FCA Consultation DP21/4
Sustainability Disclosure Requirements (SDR) and investment labels

Insight Investment response

January 2022

BNY MELLON | INVESTMENT MANAGEMENT

Executive Summary

Insight Investment is one of the UK's largest investment managers, managing over £836bn in assets for pension funds, insurers, sovereign wealth funds and financial institutions[1]. The majority of Insight's assets under management are in risk management solutions (primarily liability-driven investment, or LDI) and fixed income.

Climate change is one of the greatest challenges of our time. Governments and businesses are grappling with the implications, and responsible investors seek to discern how climate change might affect investment risks and opportunities. Insight is a committed responsible investor and was a founding signatory to the Principles for Responsible Investment (PRI) in 2006.[2] We believe that all risks, including environmental, social and governance (ESG) risks, can affect the value of an investment – and so any initiative that seeks to improve risk disclosures is a positive and constructive development.

We welcome the FCA's consultation on this important topic. Key themes that we draw out in our response are summarised below:

- **Extra sustainability label needed:** We welcome the proposed labels for sustainable products. We believe an additional label is necessary for strategies that are pursuing activity related to sustainability factors, for which none of the proposed labels apply. We believe that without this, some products that would be classified as Article 8 under the EU Sustainable Finance Disclosure Regulation (SFDR) will not satisfy the FCA's Sustainability label.
- **Alignment with SFDR is important:** We are keen that the FCA's SDR categories are easily mapped onto the EU SFDR framework and vice versa, particularly as many funds will be subject to both the FCA's and EU's sustainability rules. We highlight some issues that could make this more complicated than envisaged in the FCA consultation.
- **Some asset classes should be out of scope:** Some asset classes are not well suited to sustainability reporting due to data issues or lack of relevance. These include legacy asset-backed securities, currency instruments, repo transactions and certain derivatives.
- **Proxy data and scenario analysis:** We caution against the mandatory use of proxy data for several reasons. We also highlight that scenario analysis may not be appropriate, or possible, for some asset classes.

We would be delighted to engage further with the FCA on these issues, and to discuss our response in greater detail.

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[1] As at 30 September 2021. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.

[2] More information on Insight's responsible investment approach and activities is available at https://www.insightinvestment.com/investing-responsibly/.

Questions and answers

Q1: What are your views on the tiered approach set out in Figure 2? We welcome views on any concerns and/or practical challenges.

We agree with the proposal of simpler information for consumers versus institutional investors and other more sophisticated investors.

However, to keep the disclosure requirements manageable, we would advocate for only one format or set of data being required for the disclosures, with a summary section appropriate for consumers and more detail provided for institutional investors and other stakeholders potentially within the same report.

Q2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of product than for others, please provide examples.

Firms in scope for the rules should be aligned with the firms that would be in scope for the FCA's climate-related reporting rules aligned with the Task Force on Climate-related Financial Disclosures (TCFD) framework.

We believe products in scope should be pooled funds, whether they are marketed to retail or institutional investors.

We believe segregated mandates and single investor funds should be out of scope. These products are more flexible and driven by client/investor demands, and disclosures should be optional based on the client/investor wishes.

It must be noted that even for in-scope products, certain asset classes are not well suited to sustainability reporting either because of data issues or lack of relevance for them. We encourage a pragmatic expectation of disclosures where these assets classes are part of the investment universe. As per our response to the FCA CP21/17 consultation on enhanced climate-related reporting, we believe the following asset classes should be out of scope: legacy asset-backed securities (retrospective data is unavailable), currency instruments (sustainability metrics are not relevant), repo transactions and certain derivatives (various challenges arise with regard to sustainability disclosures).

Q3: Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable and impact) and how best should we engage with them?

Although we recognise the term 'sustainable investment' is applied to a wide range of concepts, we broadly support the framework proposed by the Global Sustainable Investment Alliance (GSIA). This approach is embedded in the Investment Association's responsible investment framework and is included as one of the options within the CFA framework.

It must be noted that while artificial categories can give an important high-level understanding of an investment strategy, many strategies do not fit neatly into one category. For example, a fund might adopt elements of exclusionary, best-in-class and positive impact approaches, and these cannot be categorised under one sustainability label easily. It would be helpful to get further clarity on treatment of these cases.

Q4: Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.

We make two main points below: a) one more category is needed, and b) the FCA labels should align with EU SFDR categories.

a) One more category needed

We broadly support the FCA's proposal for a labelling system and particularly support the attempt to incorporate 'Transitioning' strategies, recognising that investment strategies that are actively seeking to improve sustainability metrics are an important part of sustainable investment. We recognise this as a key positive differentiator relative to the EU SFDR framework, under which transitional strategies struggle to find a home due to the 'do no significant harm' principle which focuses on a point-in-time analysis rather than a pathway.

However, we believe further improvements are still necessary. Specifically, we believe one more category under the ’Sustainable‘ umbrella is needed to describe investments that go beyond the ‘Responsible’ category by embedding ESG criteria, but do not qualify for either the ‘Transitioning’ category (because investments are not transitioning) or ‘Aligned’ category (because any allocation to sustainable assets does not meet the minimum threshold). Without this we believe that many funds that would fall under the Article 8 under EU SFDR framework would fall outside the FCA’s ‘Sustainable’ label, and into the ‘Responsible’ category.

Below are some examples of products that we believe should fit within the ‘Sustainable’ category and would require another sub-category to be able to do so:

- A low carbon fund with a requirement for a maximum carbon intensity of 50% relative to a reference benchmark. This would not qualify for the ‘Transitioning’ category as it is not seeking to improve the sustainability characteristics of its investments, and it may not have enough taxonomy-aligned investments to qualify for the ‘Aligned’ category.
- Funds with investments that focus on social objectives rather than environmental or climate change-related objectives, which may not qualify for the ’Transitioning’ category (if ‘Transitioning’ is defined narrowly around environment and carbon emission targets only) and may also fall short of the threshold required to be classified under the ‘Aligned’ category.
- A fund set up as ‘Transitioning’ because its investments were initially transitioning, but no longer qualifies for the ‘Transitioning’ category once its holdings reached the end of their transitioning pathway, may also not qualify for the ‘Aligned’ category if the allocation of sustainable investments do not meet the required threshold. Such funds would therefore move from ‘Transitioning’ to ‘Responsible’. In other words, such funds would no longer be categorised as ‘Sustainable’ as a result of their investments achieving their transitioning objectives, which seems counterintuitive.

Finally, it may be difficult to retrofit these labels onto existing funds. Many existing funds focused on sustainability are likely to have a combination of transitioning, impact and low carbon investments. These do not fit into one category neatly as they seem to be a combination of a few categories. It is important to ensure that these funds are still nevertheless caught under the Sustainability umbrella.

We therefore recommend a new category be introduced under the ’Sustainable‘ umbrella to capture investments that do include ESG criteria, but do not fit the definitions of the ‘Transitioning’ or ‘Aligned’ categories.

b) FCA labels should align with EU SFDR categories

We are keen that the FCA’s SDR categories can easily be mapped onto the EU SFDR framework, particularly as many funds will be subject to both the FCA’s and EU’s sustainability rules. We note the FCA has considered this, but we highlight some issues below that could make the mapping more complicated than envisaged in the FCA consultation. We encourage the FCA to take these into consideration to ensure the SDR labels can indeed be mapped easily to EU SFDR (and vice versa).

- There are Article 8 funds that would not fit under the FCA’s proposed ‘Sustainability’ label, as explained above.
- We encourage the FCA to ensure that the mapping works both ways (i.e. EU SFDR labels should be easily mapped onto the UK SDR rules and vice versa).
- It is unclear whether the ‘Aligned’ category would easily map to Article 9 under SFDR. Under SFDR, the percentage of sustainable investments required for a portfolio to qualify for Article 9 is not prescribed, and there are a range of interpretations of this. We believe it would be beneficial if the threshold that applies to qualify for the SDR ‘Aligned’ category also satisfies the SFDR Article 9 classification.
- Similarly, in order for the Impact category to qualify for Article 9 under SFDR, the FCA will need to ensure that the percentage of impact investments required to qualify for the ‘Impact’ label, if there is such a threshold, also meets the Article 9 SFDR categorisation. Under the FCA’s proposal it is not clear whether the ‘Impact’ category would require a high percentage, or all, investments to be impact investments.

Q5: What are your views on ‘entry-level’ criteria, set at the relevant entity level, before products can be considered ‘Responsible’ or ‘Sustainable’? We welcome views on what the potential criteria could be and

whether a higher entity-level standard should be applied for 'Sustainable' products. We also welcome feedback on potential challenges with this approach.

We propose that if the entity is a signatory of either the UN-supported Principles for Responsible Investment (PRI) or the FRC UK Stewardship Code 2020, it should meet the requirements to be able to label its products as being 'Responsible'.

We do not believe a further test is needed at firm level to enable a firm to label its products as 'Sustainable', because product labels will set out the criteria for 'Sustainable' products, and the FCA's TCFD-style climate-reporting rules already set out the requirements for firms.

Q6: What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.

We believe there is a balance to be struck between providing clarity to investors and firms, without prescribing so much that activity and innovation are stifled.

While we understand there will be wide-ranging interpretations of what is acceptable in a sustainable product, there appears to be a consensus that universal restrictions may be appropriate for some industries or business types, namely:

- Tobacco manufacturers
- Controversial weapons manufacturers
- Thermal coal involvements
- Severe social or environmental controversy/ Global norms violators

At some point, it seems likely the EU will also set some minimum prescriptions. The FCA should consider whether and how to align SDR rules with those.

Q7: Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics:

- **intentionality**
- **return expectations**
- **impact measurement**
- **additionality**
- **other characteristics that an impact product should have**

We agree with the above, but would caution against strict application of 'additionality'. We believe there should be a requirement to consider 'additionality', but it should not be a necessary condition to qualify for an 'Impact' label as it is often difficult to demonstrate and measure.

For example, even within the green bond market – which is tailored to impact investing – it can be challenging to demonstrate how much of a bond's proceeds is apportioned to new versus existing projects. While we have a preference for funding new projects, we believe that re-financing existing sustainable projects (e.g. refinancing an existing wind farm) should still be included within the 'Impact' category as it can still have value in terms of the impact it helps to achieve. If this is not permitted, then many such projects may fail after the initial round of finance raising which can affect the overall success of these projects in the long-term.

Q8: What are your views on our treatment of transitioning assets for:

a: the inclusion of a sub-category of 'Transitioning' funds under the 'Sustainable' label?

b: possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?

As described in our response to question 4, we support inclusion of the 'Transitioning' category to recognise investments that are actively striving to improve sustainability metrics.

However, we would question how effective this category can be in isolation and believe that if it is to be used, one more category under the 'Sustainable' umbrella is needed to describe investments that go beyond 'Responsible' but do not qualify for 'Transitioning' or 'Aligned'. Otherwise, many funds that qualify for Article 8 under the EU SFDR framework would not qualify for the FCA's 'Sustainable' label and would instead qualify as 'Responsible' investments. More detail is provided in our answer to question 4.

Q9: What are your views on potential criteria for 'Responsible' investment products?

We agree with these criteria. We would emphasise that while ESG integration is understood to be synonymous with responsible investment within the investment community, the general public may understand responsible investment to incorporate a greater focus on sustainable investing. This gap in understanding may need to be addressed.

Q10: Do you agree that there are types of products for which sustainability factors, objectives and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?

Yes, there will be products where sustainability factors will not be relevant or considered. It should be possible to label these as SDR exempt.

Examples include passive products that track benchmarks that are not sustainability-aligned; segregated mandates that are designed to meet a specific client's objectives; and for asset classes where sustainability factors are either irrelevant, or where data gaps hinder the integration of sustainability factors even when there is a desire to do so.

Such asset classes include legacy asset-backed securities (retrospective data is unavailable), currency instruments (sustainability metrics are not relevant), repo transactions and certain derivatives (various challenges arise with regard to sustainability disclosures). From a philosophical standpoint, it is unclear whether derivatives should be 'looked through' to understand sustainability characteristics of the underlying investments.

Q11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

We believe these can be categorised as 'Aligned' under SDR and would map to Article 9 (3) treatment under SFDR.

We would advocate for Paris-aligned benchmarks being available for benchmarking active as well as passive products. It +is not clear whether SFDR permits the use of these for benchmarking active products, and we would encourage the FCA to be explicit in permitting this under SDR rules.

Q12: What do you consider the role of derivatives, short-selling and securities lending to be in sustainable investing? Please explain your views.

Securities lending: We understand that aspects of securities lending could create some challenges to a sustainable investment approach. However, we believe the securities lending industry is working on initiatives aimed at addressing these issues.

Short selling: We would encourage the FCA to ensure that the UK regime allows short selling to take place within sustainable investment portfolios because short selling can play a role within a sustainable approach. For example, a strategy with sustainability objectives could arguably hold a short position in an instrument linked to an issuer with negative sustainability or ESG characteristics.

Certain derivatives: We believe there are challenges to employing climate-related metrics with respect to derivatives instruments. Derivatives instruments (e.g., interest rate swaps and inflation swaps) often do not have an issuer linked to them to determine the metrics. While it could be argued that metrics should be reported for derivatives instruments linked to a corporate (e.g., credit default swaps or equity derivatives), holders of such derivatives do not have any direct ownership or influence on the company and its greenhouse gas emissions. There is also potential for manipulation of carbon footprint metrics at a portfolio level where negative derivative positions could be seen as offsetting positive carbon footprints elsewhere. We therefore believe there are clear nuances in the reporting of carbon metrics for derivatives and there are significant questions to answer before they are brought in scope for sustainable investment rules.

Q13: What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?

We do support streamlining disclosure requirements in line with the TCFD framework to ensure that the rules are compatible with international standards. We also support streamlining as much as possible in line with the EU SFDR rules, as many of our funds will be subject to both regimes. While doing so in full may not always be possible, there should not be any conflicts with SFDR, and it would be helpful for labels and other parameters to align with SFDR rules as much as possible, as explained in our answer to question 4.

Q14: What are your views on consumer-facing disclosures, including the content and any considerations on location, format (eg an ‘ESG factsheet’) and scope?

Yes, we would support this for consumers. See also our response to question 1. Minimum entity-level standards could also be included here.

Q15: What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?

We support aligning the SDR rules as much as possible with EU SFDR rules, as many of our funds will be subject to both regimes. While full alignment may not be possible, there should not be any conflicts with SFDR, and it would be helpful to have clear alignment of labels and other parameters as much as possible.

We would caution against the use of proxy data for meeting regulatory requirements. Use of proxy data means the output is highly susceptible to assumptions and methodologies chosen, making the output less reliable and more open to manipulation.

The use of proxy data will also mean that the data source and methodologies will change frequently. This can cause several issues. Firstly, any explanations made in any pre-contractual documents (e.g. fund prospectus) can quickly become out of date and it would not be practical to keep updating these regularly. Secondly, annual product disclosures will not be comparable over time. Finally, it may discourage managers from refining the methodology to increase accuracy if it makes the output look worse, if this is down to methodological rather than portfolio changes. We therefore believe it is more prudent to wait for the data issues to be resolved than mandating reporting based on proxy data.

Regulators can encourage the industry to resolve the data issues quickly by other means, such as through industry working groups and other initiatives, similar to the approaches adopted for the LIBOR transition.

Q16: What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?

We agree that entity-level reports should be aligned to TCFD reporting.

However, the following should be taken into account:

- Scenario analysis may not be appropriate, or possible, for some asset classes. While we strive for commonality in metrics and scenario analysis, the one-size-fits-all approach will not work for all asset classes.
- We caution against the mandatory use of proxy data as explained in our answer to question 15.
- Some asset classes should be out of scope as it may not be relevant or possible to report for them. These include legacy asset-backed securities (retrospective data is unavailable), currency instruments (sustainability metrics are not relevant), repo transactions and certain derivatives (various challenges arise with regard to sustainability disclosures).

Finally, we request that the FCA produces a glossary for investors to help them understand how terminologies map between the different regimes (e.g., UK SDR, international TCFD and EU SFDR). Without this, it will be complex and potentially confusing for investors to understand the different outputs that will be provided for their investments under different regimes. We believe it is preferable for a glossary to be produced by the regulator to minimise differences in interpretation by the industry.

Q17: How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.

In theory we support aligning requirements to the proposed ISSB international standards, pending publication of the final standards. We recommend FCA describing how these would be mapped to EU SFDR rules to help investors understand the different parameters that will be used for their reporting.

Q18: What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?

With respect to data providers, they will need to be engaged to ensure that their standard terms permit managers to disclose the data to the level required by regulatory reporting requirements. For example, if a manager is expected to report on the proportion of their fund invested in sustainable investments and the manager uses third-party data to assess this, the data providers will need to enable reporting of this underlying data to a sufficient level in line with the required disclosure. Currently there are limits on disclosures of underlying data which can make it difficult for managers to meet the aspirations of policymakers.

Q19: Do you consider that there is a role for third-party verification of the proposed approach to disclosures,

product classification and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?

There are advantages and disadvantages to third-party verification. Third-party verification can provide greater assurance of the validity of a label to investors. However, by their nature they are likely to be prescriptive and restrictive, and therefore unlikely to be flexible enough to cater for all types of investments.

We recommend setting broad criteria, along with some accepted bare minimum parameters, which managers use to assess the categorisation of their products. Managers can then choose to seek third-party verification.

Q20: What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machine-readable format to better enable data collection and analysis?

There are clearly benefits of reporting in machine-readable formats. However, it could encourage an overreliance on quantitative data rather than qualitative information in disclosures.

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