Institute and Faculty of Actuaries

25 January 2023

FCA consultation on Sustainability Disclosure Requirements and investment labels (CP22/20)

IFoA response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA consultation on Sustainability Disclosure Requirements and investment labels (CP22/20). This response was written by the IFoA's Sustainability Board and has been considered from an independent, public interest perspective.

2. The IFoA has a global membership of over 32,000 actuaries, working across the financial sector. Actuaries have a crucial role to play in promoting the understanding and integration of climate risks and opportunities within decision-making, and in supporting making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. By evaluating systemic sustainability impacts on the financial systems, actuaries are involved in assessing how sustainability topics and the transition to net zero may impact on our assessment of future liabilities and the adequacy of returns to meet these future liabilities.

3. We welcome the FCA's proposals for Sustainability Disclosure Requirements and investment labels. We believe they are in right direction of travel. However, there are some areas where we think they are less effective. Our key comments are below:

4. **Long-term goals**
A clear labelling framework should support trust in sustainable investment products. However, as drafted, the proposals are focused on the situation today. We would strongly suggest that the proposals be amended to focus on where we want to be, in line with the UK's legal commitment to net zero. While the financial risks from climate change may crystallise in full over longer time horizons, they are also becoming apparent now. As such, sustainability investments should be viewed as the standard, not as a subset of investments. Our view is, therefore, that all capital should be taking into account sustainability considerations. Not having sustainability features presents a real risk and concern.

5. **Clear distinctions between product labelling**
Labels that distinguish between different types of investment product based on their sustainability-related objectives and features are new and their criteria are still very complex. Where there is uncertainty around their criteria and judgement required for their classification, there will be a

corresponding a risk that the retail investor ends up investing in assets they don't really understand. There needs to be clarity about what goes into each category so that it is easily understood and applied consistently across the market.

6. By evaluating systemic sustainability impacts on the financial systems, actuaries are involved in assessing how sustainability topics may impact on our assessment of future liabilities and the adequacy of returns to meet these future liabilities. Clear distinctions between the proposed sustainability investment products have the potential to support our analysis and risk assumptions. The labelling of products is still at an early stage so we would want to see rigorous analysis and review of these categories. We would be interested to support and be involved in this review process.

7. **Intentionality and metrics**
Additional disclosure requirements that enable the users of the disclosures to understand both material risks and opportunities faced by an investment must include meaningful information focused on the outcomes. Quantitative metrics alone do not capture the full scope of sustainability interventions and need to be accompanied by qualitative descriptions. We believe that it is too early in the process for standardised metrics.

8. **Do no significant harm**
We are sympathetic to the reasons provided not to mirror the EU SFDR's 'Do No Significant Harm' approach. However, we note that while the Sustainable Focus category specifies that 70% of the funds must meet a credible standard of sustainability, 30% is unspecified and could have an adverse impact on ESG goals. Should the uncategorised assets present a significant negative impact on sustainability considerations, there is a risk that the proposed approach could risk undermining the regime. We would therefore recommend incorporating some minimum expectations on investments that are included; for example, these may be exclusions consistent with the Powering Past Coal Alliance[1].

Q1: Do you agree with the proposed scope of firms, products and distributors under our regime? If not, what alternative scope would you prefer, and why?

9. We would like to see greater clarity that the rules should also apply to institutional investors. The consultation summary refers primarily to retail investment products and consumers but would be of equal benefit to institutional clients. Those with fiduciary responsibilities are lay people in the main and on a similar learning journey. Research commissioned by the IFoA and carried out by City, University of London and Leeds University Business School, found that extraneous menu-effects, such as labelling, influence the financial decisions made by pension trustees.[2] Therefore, where 3.2 states, "firms may also choose to label products offered to institutional investors", we think this should be changed to "should", so that labelled funds are accessible to all clients.

10. In this way, the labels will allow pension trustees and members to apply consistent analyses of investment opportunities, in their capacities as investors of their own (i.e. retail) monies and as investors of the institutional (i.e. pension fund) money for which they carry fiduciary duty.

[1] The end of coal is in sight - PPCA (poweringpastcoal.org)

[2] https://www.sciencedirect.com/science/article/abs/pii/S0165176519304513
https://www.actuaries.org.uk/system/files/field/document/Extraneous%20menu-effects%20influence%20financial%20decisions%20%20made%20by%20pension%20trustees%20-%20Preprint.pdf

Q2: Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?

11. We do not agree with the separate implementation timeline for domestic and overseas funds. Many funds have a mixture of domestic and overseas investments. We believe it may be confusing if they are governed by a mix of SDR and SFDR rules.

Q4: Do you agree with our characterisation of what constitutes a sustainable investment, and our description of the channels by which positive sustainability outcomes may be pursued? If not, what alternatives do you suggest and why?

12. We are generally supportive of the characteristics that have been outlined. We do, however, note that information on both individual assets and the aggregate impact on a fund should be given when characterising a fund as sustainable. Product labelling needs to be applied across the full investment chain.

Q5: Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?

13. We agree with the approach taken to classify products based on intentionality. This should be made explicit when marketing the funds.

14. Our view is that the labelling of funds should not be mutually exclusive. Instead, the FCA should provide the labels but allow funds to structure themselves and disclose the allocation for each label – e.g., 70% Improvers, 30% Focus. Otherwise, it would be unnecessarily restrictive. If the labels are clear, people will understand the fund being split by those labels.

15. Funds could be required to state annually the proportion of Improvers, Focus and/or Impact investments they hold, with possible options for further labelling, e.g.,
    i. Funds with 70%+ Improvers can label themselves as XYZ
    ii. Funds with 85%+ Improvers can label themselves as ABC

16. In addition, funds could be required to state the proportion of their holdings that are unchanged from the previous year, e.g., “We hold 70% Improvers (62% of which have been held for 12 months or more) and 30% Focus (of which 15% have been held for 12 months or more).”

17. This could prevent the gaming the numbers, and may also introduce competition, if consumers perceive more of one type to be beneficial. Comparison with the previous year may give consumers more information about a fund’s commitment and directionality.

Q6: Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? If not, what alternatives do you suggest and why? In particular, we welcome your views on:

a. Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?

18. While the Sustainable Focus category specifies that 70% of the funds must meet a credible standard of sustainability, 30% is unspecified and could have an adverse impact on ESG goals. Investors need to know the aggregate focus of the fund to make an informed choice. We therefore advocate considering the outcome of the fund as a whole.

19. Should the uncategorised assets present a significant negative impact on sustainability considerations, there is a risk that the proposed approach could risk undermining the regime.

b. Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear?

20. The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society should be the aim of all asset managers. We therefore agree that active investor stewardship should be a prerequisite of a fund that aims to improve the sustainability of assets over time.

21. To demonstrate improvement, the Chartered Financial Analyst (CFA) Institute recommends reporting on a year-on-year change at the asset level rather than the portfolio level. This is to prevent fund managers gaming the system, either by selecting the benchmark year or loading a portfolio with highly rated ESG firms at the end of a reporting period.[3]

22. Metrics should be given not only on progress to date, but also qualitative assessments on firms' transitioning plans to evaluate future progress. In this way, firms that may be starting from a low base in terms of sustainability but are likely to make large strides in transitioning will also be supported.

23. We have some concern that the high bar of Sustainable Impact may lead asset managers to choose Sustainable Improvers as the go-to option. This could reduce the market for those seeking more impactful funds. Our research with City, University of London and Leeds University Business School showed that both member-nominated and employer-nominated trustees displayed naïve diversification and would change allocations according to the mix of options provided.[4] This emphasises the importance of ensuring that options for Sustainable Impact funds are readily available.

c. Sustainable Impact: whether 'impact' is the right term for this category or whether should we consider others such as 'solutions'; and the extent to which financial additionality should be a key feature?

24. 'Sustainable Impact' already has a number of meanings in the market. "Impact investing" is colloquially understood to mean that environmental and / or social impact are the primary outcomes sought, with financial returns only secondary.

25. The idea of additionality can be inferred. However, in practice, establishing a causal relationship between the intervention and the additional effects (financial, developmental or otherwise) can be difficult to evidence. Given these two points, care must be taken in marketing materials and fund reports to clearly set out the fund's intent in order to differentiate between Sustainability Impact and Sustainability Focus.

Q7: Do you agree with our proposal to only introduce labels for sustainable investment products (i.e., to not require a label for 'non-sustainable' investment products)? If not, what alternative do you suggest and why?

26. We agree that the introduction of a 'non-sustainability' label would not be appropriate, unless the sustainability bar was set at such a level that all funds identified as non-sustainable are genuinely that.

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[3] https://www.cfainstitute.org/-/media/documents/article/rf-brief/Horan-ESG_RF_Brief_2022_Online.pdf

[4] https://www.actuaries.org.uk/system/files/field/document/Extraneous%20menu-effects%20influence%20financial%20decisions%20%20made%20by%20pension%20trustees%20-%20Preprint.pdf

There are a large number of funds that fall into neither bracket, for instance index trackers, that may have some active sustainability engagement.

27. As drafted, the proposals are focused on the situation today. We would strongly suggest that the proposals be amended to focus on where we want to be, in line with the UK's legal commitment to net zero. While the financial risks from climate change may crystallise in full over longer time horizons, they are also becoming apparent now. As such, sustainability investments should be viewed as the standard, not as a subset of investments. Our view is therefore that all capital should be taking into account sustainability considerations. Not having sustainability features presents a real risk and concern. An alternative would be for funds not explicitly assessed for labelling to be marked as such, i.e., "Sustainability not assessed".

Q9: Do you agree with the category-specific criteria for:

- *The 'Sustainable focus' category, including the 70% threshold?*
- *The 'Sustainable improvers' category? Is the role of the firm in promoting positive change appropriately reflected in the criteria?*
- *The 'Sustainable impact' category, including expectations around the measurement of the product's environmental or social impact? Please consider whether there any other important aspects that we should consider adding.*

28. This is a nascent and developing area. We believe there needs to be flexibility to revisit the boundaries as it develops. We recommend a regulatory sandbox approach, similar to that for fintech, so that the categories can be refined over time in line with where we want to be in the future.

Q10: Does our approach to firm requirements around categorisation and displaying labels, including not requiring independent verification at this stage, seem appropriate? If not, what alternative do you suggest and why?

29. We agree these funds should not require independent verification at this stage. Internal controls should be sufficient. However, having clear definitions around the labels will help enforce this.

Q12: Do you agree with our proposal to build from our TCFD-aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?

30. It makes sense to build from TCFD-aligned disclosure rules as set out in the ESG source book.

31. We strongly support alignment with ISSB standards in future as this will avoid the expense and complexity of different disclosure standards and enable comparability across global markets. We caveat that with the need to consider not only the impacts on financial results (as in the current ISSB Exposure Draft), but also the impacts an entity has on the external environment. It is important that these are included within the materiality assessment to ensure that the systemic risks can be fully captured, assessed and understood.

32. It is important these disclosures are outcome-focused as firms are encouraged to transition to low carbon and net zero.

Q14: Do you agree with the proposal that we should not mandate use of a template at this stage, but that industry may develop one if useful? If not, what alternative do you suggest and why?

33. There are many different ways of measuring. Although industry may standardise this over time, we recognise the usefulness of the TCFD template in facilitating standardisation. We therefore recommend that the FCA creates a template for industry comment.

Q15: Do you agree with our proposals for pre-contractual disclosures? If not, what alternatives do you suggest and why. Please comment specifically on the scope, format, location, content and frequency of disclosure and updates.

34. We are supportive of pre-contractual disclosures.

Q16: Do you agree with our proposals for ongoing sustainability-related performance disclosures in the sustainability product report? If not, what alternative do you suggest and why? In your response, please comment on our proposed scope, location, format, content and frequency of disclosure updates.

35. This is helpful information to inform the decision-making process.

Q17: Do you agree with our proposals for an 'on demand' regime, including the types of products that would be subject to this regime? If not, what alternative do you suggest and why?

36. We agree with the proposals for an 'on demand' regime.

Q19: Do you agree with how our proposals reflect the ISSB's standards, including referencing UK-adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?

37. We agree with the proposal to reflect the ISSB's standards. It is important to have international consistency, particularly as most investment portfolios are mixed. Standards should be comparable and robust. At the same time, as part of the UK's our global leadership on financial services, we would like to see the UK standards ensure that the disclosure requirements support attracting capital to meet net zero ambitions. This may include some consideration of the material impacts an entity has on its external environment. This is important in terms of climate action and net zero commitments, and also for retail investors looking to invest ethically.

Q20: Do you agree with our proposed general 'anti-greenwashing' rule? If not, what alternative do you suggest and why?

38. Further work needs to be done on defining green washing. The term includes deliberate misrepresentation of what is on offer, but also unintentional green washing, such as using weak models, or decisions on which Scope 3 assets and sources of emissions to account for.[5] Terminology can be misleading for a lay person, who may consider sustainable investments to exclude whole sectors; a transitioning fund or an ESG tilting fund, for instance, could quite legitimately include oil and gas. The Australian Securities & Investments Commission (ASIC) has helped by setting out practical examples for superannuation and managed funds on how to avoid greenwashing[6]. The development of sustainable finance taxonomies will also provide an important reference framework to assess which investments or insured activities contribute to climate change mitigation and adaptation. These taxonomies and the definition of greenwashing will, however, change over time and should be regularly

[5] https://www.actuaries.org/IAA/Documents/Publications/Papers/CRTF_Paper5_Final_October2022.pdf

[6] https://asic.gov.au/regulatory-resources/financial-services/how-to-avoid-greenwashing-when-offering-or-promoting-sustainability-related-products/

reviewed and updated.

Q21: Do you agree with our proposed product naming rule and prohibited terms we have identified? If not, what alternative do you suggest and why?

39. We are unsure how funds with some ESG integration within their investment approach which do not meet these categories should be described within this regime. Could highlighting ESG in TCFD product reports for products that do not have a label be seen as greenwashing?

Q25: What are your views on how labels should be applied to pension products? What would be an appropriate threshold for the overarching product to qualify for a label and why? How should we treat changes in the composition of the product over time?

40. To avoid confusion, the pension choices offered to scheme members should be labelled in a similar way as investment products. Sovereign gilts and overseas funds should be excluded from the 70% in the same way as is currently done for carbon foot-printing. The fund offers should be clear about intention and transition over time.

41. There is an issue with a 70% threshold if you can take a 25% lump sum. Coming up to maturity, the 25% is likely to be held in cash. Changes in composition of the fund should be clearly communicated to the scheme member.

Q27: Are there challenges or practical considerations that we should take into account in developing a coherent regime for pension products, irrespective of whether they are offered by providers subject to our or DWP's requirements?

42. It makes no sense if you have labels on retail funds and no labels on the master trust. The same criteria need to be applied to avoid people being misled.

Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers ie do you foresee any challenges or concerns in making consumer-facing disclosures, pre-contractual disclosures and building from the TCFD product and entity-level reports?

43. There needs to be consistency in thresholds, disclosures and labelling for all financial products, whether in pensions, insurance products or ETFs on a platform.

Q29: Do you agree that the approach under our TCFD-aligned product-level disclosure rules should not apply to products qualifying for a sustainable investment label and accompanying disclosures? Would it be appropriate to introduce this approach for disclosure of a baseline of sustainability-related metrics for all products in time?

44. We believe that existing disclosure rules should continue. FCA needs to be mindful of their rules on ESG, TCFD reporting and SDR. There is a materiality threshold that applies to TCFD disclosures but not to SDR labelling. There are products with ESG integration in TCFD product reports that may not qualify for a label.

If you would like to discuss any of the points raised in this response, please contact Caroline Winchester, Policy Manager (caroline.winchester@actuaries.org.uk).