Meeting minutes for the APPG on Environmental, Social and Governance

Topic: Trust in the market for ESG products and services, attended by the Financial Conduct Authority (FCA).

Date: Tuesday 25 October at 2.00 PM

The meeting starts at 2.00 pm

Opening remarks

Good morning everyone. Welcome to this meeting of the All-Party Parliamentary Group for ESG. I'm Alexander Stafford, Chairman of the group. Congratulations to the FCA for releasing their consultation today on Sustainability Disclosure Requirements and investment labels, which will serve as a backdrop to today's discussion.

Hopefully, we now have a brighter future. Remember, Rishi was Chancellor under Boris, and Boris's government was very pro-green and sustainable. Hopefully, we can go back to that standpoint.

I especially want to hear about your look at the transition and disclosure requirements, as well as some international coordination and other ESG principles of business. Without further ado, over to you.

YR: Mark and I are going to do a quick introduction, then we'll talk you through our ESG strategy and our journey as a regulator. Mark will go over specific policy proposals which will help build trust in ESG.

I manage our ESG Market intelligence and engagement function. This is a relatively new function, which was set up 9 months ago. My team scans the horizon for new risks and issues in the ESG space.

MM: I have been leading on ESG policy at the FCA for a few years now, working with other regulators and government departments. A big focus of our work has been transparency, but I am going to talk to you about how we have expanded the ESG function over the last year or so. I will also talk about a publication from just this morning.

As an introduction to the FCA, until about fourteen months ago we were a small function in a large division. Then Sacha Sadan joined us and was given the mandate to establish a dedicated ESG division, reporting directly to the CEO. We are tasked with embedding ESG across the organisation.

We have two other teams, one is responsible for embedding ESG across authorisations. Making sure that our supervisors are asking the right questions. The other team is responsible for culture and remuneration, looking at key aspects of the G in ESG.

We have grown to almost thirty people and identified champions across the organisation that are responsible for coordinating ESG-related matters and engaging with us in embedding ESG.

ESG has grown greatly in the FCA, and is a central part of our strategy, as communicated in our business plan.

YR: To go back a step on the FCA's work in ESG, we started in 2018 on ESG, with our discussion paper on Green Finance and Climate Change. We established an objective, that we wanted to create an environment where market participants can adequately manage the risks arising from moving to a low-carbon economy and also capture the benefits for consumers.

Since then, we have done a lot of work, on a big journey as a regulator. Our strategy was released last year around COP26, which encompasses five themes:

- Transparency
- Trust
- Tools
- Transition
- Team

Today we will delve mostly into Trust.

Transparency is about promoting transparency of climate change and wider sustainability throughout the investment chain. This is to promote high-quality disclosures.

Trust in ESG labelled instruments, products and the supporting ecosystem.

Tools are working with others to enhance industry capabilities, and support firms' management of climate-related and wider sustainability risks and opportunities.

Transition and team reflect a change in the external environment and FCA internal view.

The transition refers to supporting the role of finance in delivering a market-led transition to a more sustainable economy.

Team is around developing strategies to embed ESG in everything the regulator does.

One of the core principles is building ESG capability beyond climate change. Since Sacha Sadan joined, we made a public commitment to build out our capabilities and expand ESG strategy to reflect social and governance factors.

The second one is about supporting positive market-led solutions. This involves working with Government, regulators, industry and other stakeholders. Where there are already market-led solutions, we want to seek to get behind them and not reinvent the wheel.

The third principle is about influence beyond rulemaking, and this relates to one of the things I just mentioned, where we know we can make change using our full sweep of powers as a regulator: supervision, enforcement, and in particular in my team, we’re thinking of ways in which we can intervene in the market in a more nimble way.

We are looking to be as effective and efficient as possible, and ready for a deep digital and data-led world.

I want to delve into a major point which is aiming to deliver global solutions to global problems. The firms we regulate operate in global markets. We are trying to drive forward internationally aligned solutions. We find that the IOSCO sustainable finance task force has been a hugely influential player in driving forward standards for regulators.

We’re aware that the industry regularly calls for us to make international coherence, and we're trying to do our bit to accomplish that.

Contributor: I’m interested in the convergence of regulation of reporting standards. In the European standards of reporting they are very much speeding up. They are submitting their proposal to the commission, we can’t see how this is going to be workable as it stands today. It will be more divergence than convergence compared to GRI and ISSB. Are you on top of what’s going on in Brussels? We want to do this, but we want to be able to do this. In terms of biodiversity, how are you looking at these topics?

MM: One of the aspects of the ISSB’s standards, that IOSCO will be focused on, is how effective will the standards be as a global baseline. How will those standards interoperate with individual standards in different parts of the world?

Through our engagement with ISSB and IOSCO, interoperability has been a key issue.
We have delivered three messages on this:

- First, we would like to see the ISSB standards applying equivalent definitions and concepts so that when you are measuring the same thing in each set of standards, there is an equivalent methodology.
- Second, we would like to see both sets of standards build from the TCFD four pillars. The ISSB exposure draft has done that, and the EFRAG has not.

- Third, we would like to see the global baseline information appear in a clearly identifiable way in the annual financial report. Investors with a focus on enterprise value, and how sustainability-related matters drive corporate value, can see that information presented in accordance with TCFD four pillars.

We've delivered this message. We know that the ISSB and EU colleagues working on EFRAG standards from the commission, have been engaging very actively to try to iron these matters out.

Contributor: We got a slightly different response from EFRAG saying that they are still working on cross-mapping, working on the Taxonomy

Contributor: This Friday, they will submit their proposals.

Contributor: From a TATA perspective, how can we deal with so many different standards? What is the global baseline?

MM: It's got to be the ISSB, this is what they were created for. That's why we are so behind it from an FCA perspective. I don't know that the message is very different as there is more to do, the ISSB only met last week to get board agreement on key definitions and concepts. That does now need to be taken into account in the content and the presentation of the EFRAG standards.

Contributor: I think the key thing we've had as a challenge with SFDR. And just thinking about how SDR can hopefully provide a bit of leadership on some of the gaps, is around the definition of sustainable investment. What's happening at the moment is the markets are in a bit of a spin as to what definition we should be using, there are some good signposts in the RTS for SFDR. But what I'd really like to see, is not just on the definition of sustainable investments, but also the detail of the formulas and evidence that we need to use. If we're getting to the point now, where we are calculating ESG metrics like we would for finance, the market does need a clear steer on how to do that in a like-for-like way. What we don't want to do is allow for creative accounting on ESG, because that is the entire purpose of these initiatives SDR and SFDR. So we need clarity on if that is by square metres, is it by gross asset value? What do we do when things like EPCs, which are relevant to buildings, don't exist outside of Europe? Do we ignore those percentages of our portfolios? So I'm hoping that some of these start to come through, and it'd be interesting to hear what the reflections are from you guys in the room on what SDR can do to help fill those gaps.

MM: I will get into detail about today's consultation later, but it won't give you an answer to that. We've set out to what we think sustainable investment is and should be. We have not gone into the details of the metrics. This is because we do not have a UK Green Taxonomy, and because some of those matters are best left to the market to come to a common understanding. The financial regulator is not in the best position to determine the details of the real estate industry.

We do need to get smart minds together to see what works best for particular segments of the market and to determine a common understanding and language on these matters.

Contributor: Regarding the Government's commitment at COP26 to introduce mandatory transition plans, I understood that that was supposed to be delivered through the SDR. I was wondering if you could clarify that.

MM: It is one of the policy initiatives which I was going to come back to. It is not in today's consultation, as we have been working with the Government's transition plan Taskforce on the Disclosure framework. The Taskforce is working towards the publication of the disclosure framework at COP27.

Contributor: How do you map sovereign policy, corporate policy, to financial policy? We've seen that this is quite fragmented, how do you marry that up?

YR: From a government perspective, something we found useful was the coalescence of regulatory strategies under the former green finance strategy, which is to be revised next year. It brings together a vision set by the central government, highlighting the role of the different regulators within that.

MM: It is fair to say we have sought to do work with that flow. Flowing from that came a Treasury-led task force on climate-related financial disclosures, which set a roadmap and is now being delivered. This is a strategy which covers the real economy, and the various different sectors of the financial services industry.

Last year's government roadmap to sustainable investing has launched the SDR and a pathway for each regulator to deliver their bit of the SDR. That is setting a strategy which does flow from the public policy direction of travel and filters down to financial regulation.

Contributor: Will there be a clarification in terms of what is a material factor, what is a financial or non-financial factor?

MM: First, this debate has been central to the corporate reporting debate. The dialogue between ISSB taking an enterprise value and EFRAG taking a double materiality perspective. We don't think they are that far apart. We expect many external environmental or sustainable impacts to be financially material.

Contributor: Regarding the one size fits all question, how does the baseline information trickle down to SMEs? In terms of creating standards, does that work all the way down to SMEs or are you talking about a set of standards that are only relatable to large corporations and organisations?

MM: We look at this through the lens of listed companies and financial services firms. But when thinking about the ISSB standards, they are looking to create a global baseline., which can be applied effectively all around the world, and extend to smaller and medium-sized companies. The standards need to cover all potential scopes of application.

Contributor: The larger companies reflect quite a small proportion of the employed market, 96% of businesses are represented by the SME market. What framework will startups be using?

Contributor: Will we see guidance coming out from the PRA, in terms of the methodologies to do the calculations for the risk framework?

MM: We do engage very actively with the bank. I don't know if the PRA is planning to release guidance at that granular level. The CFRF tends to deal with this kind of thing.

YR: The CFRF is a group for the industry by industry. It involves individuals from across the financial services sector, to discuss climate-related risks and produce products which would be useful for the sector. Every year they produce a series of outputs across various themes and this year we have three working groups under the CFRF. They are looking at scenario analysis, issues to do with disclosures, and the third is looking at transition.

MM: Let's dig into three areas of our policy focus. I have taken one from transparency, then I will go into trust, then an item on transition.

Promoting transparency in climate change. This has been a very core area of focus since we started on our ESG journey. We listed rules requiring climate-related financial disclosures by our largest, most prominent companies, which we then extended out to other listed companies at the end of last year. The first disclosures under our TCFD-aligned disclosure rules for our premium-listed companies came through at the beginning of this year. We reviewed those disclosures then in July, and our intervention led to a significant uplift in both the quantity and quality of financial disclosures.

Now we’re on a journey to the next phase. Domestically, we’ve been advocating for the establishment of the ISSB, and now as a global baseline. We are very positive about the ISSB direction of travel. This is a once-in-a-generation opportunity to deliver a coherent framework for sustainability-related disclosures connected with financial information.

Contributor: On the sustainability disclosure requirements, under EU requirements, the onus is on, particularly in investing in financial products, to submit ESG disclosures for products that are ESG integrated. Is it the FCA’s anticipation that you will have the same onus on sustainable disclosures for non-sustainable products and financial reporting?

MM: That links very nicely into the next piece. We already have requirements in place for that. Our TCFD-aligned disclosures for asset managers and asset owners include both an entity-level and a product-level element. All asset managers, and owners, are required to make disclosures.

Contributor: I'm thinking specifically about fund products, in the EU it's in articles 8 and 9, where we would like to highlight the lack of sustainable alignment in non-ESG products.

MM: What we have at the moment are the TCF-aligned disclosure rules, purely focused on climate-related matters. As part of that, requiring that all products in the market would have to make emissions-related disclosures for those products. What we may see in future, is building that out so that products are required to make wider sustainability-related disclosure and include other metrics beyond climate.

Contributor: I think in your view, you have two distinct things: the Taxonomy, which is green and then the reporting standards which cover everything. It's a different perspective.

MM: Relating to trust, we are delivering on part of the government's roadmap to sustainable investing, in this particular case, focused on the funds market and focused on what might need to be done to help consumers navigate a complex market and improve the information flow in relation to sustainable investment products, and reduce greenwashing. These are the core outcomes we are looking to achieve through many measures: labelling.

Labels are meant to provide a high-level filter for consumers to be able to distinguish between sustainable and non-sustainable products. Within the sustainable space, products with different orientations [the question is]: Are they having a real-world impact? Are they only investing in sustainable activities? Are they seeking to drive improvement in sustainability over time?

That filter needs to be complemented by more information about what a product is seeking to achieve in practice. Environmental, social objective? Through asset allocation, or stewardship engagement?

Contributor: There are trade-offs though, my company produces chemical pesticides, which help to increase yields, and has environmental tradeoffs. Can you ever be classed as sustainable under your framework?

MM: Let me come back to that. We're trying to clarify this through our regime.

These classifications and labelling aspects are essential to helping consumers navigate a complex market. We have another layer of disclosure which is more detailed, both for entity and product levels. It is aimed at consumers or institutional investors in fund products. Details are more complete here and tell you about how the provider is thinking about sustainability risk and opportunities at the firm level.

In another aspect, if you don't meet the criteria, you shouldn't be able to actively market your product as a sustainable investment.

If you don't qualify for a sustainable investment label, but do integrate ESG considerations in your routine, then it would be acceptable for a firm to describe what it is doing there.

Contributor: So you're suggesting that if a firm is doing "the minimum" it isn't able to call its products sustainable?

MM: Correct.

What we're proposing in the consultation paper is three sustainable investment labels. Sustainable focus, sustainable improvers, sustainable impact.

- Sustainable Focus: "invests mainly in assets that are sustainable for people and/or planet."
- Sustainable improvers: "invests in assets that may not be sustainable now, with an aim to improve their sustainability for people and/or planet over time."
- Sustainable impact: "Invests in solutions to problems affecting people or the planet to achieve real-world impact."

These products should state what reference point they have used to determine the sustainability profile of assets, and that should be credible and independently verified, as well as transparent. This also approaches social objectives, not just green.

Sustainable improvers legitimise the journey. Investing in companies that may not be sustainable today, but are transitioning.

Contributor: I don't understand the difference between sustainable focus and sustainable impact.

MM: It's about how the objective is framed. A sustainable focus product will commit within its objective to seek a financial return while investing in products with sustainability characteristics. Sustainable impact products will stay within their objective, will also try to seek positive change from either a social or environmental perspective through my investments.

Contributor: On sustainable impact, there are quite a few funds today which would have to relabel as that.

MM: We're not specifying what impact methodology should be, as long as it is clearly specified. Importantly, measurement will occur, and the firm can be held to account for its claims made.

This may lead to a lot of re-classification. A lot of products out there are not far off, however others are.

Contributor: Thinking about how this will relate to our investment approach, we don't always set a sustainability objective, but we do invest in solutions. We haven't set out with a strategy in mind with the impact we want to have, but will a lack of strategy from the outset mean we're unable to communicate around the impact of our investment?

MM: The way we see this is that the regime is grounded in intentionality. Without that expression of intent and objective upfront, a consumer doesn't know what they're buying into. That is why have included an insistence on specifying a clear objective.

Chair: Because we have to end there, are you happy to share the slides with the Advisory Board?

MM: I think we can do that, yes.

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