ARTICLE SERIES 2 OF 5 - SPOTLIGHT ON SDR: SEEING ESG CLEARLY

A stamp of sustainability

LGIM

The disclosure requirements and labelling system for sustainable investments proposed in the FCA's latest consultation aim to improve transparency. The question is, will they deliver?

Standards for disclosure of sustainability information across the investment chain are much needed as demand soars for sustainable investing worldwide.

'Sustainability is high on investors' agendas, so if the financial sector is going to help support the transition to a more sustainable future, market participants and financial services firms need high-quality information, a well-functioning ecosystem and clear standards,' said Tom Munro, a financial planner at McHardy Private Wealth in Falkirk.

In that regard, great progress has been made on improving transparency across the system over the past few years. Several regions, particularly the EU and UK, have been implementing comprehensive sustainable finance packages. Harmonisation of these packages is key and an area that could be improved.

Back in the UK, the government has been making solid progress towards implementing a core pillar of the 2019 Green Finance Strategy (GFS), specifically 'Greening Finance'. Last year, HM Treasury released an important policy update to the GFS, the 'Roadmap to Sustainable Investing'.

The creation of the International Financial Reporting Standards' International Sustainability Standards Board (ISSB) has brought together several proliferating sustainability standards for corporates and is a good demonstration of international harmonisation. This drive to develop standards that result in a high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets has drawn support from across the industry.

Included in this was the announcement of the new Sustainability Disclosure Requirement, or SDR, that outlined the government's comprehensive plans to further strengthen and pull together sustainability disclosures for corporates and financial market participants in the UK under one framework. So, it comes as no surprise that participants across the entire investment chain, including advisers, have been eagerly awaiting further information.

Once SDR is formally implemented (in the months and years after the consultation period), it has the potential to change the sustainable investment landscape, ushering in a new approach to investment research and implementation. Key to delivery is the industry's ability to be transparent and accurate with disclosures, and the FCA's ability to provide a sufficient monitoring and enforcement framework.

'Clearer disclosures and product labelling will mean consumers can rely on firms to take sustainability seriously and hopefully end the nonsense of fund managers selecting a few stocks and sticking an ESG label on them,' said Munro.

Richard Gillham, a financial planner at Progeny in London, is equally optimistic, hailing the requirements 'a sea change in sustainability reporting standards'. For him, the creation of an integrated framework for sustainability disclosures across the economy and a new investment labelling regime will aid investment decision-making and represent a 'significant step forward' in addressing greenwashing.

'Retail and institutional investors will be able to make better-informed decisions,' he said. 'SDR could eventually give asset owners such as pension funds deep insight into the environmental and social impacts of firms in their portfolios.'

THE 'THREE CS'

The eagerly awaited publication of consultation paper CP22/20 in late October unveiled the proposal for a labelling system that will compel fund managers to categorise sustainable funds in one of three ways:

- **Sustainable Focus** identifies those that invest in environmentally or socially sustainable assets;
- **Sustainable Improvers** are those that aim to improve the environmental or social sustainability of their assets over time;
- And **Sustainable Impact** funds invest in solutions to environmental or social problems to achieve a positive, measurable real-world impact.

Funds in the first two categories will be prohibited from using the term 'impact' in their names and marketing. The proposals also prohibit the use of terms such as 'ESG', 'green' and 'sustainable' by funds that do not qualify for the labels and introduce a general 'anti-greenwashing' rule applicable to all regulated firms.

Two tiers of disclosure will allow retail investors to access need-to-know information in an easily digestible format and more sophisticated investors to delve into more detail.

For Amelia Tan, head of responsible investment strategy at LGIM, the framework will help support the three Cs: credibility (for asset managers), clarity and choice (for intermediaries and investors).

'The labels will be easier markers for people on the street to go, "that's a fund that could play a part in changing the world for the better, I would like some of that",' she said.

Alexander Burr, ESG policy lead at LGIM, added that growing interest in and awareness of sustainable funds – coupled with a well-defined labelling system – could give rise to more funds being launched or repositioned as sustainable.

'If you're an investor, you'll have much more choice. You could potentially choose a fund that has very specific net-zero targets or a fund that invests in companies providing environmental or social solutions,' said Burr.

Enabling asset managers to communicate more consistently will bring credibility to the industry, levelling the playing field and raising the bar in how sustainability-oriented funds are run.

'Higher levels of transparency brought about by SDR will encourage firms to act more positively towards achieving net zero, contributing to land regeneration, protecting the planet's biodiversity, and complying genuinely with the United Nations Global Compact.'

Chris Welsford, Ayres Punchard Investment Management

REAL-WORLD OUTCOMES

The ultimate intended outcome of a labelling system that directs capital to green and sustainable finance is real-world benefits. This is a fact not lost on Chris Welsford, a long-term proponent of sustainable investing and managing director of Ayres Punchard Investment Management on the Isle of Wight.

'Higher levels of transparency brought about by SDR will encourage firms to act more positively towards achieving net zero, contributing to land regeneration, protecting the planet's biodiversity, and complying genuinely with the United Nations Global Compact,' he said.

Despite all its potential, however, shortcomings remain. For Square Mile Investment Consulting and Research, one of the key issues that SDR fails to address is the alleged misuse of the term 'ESG' in general in the market.

For the research agency, it is a risk-assessment tool – a screen that fund managers can apply to filter out stocks that may be exposed to risks associated with poorer-than-expected performance relating to environmental, social or governance considerations – and should not be used to describe sustainable funds, greenwashed or not.

‘It is not a form of sustainable investing where a fund has an explicit objective of delivering a positive result for the environment or society or both alongside financial returns,’ said Steve Kenny, Square Mile’s chief distribution officer. ‘The best [distinction] I’ve heard is that ESG is doing things the right way and responsible investing is doing the right thing.’

BARRIERS TO PROGRESS

For the most part, SDR seems to be one regulatory change that advisers are happy to embrace. However, its effectiveness in driving real change could be hampered by the inconsistent – but improving – access to sustainability data from companies across the public and private markets around the world.

The IFRS ISSB is working to address this. Progress will depend on whether governments adopt its standards and implement a strong domestic regulatory environment around the standard. It is also important that asset managers and owners engage with these companies to improve their performance and approach through active investment stewardship.

However, fund managers alone cannot drive the type of meaningful change required.

‘SDR should improve the sustainability of funds but greenwashing by certain investee companies is the ultimate threat to achieving a just transition to a cleaner planet,’ said Welsford.

‘Achieving real change requires legislation and enforcement, which is worryingly lacking at this time.’

LGIM’s Tan, meanwhile, highlights the role that asset managers can nonetheless play by using their voice to push for better ESG data:

‘To be able to allocate capital efficiently, investors need the market to accurately price in material ESG risks and opportunities. To achieve this, we need access to high-quality ESG data that is relevant, comparable, consistent and verifiable,’ she said.

‘Let’s hope the objectives of SDR are achieved and bring much-needed clarity to this market.’