FCA discussion paper (DP23/1): Finance for positive sustainable change: governance, incentives and competence in regulated firms

May 2023

Background

1. The Aldersgate Group is an alliance of major businesses, academic institutions, professional institutes and civil society organisations driving action for a sustainable and competitive economy. Our corporate members, who come from across the economy and have a collective global turnover in excess of £550bn, believe that ambitious and stable low carbon and environmental policies make clear economic sense for the UK.

Questions

1) 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.

2. Yes, all financial services firms should be expected to embed sustainability-related considerations into their business objectives and strategies, as this tracks with the government's ambition for the UK to become the 'world's first net zero-aligned financial centre'.
3. The financial services sector plays a key role in enabling the transition to a net zero and nature positive economy, by underwriting risks, lending capital, and investing in low-carbon projects. Embedding sustainability across firms' objectives and strategies will help accelerate the net zero transition.
4. As noted in the discussion paper, sustainability-related considerations should extend beyond just climate to include "human rights, diversity and inclusion, nature and biodiversity". On nature and biodiversity specifically, it is important to note that these are not separate from climate change but interconnected. The Dasgupta Review argues that the world cannot tackle climate change without protecting and enhancing nature.
5. Currently, financial services firms are exposed to significant amounts of climate-related financial risk. The Bank of England's Climate Biennial Exploratory Scenario, for example, found that under a no additional action scenario, banks and insurers could face losses of £334 billion by 2050. Embedding sustainability will help improve the stability of the financial sector throughout the net zero transition.

6. The Aldersgate Group sits on the delivery group of the Transition Plan Taskforce (TPT). From 2023, financial institutions will be required to disclosure transition plans on a comply or display basis. The TPT's draft disclosure framework takes a 'strategic and rounded approach' to transition planning, including: objectives and priorities; financial planning; engagement with value chain; board oversight and reporting; incentives and remuneration; and more.

2) Beyond the FCA's ongoing work on diversity and inclusion, and introduction of the Consumer Duty, should we consider setting regulatory expectations or guidance on how firms' culture and behaviours can support positive sustainable change? Please explain your views.

3) What steps can firms take to ensure that they have the right skills and knowledge relating to material climate- and sustainability-related risks, opportunities and impacts on their boards? Should we consider setting any regulatory expectations or guidance in this area? If so, what should be the scope of such expectations?

7. The TPT's draft Disclosure Framework requires preparers of transition plans to examine all material interdependencies, including those that relate to the natural environment, workers, suppliers, communities, and consumers.
8. This includes describing how the preparer will ensure it has the appropriate skills, competencies, and knowledge across the organisation – including at Board and executive management level – to design, develop and deliver the transition plan.
9. Beyond transition plans, financial institutions should ensure they have access to the right skills to set science-based targets, produce disclosures, and invest sustainability, whether through in-house staff or consultants.
10. Boards, for example, should be have a broad range of knowledge on sustainability, ideally with at least one board member with a sustainability background. Equally, management should be selected based on credentials including those related to sustainability.
11. In July 2022, the FCA led the private sector by example by publishing its own climate-related financial disclosure. The FCA should look to do the same by analysing its own skills and knowledge gaps and supporting its workforce to upskill.
12. The FCA should also engage closely with the organisations involved in the Green Finance Education Charter – soon to be relaunched as the Sustainable Finance Education Charter – to help build the capacity and capability of the financial services sector. The FCA could follow the example of Singapore's central bank, Monetary Authority of Singapore, which worked together with the Institute of Banking and Finance Singapore to set out 12

technical skills and competencies needed for individuals to perform various roles in sustainable finance.

4) **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?**

5) **What management information does senior management use to monitor and oversee climate- and sustainability-related developments, and to monitor progress against public commitments? Should we set expectations or guidance for decision-making processes, including systems and controls, audit trails and the flow of management information to key decision-makers? If so, what should be the scope of such expectations?**

6) **Should we consider setting new regulatory expectations or guidance on senior management responsibilities for a firm's sustainability-related strategy, including the delivery of the firm's climate transition plan? If so, which existing SMF(s) would be the most suitable to assume these responsibilities? Please explain your views.**

7) **Should we consider introducing specific regulatory expectations and/or guidance on the governance and oversight of products with sustainability characteristics, or that make sustainability claims – for example to clarify the roles and expectations of governing bodies such as Fund Boards? If so, which matters in particular would benefit from clarification?**

8) **What matters should firms take into consideration when designing remuneration and incentive plans linked to their sustainability-related objectives? In particular, we welcome views on the following:**

   a. **the case for linking pay to sustainability-related objectives**
   b. **whether firms should break down their sustainability-related commitments into different factors, allocating specific weightings to each**
   c. **whether short-term or long-term measures are more appropriate, or a combination of both**

d. **whether sustainability-related incentives should be considered for senior management only, or a wider cohort of employees**
e. **how firms could consider remuneration and incentive plans in the design and delivery of their transition plans**
f. **remuneration adjustments where sustainability-related targets (at either the firm level or individual level) have not been met.**

9) Should we consider additional regulatory expectations or guidance in any of the areas considered in Q8? Please explain your views.

13. It is important to consider the potential unintended consequences for linking pay to sustainability-related objectives before the public policy signals are in place.
14. Currently, there is no commonly agreed definition of what economic activities can be classified as green, with the UK Green Taxonomy still in development. There is also a significant inconsistency between ESG ratings, with only 60% correlated according to a 2019 study. By linking pay before a commonly agreed definition of green is in place, and without a standard for setting sustainability-related objectives, there is a risk of greenwashing. Alternatively, with a financial incentive to invest sustainably, economic sectors which are not currently 'green' but will need to decarbonise (such as heavy industry or aviation) could struggle to access transition finance.
15. Firms should ensure that sustainability-related objectives are linked to their transition plans, which themselves are science-based and have validated short, medium and long-term targets.

10) 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.

16. The FCA should open a consultation on producing a guideline on how investors can become responsible stewards of capital and engage with companies on environmental and climate ambition. It should cross-reference the guidance and recommendations of GFANZ and the TPT, and should explore how a framework for managing potential divestment could be designed.
17. Ideally, responsible stewards of capital will use opportunities to encourage businesses to transition effectively into the net zero economy. This managed transition approach would be preferable to divestment, which could lead to a myriad of issues within the economy, such as stranded

assets, or assets being sold to investors or businesses based in countries which do not share the UK's positive climate and environmental values.

18. Some financial institutions are already using stewardship to create terms upon which they may introduce financial sanctions on a company – for example, if a company refuses to publish scope 3 emissions, has no thermal coal policy, or has not responded to investor engagement. Creating a guideline for responsible stewardship of capital would enable more stewards to navigate these scenarios and drive ambition.
19. A number of progressive financial institutions are already making plans for embedding investor stewardship principles into their investment decisions. For example, Legal & General Investment Management (LGIM) has a well-established Investment Stewardship team, with a history of over ten years. Through active ownership and engagement with companies, policymakers and peer groups around the world, the Investment Stewardship Team aims to improve environmental, social and governance (ESG) standards and address systemic risks across the markets in which LGIM's clients are invested. They aim to help create a better future through responsible investing, and to help generate sustainable returns. Through LGIM's Climate Impact Pledge, they introduce sanctions on companies which do not meet their "red lines", or minimum climate-related expectations for their sector. Sanctions may include divestment, but divested companies may also be reinstated if they demonstrate sufficient improvement. Similarly, in 2019, Aviva published an Investors Stewardship and Responsible Investment Policy, which aims to deliver positive outcomes through three key principles: 1) integrating ESG considerations into investment decisions, 2) using their influence to promote good practice among those companies in which they invest, and 3) shaping markets for sustainability.

11) 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.

20. The PRA should look to publish a scenario analysis standard to enable companies and LLPs to conduct more detailed scenario analysis, as part of the requirement introduced in 2022. The standard should include formulas for conducting quantitative analysis of climate scenario risks, for both transition risk and physical risk. The Network for Greening the Financial System (NGFS) has produced a useful tool to help central banks and supervisors explore the possible impacts on the economy and financial system, which can provide a useful starting point for businesses. The PRA should now build on this to produce a version which is tailored for private

financial institutions and companies which are covered by the existing scenario analysis requirements introduced in 2022.

12) What do you consider to be the main sustainability-related knowledge gaps across the financial sector and how can these best be addressed? What do you consider to be the potential harms to market integrity, consumer protection or competition arising from these knowledge gaps?

21. According to Financial Centres for Sustainability Network, 52 per cent of financial centres surveyed reported that the lack of capacity and qualified workforce on sustainable finance is among the top barriers to scaling up sustainable finance.
22. Without the capabilities or knowledge, the financial sector will struggle to: comply with new green finance regulation, such as TCFD-reporting, UK Green Taxonomy, and transition plans; scale up and invest in the emerging low carbon economy (overcoming 'familiarity bias'); offer new ESG products; and carry out stewardship responsibilities by engaging with companies in their portfolios and loan books. This could stifle the pace of the net zero transition, increasing the risk of a disorderly transition and impacting the competitiveness of the UK financial sector internationally.

13) 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.

23. Financial institutions and corporates must ensure they have access to the right skills to produce disclosures, net zero transition plans and set science-based targets, whether through in-house staff or consultants. This should include offering existing staff training, such as through the Green Finance Education Charter, or the CFA UK Level 4 Certificate in ESG Investing

14) 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?

24. See answer to question 13.

15) Have you seen misrepresentation of ESG credentials among ESG professionals and, if so, what are the potential harms? Have you seen any consistent training metrics that can help compare firms' knowledge/capabilities? Please describe.