The Impact Investing Institute's response to the Financial Conduct Authority's consultation papers CP21/17 and CP21/18 on enhancing climate-related disclosures

9 September 2021

ABOUT US

The Impact Investing Institute ('the Institute') was launched in 2019 with a simple mission: to accelerate the growth and improve the effectiveness of the impact investing market in the UK and internationally. Our vision is for lives to improve, as more people choose to use their savings and investments to help solve social and environmental challenges, while seeking a financial return. We want to see more capital contributing to the well-being of people and the planet – as set out in the United Nation's Sustainable Development Goals (UN SDGs).

We are an independent, non-profit organisation, which brought together two influential initiatives: the government's Taskforce for Growing a Culture of Social Impact Investing in the UK and the UK National Advisory Board on Impact Investing. We are part of the Global Steering Group for Impact Investment (GSG) network. Our Theory of Change describes how we plan to achieve change in the short-, medium- and long-term. We run a series of research, education and advocacy programmes designed to bring about the market conditions to enable impact investing to flourish.

OUR KEY RECOMMENDATIONS

We make the following key recommendations to the FCA in this letter:

1. Require listed companies, asset managers, life insurers and FCA-regulated pension providers (referred to hereafter as 'market participants') to report on 'S' factors, as well as 'E' factors.

2. Align the reporting standards it requires to the concept of 'double materiality'.

3. Separately, create a comprehensive bond standard that recognises the social co-benefits generated by green bonds.

Our reasoning for these recommendations is set out below, and echoes the positions more fully set out by the Institute in:

- Our paper, *'Reporting of Environmental, Social and Economic Outcomes'*.
- Our response to the International Financial Reporting Standards (IFRS) Foundation's consultation on sustainability reporting.
- Our response to the Financial Reporting Council's (FRC) consultation on the future of corporate reporting.
- Our response to the Department for Work and Pensions' (DWP) consultation on the social risks and opportunities by occupational pension schemes.
- Our paper, *'The Green+ Gilt: How the UK could issue sovereign bonds that deliver climate action and social renewal'*.
- Our paper, *'The UK's Green Gilt: Demonstrating the Contribution to Jobs and Levelling Up'*.

- Our response to the International Platform on Sustainable Finance's draft report on a social taxonomy.[1]

OUR RESPONSE

1. Importance of enhancing social-related disclosures alongside climate-related disclosures

(Response to CP21/18 – Q21: 'What other ESG topics do you consider that we should be prioritising to support our strategic objective? Please explain.')

We urge the FCA to prioritise an equal emphasis on the 'S' factors of ESG as well as the 'E' and 'G' in order to support its strategic objective.

As set out in detail in our response to the IFRS Foundation's consultation on sustainability reporting, an organisation's impacts on society extend well beyond climate. This is encapsulated by the UN's Sustainable Development Goals, which articulate a broad range of environmental and social challenges that need addressing to ensure wellbeing and security for people and the planet, now and into the future. It is increasingly evident that climate-related impacts and social impacts are often inextricably linked,[2] and that a social as well as a green lens needs to be applied to investment decisions. For example, we can only measure and manage the successful transition to a low carbon economy if we understand its impact on skills and job markets. If we do not improve our understanding of these interdependencies through enhanced reporting on the social impacts of market participants, we risk flawed solutions which only succeed in shifting risk from one ESG factor to another.[3]

Market participants are well aware that a full range of sustainability matters – including 'S' factors – are critical components of any business model or investment strategy, and that social factors can have an impact on both near-term and long-term thinking. Recent examples of social outcomes impacting on the business model and strategy of listed companies include fair treatment of suppliers' or employees' well-being,[4] consumer protection, ensuring wider consumer access to products and services, anti-corruption, diversity and inclusion and respect for human rights through the supply chain.[5] The COVID-19 lockdowns have further highlighted and exacerbated existing social inequalities and their impact on businesses, with some able to work from home and others not, increased demand for remote access to goods and services, a return to local over global supply chains and greater vulnerability to cyber-attacks with more business conducted virtually.[6]

In addition, organisations embedding the consideration of a range of sustainability matters into their business models can derive benefits that deliver outperformance for investors.[7] An increased focus on 'S' factors would respond to the growing demands of investors worldwide

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[1] Our response to the International Platform consultation is attached to this submission as an appendix.
[2] See, for example, the social consequences of biodiversity loss: OECD Policy Responses to Coronavirus (COVID-19) Biodiversity and the economic response to COVID-19: Ensuring a green and resilient recovery (September 2020)
[3] Relatedly, in our response to the DWP consultation, we call on the UK government to establish a 'Social Technical Advisory Group' to advise on a social taxonomy' that complements the work of the Green Taxonomy Advisory Group. This social taxonomy would ensure future developments in reporting and financial regulation integrate sustainability-related matters alongside climate-related impacts.
[4] HSBC to pilot Zoom-free Friday afternoons, BBC News (May 2021)
[5] Boohoo accused of failing to improve working conditions in its supply chain, The Guardian (June 2021)
[6] COVID-19 shows ESG matters more than ever, J.P. Morgan (May 2020)
[7] Digging Deeper into the ESG-Corporate Financial-Performance-Relationship, DWS (2018)

for comprehensive sustainability reporting, in light of both COVID-19[8] and issues of equality and inclusion.

For the FCA to address fully the market integrity and harm reduction goals set out in its consultations, it is crucial that it promotes enhanced disclosure on a broad range of sustainability measures. **Accordingly, we recommend that the FCA adopts a standard of reporting that requires market participants to report on their social impact, alongside climate-related disclosures, ensuring greater recognition and consideration of interrelated environmental and social issues.**[9]

2. Moving to best practice reporting

(Response to CP21/17 - Q5: 'Do you agree with our proposals for the provision of a TCFD entity report, including the flexibility to cross- refer to other reports? If not, what alternative approach would you prefer and why?' and CP21/17 - Q7: 'Do you agree that firms not yet setting climate-related targets must explain why not? If not, what alternative approach would you prefer and why?')

We agree with the FCA that enhanced climate-related disclosure requirements will encourage more comprehensive, high-quality and consistent climate-related disclosures, which in turn will enhance market integrity through better informed asset pricing and capital allocation decisions.[10]

We agree with the proposal for an entity report which allows flexibility to cross-refer to other reports including a firm's annual financial report. Sustainability reporting standards should fit together with financial corporate reporting standards and solutions so as to streamline the corporate reporting process and reduce additional burdens on businesses, including costs and risks. We further support the FCA's requirement that such reports should occupy a prominent place on the firm's main website, ensuring they are accessible to a wide set of users and stakeholders.

We note and welcome the EU's commitment to 'double materiality' in their guidelines for non-financial reporting and the Sustainable Finance Disclosure Regulation ('SFDR') (defined therein as 'principle adverse impacts'). The FCA states that it will aim to ensure consistency both with the EU and internationally as far as possible in its disclosure requirements.[11] In that regard, **we urge the FCA to consider adoption of a 'double materiality' standard – in addition to the recommended disclosures of the TCFD – requiring market participants to report on outcomes that are material for society, the environment and the economy, even if they are not yet material for enterprise value creation.**

Materiality is a dynamic concept. A market participant's impact on people, the planet or the economy can rapidly affect enterprise value, asset pricing and capital allocation decisions, and an evolving economic landscape means that what appears financially immaterial today can quickly prove to be business-critical tomorrow. For example, £1bn was quickly wiped from Boohoo's enterprise value following revelations that it had failed to pay workers a minimum

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[8] Institutional Investor Trust Special Report: Institutional Investors US Results, Edelman (2020)
[9] Relatedly, in our response to the FRC's consultation on the future of corporate reporting, we commend the proposed development and introduction of a 'Public Interest Report' and advocate a trial initiative that tests the concept and illustrates what 'good practice' public interest reporting looks like.
[10] CP21/17, Figure 1, Chapter 1 and CP21/18, Figure 1, Chapter 1
[11] CP21-17, Paragraph 2.20

wage.[12] The changing landscape of materiality has been highlighted during COVID-19.[13] It is crucial that all market participants have a clear understanding of their positive and negative sustainability impacts. Requiring market participants to report fully on these serves the public interest, enables all stakeholders to better assess the wider environmental and social impacts of organisations, and assists market participants to address any negative impacts, maintaining or enhancing enterprise as well as social value.[14]

We believe that a complete understanding of a market participant's environmental and social impact is a critical and necessary precursor to the enhanced market integrity that the FCA is seeking to achieve. The stakeholders whom the FCA seeks to target through its proposals – in particular, those focused on objectives other than (or in addition to) economic decision-making - are increasingly aware that existing climate-related disclosure standards do not provide the complete picture of environmental and social impacts, and that reporting to the TCFD disclosure standard alone may miss out information that investors consider vital to decision-making. As Eric Usher, the Head of UN Environment Programme Finance Initiative, noted in this context:

> *'financial institutions will have on their radar screens the two materialities at hand; the classic materiality on how ESG will impact portfolios as well as the newer materiality of how portfolios will impact our planet and our society'*[15].

The need for market participants to disclose on a 'double materiality' basis is likely to become more urgent as markets react to the EU's 'principle adverse impacts' approach to disclosures in the SFDR. It is therefore vital to UK market integrity that the FCA sets out its own roadmap to adoption of a 'double materiality' standard for both climate-related and social impact disclosures.

3. Aiming beyond a green bond standard

(Response to CP21/18 - Q16: 'Should the FCA, alongside the Treasury, consider the development and creation of a UK bond standard, starting with green bonds?')
We support the FCA's proposal to consider the development and creation of a UK green bond standard, but urge the FCA to aim beyond a solely climate-focussed standard and to embrace a standard that supports both a just transition to net zero and economic and social renewal.

As the UK emerges from the COVID-19 pandemic, the FCA has an opportunity to contribute to an investment-led recovery that furthers the UK's commitment to achieving carbon-neutrality, but also mitigates the social and economic inequalities that have widened over the course of the pandemic. By developing a green bond standard that helps to deploy capital to further the transition to net zero, but also recognises the importance of social and economic factors in ensuring that the transition is just and inclusive, the FCA can play a leading role in furthering these goals.

In conjunction with the London School of Economics' Grantham Research Institute on Climate Change, we have developed a proposal for a Green+ Gilt. Our Green+ Gilt model recognises that

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[12] More than £1bn wiped off Boohoo value as it investigates Leicester factory, The Guardian (July 2020)
[13] Double and dynamic: understanding the changing perspectives on materiality, SASB blog, by Donato Calace (September 2020)
[14] This is consistent with the recommendations of Sir Donald Brydon CBE, in his report of the independent UK review into the quality and effectiveness of audit: Assess, Assure and Inform – Improving Audit Quality and Effectiveness (December 2019).
[15] TCFD View of Materiality No Longer Adequate – UNEP FI Chief, ESG Investor news, by Elena Johansson (February 2021)

the transition to net zero will have profound social and economic implications for economies, creating opportunities in new sectors, industries and skill sets, but also rendering some of these obsolete. In developing a UK green bond standard, the FCA should consider the urgent need to mitigate the social and economic impact of the transition to net zero to ensure that the cost is not borne disproportionately by those who can least afford it.

Our Green+ Gilt model is guided by the principle of a just transition that ensures that the journey to reduce emissions does not ignore the impact of economic changes on the lives of individuals and communities. An innovative feature of our model is that projects financed with proceeds of an issuance of Green+ bonds will focus on well-defined and measurable 'social co-benefits', such as skills development and education, or affordable housing and infrastructure, in addition to environmental outcomes. We noted above that there is an interdependency between actions taken to combat climate change and wider societal changes; by linking green bond issuance with social co-benefits, the Green+ bond model would enable sovereign and corporate issuers to raise capital to finance green projects to achieve net zero targets, while simultaneously providing economic stimulus and supporting a socially just and inclusive transition. Our recent paper outlining how the UK government could deliver and report on the social co-benefits of green sovereign financing expenditure expands on this in further detail.

We note that key elements for the development of a robust and comprehensive UK green+ bond standard already exist. In developing a UK green+ bond standard, the FCA should build upon the global momentum behind social impact delivery and reporting and, where possible, focus on convergence with existing global principles, standards, measurements and reporting frameworks. Otherwise, there is a risk of creating a standard that unnecessarily increases the regulatory burden on both issuers and investors. In order to incorporate social co-benefits, our Green+ bond model anticipates the use of International Capital Market's Social Bond Principles (SBPs), with which the UK's Green Financing Framework is aligned, while a 'social taxonomy' is also developed (see footnote 2).

Traditionally, green bonds with a strict environmental use of proceeds have dominated the ESG debt capital markets, with investors wary of less-well defined social outcomes. As noted in our Green+ Gilt proposal, however, in the wake of the COVID-19 pandemic and the increased focus on economic recovery, traditional green-only investors have become alert to the importance of investments that support positive social as well as environmental outcomes. In the first quarter of 2021, for example, the global issuance of sustainable bonds reached a record £170bn, reflecting an increase of more than three times the first quarter of 2020, including £73bn of green bonds, £66bn of social bonds and £31bn of sustainable bonds.[16][17] This growing shift is reflected in the International Platform on Sustainable Finance's recent draft report on a social taxonomy.[18]

We encourage the FCA to respond to the growing pool of investors who wish to support economic and social renewal by developing a UK green+ bond standard that captures the social co-benefits of climate-related investment.

4. Conclusion

We thank the FCA for opening these timely consultations and demonstrating its commitment to widening the applicability of its requirement to make climate-related disclosures. To comprehensively and credibly promote complete, consistent and decision-useful disclosures

[16] Sustainable bond volumes soar to record $231 billion in Q1 (available), Moody's (May 2021)
[17] Figures converted from US$ to £, XE Currency Converter (August 2021)
[18] Our response to the International Platform consultation is attached to this submission as an appendix.

to investors, clients and consumers, we believe that the FCA must broaden its focus from climate-related disclosures alone, and look to establish reporting and bond standards that also take account of the social impact of market participants, and the interrelationship between environmental and social issues.

We would welcome the opportunity to meet with FCA representatives to discuss our response, share ideas and consider how we can continue to support the FCA's work going forwards.