FCA DP23/1: Finance for positive sustainable change

UK Finance's Response

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Sent to: dp23-1@fca.org.uk

INTRODUCTION

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support consumers, and facilitate innovation. We work for and on behalf of our members to promote a safe, transparent and innovative banking and finance industry.

We are pleased to respond to the Financial Conduct Authority's (FCA) DP23/1: Finance for positive sustainable change. We welcome this early engagement with the FCA, to help develop its thinking on sustainability-related governance, incentives and competence in regulated firms.

The banking and financial services sector plays a key role in supporting the transition to a net zero economy and implementing wider sustainability commitments. Our members are committed to playing their role in financing the transition and driving positive sustainable change across the economy, including lending to crucial areas of the transition and embedding sustainability objectives internally. Engagement with the industry will be essential for the FCA to understand how firms operate, what they are already doing, and where further guidance or intervention might be needed.

If you have any questions relating to this response, please contact Agathe Duchiron, Manager, Strategic Policy, at agathe.duchiron@ukfinance.org.uk.

KEY RECOMMENDATIONS

- In light of the amount of new and emerging regulation in the field of conduct and corporate governance, and environmental, social and governance (ESG) issues in general, **we do not recommend the FCA undertake any new regulatory initiatives on ESG-related governance or remuneration/incentives** beyond those already timetabled. There is value in waiting for the existing pipeline to be fully implemented before expanding further.

- Given that much of banking and finance firms' exposure to ESG risks, opportunities and impacts is through **clients and supply chains**, any intervention should be designed to empower firms to more effectively promote change among those stakeholders. Where the FCA does opt to consider further regulation, this should be following **consultation with industry** and undertaken with a **principles and outcomes-based** lens, rather than introducing any new strict and prescriptive rules. This is to allow firms flexibility to incorporate sustainability factors into their businesses in a way which is appropriate to their individual business models, and in a way that materially effects positive change, instead of as a tick-box exercise.

- On training and competency, we share the concerns over misrepresentation of ESG credentials and gaps in that they may hinder a firm's ability to make informed decisions and meet its sustainability objectives. **Oversight of accreditation bodies would be an effective way to address such "competence washing" concerns.**

- There is appetite **for a consolidated list of existing rules, guidance, knowledge and sharing examples of best practice**. Where possible, the FCA should seek to summarise the swathes of sustainability rules and guidance from the various authorities involved in the UK and further afield (e.g. international best practice) in a user-friendly format and where possible including a comparison that enables firms to identify differences between the UK regulatory landscape and other regulations that may apply to them, for example as in CP22/20 on Sustainability Disclosure Requirements which highlighted differences between the FCA's proposals and the EU Sustainable Finance Disclosure Regulation. Policy making in the sustainability space is evolving at pace, to keep track of a rapidly evolving market, but it has resulted in requirements being introduced in a piecemeal way which can be challenging for firms to keep track of and implement.

- The FCA will need to carefully consider the particular circumstances and challenges that **international firms and UK-based firms operating globally** face with fragmented and evolving global regulatory frameworks for ESG. Objectives and the overall strategy, as well as remuneration, incentives, and culture generally will be set at a group level and cascaded down to UK operations. Corporate strategy will be influenced by home jurisdictional rules and approaches, which may not always completely align to the UK's and the FCA's approach to the same topics. The FCA will need to balance these considerations with ensuring a level-playing field for UK-based firms and guaranteeing that they are not put at an unfair advantage.

THE ROLE OF THE BANKING AND FINANCE SECTOR IN ACHIEVING ENVIRONMENTAL AND SOCIAL OUTCOMES

Many firms in the banking and finance sector have set ambitious targets to address their ESG impacts, including reducing their financed emissions through initiatives like the Net Zero Banking Alliance. These targets can only be achieved through action by firms' clients and value chains, with 90-95% or more of many banks' emissions coming from financing activities rather than own operations.

In many cases, the barrier to achieving these targets is a lack of action by firms in other sectors. While a quick fix would be to de-finance these activities, this will only result in "paper decarbonisation" rather than a real reduction in carbon emissions.[1] Banks have a role to play in influencing positive change and financing the wider economy but cannot compel clients and suppliers to change business practices. It is the role of the government to set a clear policy direction to achieve their environmental

[1] See, for instance, Oliver Wyman, February 2023, accessed: https://www.oliverwyman.com/our-expertise/insights/2023/feb/stepping-up-europe-climate-transition.html:
"36 of the top 50 banks in Europe have committed through the Net-Zero Banking Alliance to steeply cut their financed emissions. To hit their targets, they need their corporate clients to cut their emissions steeply – or to find new clients. Today, however, up to 20-40% of corporate debt relates to companies with only limited transition planning in place, meaning they either lack decarbonization targets aligned with a 2°C limit, or have failed to disclose at least half of the transition plan-related indicators included in the CDP questionnaire.
"While many financial institutions are keen to engage with corporates in high-emitting sectors to help them transition, it is hard for them to do so with confidence without these core elements of a plan in place. Companies that do not make progress to address these gaps are likely to find financing harder to access over time."

and social goals. For smaller financial services firms, there is a real risk that engagement on ESG issues could lead to clients finding finance elsewhere.

Any measures taken by regulators to support achievement of banking and finance firms' ESG goals must therefore aim at **empowering them to influence positive change and accompany and support their clients and real economy counterparts**. This could, for example, be by creating a level playing field for banking expectations to avoid a "race to the bottom" or ensuring that the real economy moves in lockstep through full, economy-wide action.

Separately, it is important to differentiate across different environmental and social objectives with different mechanisms of change. ESG factors are interconnected (e.g. biodiversity and climate; just transition considerations) and need to be treated holistically, but regulation cannot adopt a "one size fits all" approach: for example, whereas reducing greenhouse gas emissions will necessarily require client engagement, issues like D&I may be relatively more inward-looking. The complexity of defining and setting an approach on different issues means that prescriptive rule-making may not be helpful in all circumstances. The urgency of the climate challenge also underpins the need to avoid a proliferation of new regulatory measures.

GOVERNANCE – OBJECTIVES, STRATEGY AND CULTURE

We do not recommend any specific regulatory interventions on governance, strategy and culture, but would welcome the dissemination of lessons learned to maximise the effectiveness of firms' ESG-related activities.

Existing corporate governance frameworks in the UK are appropriate to address sustainability-specific expectations, without the need to separately address these in any new regulatory rules. Many banking and finance firms are already embedding sustainability-related commitments into their objectives and strategies, particularly for climate, nature and D&I. In addition to existing regulatory initiatives like the Consumer Duty and ESG labelling rules, we expect significant further developments in these areas, with the Transition Plan Taskforce's (TPT) recommendations and the upcoming D&I consultation[2] potentially coming into regulation, alongside various other measures as set out in the government's updated Green Finance Strategy 2023. These will all improve firms' understanding of disclosure and behavioural expectations. We would recommend that further regulation is paused whilst firms implement these frameworks

Where the FCA is considering further interventions, we recommend adhering to the following principles:

- **Where possible, embed existing frameworks with a holistic view of sustainability.** The United Nations Principles for Responsible Banking (UNPRB)[3] recommends strategic alignment to the Sustainable Development Goals (SDGs), the Paris Climate Agreement, and other relevant frameworks, such as the UN Guiding Principles on Business and Human Rights, where a bank is best positioned to do so through its business. The UNPRB recommends that firms implement their commitments through "effective governance and a culture of responsible banking", which include looking at remuneration and performance management, board and executives' responsibilities. Signatories to the UNPRB have to report yearly on their progress in implementing the principles.

[2] As explored in a previous discussion paper – DP 21/2: Diversity and inclusion in the financial sector – working together to drive change.

[3] See for instance: Principles for Responsible Banking Guidance Document, available here: https://www.unepfi.org/wordpress/wp-content/uploads/2022/04/PRB-Guidance-Document-Jan-2022-D3.pdf

Beyond the banking sector, the UN Principles for Responsible Investment (UNPRI) and the Stewardship Code are good resources.

- **Ensure that expectations lead to material change.** Care needs to be taken as to how potential policy interventions are put into practice as they will need to drive the appropriate culture change, as opposed to creating a tick box exercise.
- **Draw lessons learned and best practice from recent initiatives.** We would welcome, for example, the re-application of some of the approaches used for transition planning, including the inclusive consultation and governance process adopted in the TPT.
- **Disseminate good practice.** We welcomed the dissemination of good practice in this discussion paper. As an example, we agree with the paper that culture is key in delivering sustainability commitments, that appropriate tone needs to be set from the top, and that a bottom-up approach can be helpful. Sharing positive experiences, for example as this paper looks at the successes of establishing sustainability networks or forums, is a useful way of expanding that practice.

REMUNERATION AND INCENTIVES

We do not recommend any specific regulatory interventions on remuneration and incentives for sustainability outcomes. However, as the FCA considers these issues, it may wish to consider the following points.

The FCA has recognised the disconnect between the **shorter-term nature of remuneration** cycles and the **longer-term measurability of sustainability impacts**. However, further consideration is needed on what mechanism will be designed to translate credible sustainability-related objectives into short and medium-term targets and milestones. While firms with sustainability commitments should be expected to move the needle year on year for these matters in light of the urgency we face on some issues, the long-term nature of measuring sustainability results and impacts poses a challenge for how firms remunerate and incentivise employees on these issues. Firms normally remunerate employees positively or negatively based on the previous year's performance. Meanwhile, the effects of positive sustainability impacts are likely to be seen much later, over the course of many years. We welcome the continued sharing of good practice in tackling his challenge.

There is also a challenge in rolling appropriate remuneration strategies out across different levels of the organisation. While executives and senior leadership are often incentivised to focus more on long-term strategy, middle management may respond differently, and implementation of sustainability-related targets and incentives may be harder to control where a role is further removed from impact. Materiality in both the long and short term is therefore needed when setting objectives, an area where guidance could be used to fill the gap. Board and executive committee level targets are easier to implement.

Certain elements of sustainability may be easier to incorporate into remuneration and incentive targets in the shorter term — for instance, in areas like D&I, where progress can be directly linked to a manager's performance (e.g. in recruitment).

TRAINING AND COMPETENCIES

We do not recommend any finance-facing regulatory interventions on training and competencies, but would welcome greater oversight of accreditation bodies to address concerns over "competence washing".

The FCA's wider training and competence requirements already support consumer protection and market integrity, which should be sufficient for ensuring the right level of qualification within the financial services sector. As the FCA has identified in the discussion paper, SYSC 5.1 (the "Competent employees rule") also already requires firms to ensure that individuals engaged in regulated activity have the appropriate skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. We believe that maintaining relevant skills and expertise in relation to sustainability is included within that overall requirement.

When promoting genuine capability building and clarifying its expectations about sustainability-related skills, knowledge and expertise, the FCA should not set prescriptive or mandatory training that does not account for the individual contexts of firms and may interfere with firms' ability to develop and understand their own unique challenges and opportunities. Discussions with members highlighted that no single capability building exercise will work for all firms; instead, flexible, specialised and relevant training for organisations is needed, that reflect day-to-day operations. The rapidly changing environment also makes it extremely challenging to identify appropriate sustainability qualifications.

We share the concerns over misrepresentation of ESG credentials and gaps in training (including a failure to identify interdependencies between sustainability issues) that may hinder a firm's ability to make informed decisions and meet its sustainability objectives. **Oversight of accreditation bodies would be an effective way to address such "competence washing" concerns.**

We welcome the FCA's emphasis on developing **collective knowledge** and ongoing training in firms that can help share different expert views. To that end, there is a potential concern if one individual was to become a responsible Senior Manager Function (SMF) under the Senior Managers and Certification Regime (SM&CR) for sustainability matters. Firms recognise that there is an existing expectation from the Prudential Regulation Authority for an SMF to be responsible for a UK bank or financial services firm's response to climate risk. However, sustainability-related strategies and objectives are wide ranging, touching multiple business functions; therefore we believe that delivery of sustainability matters and goals requires collective responsibility and responsibility is not appropriate for one individual. We also note that the industry is already expecting changes to the Senior Managers and Certification Regime (SM&CR) to come through the Financial Services and Markets Bill. We recommend that the FCA does not make any more changes at this stage, and note the resourcing issues and potential delays that any additional changes might cause for the FCA in approving certifications.

INTERNATIONAL CONSIDERATIONS

The design of any future interventions must take into account the specific circumstances of international firms and UK firms operating globally.

Objectives, strategy and culture: Objectives and the overall strategy generally will be set at a group level and cascaded down to UK operations. Corporate strategies will likely be influenced by home jurisdictional rules and approaches, which may not always completely align to the UK's and the FCA's approach to the same topics. The FCA will need to balance these considerations with ensuring a level-playing field for UK-based firms, and guaranteeing that these firms are not put at an unfair advantage.

Remuneration and incentives: A firm's approach to remuneration and incentives is generally derived from group corporate strategy rather than set at individual regional level , as are sustainability goals. This is particularly challenging for international firms where the remuneration strategy would be set at group level and cascaded down to UK operations. We encourage the FCA to acknowledge this in its policy making, and we would advise caution on overly prescriptive regulatory expectations that would leave firms with competing regional strategies that deal with sustainability issues in different ways. For remuneration, in particular, it would not be appropriate for firms to set targets for individuals on sustainability, where this is not derived from a group sustainability strategy.