The Impact Investing Institute's response to the Financial Conduct Authority's DP23/1: Finance for positive sustainable change

10 May 2023

SUMMARY

The Impact Investing Institute (the Institute) seeks to make capital markets fairer and work better for people and the planet. We want to foster thriving capital markets where impact investing plays an essential role within the financial system. We warmly welcome the FCA's discussion paper, which proposes to strengthen supervisory expectations with regards to business objectives and strategies, effective stewardship and education and training across the financial sector. In our response, we make five key recommendations:

1. The transition towards a more sustainable economy is a global endeavour, requiring discussion, coordination, and promotion at the international level, with alignment sought where possible. **The UK could be a world-leading advocate for an enhanced consideration of social factors**, particularly through bodies such as the International Organization of Securities Commissions (IOSCO) and the International Sustainability Standards Board (ISSB).

2. **All firms should embed sustainability-related considerations in their business objectives**, including social considerations, especially those pertaining to socio-economic distribution and community voice that are vital for a just transition to net zero. We are pleased to be a member of the UK's Transition Plan Taskforce's (TPT) Delivery Group, as well as Co-Chair of its Just Transition Working Group, seeking to embed just transition considerations into companies' transition plans. We also believe that a theory of change can be a very useful element of a sustainable business strategy and recommend that it is a compulsory feature of all firms aiming to demonstrate sustainability impact.

3. **Fiduciary duty should be reformed** to further enable pension trustees and administering authorities (as well as those acting on their behalf, including asset managers and investment consultants) to invest with impact. We welcome the government's commitment to review fiduciary duty in the UK's 2023 Green Finance Strategy.

4. **Firms should be further encouraged to become signatories of the UK stewardship code**, to acknowledge and strengthen the positive impact that investors can have through their stewardship and engagement activities. To foster the uptake of collective stewardship, the CMA should consider granting collective agreements that pursue social sustainability similar leeway to that envisaged in the draft guidance for environmental and climate related collective agreements.

5. **The FCA's training and competence framework should expand to include certificates relating to ESG**. We could support the FCA in developing an impact investing certification, building on our Learning Hub and/or of the relevant training courses developed by our partners. Professional financial services' trainings and certificates providers could also be encouraged to integrate the Impact Investing Institute's learning materials into impact investing products, to promote a uniform approach to impact investing.

impact investing institute

ABOUT THE IMPACT INVESTING INSTITUTE

The Impact Investing Institute was launched in 2019 with the mission to accelerate the growth and improve the effectiveness of the impact investing market in the UK and internationally. Our aim is for capital markets to be fairer and work better for people and the planet, in order to deliver sustainable and inclusive economic growth.

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 GSG – the Global Steering Group on Impact Investment, which brings together leaders from finance, business, and philanthropy to contribute to solving some of the world's most pressing social and environmental challenges. Our Theory of Change describes how we achieve change in the short-, medium- and long-term. We run a series of research, education, advocacy and practical programmes designed to bring about the market conditions to enable impact investing to flourish.

We are pleased to be a member of the FCA's Disclosures and Labels Advisory Group (DLAG) and welcome any additional opportunity to help the FCA to deliver this important initiative. We recently submitted a response to the FCA's consultation on Sustainability Disclosure Requirements (SDR) and investment labels, advocating for the further strengthening of the Sustainable Impact label framework, allowing for more expansive criteria with regards to demonstrating impact – thereby allowing for the full range of asset types and strategies that can deliver impact. In 2021, we also submitted a response to the Financial Conduct Authority's (FCA) consultation papers CP21/17 and CP21/18, suggesting that the FCA could broaden its focus from climate-related disclosures alone and 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.

1. THIS SECTION ADDRESSES THE FOLLOWING QUESTIONS:

Q1: SHOULD ALL FINANCIAL SERVICES FIRMS BE EXPECTED TO EMBED SUSTAINABILITY-RELATED CONSIDERATIONS IN THEIR BUSINESS OBJECTIVES AND STRATEGIES? IF SO, WHAT SHOULD BE THE SCOPE OF SUCH EXPECTATIONS? PLEASE EXPLAIN YOUR VIEWS.

Q4: WHAT ARE LIKELY TO BE THE MOST EFFECTIVE STRATEGIES IN EMBEDDING CLIMATE- AND SUSTAINABILITY-RELATED CONSIDERATIONS ACROSS A FIRM'S OPERATIONS? WHAT IS THE POTENTIAL BENEFIT OF INITIATIVES SUCH AS THE APPOINTMENT OF FUNCTIONAL 'CHAMPIONS', OR THE CREATION OF DEDICATED WORKING GROUPS OR FORUMS? AND HOW CAN THE VALUE OF SUCH INITIATIVES BE ENHANCED?

We strongly support the introduction of compulsory requirements for firms to embed sustainability-related (environmental, social and governance) considerations in their business objectives and strategies and recommend the following to enable this.

1.1 SOCIAL CONSIDERATIONS AND A JUST TRANSITION

We welcome all FCA efforts to facilitate the necessary transformation of the global economy towards a more sustainable future, and we find it appropriate that all companies should embed sustainability-related considerations in their business objectives and strategy. At the Impact Investing Institute, we believe it is imperative that financial markets create positive outcomes for people and the planet. We must rapidly mobilise capital towards having a positive impact if we are to meet the targets outlined by the Paris Agreement and the Sustainable Development Goals (SDGs) and prevent the collapse of natural systems. We are actively engaged in promoting a just transition: a transition to net zero that ensures no one is marginalised or left behind. This approach is necessary not just because it is equitable and inclusive, but because a lack of public buy-in and participation will delay or even prevent necessary action. In short, the transition to net zero will not be successful if it is not a just transition. The UK could further promote such efforts and principles at the international level through its role in international bodies such as IOSCO and the ISSB. The long-term, global success of the sustinainable finance agenda will require commitment and cooperation across jurisdictions.

Under the UK's presidency of the G7 in 2021, we co-led the Impact Taskforce: an independent, industry-led effort. Our final report highlighted that, to properly deliver a just transition, the socio-economic consequences of climate change need to be addressed in parallel to the environmental ones. Drawing on the Impact Taskforce report, **we recommend that the FCA includes in the scope of its sustainability expectations the three elements of a just transition**: (i) Climate and Environmental Action; (ii) Socio-economic Distribution and Equity; and (iii) Community Voice.

In partnership with global financial institutions with over £4 trillion of assets, or assets under management, we are now developing a Just Transition Criteria to help investors to design products which deliver on these three elements. The criteria (as currently proposed) would require: (i) a product-level commitment to the three elements; (ii) each investment within the product being assessed to avoid harm to any of the three elements; and (iii) each investment within the product being selected and retained based on its positive contribution to all their elements. For example, a Clean Energy Just Transition equity product could demonstrate its product-level commitment through offering appropriate, affordable, high quality clean energy to households, businesses, and the grid in low-income regions, while placing a specific focus on identifying companies that seek to engage and benefit local communities in their activities.

1.2 JUST TRANSITION PLANS

Later this year, listed companies and large regulated asset owners and asset managers will be required to publish transition plans – action plans for how they will be changing their businesses to operate in and support a net zero carbon economy. To support those efforts, the UK's Transition Plan Taskforce (TPT), a government initiative with industry representation, is developing a 'gold standard' for private sector transition plans.

It is essential for these transition plans and the accompanying guidance to include just transition considerations so that companies, asset managers, and asset owners can ensure their worforce, supply chains, customers and communities are integral to their plans. For example, the transition should create decent work opportunities; where people are supported to retrain where necessary; where products and services are accessible; and where communities are not disenfranchised. There is strong support for this in the private sector: over 11,000 real economy companies, with a total market capitalisation of over £650 billion, joined the UNFCCC Race to Zero campaign in 2021 and agreed to "phasing down and out all unabated fossil fuels as part of a global, just transition."

Such considerations are further detailed in the Financing a Just Transition Alliance's (FJTA) response to the TPT's proposals for the Disclosure Framework and Implementation Guidance of Transition Plans, which we co-signed. For instance, in developing policies and conditions, companies could consider: paying the Real Living Wage; providing equal training and employment for women, young people, low- income and other marginalised groups; safeguarding human rights, labour and social standards-related requirements for suppliers to prevent modern day slavery; detailing health and safety policies, practices and strategies; committing to freedom of association and collective bargaining for the workforce; ensuring compensatory measures for when changes to biodiversity and natural capital create an adverse net-impact for local populations; and detailing processes for how different voices, particularly the voices of workers, consumers and local communities, affected by the organisation's operations, products and services are represented and incorporated into strategy, activities and governance.

We welcomed the TPT's Disclosure Framework and Implementation Guidance proposals, which are a significant step towards developing the gold standard for UK companies' climate transition plans. We are pleased to have contributed directly to the Taskforce as a member of its Delivery Group, advising on how it can incorporate social – or just transition – considerations into its work. We have also been appointed, alongside the London School of Economics' (LSE) Grantham Research Institute, to co-lead the TPT's Just Transition Working Group, focused on **how the 'just' element of a transition can best be reflected in the action plans companies will have to draw up to make their businesses carbon neutral**. Such an approach is globally pioneering, and we hope that it will further underline the UK's key role in **ensuring global convergence in international frameworks and standards**, with regards to the 'S' as well as the 'E'.

1.3 THEORY OF CHANGE

Another approach to embedding such considerations is via a theory of change, which we recommended as a distinguishing feature of the Impact label in our response to the FCA's consultation on Sustainability Disclosure

Requirements (SDR) and investment labels. A theory of change requires the investor to have a clearly defined framework both for selecting assets based on their expected positive impacts in the real-world, and for recording how they, the investor, contribute towards enhancing those impacts and mitigating negative consequences.

We recommend that the FCA **provides worked examples of theories of change that conform to best practice**, after engagement with best-in-class impact investors and other stakeholders. We would be happy to assist the FCA in developing a template and guidance for theories of change. For example, we have published guidance on the development of a theory of change in our draft Just Transition Criteria, which build on the work of the Global Impact Investing Network, to support financial institutions to design and manage investment products that contribute towards a just transition to net zero.

1.4 FIDUCIARY DUTY REFORMS

Increasingly, investors are seeking to understand both how sustainability issues may affect a company, and how a company affects society and the environment – with a view to identifying and managing material impacts. This concept, enshrined in the EU Non-Financial Reporting Directive, is called 'double materiality.' We recommend that UK regulators adopt 'double materiality' in financial reporting standards, 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.

This concept of double materiality underpins our work on clarifying pension trustees' fiduciary duty. We have worked with leading law firms to publish a paper that explains how impact investing can help pension schemes manage the risks and opportunities presented by environmental, social and governance factors, and therefore deliver on their fiduciary duties. Subsequently, through consultation with a range of UK pension schemes, we developed our Impact Investing Principles for Pensions, which have mobilised more than £20bn of assets, plus a range of investment consultants, to commit to embed an impact investing approach into their investments and advisory services.

However, due to prevailing widespread misunderstanding, many schemes, investment consultants and asset managers remain cautious of pursuing an impact investing strategy. Alongside other influential thought-leaders, including the Principles for Responsible Investing (PRI), we have developed proposals for how **the concept of fiduciary duty, and the supporting regulation and guidance, can be clarified to make it easier for pension scheme trustees/administering authorities to consider the impact of their investments on society and the environment**. This could unlock significant amounts of capital to invest in assets that drive economic growth and deliver social and environmental impact across the UK.

The FCA could **support calls for the UK government to reform fiduciary duty**. We are pleased to be part of a new Financial Market Law Committee (FMLC) working group, seeking to provide policymakers with clear options on fiduciary duty reform, as highlighted in the UK's 2023 Green Finance Strategy.

One option would be the legislative changes proposed by ShareAction to reform The Occupational Pension Schemes (Investment) Regulations (2005)'s description of what is in beneficiaries' "best interests". This would effectively mirror the type of obligation imposed on companies through Section 172d of the Companies Act of 2006, which requires directors to "have regard to the impact of the company's operations on society and the environment." A pension trustee would then be allowed to consider whether the pension portfolio was contributing positively to society and the environment and would be allowed to take that contribution into account when considering investments. An alternative proposal would be the Better Business Act, which contains a stronger obligation on directors, including the requirement to act in a manner that benefits wider society and the environment (in proportion to the size of the company), and to reduce harm and costs to society and the environment.

2. THIS SECTION ADDRESSES THE FOLLOWING QUESTIONS:

Q10: SHOULD WE CONSIDER ADDITIONAL REGULATORY MEASURES TO ENCOURAGE EFFECTIVE STEWARDSHIP, PARTICULARLY IN RELATION TO FIRMS' GOVERNANCE AND RESOURCING OF STEWARDSHIP, AND ASSOCIATED INCENTIVE MECHANISMS AND CONFLICT OF INTEREST POLICIES? ARE THERE REGULATORY BARRIERS THAT WE SHOULD CONSIDER? PLEASE EXPLAIN YOUR VIEWS.

Q11: WHAT ADDITIONAL MEASURES WOULD ENCOURAGE FIRMS TO IDENTIFY AND RESPOND TO MARKET WIDE AND SYSTEMIC RISKS TO PROMOTE A WELL-FUNCTIONING FINANCIAL SYSTEM? HOW CAN THE COLLECTIVE STEWARDSHIP EFFORTS OF ASSET OWNERS AND ASSET MANAGERS BEST BE DIRECTED TOWARDS THE MOST PRESSING SYSTEMIC ISSUES? AND HOW CAN REMAINING BARRIERS BEST BE REDUCED? PLEASE EXPLAIN YOUR VIEWS.

2.1 STEWARDSHIP

As highlighted in our response to the FCA's consultation on Sustainability Disclosure Requirements (SDR) and investment labels, an **investor's contribution to real-world impact on society and/or the environment can be achieved through capital allocation and/or investor stewardship**. We recommended these are not presented in a hierarchy ('primary channel' vs 'secondary channel' for sustainability outcomes) but alongside one another, allowing the Sustainable Impact label to also encompass public market investments.

The FCA could **promote effective, active stewardship by providing guidance and highlighting best practice**. The European Centre for Corporate Engagement, for example, published a paper in 2022, indicating that not all engagement is equally effective. Factors that may improve effectiveness include frequency of contact; breadth of advocacy among multiple shareholders; sensitivity to ESG issues generally; financial materiality; cost of implementation of proposed measures; and targeting low-ESG companies with more scope for improvement. We recommend the FCA considers key resources in this area, including: (i) key steps for effective stewardship established under the Institutional Investors Group on Climate Change's (IIGCC) Net Zero Stewardship Toolkit (NZST); (ii) ShareAction's Voting Expectations of Asset Managers; and (iii) the Best Practice Engagement Reporting Template, also published by ShareAction last year.

The FCA could also **encourage all UK financial firms to become signatories of the UK Stewardship Code,** and adopt guidelines to highlight best practices. Given the global feature of the sustainable agenda, we also support measures fostering the uptake collective stewardship efforts. In respect of collective action for sustainability, we also welcome the draft guidance of the Competition and Markets Authority (CMA) on the application of the competition rules to agreements between competitors or potential competitors in relation to environmental sustainability (and climate change action). **We strongly encourage the CMA to consider extending such guidance to agreements that pursue social sustainability (e.g., labour rights).**

2.2 OTHER MEASURES

Despite the frequent reference to ESG, for a long time, regulators and the industry have favoured regulatory action and engagement related to the E rather than the S (or the G for that matter). This is proven by the relevance, visibility and momentum attained by platforms such as the Taskforce on Climate-Related Financial Disclosures (TCFD) and the Taskforce on Nature-Related Financial Disclosures (TNFD) compared to, for example, the Taskforce on Inequality-related financial disclosures (TIFD). Businesses and investors also report that social factors are hard to identify and monitor in a systematic way.

Despite this, industry and regulators increasingly recognise the are substantial systemic risks linked to not contingently addressing social factors alongside environmental ones. We are also pleased to sit on the Department of Work and Pensions' Taskforce on Social Factors, supporting the development of an understanding of social factors in the pensions industry. To support these efforts, we have published a report scoping the wide range of existing social disclosures in the UK. The report indicates that three stand out as sufficiently developed as to provide a strong starting point for a social metrics framework by policymakers: 'non-discrimination' (in relation to employment (i.e. workforce equality)), the National Living Wage (as determined by the Living Wage Foundation) and 'education'. 'Non-discrimination' contains a series of well-developed metrics, including gender pay gap reporting, ethnicity pay gap reporting and board diversity targets.

UK leadership on the 'S' could be further strengthened **by providing additional support to the TIFD, or by building on the work of the TIFD to establish a Taskforce on Social-related Financial Disclosures (TSFD)**.

3. THIS SECTION ADDRESSES THE FOLLOWING QUESTIONS

Q13: DO YOU THINK THERE IS A NEED FOR ADDITIONAL TRAINING AND COMPETENCE EXPECTATIONS WITHIN OUR EXISTING RULES OR GUIDANCE? IF SO, IN WHICH SPECIFIC AREAS DO YOU CONSIDER FURTHER RULES AND/OR GUIDANCE ARE REQUIRED? PLEASE EXPLAIN YOUR VIEWS.

Q14: WHICH ASPECTS OF THE TRAINING AND CAPABILITY-BUILDING INITIATIVES DISCUSSED ABOVE, OR ANY OTHERS, WOULD BE PARTICULARLY USEFUL TO CONSIDER (FOR EXAMPLE IN IDENTIFYING WHICH SKILLS AND/OR TRAINING IS NEEDED) AND HOW BEST SHOULD WE ENGAGE WITH THEM?

3.1 EDUCATION & TRAINING

The FCA's training and competences regime **training and competence framework currently makes no** explicit reference to ESG and related competences. As impact investing and wider sustainable investment approaches increase in popularity, financial advisors that deal with ESG preferences and products should be required to demonstrate their knowledge (i.e., by means of training and certification).

The FCA may also consider reviewing the ESMA guidelines for the assessment of knowledge and competence (still relevant for the UK) to mainstream ESG across the mainstream provision of investment advice, or provision of information about financial instruments, structured deposits, investment services or ancillary services to clients on behalf of the investment firm.

We want to increase competence in impact investing so more investors incorporate impact into their work and investment decisions. Lack of knowledge about impact investing remains one of the main reasons for people not to consider impact in their financial decision-making process. We therefore created an Impact Investing Learning Framework for providers of investment qualifications and trainings, such as professional bodies and trade associations. The framework is intended to help investment professionals integrate impact into their advice and products and to help asset owners (and their advisers) understand how to integrate impact into their investment philosophy and portfolio.

This formed the basis for our open-source Learning Hub, packed with helpful and accessible resources, that helps individuals and organisations to build their knowledge and skills. We have formed partnerships with organisations to help them use our Learning Framework and Hub to deliver educational events and develop training materials on impact investing for their members, such as the Chartered Institute for Securities & Investment and CFA UK, a professional membership body representing 11,000 investment professionals in the UK.

To strengthen impact investing knowledge and adoption in the UK, the FCA could **direct investment professionals towards our Learning Hub**, and/or towards the relevant courses developed by our partners. The FCA could also encourage/mandate providers of major training and qualifications, such as the CFA institute, to use the Impact Investing Institute's Learning Framework to incorporate impact investing in as one of the available certificates.