XPS Investment

Investment briefing

November 2022

The FCA's draft Sustainability Disclosure Requirements are a positive step in the fight against greenwashing

In brief

- On 25 October 2022 the FCA issued a Consultation Paper on Sustainability Disclosure Requirements, including labels to be used for sustainable products.
- The aim is to support investors when reviewing sustainable investment products, to provide clarity on the different approaches taken by different funds.
- The key proposal is a labelling regime for investment funds, which puts forward 3 sustainable labels: Sustainable Focus, Sustainable Improvers, Sustainable Impact.
- This is a significant development for the UK market and should serve to standardise naming convention used by managers, reducing greenwashing and providing more useful information to investors.
- The final regulations are expected in June 2023, with the regulations then applied in June 2024.

Alex Quant outlines the FCA's proposed UK Sustainability Disclosure Requirements (SDR) and investment labelling regime from the perspective of pension schemes investors.

There continues to be a huge amount of focus on integrating ESG and sustainability when setting pension scheme investment strategy. More schemes are taking steps to enhance the sustainable approach within their portfolios, as the risks and opportunities relating to these issues become more prominent and the regulatory landscape (climate change reporting, for example) drives change.

One of the well-known challenges around investing responsibly is a lack of standardised data and reporting on sustainability issues, leading to mixed messaging by investment managers on their given approach and ultimately a risk of greenwashing where investors are misled as to what they are investing in.

In Europe, the Sustainable Finance Disclosure Regulation (SFDR) was introduced in March 2021 and set minimum requirements for funds that wish to market themselves as sustainable – you can **read more here**. The FCA's SDR and the proposed labelling regime is part of the UK's answer to this same issue.

How did we get here

- In October 2021 the UK government announced its Roadmap to Sustainable Investing. This signposted plans to introduce Sustainable Disclosure Requirements.
- The FCA then published a Discussion Paper for feedback in November 2021 which set out some preliminary ideas for the labelling regime.
- The proposals in this latest consultation build on the previous ideas from the Discussion Paper taking into account the feedback received.
- Whilst the UK Roadmap to Sustainable Investing set out an initial framework for asset owner reporting on sustainability, that is not the focus of the current consultation so we expect more detail on that in due course.

Alex Quant
Investment Consultant & Head of ESG Research

Summary of proposals out for consultation

The key aspect of the proposals is a framework for Sustainable investment labels, as detailed below. To earn a sustainable label managers must evidence:

- **Sustainable objective (summarised below)**
- **Investment policy**
- **Key Performance Indicators (product specific metrics and targets for delivering objective)**
- **Resources and governance**
- **Stewardship**

The criteria for each of the above elements will vary depending on the label.

		Sustainable labels		
Category	**No Sustainable label**	**Sustainable Focus**	**Sustainable Improvers**	**Sustainable Impact**
Description	Products that do not meet any sustainable label criteria	Objective to invest mainly in assets that are deemed environmentally / socially sustainable Products will have to invest at least 70% in assets that meet credible standard of sustainability, or align with specified sustainable theme	Objective to deliver measurable improvement in sustainability profile of holdings. Invested in assets that may not be sustainable now but selected on basis of potential to become more sustainable over time.	Products with an explicit objective to achieve a pre-defined positive, measurable contribution to sustainable outcomes. Invest in solutions to real-world sustainability problems.

The labelling regime will be supported by:

- **Disclosure requirements for asset managers**
  - A summary for retail investors to highlight the key sustainability features of the product – for funds with or without a sustainable label.
  - Detailed disclosures for institutional investors and consultants including sustainability performance against the sustainable objective and KPIs, and information on sustainability issues concerning the entity (investment manager).
- **Naming and marketing rules**

  Restriction on the use of sustainability-related terms in the names of products, such as 'ESG', 'sustainable', 'impact', 'net zero', 'Paris-aligned' for retail funds (rather than institutional funds) that do not earn a sustainable label.
- **A general anti-greenwashing rule**

  Which will apply to all regulated firms reiterating existing rules to ensure sustainability-related claims are clear, fair, and not misleading.

Key points to note

- **There is no 'responsible' fund label** – in a change to earlier iterations of the requirements, funds which do not achieve one of the Sustainable labels do not get a label at all. The consultation is clear that fundamentally considering ESG issues (i.e. taking a responsible approach) is widely considered to be a normal part of investment management.
- **The FCA are very keen to stress that there is no hierarchy to the Sustainable labels** – they should be considered as equally valid approaches, intended to meet the varying needs and preferences of investors.
- **The FCA have intentionally not been prescriptive around how firms should define 'Sustainability'**, managers are simply asked to be transparent over how they do that. However this is expected to evolve as there is an indication that the UK Green Taxonomy, once developed, could be used to demonstrate a credible standard of Sustainability, and that incoming reporting standards from the International Sustainability Standards Board (ISSB) could be used to form a baseline of sustainability metrics.

Alignment to XPS Sustainable Designation and ESG ratings

In 2019 at XPS we recognised that there was no clear definition of sustainable funds, and therefore we developed our own Sustainable designation for funds which meet our high standards of ESG integration and involve portfolio construction tilted towards sustainable practices, as well as demonstrating strong active ownership. Happily, our approach to defining sustainable funds aligns with the FCA's proposals and we would expect that all of our existing recommended sustainable funds would fit into one of the three Sustainable labels, noting that funds also need to meet a range of other stretching criteria in order to be recommended to our clients.

More generally when recommending any fund, sustainable or not, we require minimum levels of ESG integration and therefore will not recommend funds which do not take a responsible approach. This is consistent with the ethos communicated by the FCA that consideration of ESG risks and opportunities are increasingly considered to be integral to an investor firm acting in accordance with its fiduciary duty.

Summary

The new disclosure framework and labelling regime represents a significant step in the right direction towards improving the choice available to investors with sustainability objectives alongside financial goals, by increasing clarity and transparency and therefore reducing greenwashing.

However, we feel that in order to have full benefit there are several key aspects to refine:

- Clarity on UK Green Taxonomy, to provide guidance on what activities are deemed sustainable when constructing portfolios.
- Support for investment managers and investors in terms of setting measurable metrics and targets for social outcomes in particular, which have historically received less attention than environmental issues.

We're clear that considering sustainable themes will improve outcomes as a result of better management of risks and accessing opportunities – the new labelling regime should provide welcome transparency and insight for more investors to consider sustainable themes alongside their financial goals.

How XPS can help

We strongly believe that considering ESG factors is fundamental to good investment management, and that considering sustainability within investments will improve financial and real-world outcomes.

The SDR labeling regime is expected to be applied from June 2024. We have a clear framework for helping clients now to enhance their approach towards sustainable investment, starting from helping to define their beliefs and reviewing the current approach taken by their managers.

Notably, we have established a range of sustainable funds across all asset classes, using our Sustainable Designation, which proactively pursue sustainable theme alongside their financial objectives.

Please get in touch if you would like to discuss how we can help you review your responsible investment approach.

To discuss any of the issues covered in this edition, please get in touch with Alex Quant.

Alex Quant
Investment Consultant & Head of ESG Research

t 020 8059 7652 e alex.quant@xpsgroup.com

Alternatively, please speak to your usual XPS Investment contact.