UKSIF Response: FCA consultation paper CP21/17- Enhancing climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers

Introduction

The UK Sustainable Investment and Finance Association (UKSIF) is the membership organisation for those in financial services committed to the growth of sustainable and responsible finance in the UK. We look to promote a more sustainable and inclusive financial system that works for the benefit of the environment and wider society. UKSIF represents a very diverse range of financial services firms committed to these aims, and our 270+ members include investment managers, pension funds, banks, financial advisers, research providers, NGOs, among others.

UKSIF and our members have played a prominent role in embedding sustainability in UK policymaking over recent years. We were pleased to work closely in recent months with policymakers over the design of the UK's National Infrastructure Bank, including through a coalition group led by climate change think-tank E3G, and were delighted to see a drive to net-zero put at the core of its mandate. Most recently, UKSIF was appointed a representative of the Green Technical Advisory Group (GTAG) to advise on the delivery of the UK's 'green taxonomy' and we look forward to helping ensure the taxonomy can set a high standard for green investment for the rest of the world to follow.

On climate-related disclosures, for a number of years UKSIF has called for the roll out of mandatory Task Force on Climate-Related Financial Disclosures (TCFD) aligned disclosures across the economy. We want the UK to now build on its existing global leadership on climate disclosure, seeking ways to improve the operation and implementation of TCFD, and we strongly welcome the FCA's latest steps to progress the UK's over-arching objective for mandatory climate-related disclosures across the whole economy.

UKSIF and our members very warmly endorse the direction of travel outlined in the FCA's consultation, broadly supporting the majority of the proposals, including the proposed scope of firms and products, timeframe for implementation and core list of metrics identified. Our response does highlight several concerns on some detailed implementation challenges for parts of the sustainable finance sector, especially smaller firms, including on providing granular product-level disclosures for certain asset classes and the scenario-analysis requirements.

UKSIF's response draws on the views of our deep asset manager and asset owner membership, who we recently consulted in a private roundtable discussion to consider the main areas and themes in the consultation.[1] Below are the main conclusions from our roundtable discussion, and other separate bi-lateral discussions with our members.

Q1: Do you agree with our proposed scope of firms, including the £5 billion threshold for asset managers and asset owners? If not, please explain any practical concerns you may have and what scope and threshold would you prefer.

We support the proposed scope of firms outlined by the FCA, including the £5bn threshold, though we believe consideration should be given to lowering this threshold to capture a wider group in future, including smaller investment managers and boutique firms over time. This view effectively mirrors our recent call to the Department for Work and Pensions (DWP) to extend the TCFD regulations to smaller pension schemes, when it conducts its review to consider an extension in 2023.

We know there will be a number of UKSIF's investment manager members, particularly many boutique managers, which fall below the £5bn threshold that will widely market ESG products with sustainability characteristics, and we strongly believe clients and savers should have clarity over as wide range a scope of products offered by firms as possible, making the case for an extended scope in future.

[1]UKSIF's private roundtable for our membership on the FCA's consultation was attended by more than 80 member representatives, the majority of whom have responsibility for helping implement ESG strategies within their firms.

Some of our boutique members will already be complying with the Sustainable Finance Disclosure Regulation (SFDR), facing the demand to disclose more information from clients, or be motivated to disclose against TCFD for commercial reasons. In the immediate term, the regulator could actively encourage voluntary disclosure by boutique managers and others falling below the £5bn threshold, and flexibility should be in place for those looking to voluntarily disclose.

Immediately applying disclosure requirements from 2023 to a broader scope of smaller managers and asset owners below the £5bn threshold could be complex however, due to challenges around reporting and data availability this group could experience, particularly for some asset classes such as government bonds and private debt where carbon footprint reporting remains nascent. This should not limit a longer-term ambition however, and **the DWP's planned review in 2023 to consider the case for extending TCFD requirements to smaller schemes (which UKSIF fully supports), could be a model for the FCA to consider for its approach.**

In terms of the scope of the requirements specifically for occupational pension schemes, we have concerns that some of these schemes which have in-house fund management arms (regulated by the FCA) could be subject to duplicative reporting requirements from both DWP and the FCA, and we would request both parties consider this issue further. Finally, while we agree with the proposed scope of firms, which will cover a significant swathe of the industry, **we should recognise the proposals will be challenging for smaller firms, due to the TCFD skills shortage we see in the market**. UKSIF continues to give careful consideration to how we can address this skills deficit in the sector in the years ahead.

Q2: Do you agree with our proposed scope of products? If not, what types of products should, or should not, be in scope and why?

UKSIF agrees with the proposed scope of products outlined in the consultation. We do note the proposed scope is very wide, and it should be recognised in the FCA's final proposals that there will be some complexities for firms' product disclosures, including in relation to private equity and private market activities for example.

This means that for the consultation's proposals relating to the setting of climate-related targets, this should be on a 'comply and explain' basis as there will generally be good reasons why targets have not been set for certain investment strategies and product types, such as alternative investment strategies (we expand on this subject below in Q7).

Q3: Do you agree with our phased implementation and timings? If not, what approach and timings would you suggest and why?

UKSIF is supportive of the implementation timetable outlined by the regulator, including the June 2023 timeframe for the first entity-level and product disclosures by large firms and the June 2024 timeframe for other firms. While climate-related disclosures are increasingly becoming available in the market, in part due to increasing client demand, and with some of our large members already publishing their first TCFD reports (or shortly planning to do so), we believe the timings outlined are proportionate.

One reason for this position is that some comparatively smaller investment managers captured by the proposals (e.g. those just above the £5bn threshold) will generally have fewer resources to comply with the obligations, and experience more difficulties in accessing good-quality data to publish their TCFD reports. **Many smaller members impacted will need until the June 2024 deadline to complete effectively all sections of their TCFD report**, with some sections easier to fill out at present, such as the governance section. The shift from pressures coming from the market, namely clients, to regulatory obligations for smaller managers will be quite significant for some firms in this group and should be kept in mind by the regulator for this category, which should not be put at a competitive disadvantage. We see an 'evolutionary approach' as more likely to be adopted by smaller managers when producing their TCFD reports.

By contrast, many large investment managers captured in the proposals will, and in our view should, have their reports prepared ahead of June 2023, particularly in relation to their main asset classes such as equities and corporate bonds (though not all asset classes potentially). Anecdotally, some of our large members have already published their first TCFD reports this year or plan to do so shortly. **We therefore would support the regulator actively encouraging larger firms to publish TCFD reports ahead of the June 2023 deadline.** We expect, and strongly hope, the quality of disclosures to continually improve over time, particularly as 'best practice' emerges, and the sooner the process of disclosure by the industry starts, the better. More expeditious disclosures by larger firms will be of significant value to smaller firms and others parts of the investment chain relying on good data for their obligations.

It should be noted that even for larger firms, there will be some challenges in the publication of their TCFD reports; for example, in reporting on global companies and assets in portfolios, there will be data gaps for some global companies which managers will need to address in their stewardship activity, pressuring companies to disclose more meaningful information. There will be specific data gaps in companies' disclosures of scope 3 emissions, which continues to not be measured consistently by listed companies.

Despite these challenges, this should not be a reason for delaying the implementation of the FCA's proposals beyond the first June 2023 deadline, and **we recognise there will be an evolution in TCFD reports over time for all firms across the sector**. Minimising delays should allow us to get a far clearer picture of how industry and investee companies are approaching disclosures. Finally, the regulator should consider how proposals will be implemented in a way that is as consistent as possible with rules the industry is implementing from the EU and elsewhere, and investors would welcome as consistent approach as possible across the EU and UK on disclosure requirements.

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?

We agree with the proposal for flexibility for firms to cross refer to other reports in the provision of their TCFD entity report, which could allay some of the challenges with firms' requirements to report on a significant number of ESG issues. This flexibility will be important to avoid duplication of reporting by firms in some instances. Cross-reference to other reports, such as stewardship and sustainability reports where a lot of detail will be included on ESG issues, will need to be done by firms in a way that is transparent for end users of TCFD reports. This includes clearly signposting users and ensuring disclosures are accessible to make sure there are not barriers in place to making effective use of these.

On the proposals for TCFD product reports to be published in annual reports, there is the question of whether this information can be sufficiently reflected and given proper consideration in an annual report, though we do not necessarily hold a strong view on this issue. The regulator could encourage an annual report to reference far more detailed reports where information on climate and ESG issues is contained, such as a sustainability report.

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?

UKSIF strongly believes in a 'comply and explain' approach for firms not yet setting climate-related targets in their disclosures. One reason for this is that different portfolios, investment strategies, and asset classes will all have very different pathways to net-zero and will reach a specific climate or net-zero target in a very different manner. **While we think encouraging climate targets is important, we do not believe it should be mandatory at this point in time.**

For example, **the carbon intensity of a particular portfolio may fluctuate in the short and medium term significantly as a manager re-allocates capital within different sectors, while still aligning with the 1.5°C Paris Agreement goal or achieving net-zero by 2050** (reducing the carbon footprint of a portfolio will not equate necessarily to long-term temperature alignment). Climate targets will need to be aligned with the real economy, and targets, such as for the carbon intensity of a portfolio, will not always follow a linear path downwards. We do expect the general trend to be lower however for portfolios.

With a very wide range of investment products subject to the proposals, it will be very important to have a ‘comply and explain’ approach as some strategies and products may not have targets for valid reasons, and this includes private equity, derivatives, sovereign bonds, and passive tracker funds, the final of which will heavily influenced by the activities of the real economy. **Firms should carefully inform and explain to their clients why mandatory targets have not been set in relation to some products and portfolios, and fully justify their approach.**

A mandatory approach to setting climate-related targets could inadvertently lead to hugely negative consequences. This approach could lead some investors to divest immediately from carbon-intensive industries and sell off companies to certain investors (e.g. in private markets) not effectively engaging in active stewardship or good reporting. Immediate divestment could fuel ‘green bubbles’ in markets, and will not help with transitioning certain sectors, with active investor engagement a more effective approach on convincing companies to deliver progress on areas such as increasing the percentage of a company’s capital allocation to new green investments.

While the transition will take some time, more active stewardship with companies can speed up this journey and ensure more effective alignment with the Paris goals. Divestment will remain an important tool for our members to have at their disposal when engagement does not deliver meaningful results over time, but it is not an appropriate step that UKSIF would endorse our members adopting initially.

Mandatory targets are also not appropriate due to the continuing lack of widespread agreement on methodologies, and with the whole economy not yet aligned to the Paris Agreement goals (there are challenges for investors in creating a 1.5°C aligned portfolio in a 4°C aligned economy). Any mandatory approach to target-setting will require first careful consultation with clients and could conflict with their preferences and mandates. In some respects, decarbonising portfolios can be easy should divestment be adopted immediately, but there is the question of whether this leads to meaningful decarbonisation of the real economy.

From the perspective of asset owner clients, some, through their mandates with managers, may make climate targets compulsory in some cases and will select specific mandates with managers that are suited to their climate risk strategies. For some of our smaller members, they will continue to assess what climate and net-zero targets, and initiatives, would mean for their business and clients. **A ‘comply and explain’ approach would allow the sector to explain and justify different targets for different asset classes, and the reasons for the deviations in approach**. A smaller firm should be allowed to explain for example what percentage of a portfolio, and why, is covered by climate-related targets.

Q10: Do you agree with our proposed requirements for product or portfolio-level disclosures, including the provision of data on underlying holdings and climate related data to clients on demand? If not, what alternative approach would you prefer and why?

We support firms providing data on underlying holdings and climate-related data to clients on demand, but there is a question over the granularity of portfolio-level data that industry, particularly smaller firms, should be mandated to provide as part of the proposals. Some of the practical challenges that need to be carefully considered by the regulator include:

- The availability of good data for industry, and how firms can share product-level data within multi-asset portfolios and for less liquid assets, private assets, bank loans, and other asset classes.
- The issues around firms’ licensing agreements with their ESG data providers.
- Commercial considerations for firms: a manager publishing very detailed data on underlying holdings within a fund in the public domain could allow a competitor to effectively model their portfolio themselves, and many managers will not provide this very detailed data publicly as a result.
- The view of certain clients who may have concerns on firms disclosing information on their funds publicly.
- The issue of different methodologies around how managers can report on underlying holdings: the diversity of methodologies could lead to very misleading conclusions for clients.

Every manager will use a very different methodology in their reporting, while different asset classes, from bank loans to sovereign bonds and high-yield products, will have very contrasting net-zero pathways, and targets for a portfolio will therefore need to be nuanced.

For these reasons, **the regulator should recognise the challenges for firms providing, at least from the onset, very detailed data for all product-level disclosures, particularly for certain asset classes.** The inclusion of a 'best efforts basis' should be considered for those asset classes that are far more difficult to provide good, granular data on (it will be easier to provide data to clients for equities and corporate bonds for example). Also, any data on holdings shared should be on an annual basis, as generating this data at different intervals would create a significant burden for firms.

The regulator and industry could together consider creating a common framework for clients' requests on product-level data to help managers effectively respond to these requests; at present, clients' requests for proposals (RFPs) will ask quite similar questions in different ways on this data and we expect client demand for this data to continue to increase. We believe the proposed requirements could evolve in time, and firms should review the progress of their reporting and where the data is weaker, but that managers would not be in a position currently to share all data on product disclosures immediately.

A final point is that a central component of TCFD is for clients to have far more clarity on portfolio-level information, and our members are very keen to continue to work towards this objective particularly applying this to a wider scope of funds and asset classes. In future, we see these disclosures as part of firms' regular communication with clients, as well as RFPs, understanding that client demand will undoubtedly rise over time on areas such as a fund's carbon footprint.

Q11: Do you agree with the list of core metrics, including the timeframes for disclosure? If not, what alternative metrics and timeframes would you prefer and why?

UKSIF agrees with the list of core metrics identified in the consultation, which are generally well understood within the industry. There are some outstanding questions over some metrics such as the weighted average carbon intensity (WACI) metric, but we support its inclusion here.

In time, we hope to see greater alignment in metrics and a reduction in the significant number of approaches that we currently see (e.g. we see different metrics currently for SFDR compared to those for TCFD). Greater alignment would be a positive development for industry and clients, including their ability to compare different products, and for reporting purposes for both groups. It should be noted that metrics will differ depending on the asset class, with a different metrics required for government debt and there are dangers in aggregating the data for equities alongside data for sovereign debt for example.

At the global level, we would welcome the FCA continue working with global regulators and bodies, such as IOSCO, to co-ordinate work on common frameworks for metrics. The FCA could in future provide greater clarity on effective metrics to be used in the sector once understanding has improved and provide an update in this area. On the Scope 3 GHG emissions metric proposed in the consultation, we welcome the regulator's recognition of significant data gaps among investee companies and the difficulties industry will experience in disclosing this (e.g. the issue of 'double counting' of emissions).

ESG data provider estimates on Scope 3 data can be very varied, particularly with very few companies providing this data and estimation models from providers can vary hugely; clear 'health warnings' for stakeholders analysing this data is vital. There can be up to 15 categories within Scope 3 emissions to measure, with most companies reporting on one or two categories and not all reporting on the same categories of Scope 3 emissions. The one-year extension proposed for Scope 3 emissions reporting is therefore welcome, and we hope that by June 2024 some of the major issues here will have been addressed. Given the issues around scope 3 data, we would suggest that narrative reporting be encouraged by the regulator.

By contrast, disclosing scope 1 and 2 emissions for portfolios does not generally pose challenges for industry, including small managers, though scope 1 and 2 data is still reported by less than half of listed companies. On the carbon footprint metric, widely used in the market, it should be noted investment managers often use different calculations for this and consistency will be required for this metric alongside others across asset classes. While we agree with the core metrics identified by the regulator, there is the question of whether the proposed list of common metrics would provide too static a view of a portfolio's trajectory, and not address sufficiently the transition (they potentially focus too much on reporting on the historic carbon footprint of data).

We believe that while including core metrics is very positive, it should be recognised they will provide a partial picture to investors and most will want to establish a richer, more nuanced view on how their investments are addressing climate-related issues. Climate data, such as carbon-footprint data, should be not viewed as a 'silver bullet' for clients and other stakeholders, and should not be used as the key consideration in motivating investment decisions. Firms will need to consider how to communicate their disclosures well to clients and not seek to comply with standardised forms.

Q14: Do you agree with our approach to additional metrics and targets? If not, what alternatives would you suggest and why?

We support the existing additional metrics outlined by the FCA, **though we would suggest consideration be given to including certain other metrics under the 'additional metrics' section** for firms to choose from to provide a richer picture for clients on a full range of climate risks.

These additional optional metrics could include: a stewardship metric for firms wanting to report in greater detail on their engagement activities (e.g. an outcomes-based metric, though stewardship metrics pose challenges as a very nuanced area), and metrics forming part of the IIGCC's net-zero investment framework (given the positive uptake across the sector), and the Net-Zero Asset Owners Alliance Protocol. We do not think these should yet form part of the regulator's list of core metrics.

Flexibility for firms in choosing additional voluntary climate metrics will be important. For example, some of our investment manager members, including our smaller members, would welcome this to provide additional context for clients particularly if they score less well on certain metrics compared to others. This development could, for example, be a result of their investments in more transitional activities and technologies, such as battery technology, solar supply companies or other more capital-intensive businesses that still are contributing positively to the transition to net-zero.

A broader point is that the range of climate metrics overall remains very diverse, and could lead to a series of very different approaches by industry as a result, with the IIGCC's net-zero investment framework for example using a large number of metrics. The encouragement of alignment over time by the regulator and industry together will be very important. The European Commission has begun to take steps in this regard, suggesting KPIs for firms to encourage standardisation, while we have seen some guidance on climate targets for different asset classes (e.g. Yale University and Columbia University joint work on an environmental performance index metric for sovereign bonds).

We recognise, as the regulator has done in its consultation, some of the challenges associated with many of the additional metrics outlined. For example, the Climate Value-at-Risk (VaR) metric, while potentially being invaluable in assessing the financial impact of climate risk on a particular product or entity if this had a well-defined methodology, has issues with Climate VaR results varying significantly between data providers and not offering comparable outputs for industry. Finally, alongside additional voluntary metrics, we would encourage firms to supplement these with qualitative commentary to provide a more holistic picture for clients.

Q15: Do you agree with our approach to governance, strategy and risk management, including scenario analysis at product or portfolio-level? If not, what alternative approach would you prefer and why?

On the regulator's approach to scenario analysis, we do not yet believe this should be mandated for all asset classes necessarily, and the reasons for this include:

- Scenario analysis needs to mature further with effective scenario analysis tools not yet widely available for industry.

- The costs of scenario analysis for our smaller members, which will sometimes will only be able to rely on free tools which have inherent flaws.
- The utility that scenario analysis can be for some asset classes for clients, including the issue that results from scenario analysis will not always be decision-useful. Its utility will be dependent on the investment strategy chosen and asset class; for example, given that most scenarios apply to economic sectors with high carbon emissions, a strategy that does not have exposure to these sectors will mean scenario analysis would not be a helpful exercise for these strategies.
- The lack of standardisation of scenarios, which can lead to disparities in reporting and the challenges in applying scenario analysis to certain asset classes like fixed income.
- Different clients will have very different expectations on specific scenarios they will request from their managers.

Some of our smaller members will exclusively use free scenario analysis tools, which have significant flaws such as a 'positive bias' towards more profitable companies, with less profitable companies 'punished' by contrast despite offering solutions to the transition to a low-carbon economy.

We believe scenario analysis at a product-level should be on a 'comply and explain' basis, with firms allowed to provide accompanying commentary for context, while the FCA could consider providing further guidance in this developing area, including guidance on how firms should be expected to differentiate between the different levels of scenario analysis required. **We see scenario analysis remaining a real area of challenge for UKSIF's smaller investment manager members.**

Q17: Do you agree with our proposed approach that would require certain firms to provide product or portfolio level information to clients on request? If not, what approach and what types of clients would you prefer and why?

Providing data on certain portfolio-level information to clients on request will be challenging, due to licensing agreements with data providers, among other reasons which we outline above in our response to the question of providing data on underlying holdings to clients on demand.

Conclusion

UKSIF strongly endorses the majority of the FCA's proposed requirements in the consultation. We expect the first several years of TCFD reporting to be complex for many of our members, with a lot of the information creating some confusion and 'noise' for clients. We hope the data disclosed by our members to become far more effective over time and decision-useful, as we expect disclosures will be from corporates as well.

We hope and will actively encourage the sector to engage in 'best in class' TCFD reporting which will see firms gain a competitive advantage in the market and encourage healthy competition and innovation in the industry. We see huge opportunities for firms to demonstrate how effective disclosure can be implemented, and hope to see the overall equality of disclosures improve in time.

The regulator will in time need to consider refining the proposals as data availability improves. **We believe the FCA will need to allow the proposals to bed in in the industry before considering a review in several years to assess how the new proposals are being delivered.** The tangible value of TCFD reports for entity-level and product-level disclosures should be kept under regular view by both industry and the regulator, with both together needing to judge how much tangible value TCFD reports bring to clients and other stakeholders, including the approach to metrics.

For many retail savers, it will be product-level, rather than entity-level, disclosures which they will gravitate towards, and a challenge for industry will be the extent of preparation and resources directed to making entity disclosures as accessible as possible to retail clients who may not rely on them to the same extent as product disclosures. This consideration will need to be balanced by firms against the risks of not adequately meeting the disclosure needs and preferences of more sophisticated institutional clients, which may be more likely to rely on entity disclosures. **The issue of how we can collectively ensure that the most decision-useful information is disclosed and available to different groups of clients will need to continue to be considered by the industry and FCA.** A final broader point is that the direction of travel on climate disclosure should look to be as consistent as possible from different departments leading on proposals for different part of the economy and investment chain. This should help different parts of the investment chain communicate clearly with each other and more easily assess climate-related data.