustainable investment label[6] is unlikely to hold financial institutions to account for impact washing[7] and could actually enable impact washing. The lack of robust standards and scrutiny applied to the market undermines the efforts of those financial institutions that do want to make a real difference and the integrity of the market generally.

The Six Tests

This report sets out six tests which can be used to evaluate the social impact of finance and challenge claims made by financial institutions. The tests can be used to rate individual social sector assets or to produce a composite rating of portfolios of assets including pension funds, insurance funds, investment funds, bank loan books and so on. The six tests cover:

Forgoing market returns – The first test we apply is: what is the primary purpose of committing finance to a company or venture[8] - making a market return or making an impact? Of course, it can be both. But, if generating a market return is a prerequisite before committing finance, we would argue

[6] Sustainability disclosure and labelling regime | FCA
[7] or greenwashing for that matter
[8] investing in, lending to, or insuring a company/ venture

this is not true social impact finance. Note that we would say that return-seeking finance could still be classified as ethical or socially sustainable if it drives the highest standards of corporate behaviour – see below. Or if the returns generated are then used for explicit social purposes – e.g. if a charitable foundation invests in listed companies to generate the assets for grant making. This test is set to identify the 'purest' social impact finance. There is a more general point here. Most finance can be said to be having an impact. For example, investment in technology or pharmaceutical companies undoubtedly has an impact on our lives. Yet we wouldn't classify this as *social* impact finance. So, we need to clearly delineate finance which has social impact as its primary goal and finance which treats social assets as just another financial asset from which to make returns.

The role of corporate welfare – Corporate welfare includes financial commitments being deregulated, 'de-risked', or incentivised by governments and others such as non-governmental organisations (NGOs). Corporate welfare is a transfer of *value* from the state or other non-market actors to financial institutions, investors, and shareholders. It is a transfer of *risk* from private sector financial institutions, investors, and shareholders to the state and other non-market actors. It is known as socialising the risks, privatising the rewards. Poorly designed financial models that generate market returns and involve corporate welfare are redolent of the controversial private finance initiative (PFI) and public private partnerships (PPP). We would argue that financial institutions that avail of corporate welfare should not brand that finance as social impact or sustainable. Again, in this case, the primary goal is protecting the commercial interests of financial institutions providing the finance, not social impact.

Standards of corporate behaviour – The term *social impact* suggests going beyond sustainability or ESG finance to have a significant, measurable impact on social goals. Yet, the current approach to ESG finance generally, and the Financial Conduct Authority (FCA) labelling regime (see below) allows financial institutions to gain a reputational advantage for just doing what society expects on social goals. For example, they may restrict their investments to companies that comply with acceptable standards on human rights, fair wages, and working conditions in supply chains. That may be welcome, but does it deserve special recognition? We would say special recognition should be reserved for investing in companies that, for example, have top quartile performance on social issues such as paying fair wages, ethnicity and gender pay gaps, diversity and inclusion in the workplace, supply chain behaviours, and human rights. Powerful financial institutions need to be held to higher standards on social impact. By way of analogy, with the Honours system ordinary citizens receive an OBE or CBE only if they go beyond what is expected by society, not for just doing the minimum expected.

The Do No Harm Principle – Social impact finance should follow the do no harm principle. That is, finance which produces a positive social impact in one area should not cause harm in another. Or finance which supports one social goal should not undermine another.

Social sector assets - Financing 'social sector' or 'inclusion' assets (e.g. social care, social housing, education, levelling up, and community lending) should not be automatically classified as social impact or sustainable finance unless the other conditions are met.

Development finance - Development finance, such as lending to or investing in Low and Middle Income Countries (LMICs) or deprived areas of UK should not be automatically classified as social impact unless the other conditions are met. For example, private finance which makes generating a market return or receipt of corporate welfare a prerequisite before committing that finance should not be considered social impact finance. The same approach should apply to 'catalytic' or 'blended' finance models.

Applying the tests

Existing ESG and sustainability ratings use a two-stage approach. First, the constituent assets are rated, which then allows for a composite rating of funds, portfolios, loan books, financial products, and financial institutions. We propose a similar structure. The difference is the input tests we propose to rate the constituent assets are more challenging. We think this would give a more objective assessment of the overall social impact performance of financial institutions.

Applying the tests, we propose that assets should be classified into four grades:

- **Focused Social Impact assets:** The highest-grade assets that pass all the relevant tests.[9]
- **Social-Sustainable assets:** Assets can generate a market return, but the company/venture passes the other tests relevant to its corporate activities and meets the highest standards of corporate behaviour[10] without relying on corporate welfare.
- **Social-Neutral assets:** Assets generate a market return but do no harm. Note that 'do no harm' in this instance means complying with a recognised *acceptable* standard on corporate social responsibility. This would not imply that financing these corporate assets is deemed to be having a *positive* social impact, it just does no harm.
- **Social-Negative assets:** Specific assets could also be evaluated to determine if they are causing or contributing to social harm. A clear example might be companies using suppliers that do not comply even with basic standards on human rights, fair pay, or employment rights. This would be the social equivalent of climate harming activities.

These names are not intended to be used for communication purposes. They convey different levels of intent and degrees of compliance with social goals. The tests can used to rate the financing of specific assets – for example, if an insurer invests in 'affordable' housing and claims to be making a social impact. Most finance is now 'pooled' so the tests can also be used to produce a composite or aggregate rating for: a financial institution's overall performance; collective or pooled finance such as pension, insurance, investment and private equity funds, and loan books; and financial products/funds aimed at retail consumers. Examples are included in the report.

The tests and ratings can be used by individuals, financial advisers, financial institutions, pension fund trustees, managers of charitable and endowment funds, NGOs and civil society,[11] and ratings agencies. The tests can also be used by civil society and media to challenge claims about social impact and sustainability.

There is much riding on the FCA's new sustainable label regime. It is the regulator's flagship intervention in the sustainable finance field. The FCA's labels conflate environmental and social goals. The regulator's approach relies far too much on self-regulation and disclosure. Firms will have too much leeway on defining investments as sustainable. The FCA is not going to approve the use of a label by an investment firm or require independent verification. Indeed, we fear the FCA's label regime will enable social impact washing and greenwashing.[12] The new regime will be difficult to

[9] For example, Test 6 which relates to development finance would not be relevant for investment in social sector assets which is covered by Test 5.

[10] For example, measured against the most robust standards developed by trades unions and NGOs on workers' rights in supply chains

[11] Those with important governance roles such as trustees can assess their own social impact performance as well as that of external investment managers.

[12] For a full explanation of the flaws in the FCA regime, see: Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre

enforce. The tests proposed here could enable civil society and the media challenge investment firms that use the FCA's sustainable investment labels to promote and market funds and hold the regulator to account.

We argue above the term *social impact* should be reserved for finance that is willing to accept a below market return. However, the FCA labels will be used by investment firms intending to generate market returns for clients who also want to take sustainability into account. To accommodate this, we propose that assets in portfolios which fall below the Social-Sustainable grade should not count towards the 70% threshold of qualifying assets that has to be met for a fund to use a label.[13]

These tests would set a higher bar for using the terms *social impact* or *sustainable* finance than is currently used in the market. The bar does not seem unreasonably high to us. To be clear, we are not saying that private finance which does not meet all the relevant tests is 'bad' finance. It will be for users to determine how strict they want to be when screening financial activities as the tests can also be aligned with users' own expectations of social impact and sustainability. However, we hope that these tests will provide a much more challenging process for screening financial activities that claim to be social impact or sustainable.

Policy recommendations

We also make a series of recommendations to embed higher standards and accountability into the social impact and wider sustainable finance market:

- The FCA and other regulators should have a clear strategy for combatting social impact washing separate from greenwashing. Social impact should have its own specific sustainability label.
- The asset minimum to attract an FCA social sustainability label should be the 80% threshold used in other major financial jurisdictions.
- Robust social impact standards should be rapidly rolled out to pensions and other financial activities not limited to investment funds.
- A comply or explain approach which relies on disclosure is not sufficient. The FCA should establish an approved list of independent social impact benchmarks. Firms should be required to choose from this approved list when making claims about social impact or sustainability.
- The FCA's labelling regime and the wider approach to sustainability assessment and reporting relies far too much on self-regulation by financial institutions. We urge civil society organisations to develop and agree a 'gold standard' for financial and corporate behaviours on social issues. Compliance with this gold standard should be independently verified.
- UK policymakers should develop a regime to allow evaluation of offshore and overseas funds given the international nature of finance based in the UK.
- UK policymakers should consult with civil society organisations and investors to develop a similar framework and tests for concepts such as development finance, catalytic and blended finance that are targeted overseas.

[13] To use a sustainable label, 70% of the assets in a fund must meet a sustainability objective (environmental or social). The other 30% should not conflict with that objective.

Introduction

As part of its work on the environmental, economic, and social utility of finance,[14] The Financial Inclusion Centre published a major report called *The Devil is in the policy detail – will financial regulation support a move to a net zero financial system?*[15] The work highlighted serious flaws in the overall approach to climate-related financial regulation adopted by policymakers and regulators. The report raised specific concerns about the Financial Conduct Authority's investment label regime and ESG ratings more generally.

In the course of researching and producing the report we became increasingly concerned that *social impact washing* was not receiving the same degree of scrutiny as its 'twin', greenwashing. The current approach to defining social impact or sustainable finance is far too lenient. It allows financial institutions to gain a reputational and marketing advantage for doing no more than society expects[16] on social goals (such as investing in companies that pay fair wages or comply with human rights standards).

In this new report, we argue higher standards need to be applied to identify genuine social impact and sustainable finance and expose impact washing. The report sets out six tests or conditions we think could be used to identify finance where the *primary* goal is creating positive social impact.

Critically, we will need a robust standard against which to challenge investment firms using the FCA's investment label for marketing and promotional purposes. We are concerned the FCA's flagship initiative in the sustainable finance field could actually facilitate social impact washing.

The tests are designed to be used by those with an interest in social impact, sustainability, or wider ESG including: financial institutions and professionals; pension fund and charity trustees; social finance institutions; financial advisers and their clients; individual investors; civil society and NGOs; and ratings organisations.

There is clearly more work to be done in this field. However, we hope these tests bring some clarity and rigour to the approach to social impact and ESG finance more generally. If you have any questions or comments please do contact mick.mcateer@inclusioncentre.org.uk

Report structure

Below, we explain some of the key terms used in the social impact and sustainable finance, and wider ESG field. Following that, we set out the case for a new approach to evaluating social impact and sustainable finance.

Then we describe in more detail the six tests we propose along with an explanation of why the test is needed. We include examples of activities we think could constitute social impact washing. We then explain how the tests can be used to rate assets and different types of financing. Finally, we make a number of policy recommendations aimed at embedding good practice into the wider sustainable finance market.

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[14] That is, how well finance serves the interests of the environment, real economy, and society Financial markets, climate change, economic and social utility | The Financial Inclusion Centre

[15] The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre

[16] For attitudes towards social issues see, for example, 2020 Edelman Trust Barometer Global Report.pdf

Definitions

What does 'social impact' refer to?

There are a number of terms relating to ESG and sustainability used in the world of finance these days. There are three main pillars to ESG finance – environmental, social, and governance.

Environmental impact relates to the impact finance has, for good and bad, on climate change and the wider environment.

Social impact relates to the impact finance has on social issues such as workers' rights, tackling gender wage inequality, labour market rights in corporate supply chains, and investing in low-medium income countries (LMICs). However, as we explain in the report, finance is playing a much wider role in social and public policy issues such as regeneration and levelling up, funding affordable housing and infrastructure and so on.

Corporate governance relates to how an organisation is governed and run.

The social and environmental pillars are sometimes referred to as 'people and planet'. Environmental and social impact are seen as goals. The governance pillar is seen more as an 'enabler' for those two goals. The theory goes that a well-run company or organisation is more likely to be aligned with environmental and social goals.[17]

Sometimes the terms sustainable finance or sustainability are used. The FCA, the main financial regulator, now tends to use sustainable or sustainability to encompass environmental and social goals. Other terms such as ethical finance, responsible finance, social purpose finance, or corporate social responsibility will crop up in the debate. Concepts such as 'blended finance' or 'catalytic finance' are related. A glossary of the main terms can be found in Annex 1.

Types of finance

Finance, whether it is social impact or conventional market finance, can be provided in a number of forms. When we refer to finance in the report we include all types of financial activity including savings, investment, insurance, and loans (including via bonds).

Any financial market transaction involves: i. a provider of finance; ii. a recipient of that finance; and iii. usually, some form of intermediary and/ or information or ratings provider which influences the decisions of the provider of finance.

Providers of finance can include individuals, institutions such as pension funds, insurers, banks, private equity, family offices, philanthropic funders, foundations, charities, non-governmental organisations (NGOs), and even states. They make decisions, often with advisers and intermediaries, on where to allocate financial resources (loans, investments, and insurance) to companies and ventures, and on what terms. This is known as the asset allocation and investment decision making process.

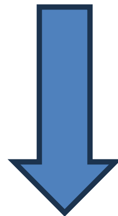
[17] Of course, this all presumes that company boards and management believe that the interests of the shareholders are aligned with environmental and social goals. But, that's for another report.

The recipients of finance can include companies, individual projects and ventures (large scale and community based), non-profit organisations/charities, and even other states. We use the term assets as a shorthand for the recipients of finance.

Intermediaries and decision aids influence the decisions made by the provider of finance. These can include financial advisers, consultants, or comparative information/ratings providers and initiatives such as the FCA's investment label scheme.

Box 1: Schematic of financial decision-making process and channels

Providers of finance – Direct, intermediated/pooled, retail savers/investors, financial institutions, charities and endowments, pension funds, banks, insurers



Intermediaries and decision aids
advisers, ratings agencies, information providers, labels

Recipients of finance – specific projects/ventures, joint ventures/partnerships, infrastructure, public and private companies, non-profit and for-profit organisations

The important point to note here is that any evaluation of the social impact or sustainability of finance needs to be built up from an assessment of the individual assets.

The report covers *direct* and *intermediated/pooled* finance. Direct finance includes, for example, directly lending to or investing in a specific asset, activity, project and so forth. There is a direct, one-to-one relationship between the provider of finance and the recipient of that finance. The decision to finance a particular asset may be done using a financial intermediary such as an independent financial adviser or an ESG ratings adviser. However, there is still a direct one-to-one financial relationship between the provider and recipient of the finance.

Most finance nowadays is pooled or intermediated in some way through pension funds, insurers, asset managers, bank loan books, and private equity funds, and financial products. For example, the pension contributions of millions of individuals are pooled in pension funds and given to asset managers who make the financial decisions on where to invest those funds. The pooling of our savings enables banks to lend to large numbers of companies. Asset management firms manage investment funds which consist of the investments of thousands of retail investors. These investment products may be eligible to use one of the FCA's new sustainable investment labels if they meet the qualifying criteria.

Why new standards on social impact and sustainable finance are needed

During the process of undertaking the research for the *Devil is in the policy detail* report, and now this new report, one of the major issues we encountered was the absence of consistent standards or criteria used by the market to distinguish between finance that has a clear, primary social purpose and potential impact washing.

The FCA's investment labels

We have particular concerns with the FCA's new Sustainability Disclosure Requirements (SDR) and investment label regime aimed at investment funds. This is the main regulatory intervention intended to tackle greenwashing[18] and help investors make informed sustainable asset allocation decisions.

Investment products that have 70% of assets invested in accordance with a sustainability objective (environmental or social) can use one of the FCA's four sustainability labels – Sustainability Impact™, Sustainability Focus™, Sustainability Improvers™, and Sustainability Mixed Goals™.

As explained elsewhere,[19] we think the FCA's approach is confused, too narrow in scope and would allow the investment industry too much leeway to 'mark its own homework' on whether an investment fund warrants a sustainability label. Asset managers will not have to obtain *independent* external assessment of sustainability claims. There is no standardised disclosure template to allow investors to readily compare different funds. The FCA is not going to approve *ex ante* the claims of sustainability made by firms using a label. It may supervise and enforce *ex post* misleading claims. But, as explained below, the lack of robust standards means we think the FCA will find it hard to police and enforce breaches.

The FCA has kept the approach which confuses very different ***goals -*** environmental and social/social impact – and conflates these into a single sustainability label. The FCA approach conflates ESG goals with the ***approach*** adopted by funds – that is, does the fund intend to make an impact, does it have a focus, does it seek to improve matters, or does it have a mixed approach. This will make it harder to focus on the social dimension of the assets held in a fund.

The FCA decided not to go for a clear rating system to communicate how sustainable funds are e.g. a 1 – 5 star ratings even though consumers understand and value ratings. The FCA's own analysis shows that objective grading systems influence investors' decisions.[20]

The FCA regime is, to all intents and purposes, a voluntary approach. Investment firms can choose whether to subject their investment funds to scrutiny to see if the funds might qualify for a sustainable investment label. Firms that do not use a label will escape scrutiny for the climate or social harm they cause.

It only covers investment funds, so it is obviously very limited in its scope. Yet, there are still more than 800 funds claiming to have responsible, sustainable or ethical characteristics[21] out of the 4,000

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[18] Note that greenwashing in this case is taken to mean social issues not just environmental issues

[19] For a full explanation of why the FCA's approach won't work see: Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre

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

[21] See: DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk), para 1.15

investment funds for sale in the UK classified by The Investment Association.[22] This is a significant number of funds that may need to be scrutinised especially if the fund manager decides to use an FCA label.

The labelling regime is not only confused. The FCA has not clearly defined what it thinks constitutes social impact or sustainable activities.

To be fair, the FCA does say that the assets that count towards the 70% qualifying threshold must be selected with reference to a '*robust, evidence-based standard that is an absolute measure of environmental and/ or social sustainability*.'[23] It also says '*firms should select assets using a methodology or approach that is applied in a systematic way*' and *'the methodology or approach may be based on, or determined by, an authoritative body (e.g., a government or regulator), industry practice (e.g., a third party data or analytics service provider) or a proprietary methodology (developed in-house by the firm).'*

Despite this, the FCA gives firms significant discretion to select the relevant standard. It has not produced a list of approved reference benchmarks or standards that firms should be required to use to determine whether an asset is eligible for inclusion in a fund with a label. The qualifying thresholds will be easily manipulated.

The FCA also gives firms significant discretion on whether to obtain external validation of its methodology or approach and what form of external validation it can use. Firms can use third-party data or analytics providers and even use their own in-house methodology. A methodology or approach based on industry practice or in-house methodologies is, in effect, self-regulation. Firms can even use different types of standards such as social criteria or a taxonomy-based. Even more confusing, the requirement to use a standard depends on which label the fund uses.

The lack of definition and the degree of discretion given to investment managers means it is genuinely difficult to see how investors, retail or institutional investors such as pension fund trustees, will be able to make effective decisions based on the FCA's label regime. Investors will not only have to decide which label is appropriate. If they want reassurance, they will have to investigate and compare the underlying methodologies, compare different standards, and the integrity of any third-party analytics providers involved.

Far from exposing social impact washing, we fear the FCA's approach will actually enable the practice. The FCA's approach includes no meaningful definitions of social impact. For example, as we explain below, firms will be able to extract market returns from, say, social housing or care homes and still claim they are making a social impact rather than just treating social assets as yet another return-generating asset class.

Of course, as with any regulated activity, the FCA will supervise and attempt to enforce against breaches of rules where it thinks it is appropriate. The FCA says that: '*We will apply our usual supervisory and enforcement approaches to this regime. We will respond to compliance issues when they arise and act if we have intelligence that indicates a firm may not be meeting the requirements.*

[22] Fund Sectors | The Investment Association (theia.org)
[23] Ibid, Annex 2, Box 2, p100, ps23-16.pdf (fca.org.uk)

We may take enforcement action where we have reason to believe that serious misconduct may have taken place.'[24]

But, to reiterate, the FCA will allow firms significant discretion to define what constitutes social impact and sustainable. We lack robust, consistent reference standards or benchmarks. We fear that Investment firms will be able to easily argue that they are complying with the requirements.

The FCA is introducing a general anti-greenwashing rule. However, the vagueness of the criteria means investment firms will be able to easily justify decisions to include questionable assets in their sustainable funds. This will make it difficult for the FCA to make enforcement cases stick.

Much is riding on the FCA's labelling initiative. A robust approach to assessing the claims made by investment funds will be critical. The tests outlined in this report could help civil society organisations, financial advisers, media, and ordinary investors with an interest in social impact and sustainable finance hold financial institutions to account and identify potential impact washing. The tests could help hold the FCA to account for failing to tackle impact washing.

Wider concerns about social impact and sustainability washing

The concerns we have about potential social impact washing go much wider than the FCA's sustainable investment label regime. We have four main areas of concern:

- Financial institutions presenting conventional return-seeking finance as social impact or sustainable finance
- The role of corporate welfare
- The emergence of a social sector asset class
- Low expectations regarding standards of corporate behaviours

Social impact or conventional return-seeking finance?

Recently, we have seen a push by various private finance lobbies for financial deregulation to 'encourage' investment in the green transition, the levelling up agenda, and to meet public policy challenges such as building affordable housing.[25]

If financial institutions are to finance those public policy goals they will expect to generate a decent return on their investments, loans, or insurance. That is to be expected; financial institutions are not charities. But, private finance tends to be more costly than state funding.[26] Relying on private finance has a real world cost. Ceteris paribus, using higher cost private finance to build core infrastructure or affordable housing would translate into higher bills or rents for households. Households would be paying to meet the higher return expectations of private finance.

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[24] Ibid, para 3.13

[25] The Solvency II 'reforms' are undoubtedly a weakening on prudential rules for insurers. The main insurance lobby group, the ABI, pushed for these reforms claiming this would allow insurers to invest in levelling up, social infrastructure, and the green transition Solvency II reform welcomed by insurance and long-term savings industry | ABI Phoenix urges solvency reforms to unleash £50bn for UK economy (ft.com)

[26] Private finance tend to demand returns above the 'risk free' rate. This is usually taken to mean the yield on benchmark government bonds (Gilts), which is the cost of government borrowing. So, the state can borrow to invest at a lower cost compared to the cost of finance provided by private sector financial institutions. Indeed, the state can raise money through taxation. We do not comment on the use of government borrowing or taxation to meet public policy goals. That is outside the scope of our work. For this report, we are concerned about whether private finance can be considered social impact or sustainable finance.

Should more costly private finance that displaces lower cost state finance be considered as social impact or sustainable? Should financial institutions that make generating a market return a prerequisite for investing in affordable housing or infrastructure be allowed to brand their activities as social impact or sustainable? Should they be able to get a reputational and marketing advantage for doing so? We would argue not. As we explain below, in cases such as this, financial institutions are treating these 'social sector' assets as just another form of return-seeking asset in their investment decision making process. Making a financial return trumps making an impact.

Corporate welfare

It doesn't stop there. Private finance not only wants to generate market returns from core social needs; it wants the state and other non-private sector bodies to provide corporate welfare. This can be in form of deregulation,[27] 'de-risking' the finance, or expecting financial incentives before committing to providing finance. This is known as socialising the risks, privatising the rewards.

Extractive financial models that allow financial institutions to generate market returns and have financial commitments de-risked are redolent of the controversial private finance initiative (PFI) and public private partnerships (PPP). We would say that allowing financial institutions to brand that finance as social impact or sustainable finance for commercial or reputational advantage is surely social impact washing.

Concepts such as 'blended finance' or 'catalytic finance' use finance provided by states and NGOs to scale up private finance to meet development goals or climate goals. Funding models can differ but generally speaking it involves the public sector or agencies 'de-risking' projects to attract private finance. Many experts will argue that this is necessary to attract the required funding. However, poorly designed models which just socialise the risk and privatise the rewards are another form of corporate welfare.[28]

The social sector asset class

One trend we have noticed is the emergence of what we call a *social sector asset class* as part of the wider financialisation of the economy. Financial institutions are seeking to generate market returns from initiatives to tackle social issues and meet public policy goals.

This social sector asset class has expanded as the state (central and local) withdraws from or reduces its role in funding social housing, health, social care, specialist education, and other public services and financial institutions step in to provide the finance. We would also include providing finance at market rates to non-profit lenders and social enterprises to tackle problems in local communities.

We are not debating whether this financialisation is a good or bad development, *per se.* That is also outside the scope of our work. However, as with financing infrastructure or affordable housing, we do point out that private finance for the most part expects to make a market return from investing in or lending to the social sector. That expectation of making a market return means that the cost of financing those core social needs would be more costly than if funded by the state.

[27] The deregulation of Solvency II (now called Solvency UK) is a case in point. See: Submission to HM Treasury Review of Solvency II consultation | The Financial Inclusion Centre

[28] We would argue it is different if those providing the de-risking charge appropriate fees for underwriting early stage risks or share risks and rewards (that is more akin to insurance)in a balanced way with private finance. That is not corporate welfare.

For financial institutions seeking to generate a market return, the social sector is just another type of asset, part of the usual asset allocation and investment decision making process. Making a market return from financing the provision of social needs or community lending is no different to investing in, say, the pharmaceutical, car manufacturing, or technology sectors.

The difference is financial institutions want to get a double benefit by generating returns and a reputational and marketing advantage by branding these investments as social impact. For example, the FCA's new investment label regime would allow an investment fund that makes profits from properties used by local authorities to house homeless people to use the Sustainability Impact™ label.[29]

Standards of corporate behaviour

Financial institutions already claim to behave in a socially sustainable way by investing in or lending to companies they say meet certain standards on issues such as human rights and working conditions. Reference standards might take the form of ESG performance data, ratings, benchmarks, and indices. Sitting behind those metrics are ESG principles and frameworks. The UN's Sustainable Development Goals (SDGs) are a common reference point for these claims.[30]

Meeting external standards may be fine. At least they are not doing harm - if, that is, those external reference standards are meaningful and corporate behaviours have been independently scrutinised and verified.

There is a plethora of approaches to measuring the social impact or sustainability performance of financial institutions. There may well be a case for having different approaches to measuring social impact as financial institutions may want to focus on different aspects of social impact or sustainability. However, the sheer number and variety of approaches makes it all the more difficult to establish whether financial institutions are making a meaningful difference with their asset allocation decisions. There needs to be a meaningful benchmark which sets high standards.

Even when there is a recognised external reference point to compare impact performance, financial institutions are not performing well. The European financial supervisory authorities are more advanced than their UK counterparts in assessing the compliance of financial institutions with sustainability goals, both environmental and social. Interestingly, the European Securities and Markets Authority (ESMA) research found that investment funds which claim to support the United Nations Sustainable Development Goals (SDG) do not differ from non-SDG aligned funds in their alignment with the goals. ESMA concluded that SDG funds can be particularly prone to impact-washing.[31]

There is a more fundamental point here. The essence of social impact or sustainable finance is that financial institutions should influence standards of corporate behaviour on social issues such as human rights, fair wages, and fair treatment of workers in supply chains. The question is: what standards of corporate behaviour should financial institutions be expected to drive to obtain reputational and, therefore, commercial advantage?

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[29] See the example of the *ABC Social Impact Real Estate Fund*, in FCA Sustainability Disclosure Requirements (SDR) and investment labels Policy Statement PS23/16, p108

[30] THE 17 GOALS | Sustainable Development (un.org)

[31] ESMA50-524821-3098 TRV article - Impact investing - Do SDG funds fulfil their promises.pdf (europa.eu)

Even if financial institutions do comply with reasonable standards of corporate behaviour, should they expect to receive a reputational and therefore a marketing advantage for doing so? Financial institutions might claim they are behaving responsibly by avoiding companies that don't treat workers fairly or investing in companies that claim they are committed to closing the gender pay gap. Yet, that is doing no more than what society expects of well-run corporations. We would argue that financial institutions should only be able to claim credit for financing companies that surpass those standards rather than merely meet those standards. For example, companies should have top quartile performance on social issues such as paying fair wages, ethnicity and gender pay gaps, diversity and inclusion in the workplace, supply chain behaviours, and human rights.

By way of analogy, think of the Honours system. As citizens, we expect to receive an OBE or CBE only if we go beyond what is expected by society. If we fail to observe the standards society expects of us (whether legal or social standards) we are sanctioned (legally or informally). If we do what is expected, we do not expect or get special recognition from the state or the rest of society.

Yet, the basic approach to ESG finance generally, and specifically the new regime introduced by the FCA, rewards financial institutions for just doing what is expected. Moreover, financial institutions that fall below expected standards do not face sanction.[32] It cannot be right that financial institutions are held to lower standards for their social impact than ordinary citizens.

So, there is an absence of meaningful standards, low expectations of corporate behaviour, and inconsistencies in definitions and methodologies used to assess the social utility of finance. This means there is plenty of scope for social impact washing. It calls for a much more robust approach to assessing whether finance is indeed having a measurable, positive social impact. We need to be able to delineate between finance that:

- Clearly has a positive impact on corporate behaviours
- Just meets expectations with regards to corporate behaviours
- Tolerates or enables socially harmful activities.

[32] Of course, some might argue that competition dynamics in the market will 'sanction' those who fail to meet standards. The theory goes that, for example, the existence of the FCA's sustainable label will incentivise 'good' behaviours and those financial institutions who comply with the FCA's standards will win business from those who don't. There is not much reason to support the theory that competition polices behaviours in financial services. Moreover, it would all depend on the reliability and integrity of the label regime – which is the point of this report.

Six tests to evaluate the social impact of finance

We are proposing six tests to distinguish between genuine social impact and sustainable finance, and conventional return-seeking finance masquerading as such.

Those with an interest in social impact or sustainable finance can use these tests to ask a series of challenging questions before committing to, say, financing a project, investing in a company, or selecting an investment product. The tests can be used to evaluate claims made by financial institutions about the social sustainability of their activities.

The tests also enable the calculation of overall social impact ratings for portfolios and funds which consist of numbers of individual assets. Critically, the tests can be used to challenge the claims made by investment firms which use one of the FCA's sustainability labels and for exposing social impact washing.

In this section, we take each of the six tests in turn to describe what type of practice it is intended to address with illustrative examples of what we would consider to be social impact washing. The six tests relate to:

- Forgoing market returns
- The role of corporate welfare
- Standards of corporate behaviour
- The Do No Harm Principle
- Social sector assets
- Development finance (domestic and overseas)

Forgoing market returns

To be considered as having the highest level of social impact, providers of finance (loans, investment, and insurance) should be willing to forgo market level returns. This should be clearly disclosed and be a firm commitment on the part of the financial institution.

<u>Description and rationale</u>

Making a market return a prerequisite for providing finance just treats a social asset the same as any other asset considered during the investment decision making process. This is a particular issue with regards with what we term the 'social sector' asset class.

So, the first question users of this new approach would ask is: what is the primary driver behind the provision of this finance? Is it to make a social impact? Would the social asset be financed if the providers of finance did not expect to make a market return?

If it is clear that the providers of finance are happy to forgo a market return in pursuit of a social goal then this activity should be considered social impact finance. If the providers of finance make a market return a prerequisite before committing finance, then this should not be considered to be the highest grade of social impact finance.

For example, if an insurance company, pension fund, or asset manager invested in 'affordable' housing, infrastructure in a deprived area of the country, or children's care homes *and* expected to make a market return from that investment, in our view this should not qualify as social impact finance.

Some might ask: how can a financial institution determine in advance *not* to make a market return? Obviously, it is not possible to predict with certainty what return will be generated from providing finance. Returns on assets are not guaranteed and can be volatile. So, how can a provider of finance undertake to forgo a market return if they don't know what the market return will be?

However, financial institutions (lenders, asset managers, pension funds, insurers and so on) do model the returns they expect to generate from return-seeking assets or portfolios of assets. This may be expressed in the form of, say, 'the risk-free rate plus 3%'.[33] So, financial institutions are in a position to determine in advance what return they expect from financing activities. They can decide to accept a below market return. If a market return is generated unintentionally, there should be an undertaking to reinvest or redistribute the windfall into the activity being financed.

The clearest form of social impact finance would be grants, or finance which is willing to make a loss or just break even in pursuit of social goals. There is a case for saying that finance which expects to make the risk-free rate would be considered social impact as this would be equivalent to the cost of state financing funded via government borrowing.[34] This would not be as 'pure' as grants, loss-making or break-even finance. Nevertheless, it would demonstrate that pursuit of financial returns is not the primary motivation.

Some social finance institutions do invest/lend to make a market return and then use the proceeds to finance pure social activities. For example, charitable/endowment funds may invest in listed companies to generate a market return but then use the proceeds to provide grants to social ventures or non-profit community lenders. In this instance, there is a good case for saying that, even though market returns are generated, the overall purpose should still be considered social impact. Of course, if the fund invested in companies which caused social harm, then this would offset the social good created.

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

Examples of social impact washing

Let's take, as an example, a community facing lack of access to credit with only very high interest loans available and loan sharks operating in the area. If a financial institution provided finance (loans, investment, or underwriting) to non-profit community lenders this could improve access to affordable loans.

If the financial institution provides a grant, or is willing to accept a below market return without corporate welfare such as de-risking or incentives, then clearly the primary concern is the impact on communities. The financial return is a secondary consideration. This would clearly be social impact finance.

What about the case of a bank providing capital to non-profit community lenders which expects to make a market return from that financing and/or for the finance to be underpinned by de-risking on

[33] The risk-free rate tends to be the return expected to be generated from assets such as UK Government Bonds (Gilts). The Gilt rate reflects the cost of government borrowing. Private finance institutions expect to receive an additional return above the risk-free rate for financing activities they consider to be a higher risk. This risk premium in the form of this higher return is one reason private finance can be much more costly than state financing.

[34] Of course, the state doesn't have to rely on borrowing to fund social needs. It can finance activities even more cheaply through, say, hypothecated taxes. However, FIC does not comment on tax policy. The point here is to suggest a benchmark that would determine genuinely social impact finance.

terms that are favourable to the bank? It could claim the finance was making a social impact. We would say that if the financial institution is expecting a market return and/or corporate welfare then it is treating the community lenders as just another return-seeking asset. This would be no different to investing in any other asset as part of the investment decision making process. If the financial institution claimed this was social impact under these conditions, then we would say it is impact washing.

Looking at the conditions attached to the FCA's investment label regime, a fund providing capital to non-profit community organisations on *market* terms would be allowed to count those assets as sustainable.

As another example, let's take an investment fund that invests in low-middle income countries (LMICs) where assets can be bought cheaply, and the fund manager believes prospects for economic growth and investment returns are good. The fund manager could argue that this investment is having a social impact as it creates jobs in an area of need. 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? Yet the FCA investment label regime would allow these assets to be classified as sustainable Impact.

The role of corporate welfare

To qualify as social impact or sustainable finance, there should be no corporate welfare involved. Financial institutions which expect corporate welfare to underpin investments, loans, or insurance should not be allowed to describe those activities as social impact or sustainable finance.

Description and rationale

Corporate welfare can apply at two levels: i. the financial institutions who provide finance; and ii. the companies/ventures who are financed (the assets).

For financial institutions, corporate welfare can include policymakers weakening regulatory requirements to encourage financial institutions to commit finance to ventures such as infrastructure, having a financial commitment 'de-risked', or requiring financial incentives to provide finance.

Corporate welfare also applies to the business activities of the companies/ventures that are financed. Incentives might involve favourable tax treatment or grants to encourage inward investment to underdeveloped regions. Freeports are another example of corporate welfare.

De-risking might come in the form of an external agent (state or NGO) taking on the early-stage risk of funding a social project and then passing it onto private finance providers once it is clear that the project is now viable and is generating returns. It might involve the state de-risking investment in core infrastructure to minimise the risk for the financial institutions providing the investment and allowing those financial institutions to receive the future returns generated.

This is similar to the first test above. Whichever mechanism is used, some form of corporate welfare is a prerequisite for committing the finance. Private finance providers would not lend, invest, or insure unless an external agent was willing to subsidise those returns and/or risks in some way.

To be clear, we make a distinction between genuine risk sharing or fair de-risking models and de-risking that confers disproportionate value to financial institutions providing the finance. For example, if state institutions or NGOs de-risk a venture by providing a form of insurance and charge a proper fee for doing so, that is one thing. But, if the arrangement involves the state/NGO underwriting early-stage risks with the financial institution benefiting from the future returns, that is quite another. That is known as socialising the risk, privatising the rewards. If the venture fails, society picks up the bill. If the venture succeeds, financial institutions get the rewards. In other words, 'heads they win, tails we lose'.

Corporate welfare is a transfer of *value* from the state or other non-market actors to financial institutions and their shareholders. It is a transfer of *risk* from private sector financial institutions and their shareholders to the state and other non-market actors. Either way, financial institutions expect return expectations to be met before committing finance – finance which is generally more costly than state provided finance. We would argue that corporate welfare models risk repeating the mistakes we saw in poorly designed private finance initiatives and public private partnerships.

Government and others may believe that corporate welfare is necessary to support policy goals such as regional development or financing the building of core infrastructure. We would argue that it would be misleading to describe this as social impact or sustainable finance.

Examples of social impact washing

The use of corporate welfare creates clear opportunities for social impact washing. Financial institutions can get a double benefit of reputational and corporate advantage and commercial gain by having return expectations underwritten or incentivised.

Let's take the hypothetical example of an investment fund which intends to use the FCA Sustainable Impact™ label. The fund includes within its portfolio investments in companies which receive government subsidies to set up in economically deprived areas of the UK. The fund also wants to generate market rates of returns from those investments.

We think that the lack of meaningful definitions and standards in the FCA's regime, means a fund could count those assets towards the 70% threshold of sustainable assets needed for the Impact label – see below for more detail on the FCA's label regime.

The fund managers might claim that they are financing a socially sustainable investment activity, by supporting regional development and levelling up. But is supporting sustainable development goals really the primary motive here? Would the fund have invested in those companies without corporate welfare to underwrite the risk of market returns not being delivered to shareholders?

We would argue that these assets should not count towards the 70% qualifying threshold for this label. The primary motive here is not social impact or sustainability. In our view, obtaining a reputational advantage from investments underpinned by corporate welfare would be a clear example of impact washing.

Concepts such as 'blended finance' or 'catalytic finance' use finance provided by states and NGOs to scale up private finance to meet development goals or climate goals. Poorly designed models can also facilitate impact washing for the same reasons. This is discussed further, below.

UK freeports provide an interesting example. These are often situated in areas that certainly could do with a development boost. Freeports offer various tax and customs reliefs to attract companies to set up there. Should financial institutions that invest in companies located in freeports be allowed to include those assets towards the 70% threshold? The state is effectively underwriting returns to investors and this is a form of corporate welfare. There are also concerns about low regulation and limited provision of data by the sponsors and firms involved meaning the social element will be very difficult to verify.[35] We would argue investing in companies located in a freeport should not be considered social impact assets.

Standards of corporate behaviour

To be considered as social impact assets, companies that are recipients of finance should exceed, not just meet, meaningful standards of corporate behaviour on social issues such as human rights, fair wages, diversity and inclusion, and working conditions in supply chains.

Rationale and description

A key selling point of social impact or sustainable finance is that financial institutions can influence corporate behaviours for the good of society. For example, by investing in companies that claim to meet certain standards on social issues such as human rights, fair wages, working conditions, or economic and social justice. Claims are backed up by reference to standards or benchmarks. Reference standards might take the form of ESG performance data, ratings, benchmarks and indices and, sitting behind those metrics, ESG principles and frameworks. The contribution financial activities make to the UN Sustainable Development Goals (SGDs) is often used as a reference standard.[36]

Meeting external standards may be fine. At least financial institutions can be said to be not doing harm. These external reference standards need to be meaningful, and the claims made by financial institutions and investee companies should be independently scrutinised and verified.

There is no single agreed measure of social performance. There is a plethora of approaches to measuring the social impact or sustainability performance of companies and therefore the social performance of those institutions which provide the finance.

There may well be a case for having different approaches to measuring social impact. Different providers of finance will focus on different aspects of social sustainability. However, the sheer number of different approaches makes it all the more difficult to establish whether financial institutions are making a meaningful difference to human rights, employee rights, or behaviours in supply chains with their investing or lending decisions.

There is a more fundamental point here. Financial institutions are expecting to receive a reputational and therefore a marketing advantage for investing in, lending to, or insuring companies that are just doing what is expected of well-run corporations in relation to social issues.

[35] This paper No strings attached: Corporate welfare, state intervention, and the issue of conditionality - Fabio Bulfone, Timur Ergen, Manolis Kalaitzake, 2023 (sagepub.com) illustrates some of the worries about data from freeports.

[36] THE 17 GOALS | Sustainable Development (un.org)

If financial institutions do invest in companies that comply with minimum global standards on, say, gender pay fairness, that is to be encouraged. But, we would argue they should not expect special recognition for just doing what is acceptable. Special recognition should be reserved for financial institutions that drive corporate behaviours that go beyond what is acceptable. As explained above, ordinary citizens have to go beyond what is expected of a 'typical' citizen if they are to be rewarded for making a social contribution.

Yet, much of the approach to ESG finance, and the new labelling regime introduced by the FCA, rewards financial institutions for just doing what is expected. Critically, the current approaches do not sanction them for financing activities that continue to harm people and the planet.

So, we would argue that there should be a clearer distinction between financial and corporate behaviours that go beyond what is expected and behaviours which merely meet minimum acceptable standards.

If there is no special recognition attached, how do we encourage financial institutions to at least support corporate behaviours that meet minimum acceptable standards. In our view, the most effective way is to ensure there is a deterrent or penalty for behaviours that fall below accepted standards.

In other words, we should think about the outcomes of financial activities in three tiers – financing corporate behaviours that:

- meet the highest standards of corporate behaviour on social issues
- meet minimum acceptable standards
- fall below minimum acceptable standards

If we are to incentivise genuine social impact finance and deter socially harmful finance, any labelling regime or rating system should incorporate this distinction. How this could be done is set out in the section on using the six tests.

Assessing corporate behaviours against this test does require meaningful independent reference benchmarks. As we set out in the policy recommendations, below, we urge civil society organisations to develop and agree a 'gold standard' for corporate behaviours on social issues. Moreover, compliance with this standard would need to be independently verified. The FCA's labelling regime and the wider approach to sustainability assessment and reporting relies far too much on self-regulation.

Examples of social impact washing

The FCA's Sustainability Improver™ label is very open to manipulation. The lack of robust, consistent standards, and the leeway fund managers have to mark their own homework on compliance, provides them with plenty of room to define assets they invest in as 'improvers'. Worryingly, it looks like the new regime would enable an asset manager to market a fund with the Sustainability Improver™ label that invested in companies that did not even meet, never mind surpass, global social standards.

To reiterate, the FCA says the Sustainability Improver™ is for funds with a sustainability objective '*consistent with an aim to invest at least 70% in assets that have the* ***potential to improve*** *[our*

emphasis] environmental and/or social sustainability over time, and that are determined by their ***potential to meet*** *[our emphasis] the robust, evidence-based standard of sustainability. Firms must obtain robust evidence for selecting those assets*.'

The FCA also says: '*The methodology or approach to select assets may be a relative measure or approach eg, selecting the 'best-in-class' for a particular sector. The evidence firms may use as the basis for selecting assets may, for example, include forward-looking metrics, transition plans, strategies or other credible information that demonstrates those assets are on a pathway to becoming more sustainable*.'

The FCA's Sustainability Disclosure Requirements (SDR) and investment labels Policy Statement PS23/16 includes the example of the *ABC Emerging Markets Social Advancement Fixed Income Fund.*[37] To quote the FCA: '*The fund aims to provide capital growth over the long term by investing in the bonds of companies in emerging markets that have committed to improving their business practices in line with key global social standards, in relation to human rights, working conditions and local community impact*.'

The phrasing of this example is very unclear. Does it mean that a fund manager could use the Improver label if the companies it invested in did not meet global social standards at the time but just *committed to improve*? Or does it mean that it would comply with existing standards now and commit to match any improvement in standards if those standards improve?

Even if it was the latter, this would still mean that fund managers could obtain a marketing and commercial advantage by investing in companies that just aim to comply with but not exceed existing standards.

Moreover, as outlined above, the FCA is allowing fund managers to select which 'credible' standards to use. The FCA has not set out what it means by 'credible'. An investor who is considering investing in an Improver fund would have to trust: the fund manager's compliance with the label's standards; the intentions of the underlying companies that claim they intend to improve their behaviours; and the credibility of any reference benchmark.

As mentioned above, the actual performance of funds claiming to be aligned with established, well recognised reference standards such as the UN SDGs is not good. The fact that the FCA is allowing financial institutions leeway to mark their own homework on compliance is worrying enough. But, to allow self-policing on funds which claim to be sustainable based on the *commitments* and *intentions* of investee companies rather than hard evidence on actual performance is particularly risky. Remember, the FCA is not requiring independent verification of labels, nor is the regulator approving the use of the labels.

It is unclear how or why investors should be expected to trust funds with this label given that the FCA is allowing what is in effect self-regulation of compliance, does not require independent verification, and has not mandated what it thinks is a gold standard of reference benchmarks.

[37] FCA Sustainability Disclosure Requirements (SDR) and investment labels Policy Statement PS23/16, p106.

The Do No Harm principle

Finance should follow the do no harm principle. Finance which produces a positive social impact in one area should not cause harm in another. Finance which supports one sustainable development goal should not undermine another goal.

Rationale and description

Investment funds and other forms of finance claiming to be socially sustainable should ensure that financial activities aimed at benefiting one community do not result in harm to other vulnerable communities. Otherwise, the benefit that accrues to one community would be offset by the harm caused to another meaning there is no net gain in welfare. This condition should apply to funds that invest in the UK or overseas.

The do no harm principle is particularly relevant for funds investing in companies that may be located in one region, say the UK, but which sell products and services for use in other countries around the world. It is also relevant for investing in companies that set up in a deprived area of the UK but rely on overseas supply chains.

Examples of potential social impact washing

By way of 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 if the fund invested in technology companies that set up in a UK deprived region but sold their technologies to oppressive regimes to spy on citizens? What about investing in a company that set up in a deprived area of the UK but treated overseas workers in its supply chain unfairly?

Would any of those companies be eligible for counting towards the threshold to qualify for one the FCA's sustainability labels? The asset manager might claim that the fund is having a positive social impact by financing job creation in deprived regions of the UK. Yet the company's revenues would be generated by activities which clearly harm other vulnerable people in a different part of the world.

We would suggest that financing these assets should not be counted as social impact or socially sustainable finance generally or count towards the 70% threshold for one of the FCA's labels.

Financing social sector assets

The use of private finance to meet core needs in the social sector should not be automatically classified as social impact or included within a broader sustainability label unless other conditions are met.

Description and rationale

One trend we have noticed is the emergence of what we describe as a *social sector asset class*. This social sector asset class has grown as the state, both central and local, withdraws from or reduces its role in funding social or affordable housing, health, social care, specialist education, and other public services. Moreover, linked to this, politicians are relying more on private finance to fund core infrastructure and levelling up programmes. The social sector asset class also includes banks and others financing community lenders such as Community Development Finance Institutions (CDFIs) and other community-based services.

We are not debating whether this transfer of funding responsibility is a good or bad development, *per se.* That is a political decision and is outside the scope of our work. However, we do point out that private finance, for the most part, expects to make a market return from investing in or lending to the social sector. That expectation making a market return means that the cost of financing those core social needs is more costly than if funded by the state.

Major insurers and other private finance institutions such as private equity funds are targeting this social sector asset class as a growth area for generating financial returns. Finance lobbies have even been pushing for deregulation and corporate welfare to be provided before making financial commitments.

Financial institutions sometimes use terms such as purpose-based finance, sustainable and social impact finance to describe this financialisation of the social sector.

It is very important to clearly delineate a social sector asset class. For private finance, the social sector is just another type of asset to be considered as part of the asset allocation and investment decision process. Making a market return from social harm or the provision of social needs is no different to investing in, say, the pharmaceutical or technology sectors. The difference is financial institutions want to get a reputational and marketing advantage by branding these investments as social impact or sustainable.

Examples of potential social impact washing

Let's take the case of an investment fund or insurance company that invests in building social or 'affordable' accommodation or in care homes but which also aimed to generate a market-matching or market-beating return from these activities.

In this case, financial institutions are able to exploit the fact that the state is no longer meeting a social need, such as ensuring there is sufficient affordable housing or social care facilities for citizens, to generate market returns for investors. If the financial institution classified these activities as social impact or sustainable, we would say this is social impact washing.

Yet, from what we know, the FCA regime would allow this type of investment to be classified as called Social Impact. The FCA has produced guidance to help investment firms understand what should and should not be considered sustainable. In this guidance it actually references a hypothetical investment fund that makes profits from properties used by local authorities to house homeless people. This fund would be allowed to use the Sustainability Impact™ label.[38] In contrast, if the investment fund makes a market return from these activities while marketing the fund as 'Impact', we would say this is social impact washing.

Let's take another example. Supporting financial inclusion is a common way for banks and other financial institutions to demonstrate their corporate social responsibility (CSR) commitments. The challenge of supporting community lenders such as CDFIs is very topical. If a bank provides grants or below market rate finance to a community lender, without corporate welfare, then we would say this is clearly social impact finance. However, if it provides finance at market rates and/or expects to

[38] See the example of the *ABC Social Impact Real Estate Fund*, in FCA Sustainability Disclosure Requirements (SDR) and investment labels Policy Statement PS23/16, p108

be the priority creditor in any arrangement to de-risk the finance then, in our view, this is not social impact or sustainable finance. Indeed, if it tried to market this finance as social impact or sustainable we would say this is an example of social impact washing.

Note that we are not saying that this finance is ‘bad’. It would be a vote of confidence in the sector and that finance may well indeed allow CDFIs to expand their loans. But, we would say it should not be branded as social impact or sustainable finance. It would be no different to providing finance to, say, a technology company looking to expand its business.

Development finance and social impact

Domestic or overseas ‘development finance’, such as lending to or investing in deprived areas of UK or Low or Middle Income Countries (LMICs), should not be automatically classified as social impact unless the other conditions are met.

Description and rationale

This is similar to the above points. Just because a private finance institution finances economic activities in deprived areas or communities in the UK or overseas, this should not automatically be considered as social impact. Similarly, just because a financial institution claims to be aligned with external initiatives such as the UN Sustainable Development Goals should not make this social impact or even sustainable by default.

Concepts such as ‘blended finance’ or ‘catalytic finance’ use finance provided by governments and NGOs to scale up private finance to meet development goals or climate goals. Funding models can differ, but, generally speaking, it involves the public sector or agencies ‘de-risking’ a venture or providing some sort of incentive to make it commercially attractive to private finance. Once the venture has been de-risked or returns cross subsidised, this leaves the private finance provider to benefit from future returns. Experts may argue that this is necessary to attract the required funding. But, poorly designed models that protect financial institutions from downside risk but allow them to exploit upsides (socialising the risk and privatising the rewards) are just another form of corporate welfare.

Examples of social impact washing

Recently, we have seen a big push by UK private finance lobbies for financial deregulation to ‘encourage’ investment in the green transition, to meet public policy challenges such as building affordable housing, and even to support the levelling up agenda.[39]

As with social sector assets above, if making a market return is a prerequisite for investing in, say, infrastructure or a company located in a deprived area of the UK then they would be treating this as just another asset class. They would not finance this infrastructure or invest in the company unless they could generate a market return.

[39] The Solvency II ‘reforms’ are undoubtedly a weakening on prudential rules for insurers. Submission to HM Treasury Review of Solvency II consultation | The Financial Inclusion Centre The main insurance lobby group, the ABI, welcomed these reforms claiming this would allow it to invest in levelling up, social infrastructure, and the green transition Solvency II reform welcomed by insurance and long-term savings industry | ABI

With regards to, say, funding infrastructure and affordable housing in a deprived area of the UK, this form of finance would be more costly than state funding. This would be push up the cost of funding these policy goals. In this case, more costly private finance would be displacing more cost-effective state finance.

Furthermore, there is the impact of using private finance on inequality. Using private finance generates an upward transfer of wealth to investors in the form of investment returns. The more assets a person has, the greater the gain. There is marked regional wealth inequality in the UK.[40]

Financialisation drives up the incomes of financial sector employees compared to non-financial sector employees as well as boosting the returns of those with financial assets.[41] The dominance of the City of London and concentration of financial and associated professional services in the capital, means financialisation contributes to inequality.[42]

We would argue that just because financial institutions invest in deprived regions of the UK, this should not be presumed to be social impact or sustainable finance. If making a market return is a prerequisite, it is just another asset allocation decision. If financial institutions claim that it is social impact or sustainable finance, we would say this is impact washing. All the more so, if financial institutions expect corporate welfare in the form of 'de-risking' or incentives.

Similar points can be made about 'development finance' aimed at Low and Medium Income Countries (LMICs). Some might argue that the provider of finance is taking a greater risk by allocating assets to LMICs. But, presumably it would also adjust its return expectations upwards to reflect that risk.

The point is would UK private finance institutions be willing to invest in, lend to, or insure assets in LMICs unless they expect to generate market returns and/or have the finance de-risked or incentivised in some way? Can private finance which generates high returns for investors in High Income countries (HICs) by investing in LMICs be really said to be social impact or sustainable finance - especially if corporate welfare and generating market returns is a prerequisite for investing?

In our view, development finance, whether domestic or overseas, provided on those terms does not merit a social impact or sustainable finance label, as it is merely a strategic or tactical asset allocation decision which also generates a reputational gain for the institution.

[40] Households in the South East, East of England, and London have significantly higher median wealth than those in other GB regions. See: The Scale of Economic Inequality in the UK | The Equality Trust
[41] How household debt influences inequality | British Politics and Policy at LSE
[42] London is a major reason for the UK's inequality problem. Unfortunately, City leaders don't want to talk about it - Queen Mary University of London (qmul.ac.uk)

Applying the six tests to assess the social impact of finance

The tests can be used for a number of purposes and at all levels in the financial decision-making process. They can be used by individuals, financial advisers, financial institutions, pension fund trustees, managers of charitable and endowment funds, NGOs and civil society, and ratings agencies.

The tests can be used to assess and rate: the financing of specific projects and ventures; joint projects/ventures including concepts such as 'blended' or 'catalytic' finance; and investments in, loans to, and insurance provided to companies by financial institutions. An assessment of 'pooled' investment portfolios, pension/insurance/investment funds, and loan books can also be undertaken.

Those with important governance roles such as pension scheme trustees can use the tests to evaluate the social impact performance of external investment managers and their own performance. The Department for Work and Pensions (DWP) Taskforce on Social Factors has just published recommendations on how pension trustees can integrate social factors into decision making.[43] The tests outlined here provides a practical way for trustees to do that.

To reiterate, we are not saying that financial activities which do not pass all the tests are 'bad'. For example, a pension fund may seek to generate a market return but only by investing in companies which comply with the other tests. The pension fund can at least be said to be not causing social harm. However, we would argue this is a 'socially sustainable' or 'socially neutral' strategy, not a positive social impact strategy.

These tests can also be aligned with users' own expectations of social impact and sustainability. Some users, for example, charitable funders may wish to identify corporate assets and finance which pass all the tests – the highest standard of social impact. Others may be willing to accept lower standards. For example, they might want to seek a market return but ensure that the finance provided is at least meeting the other tests.

The important point to note here is that if we are to evaluate the social impact of finance then we need a way to assess the impact of individual assets *and* the providers of finance that lend to, invest in, and insure those assets – see the schematic outlined above.

As a reminder, the six tests we propose relate to:

- Forgoing market returns
- The role of corporate welfare
- Standards of corporate behaviour
- The Do No Narm Principle
- Financing social sector assets
- Development finance (domestic and overseas)

Rating the specific assets

There are a number of ways to convert the six tests into a rating system for the assets being considered as potentially eligible for the social impact category. For example, we could use a fairly simple four tier system (although there will be other approaches which could be more effective).

[43] considering-social-factors-in-pension-scheme-investments-recommendations.pdf (publishing.service.gov.uk)

Focused Social Impact assets: The highest tier which pass all of the tests.

Social-Sustainable assets: These assets can generate a market return and the company/venture passes the other tests relevant[44] to its corporate activities and meets the highest standards of corporate behaviour[45] but without relying on corporate welfare.

Social-Neutral assets: These assets generate a market return but do no harm. Note that do no harm in this instance means companies complying with a recognised *acceptable* standard on human rights, fair pay and other related requirements. This would in no way imply that financing these corporate assets is deemed to be having a positive social impact. This is just doing no harm. To qualify for the higher classification of social aligned assets, companies would have to meet the highest standards of corporate behaviour. Assets that aim to generate a below market return but require corporate welfare to underwrite an element of risk could be classified as neutral depending on the balance between the returns and amount of corporate welfare.

Social-Negative assets: Specific assets could also be evaluated to determine if they are causing or contributing to social harm. This would be the social equivalent of climate harming activities. For example, a company based in a deprived area of the UK which imported raw materials from firms which failed to meet accepted standards of corporate behaviour would fail the Do No Harm test as a result of practices in their supply chain. We would also argue that an asset which is expected to generate a market return and receives corporate welfare should always be deemed as socially negative regardless of the activity. For example, if an insurer will only invest in social infrastructure if it receives corporate welfare from the state to underwrite its returns then it is extracting value from communities and taxpayers and transferring wealth to its investors and shareholders.

Note that there are probably more user-friendly names available for these four tiers. These are not intended to be used for communication purposes. These are intended to convey different levels of social impact intent and compliance with the tests to allow for an overall rating of specific assets and portfolios and funds.

Assessing the specific assets

The tests can be used by individuals or financial institutions (commercial and non-profit/NGOs) to assess a project/venture/company they are considering financing. Or the tests can be used by external independent civil society organisations and media to assess the behaviours of financial institutions and scrutinise social impact claims.

Financing may be done through a loan, investment, or project finance and so on. Before making a financial commitment, the tests can be applied to determine whether an intended recipient of the finance has the potential for meeting higher standards of positive social impact.

For example, a pension fund manager could use the tests to screen companies and choose to only invest in or lend to companies that go beyond current standards of corporate behaviour in relation to gender pay gaps and treatment of workers in supply chains.

[44] For example, Test 6 which relates to development finance would not be relevant for investment in social sector assets which is covered by Test 5.
[45] For example, measured against the most robust standards developed by trades unions and NGOs on workers' rights in supply chains

Similarly, a pension fund manager could be thinking about investing in ventures/companies that claim to be committed to regeneration in the UK by establishing operations in deprived regions. The investee company might pass the first part of the test by setting up in a deprived region and creating jobs.

With this new, more rigorous, approach, it would not qualify as true social impact finance if that company's products caused harm to another vulnerable community in another part of the world. It would also not qualify as social impact if the investee company required some form of corporate welfare to establish operations in that deprived region.

As another example, consider an investment in or loans to private sector companies which run children's care homes or specialist housing to rehabilitate homeless people for a profit. This company might be said to be doing a social good. The fact that it makes a profit from doing so means the provider of finance makes a market return from this asset as a result. This just treats this 'social' activity as another asset class from which to generate returns. So, we would say this would fail the tests.

What would happen if an insurance company decided to invest in building 'affordable' housing or infrastructure in a deprived area of the UK claiming it is helping with the levelling up agenda? If the insurer sets out to make a market return from this investment or will only provide the finance if it is 'de-risked' or incentivised by the state, local government or some other agency, then this would fail the tests. Market returns and corporate welfare are preconditions for providing the finance. The primary motivation here is not making a social impact. The insurer should not be able to obtain a reputational or marketing advantage for doing so.

Assessing and rating pooled financing vehicles/portfolios

The tests can then be used to evaluate and rate the social performance of those who provide the finance. There is a range of different types of for-profit/non-profit, and state/private/third sector providers of finance – individuals and institutional (charities and endowments, pension funds, insurers, banks, asset managers, private equity etc.).

Many individuals do still prefer to hold shares and bonds directly. The tests can, of course, be used by direct individual investors who are considering financing individual companies or ventures (through shares, bonds, or crowdfunding).

As explained above, direct investment now represents a small share of the total value of investments and loans. Most financing now is pooled/diversified or intermediated in some way for example through a pension fund, insurance fund, investment fund and private equity funds, or on bank loan books.

Given the pooled nature of finance, we need a way to measure the overall social impact contribution of the assets held in portfolios. Once the individual assets are assessed, it is a fairly mechanical process to then assess or rate the overall social impact contribution of a portfolio and the social performance of a financial institution.

Pooled portfolios (pension funds, investment funds, loan books etc.) are made up of individual assets. Interested parties could use the tests to produce an overall rating for a pooled portfolio

rather than an individual asset. To do this, each of the assets could be allocated a score based on whether it is Focused Social Impact, Social-Sustainable, Social-Neutral, or Social-Negative.[46]

Users could choose to just allocate scores to Focused Social Impact, Social-Sustainable, and Social-Neutral. For example, give 3 to Focused Social Impact, 2 to Social-Sustainable, and 1 to Social-Neutral and not factor in Social-Negative assets. This would focus on producing an aggregate score of the overall *positive* social impact of the portfolio/fund.

Alternatively, Social-Negative assets could also be allocated a -VE score. With this second approach, Social-Negative assets would offset and reduce positive scores to provide a 'net' social impact score.

Table 1: Example of a portfolio/ fund/ loan book scoring assessment

Fund/ portfolio A

Asset	Social score of the asset	% share of portfolio	Social Factor=SS* % share
A1	S1	30%	0.3*S1
A2	S2	25%	0.25*S2
A3	S3	15%	0.15*S3
A4	S4	20%	0.20*S4
A5	S5	10%	0.10*S5
Weighted average/ total social score			= sum of social factors A1-A5

Table 1 provides an example of how to calculate the overall social impact performance of a hypothetical fund, portfolio, or loan book. For illustrative purposes, we have included just five assets A1-A5. Real world portfolios will usually contain many more individual assets. But, the approach remains the same. The total social score would be calculated by applying the portfolio weighting of each asset to that asset's social score. Portfolios/ funds/ loan books could then be compared using their total portfolio scores and rated.

Using the tests with the FCA's investment labels

Specifically, the tests can be used to challenge financial institutions that use an FCA sustainable investment label for marketing purposes. The test allows users to apply a more challenging standard to greenwashing. Note that greenwashing here covers sustainability generally so includes misleading social impact claims, not just environmental claims.

The new FCA labelling regime has a 70% threshold for a fund to be able to use a sustainability label. For example, to use a Sustainability Focus™ label, the FCA says that products should aim to invest at least 70% in assets that are environmentally and/or socially sustainable determined using the robust, evidence-based standard that is an absolute measure of environmentally and/or socially

[46] More sophisticated scoring could be developed for example using a 1-10 range based on *how* socially positive or negative the asset is.

sustainability. However, the FCA does not specify any robust, evidence-based standards that are an absolute measure of social sustainability.[47]

For the Sustainability Impact™ label, at least 70% of the assets should aim to achieve a pre-defined positive, measurable, impact in relation to an environmental and/or social outcome. The FCA says that firms must specify a theory of change setting out how they expect their investment activities and the product's assets to contribute to positive impact; and specify a robust method for measuring and demonstrating the positive impact of both their investment activities and the product's assets. But, again, the FCA does not provide any detail on what a robust method of measurement is.

For the Sustainability Improver™ label, at least 70% of assets should have the potential to improve environmental and/or social sustainability over time. The FCA says that firms must obtain robust evidence for selecting those assets. But, the FCA does not specify what robust evidence means. The Sustainability Improver™ label has the potential to be particularly misleading as it will be very difficult to disprove any claims about intending to improve. The standards are particularly undemanding and open to misrepresentation.

The Sustainability Mixed Goals™ label requires 70% of assets comprising a combination of assets that would qualify for the other three labels. Given the lack of meaningful standards underpinning the other three labels by definition this means the Mixed Goals label will also be misleading.

The failure of the FCA to specify what are robust, trustworthy reference benchmarks or standards is a particular problem as this could enable social impact washing. If assets which meet undemanding standards of social impact are included in a fund and count towards the 70% threshold, this, by default, will mislead consumers.

The six tests provide a robust method to evaluate each asset held within an investment fund to judge how fairly the choice of label reflects the investment fund's social performance.

As explained above, we argue that the highest standard of social impact should be reserved for finance that is willing to accept a below market return. However, the FCA labels will be used by investment firms and advisers intending to generate market returns for clients who also want to take into account sustainability issues.

To accommodate this, we propose that individual assets that fall below the Social-Sustainable tier described above should not count towards the 70% threshold for the Sustainability Focus™, Sustainability Impact™, and Sustainability Mixed Goals™ labels. The Sustainability Improver™ label is potentially so misleading that we would recommend avoiding this altogether. That said, if investors do want to buy funds and products with this label then the tests could be used to set a target for social sustainability.

[47] We are focusing on the social element of sustainability in this report. Yet the failure of the FCA to provide details on robust evidence based reference standards on *environmental* goals is just as big a problem with the FCA's approach.

Policy recommendations and next steps

In the above sections, we set out why new standards on social impact finance are needed. We have proposed six tests to allow users to assess whether financial activities can be objectively judged as intending to have a social impact, and actually do so. We also described why each of those tests is needed. We include examples of types of current activities which are currently regarded as social impact or sustainable but which we think should not be considered as social impact. We then provided some ideas for how the tests could be used to rate assets and portfolios, and challenge firms that use the FCA's new sustainable investment labels.

We encourage social impact funders (whether in government, civil society/NGO, or private finance sectors) to use the tests when considering their social impact activities. We hope this new approach will help bring some rigour to the debate about social impact and sustainable finance and help expose social impact washing.

However, more is needed if we are to embed higher standards into the wider sustainable finance market. As we explained in the Introduction, social impact finance and social impact washing has not received as much attention as environmental finance and greenwashing. Therefore, in this final section, we make a set of policy recommendations to embed higher social impact standards into financial services.

Policy recommendations in brief

- The FCA and other regulators should have a clear strategy for exposing and combatting social impact washing separate from greenwashing.
- Social impact should have its own specific label and not be conflated with environmental impact.
- Social investing criteria should be rolled out rapidly to pension funds and other financial activities, and not be limited to investment funds.
- An independent external reference or benchmark is required for social impact and sustainable finance.
- A comply or explain approach which relies on disclosure is not enough. There needs to be a clear system which provides objective ratings of positive and negative social performance, supported by robust enforcement to ensure compliance with standards.
- The asset minimum to attract a social label or general sustainability label should be the 80% threshold used in other financial centres.
- UK policymakers should develop a regime that allows for comparison with social and social impact goals of offshore funds and other financial vehicles given the international nature of some investors' portfolios and finance more generally.
- UK policymakers should develop a new framework in consultation with civil society organisations to integrate catalytic and blended finance into a new framework.

Policy recommendations in detail

The FCA and other regulators should have a clear strategy for exposing and combatting social impact washing separate from greenwashing.

The FCA should apply strict criteria to evaluate claims made by asset managers and penalise social impact washing. The FCA should ensure sufficient supervisory resources are dedicated to tackling social impact washing. Regulators should also remain vigilant about the use and abuse of marketing terms in the wider sustainable and ethical finance market.

The FCA's policy statements make many references to examples of greenwashing and environmental sustainability. There are few references to social impact. We are concerned that the attention given to greenwashing means that social impact washing will not get the attention it deserves. Greenwashing is somewhat easier to identify and quantify. There are a number of quantitative metrics which can be used to judge environmental harm caused by finance such as portfolio emissions data which can be evaluated at the level of shares and bonds, funds, loan books and financial entities.

It is interesting that a global marketing data business Kantar has raised many of these concerns. Again, it makes most mention of greenwashing, but a recent report[48] also makes mention of 'social issue washing'. Quoting its own global research among consumers, it says: '*An incredible 67% of global consumers say they worry brands are involved in social issues just for commercial reasons. A sense that brands put greed and profit above all else has grown over recent years, which explains a base level of cynicism across all sectors*.'

A better targeted label could build broader trust among investors as part of work to extend that trust across society.

Social impact should have its own specific label and not be conflated with environmental impact in a single sustainable label.

Social impact and socially sustainable investing requires its own clear system of categorisation and labelling when it comes to guiding investors and changing corporate behaviour in the financial sector.

The FCA's approach combines two concepts for environmental and social under a broad heading of sustainability. The FCA should have tested public appetite for a clearer distinction between the two. The recent FCA Financial Lives survey found that 76% of the public would like to invest in a way that protects the environment and 74% would like to invest in a way that has a positive social impact.[49] But, rather than assuming a big cross over, the regulator should have gone on to consider how regulation around these labels could have reflected consumer preferences.

It would have represented a helpful departure from the ESG acronym which itself has become rather confused. It could be argued that again the FCA's own policy paper even alludes to this saying: ''*Terms such as 'ESG (Environmental, Social and Governance)', 'responsible', 'green' or 'sustainable' are open to interpretation and are often used loosely and interchangeably*.''

[48] Mistrust and rejection: The impact of greenwashing and social washing on brands (kantar.com)
[49] ps23-16.pdf (fca.org.uk), para 1.2

'Sustainability' is too broad an overarching category and will likely confuse investors as to what is being focused on, and what impact is being made. Social investors are at risk of becoming 'the poor relation' within the labelling regime. Funds investing in the environment and those investing in addressing a social problem will have the same label despite very different goals.

Bracketing environmental and social impact together was not necessarily always the case. For example, in 2016, in a feedback statement[50] to a **'**Call for Input: Regulatory Barriers to Social Investments', the FCA itself noted the following. '*Concern was expressed by some respondents that there was a tendency to bracket social investments with traditional green/ethical investments. The latter, it was argued, are well established forms of investment at both retail and institutional level with different risk profiles, regulation and guidance*.'

Several jurisdictions have at least incorporated social elements into their taxonomies. Mexico adopted its taxonomy in 2023.[51] The Georgian central bank's taxonomy has clear, separate green and social elements.[52]

To quote the Stanford University Social Innovation Review which talks about fixing the 'S' in ESG, it says: '*Reliable, high-quality S data requires specialized taxonomies, questionnaires, and independent verification. This will also create a whole new level of ESG*.'[53]

Robust social impact standards should be rapidly rolled out to pensions and other financial activities not limited to investment funds.
Limiting the labelling system to investment funds and fund managers is unlikely to achieve the required purchase in terms of public awareness. The FCA does say it will seek to apply the regime to pension products in the 'medium term'. In our view, that it not fast enough. The FCA and The Pensions Regulator (TPR) should collaborate and take swift action to apply the labelling regime or a rating system to pensions and other financial activities.

Otherwise, we will be left with a system where UK investors, savers and pension scheme members will see some products and funds labelled while other parts of their portfolio which could have similar objectives will not. Apart from anything else, they will not be able to accurately evaluate the overall social performance of their total portfolio.

An independent external reference or benchmark is required for social impact and sustainable finance labels.
An approved list of external independent reference benchmarks should be established for social issues such as diversity and inclusion, fair pay, human and labour market rights. Fund managers should not be able to select their own external or internal reference benchmarks.

For example, the FCA talks about 70% of the product's assets needing to be selected with reference to a robust (i.e. stand up to scrutiny), evidence-based (i.e. derived from or informed by an objective and relevant body of data or other evidence) standard that is an absolute (as opposed to a 'relative') measure of environmental and/or social sustainability.

[50] feedback statement fS16/11
[51] How Mexico's sustainable taxonomy tackles both environmental and social issues | S&P Global (spglobal.com)
[52] The NBG publishes Sustainable Finance Taxonomy for public consultations
[53] The S in ESG Investing Has a Data and Measurement Problem (ssir.org)

The standard may be based on general environmental and/or social criteria such as the percentage of revenue associated with sustainability matters; reference an authoritative taxonomy such as the EU taxonomy or forthcoming UK Green Taxonomy; or set a minimum threshold of greenhouse gas (GHG) emissions for assets.

For all labels, independent assessment to confirm the standard is fit for purpose may be obtained via either internal processes or third parties, provided that the chosen method is independent from the fund manager's investment process.

Yet, the FCA has not specified what robust means, what level of evidence is deemed appropriate, or said anything about the bona fides of any internal models or external agencies that might be used to assess standards. Given that there is a plethora of standards, ratings, data, and narrative reporting frameworks that claim to allow for assessment of environmental sustainability the fact that the FCA has not specified standards is a real concern.

A fund may well have 70% of its assets invested in what the fund manager claims are sustainable by reference to a standard. But, if the fund manager has been able to select the standard and who assesses that standard, and the FCA has not determined what robust or evidence-based means then this does not engender trust and confidence in any fund claiming to have 70% sustainable assets. Moreover, both the UK green and EU social taxonomies, which might provide some sort of external reference point, have been subject to delay and indeed intense lobbying.

There is much to do on the standards relating to environmental sustainability but at least there has been some good progress. The same cannot be said for data and standards frameworks on social sustainability. These are far less developed. Developing meaningful and robust standards on the social aspect of sustainability should be a priority for the FCA and civil society.

The other closely related issue is the matter of ESG and sustainability rating agencies and consultancy firms. The Financial Inclusion Centre has called for the swift regulation of ratings agencies. The UK Government has said that it intends to regulate ratings agencies. As an interim measure, the FCA has allowed the *industry* to develop a voluntary code of conduct. This does not inspire confidence.

We have set out, above, a framework for objectively evaluating and rating investment funds and financial activities. However, the input data e.g. 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.

A comply or explain approach which relies on disclosure is not sufficient.
A comply or explain approach is often implemented as an early phase in the development of a tougher and more rigorous regime. We contest the assertion made in the FCA paper (which we quote at length for understanding) that its plans would bring '*reduced harm from greenwashing and increased consumer protection, increased provision of standardised sustainability-related information, better informed capital allocation and asset pricing, and better labelling and transparency to help facilitate an orderly transition to a more sustainable future*.'

'*We expect the updates to our proposals will enhance these benefits through increased provision of standardised sustainability-related information which will enable consumers to better navigate the*

market and make more informed decisions. This is due to the introduction of the fourth label, increasing label uptake, and our revised naming and marketing rules allowing firms to use sustainability-related terms and to explain the sustainability features of the products through consumer and product-level disclosures.'

To be blunt, we do not believe the supporting system put in place by the FCA is robust enough to support this contention.

There are other worrying developments. As reported in Business Green, the UK's financial auditing regulator has dropped plans to add specific environmental, social and governance (ESG) requirements in the UK Corporate Governance Code in a bid to limit administrative burdens on businesses '*to the minimum necessary*'. The website adds: "*FRC's 'comply or explain' principle is set to remain, meaning that companies will have to show that they are adhering to financial regulatory requirements - such as those on climate risk reporting - or provide an explanation to the regulator as to why they have not been able to.*" This will have clear knock-on effects across asset management and funding decisions and is a new challenge to labelling.

The FCA states: '*The FRC considers this approach to internal controls, which is principles based and relies on Boards making their own judgments on what is material, is better suited for the UK commercial and governance framework than a more intrusive and prescriptive approach required in other jurisdictions*.'

We question the benefits of getting out of line with neighbouring jurisdictions. Moreover, we would question the wisdom of relying on the comply or explain approach to police the behaviours of commercial vested interests on matters relating to environmental or social impact.

The asset minimum to attract a social label or general sustainability label should be the 80% threshold used in other financial centres.
As explained above, the FCA has adopted a threshold of 70% of qualifying assets to allow funds to use a sustainability label. This is disappointing. The UK should have as tough a regime as two major global centres for asset management, the US[54] and the EU.[55] These have generally favoured a qualifying assets threshold of 80%.

If asset managers in other major centres can cope with an 80% threshold, it is difficult to understand why the FCA has adopted the lower threshold. The effect of this lower threshold is that UK investors who are interested in social impact or sustainable investment will get a lower 'social return'.

UK policymakers and regulators should develop a regime that allows UK investors to compare the social performance of domestic and offshore and other overseas funds.
Many investors have portfolios containing a mix of UK and overseas funds. They will need to understand how overseas funds perform on social impact measures and to be protected from social impact washing.

[54] SEC.gov | SEC Adopts Rule Enhancements to Prevent Misleading or Deceptive Investment Fund Names
[55] - esma34-472-373_guidelines_on_funds_names.pdf (europa.eu)

The UK is to rely on disclosure to some degree. The FCA says that: '*We continue to work with the Treasury on the approach to overseas funds and are introducing the requirement for distributors to add a notice on overseas funds to inform consumers they are not subject to the regime*.'

Distributors will also be subject to greenwashing regulations. In our view, disclosure may not be enough. Investors may get a mishmash of regimes with some jurisdictions applying a robust regime, others a much lighter one. For example, the ASEAN taxonomy,[56] borrows many concepts from the EU such as Do No Significant Harm. Although, it is much less prescriptive and is a high-level overarching framework due to the very diverse range of development stages across the member countries. It does mention how the taxonomy can help investors in social. But, it is mostly an environment-focused document. We are not suggesting that advisers understand every nuance of difference and an ASEAN domiciled fund recommendation may be rare. However, it surely makes sense that financial advisers link their clients' preferences on social investing to advice recommendations wherever funds are domiciled. They should also exercise oversight on behalf of clients if recommending overseas funds.

Therefore, we argue that advisers and product distributors should have a duty to do due diligence when recommending or distributing offshore and overseas funds to investors interested in social issues. This would make the UK/offshore 'interface' more robust.

UK policymakers should consult with civil society organisations and investors to develop a robust framework for concepts such as development finance, and catalytic and blended finance targeted overseas.

A presumption is often made that providing finance to companies or ventures in Low and Medium Income Countries (LMICs) is more likely to meet the criteria for social impact and sustainable finance. Delineating genuine social impact finance can be challenging enough in high income economies with relatively developed financial markets but even more so when it comes to LMICs. The countries may well have booming economies but can have somewhat less developed public financial markets, financial reporting standards, and corporate law regimes.

Approaches such as development finance and related concepts like blended and catalytic finance aim to attract and channel private finance to meet sustainability goals in LMICs. Funding models can differ but generally speaking it involves the public sector or agencies 'de-risking' projects to attract private finance. Many experts will argue that this is necessary to attract the required funding. However, poorly designed models which just socialise the risk and privatise the rewards are another form of corporate welfare.[57]

Therefore, we argue that a framework and tests similar to those outlined in this paper is needed to ensure that development finance, catalytic and blended finance is genuine social impact and not used as a cover by UK financial institutions primarily to generate returns.

[56] AT V2 Main Rpt Draft_08Jun23_1700BKK (asean.org)

[57] We would argue it is different if those providing the de-risking charge appropriate fees for underwriting early stage risks (that is more akin to insurance) or share risks and rewards in a balanced way with private finance. That would not be corporate welfare.

The role of civil society

The role of civil society is especially important given that the FCA's labelling regime is far from optimal. In our view, civil society groups should:

- Develop a separate social impact label
- Identify and produce a robust set of data sources and a 'gold standard' reference benchmark to objectively judge the social performance of financial institutions, funds, and products and to reduce the reliance on commercial ratings providers
- Be alert to the emergence of a purely profit driven social investment sector and continue to campaign for higher, more rigorous standards
- Hold financial regulators to account for their performance in exposing social impact washing by companies and financial firms
- Campaign to persuade the FCA to increase the threshold of qualifying assets for a sustainable label to 80%.

April 2024

Glossary

The glossary below is designed to help those involved in these discussion and debates to get a handle of many of the main terms. Despite the FCA policy paper, we feel that these terms remain up for debate. Indeed, in certain ways the charter is disputing them and calling for further clarification.

Blended Finance is an approach to financing emerging and frontier markets which combines official development assistance with other private or public resources, in order to 'leverage' additional funds from other actors. Generally, it is public and potentially philanthropic money established first. It then can drive a huge range of approaches to funding. It is often aimed at helping countries meet climate change and Sustainable Development Goals. However, the LSE sets out the current challenges. To quote: '*The success of blended finance rests critically on the ability to maximise additionality, both in terms of the financial resources mobilised and the developmental impact created, while minimising concessionality, i.e. providing public capital at as close to market conditions as possible*.'

LSE explainer: How can 'blended finance' help fund climate action and development goals? - Grantham Research Institute on climate change and the environment (lse.ac.uk)

Oxfam report: Blended Finance: What it is, how it works and how it is used - Oxfam Policy & Practice

Catalytic Finance is closely related to blended finance. It is defined by USAID as the provision of resources to an investment fund or vehicle designed to mitigate risk and improve the fund's overall viability to attract new investment for development goals. These intermediaries pool resources and distribute risks among investors and are a primary vehicle for blended finance.

USAID: Catalytic Funding | Document | U.S. Agency for International Development (usaid.gov)

Corporate social responsibility (CSR) describes a company's approach to social issues such as reducing carbon footprint, improving labour market practices, or engaging with local communities and charities. It is similar in concept to ESG, see below. The main difference is that CSR is considered to be more of an internal governance framework while ESG has a more external focus – for example, it aims to allow investors to assess the impact a corporation has on the environment and wider society.

Corporate Welfare is a term used often within politics and by campaign groups to describe a government's bestowal of money grants, tax breaks, or other special favourable treatment to corporations. It remains a contentious area, but with regard to social and social impact, it is where the government may have removed almost all risk or even effectively guaranteed returns.

Environmental, social and governance (ESG) – sometimes described as ESG factors when applied to investing - is a set of considerations, including environmental issues, social issues and generally matters to do with corporate governance that can be considered when making financial decisions. The combination of the three and which letter or letters is emphasised has been the subject of a lot of debate as is whether it is risk management or stock selection tool. The UK may be edging away from the term given the FCA's labelling plans. By contrast, it is being placed at the heart of the US SEC's 'Names' legislation clamping down on ESG-washing by funds.

Ethical Investing describes matching a fund or portfolio to an investor's ethical principles which can involve screening out various types of securities due to various convictions including religious ones including tobacco, alcohol, pornography and arms. In the UK, it has a long tradition as a specialist area and, arguably, religious roots.

Greenwashing essentially involves a company, financial entity or fund, organisation or indeed government making unsubstantiated claims about a product, service or policy being environmentally friendly or making an environmental impact. It varies dramatically in degree between being overoptimistic about future plans or technologies to being deliberately misleading, but it has one benefit that claims about emissions can usually be verified and with increasing accuracy.

Impact Investing refers to investments made into company stocks and shares generally by funds and pension funds aimed at generating a measurable, beneficial social or environmental impact alongside a financial return. The concept has shifted from private to public markets recently. There is much debate about what is truly measurable in terms of impact and regarding the level of returns.

Impact washing is when fund managers and/or the companies they invest or lend to overstate or falsely claim an investment's positive impact on the environment or society. Much depends on the measurement to test the scale of the falsehood.

Social Impact washing is when fund managers and/or the companies they invest in overstate or falsely claim an investment's positive impact on society and the economy whether locally or internationally. Much depends again on the measurements and benchmarks. Yet beyond important matters such as gender balance and employment practices, it may lack agreed upon and established measures.

Social Sustainability has a broad society-wide definition in the first instance covering social equity and justice, diversity and inclusion, democratic participation and empowerment, livelihood security, and social well-being and quality of life. For companies, it is about monitoring both positive and negative effects of their activities on these areas. For practical effect, it could involve the gender balance of the workforce or standards at suppliers among a host of other measures. It is often discussed as part of ESG.

Sustainable Finance is the process of taking environmental and social matters into account when making investment decisions.

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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