FINANCIAL CONDUCT AUTHORITY

Discussion Paper

DP23/1

Finance for positive sustainable change: governance, incentives and competence in regulated firms

February 2023

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Or in writing to:

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Disclaimer

The views expressed by the authors of the externally commissioned articles in Chapter 6 in this paper should not be interpreted as reflecting the views of the Financial Conduct Authority. The purpose of the articles is to provide different perspectives on aspects of governance, remuneration and stewardship. The articles are solely the responsibility of the authors. All errors and omissions are the authors' own.

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Chapter 1

Overview

Introduction

1.1 Good governance and a healthy culture are critical to financial services firms' delivering value to clients and consumers and supporting market integrity. A firm's governance, purpose and culture are central to how it embeds environmental and social considerations into business, risk and capital allocation decisions for the benefit of clients and consumers. Our new Consumer Duty puts governance at the centre.

1.2 Firms' management of sustainability-related risks and opportunities has come under closer scrutiny in recent years – especially in relation to climate change, which has been catalysed by the work of the Taskforce on Climate-related Financial Disclosures (TCFD).

1.3 And it is increasingly recognised that the financial sector has an important role to play in contributing to the transition to a net zero economy and a more sustainable long-term future. As we said in our strategy for positive change, published in November 2021, 'Institutions large and small can use their business decisions, their innovation and creativity, and their voice and their influence, to encourage positive change.' But in a changing world, financial services firms must continue to adapt their objectives, priorities, business models and strategies. And, as their business imperatives evolve, their governance arrangements, incentives structures and capabilities must keep pace.

1.4 Many firms have already integrated material sustainability-related risks, opportunities and (in some cases) impacts into their business, risk and capital allocation decisions. Firms, investors and employees recognise that this is simply good business. Society now expects more from companies in all sectors, including financial services. Consistent with the notion of a 'social license to operate', our own Financial Lives Survey, the full results of which will be published later this year, reveals that at May 2022 79% of consumers think businesses have a wider social responsibility than simply to make a profit. So lending to, or investing in, businesses that pursue positive sustainability outcomes may be expected to improve enterprise value over the long-term.

1.5 An increasing number of firms are committed to sustainable objectives, with climate-related commitments currently the most prevalent. More than 550 firms, across more than 50 jurisdictions, have voluntarily signed up to the Glasgow Financial Alliance for Net Zero (GFANZ), a global initiative of financial institutions committed to accelerating progress towards a net zero economy.

1.6 The UK's Transition Plan Taskforce (TPT), launched in 2022 to support the UK Government's commitment to make the UK the world's first net zero financial centre, is consulting on a Disclosure Framework for credible transition plans that builds on GFANZ's recommendations and guidance. Both GFANZ, and the TPT recognise that a credible strategy to deliver on net zero commitments will require fundamental changes to governance, culture, people strategies and incentives.

1.7 The aim of this Discussion Paper (DP) is to encourage an industry-wide dialogue on firms' sustainability-related governance, incentives, and competencies. In a field where there are many initiatives taking place, our aim is to help narrow this field and help with highlighting good, evolving practices if finance is to deliver on its potential to drive positive sustainable change.

1.8 We will use the feedback in considering what the industry would find most helpful in this fast moving and evolving area. The feedback will help us in considering what direction our future regulatory approach should take. We will of course consider proportionality and whether differentiation between firms on the basis of size (or other characteristics) would be needed when deciding on the most appropriate course of action for each of the topics discussed.

1.9 In parallel, we will consider firms' arrangements in many of these areas as part of our supervisory engagement with firms. For instance, the topic of governance of ESG and stewardship – including the role of product governance bodies in overseeing ESG and sustainability integration in investment processes – is a prominent theme in our recent letter to CEOs on our asset management supervision strategy.

1.10 This DP also includes a collection of 10 commissioned articles from experts, including industry practitioners, academics and other thought leaders, with relevant and interesting perspectives on firms' sustainability-related governance, incentives, competence and stewardship arrangements. By including the views of experts, we aim to encourage diversity of thought and wide-ranging debate in this evolving area, complementing our own ideas and analysis. The views expressed in these commissioned articles are those of the authors and do not necessarily reflect our views.

1.11 The **first part** of the DP (Chapters 1 to 5) is organised as follows.

- In Chapter 2, we examine how governance, incentives and competence are considered in the TCFD's recommendations, and how expectations in these areas are evolving with the work of the International Sustainability Standards Board (ISSB), the TPT and GFANZ.
- In Chapter 3, we consider more deeply firms' sustainability-related objectives and strategies, and how these are supported by their governance and incentive arrangements. We also reflect on how asset managers and asset owners organise and govern their stewardship activities to influence positive change. Our observations and discussion questions are motivated by the commissioned articles, a review of relevant literature, and our own analysis – including a review of firms' public sustainability-related disclosures, such as their TCFD-aligned disclosures.
- Chapter 4 considers firms' training and competence, and Chapter 5 summarises next steps.

1.12 The **second part** of the DP (Chapter 6) includes the commissioned articles. These articles, along with our analysis, may help firms to reflect on how their approaches to governance, incentives and competence support positive change. This may encourage firms to review their practices, even without our setting further regulatory expectations.

Feedback we are seeking

1.13 We are committed to supporting the role of the financial sector in enabling an economy-wide transition to net zero, and to a sustainable future more broadly. Achieving an orderly transition depends on the combined efforts of government, industry, regulators and individuals. Through our strategy for positive change, we aim to build regulatory foundations and set appropriate guardrails to support the potentially powerful role that finance can play in the transition.

1.14 Under the Trust theme of our strategy, we committed to developing 'a policy approach to ESG governance, remuneration, incentives and training/certification in regulated firms'. Through the feedback we receive from this DP, we will consider if introducing additional regulatory expectations in this area will be an effective solution to promote positive change.

1.15 We increasingly expect firms to assess and integrate material sustainability risks, opportunities and impacts into their operations and financing activities. This is consistent with our strategic objective to make relevant markets function well, and our operational objectives to protect consumers, to protect and enhance market integrity and to promote effective competition in the interests of consumers. We also expect firms to be accountable for their sustainability-related claims and commitments, linking their governance arrangements and incentive structures to their stated objectives, and building relevant skills and capabilities across their organisations.

1.16 We are interested in how firms embed a clear purpose, how this relates to sustainability objectives, and the strength of the 'tone from the top' on sustainability-related matters. We think remuneration is a crucial tool to help align corporate outcomes with long-term sustainability aims. More generally, we welcome feedback on how firms' governance, incentives and competencies align with their integration of sustainability-related considerations and their commitments to contribute to positive change. Our questions focus on:

- whether firms have environmental or social objectives and how these are reflected in their policies and strategies
- how firms design their approaches to governance, remuneration, incentives, training and competence, to deliver effectively on these objectives
- practical challenges, and observed gaps and shortcomings
- whether existing rules and guidance in these areas are appropriate, or need to be refined to adapt to the changing role of finance

1.17 One of the target outcomes under our ESG strategy is active investor stewardship that positively influences companies' sustainability strategies, supporting a market-led transition to a more sustainable future. While wider aspects of the regulatory framework for asset management will be covered in other future work, in this paper we are inviting specific feedback on how FCA-regulated asset managers and asset owners govern and incentivise effective investor stewardship.

1.18 Our work in this area aligns with the proposed amendment to FSMA 2000 (in the Financial Services and Markets Bill) to introduce a new regulatory principle for the FCA (and Prudential Regulation Authority (PRA)) to 'have regard to the need to contribute towards achieving the Government's target of reaching net zero greenhouse gas emissions by 2050'. It also supports expectations in the Chancellor's latest remit letter to the FCA, received in December 2022: that we 'have regard to the Government's ambitions for the provision of sustainable finance'.

1.19 While many firms' policies in this area are currently focused on climate change, this DP seeks feedback on how firms are dealing with the breadth of sustainability topics, encompassing both environmental and social matters.

1.20 A firm's approach to diversity and inclusion (D&I) is one relevant area of focus. Diversity and inclusion can not only be a relevant social consideration, but also an enabler of good governance. For instance, increased diversity and inclusion on boards can improve the range of experience and quality of decision-making, helping firms to develop and deliver more effectively on their sustainability commitments.

1.21 We, alongside the PRA and the Bank of England, recently sought feedback on potential policy considerations in the area of D&I in the financial sector (DP21/2). Our work is ongoing, and we remain committed to consulting on a new regulatory framework for D&I and data requirements to accelerate the pace of change in this area. We have also recently published observations from a multi-firm review on D&I in financial services firms, which found that 'all were early in the development of their approach on diversity and inclusion'. This DP seeks feedback on a much wider scope of issues that complement our more targeted work on D&I.

Who will be interested in this DP?

1.22 This DP will be of interest to all regulated firms across the financial sector. In particular:

- banks
- building societies
- insurers
- asset management firms
- investment firms

1.23 The discussion will also be of interest to:

- industry groups/trade bodies
- consumer groups and individual consumers
- policy makers and other regulatory bodies
- industry experts and commentators
- academics and think tanks
- civil society

Equality and diversity considerations

1.24 We considered the equality and diversity issues that may arise from this DP. Overall, we consider that the DP will not impact any of the groups of persons with protected characteristics under the Equality Act 2010 as we are advancing discussion at this stage. We also consider that publishing articles from academics, practitioners and thought leaders brings together a range of views and provides diversity of thought.

1.25 We will continue to consider Equality and Diversity implications when we review the feedback and decide on next steps. Feedback on how firms consider social, and governance matters in their operations can potentially inform directly future policies in respect of groups with protected characteristics covered by the Equality Act.

Next steps

1.26 We welcome feedback on the topics discussed. A full list of the questions on which we are seeking feedback is available in Annex 1. The discussion period will end on 10 May 2023. We will consider the feedback received to determine our next steps.

What do you need to do next?

1.27 You can respond by email dp23-1@fca.org.uk, or use the contact details on page 2.

Chapter 2

How firms' governance, incentives and competence can support positive change

2.1 Across the finance sector and real economy, firms' consideration of sustainability-related risks, opportunities and impacts is coming under closer scrutiny – especially with firms increasingly making public commitments about their sustainability-related objectives.

2.2 Much of the regulatory focus to date has been on climate-related matters, with a 'disclosure first' approach, built around the TCFD's recommendations. These recommendations are referenced in disclosure rules in our Handbook (PS20/17; PS21/23; PS21/24), which we introduced as part of a wider UK Roadmap towards mandatory climate-related financial disclosures (flowing from the Government's 2019 Green Finance Strategy).

2.3 The work to implement the TCFD's recommendations is informing our approach to regulation in relation to other sustainability topics. In articulating the rationale for enhanced disclosures in this area, the Roadmap report explained that the aim was '... not only to improve the flow of information, but also to foster a step change in how organisations think about climate-related risks and opportunities. Spanning governance, strategy, risk management and metrics and targets, the TCFD's recommendations encourage organisations to behave more strategically, to manage risks better and to ensure they are fit for the future.' The PRA also expects dual-regulated firms to manage the financial risks from climate change (SS3/19).

2.4 When we consulted on our own disclosure rules consistent with the TCFD's recommendations (CP20/3), we stressed that clarity on our expectations in this area would encourage 'a structured dialogue within companies/firms on matters of governance, strategy and risk, and more robust processes to support climate change analysis'.

2.5 But this is evolving:

- *Focus beyond climate*. Attention is turning also to other – often inter-related – sustainability topics, such as human rights, diversity and inclusion, nature and biodiversity. There is increased scrutiny from investors and a demand for wider sustainability-related measures to be considered. As we flagged in our ESG Strategy, we are developing further our thinking on these matters, and will publish further details on our approach later in the year. The ISSB, which is developing a global baseline of corporate reporting standards on sustainability-related matters that builds from the TCFD's recommendations, has consulted on general sustainability-related disclosure requirements, alongside climate-related requirements. At its December meeting, the ISSB elaborated further the conceptual underpinning of its work on sustainability, concluding that 'sustainability is a condition for a company to access over time the resources and relationships needed (such as financial, human, and natural), ensuring their proper preservation,

development and regeneration, to achieve its goals'. The ISSB also confirmed that it will issue an agenda consultation on its future direction, in which it will seek feedback to inform potential research projects on biodiversity, ecosystems and ecosystem services, human capital (including diversity, equity and inclusion), and human rights (including labour rights and communities' rights in the value chain). In relation to nature, we support the ISSB's having regard to the work of the Taskforce on Nature-related Financial Disclosures (TNFD) as it develops its standards in this area.

- *Driving positive change*. Our ESG strategy emphasises that transparency and trust are enablers of the role of finance in driving positive change. Only with a trusted market and a flow of decision-useful, comparable and reliable information along the value chain can we expect the financial services sector to realise its potential in allocating capital to support a market-led transition to a more sustainable future. Again, most of the progress to date has been in relation to climate change. Through the work of initiatives such as GFANZ and the TPT, there is a growing understanding of the deep transformation that will be required in businesses across the real economy and the financial sector to back climate commitments with concrete action.

2.6 In this DP, we are seeking views on how we can move most effectively beyond disclosure-based initiatives to help and encourage firms as they develop their arrangements for governance, incentives and competence in the area of sustainability.

2.7 The remainder of this chapter introduces the frameworks that guide our thinking on how governance, incentives and competencies may need to adapt to better equip firms to play their part in embedding and accelerating the transition.

Taskforce on Climate-related Financial Disclosures (TCFD)

2.8 The TCFD published a set of voluntary climate-related financial disclosure recommendations in June 2017. The Taskforce set out recommendations in four thematic areas: governance; strategy; risk management; and metrics and targets. This has become a widely accepted framework for climate-related disclosure internationally and is widely used globally. An ecosystem has since built around the recommendations, including through the work of bodies such as our own Climate Financial Risk Forum, which published its latest outputs in December 2022.

2.9 Consistent with the government's Roadmap to mandatory TCFD-aligned disclosures across the UK economy, the recommendations are now referenced in our climate-related disclosure rules for premium-listed commercial companies, certain standard-listed companies, asset managers and asset owners. The first disclosures by premium-listed companies made under our rule were published in the first half of 2022. We published a multi-firm review of these disclosures in July 2022, alongside a complementary report from the Financial Reporting Council (FRC).

2.10 Our disclosure requirements for asset managers are also consistent with International Organization of Securities Commissions' (IOSCO) recommendations for asset manager practices, policies, procedures and disclosure. These recommendations set expectations for asset managers to make disclosures covering governance, strategy, risk management and metrics and targets on sustainability-related risks and opportunities in their capacity as a fiduciaries of client assets.

2.11 A key aim of the TCFD's recommendations is to help organisations 'better demonstrate responsibility and foresight in their consideration of climate issues', to promote 'smarter, more efficient allocation of capital, and help smooth the transition to a more sustainable, low-carbon economy'.

2.12 Of particular relevance to this DP, the governance pillar of the TCFD's recommendations emphasises the importance of board and management focus on climate-related issues. The TCFD notes that, in gauging the effectiveness of an organisation's climate response, investors and other stakeholders need to understand 'the role an organization's board plays in overseeing climate-related issues as well as management's role in assessing and managing those issues. Such information supports evaluations of whether climate-related issues receive appropriate board and management attention.'

2.13 The other pillars of the TCFD's recommendations go on to consider:

- how climate-related issues may affect an organization's 'businesses, strategy, and financial planning over the short, medium, and long term' (Strategy)
- how 'climate-related risks are identified, assessed, and managed and whether those processes are integrated into existing risk management processes' (Risk Management)
- the metrics used to measure and manage climate-related risks and opportunities by an organization and key climate-related targets (Metrics and Targets)

2.14 As part of its framework, the TCFD also considers remuneration policies as providing important incentives for achieving an organization's goals and objectives, and providing insight on an organization's governance, oversight, and accountability for managing climate-related issues. This is consistent with our views that remuneration policies that are aligned to a firm's business strategy and values can help firms deliver against their long-term sustainability-related commitments.

The International Sustainability Standards Board (ISSB)

2.15 The ISSB is developing international corporate reporting standards on sustainability-related matters. The initial standards, issued for consultation in March 2022, comprise general sustainability-related disclosure requirements and climate-related disclosure requirements. These integrate the TCFD's recommendations and apply the same four pillars of disclosure.

2.16 The ISSB's standards will provide a global baseline for sustainability-related reporting to meet investors' information needs, that is connected with financial reporting. The UK Government's Roadmap to Sustainable Investing set the expectation for Sustainability

Disclosure Requirements (SDR) to be introduced across the economy, building from the economy-wide TCFD implementation. It signalled that the ISSB's standards will 'form a core component of the SDR framework, and the backbone of its corporate reporting element'. We have committed to consulting on implementation of the ISSB's standards, adapting our existing TCFD-aligned disclosure rules for listed companies, once finalised and available for use in the UK. We also intend to evolve our sustainability disclosure requirements for asset managers (as proposed in CP22/20) in line with the ISSB's standards in time.

2.17 Building from the TCFD's disclosure recommendations on governance, and accompanying guidance, the ISSB's governance-related disclosure requirements cover a range of topics that emphasise many of the matters that we explore in this DP:

a. the identity of the body or individual within a body, responsible for oversight of sustainability-related risks and opportunities
b. how the body's responsibilities for sustainability-related risks and opportunities are reflected in the entity's terms of reference, board mandates and other related policies
c. how the body ensures that the appropriate skills and competencies are available to oversee strategies designed to respond to sustainability-related risks and opportunities
d. how and how often the body and its committees (audit, risk or other committees) are informed about sustainability-related risks and opportunities
e. how the body and its committees consider sustainability-related risks and opportunities when overseeing the entity's strategy, its decisions on major transactions, and its risk management policies (including any assessment of trade-offs and analysis of sensitivity to uncertainty that may be required)
f. how the body and its committees oversee the setting of targets related to significant sustainability-related risks and opportunities, and monitor progress towards them, including whether and how related performance metrics are included in remuneration policies
g. a description of management's role in assessing and managing sustainability-related risks and opportunities, including whether that role is delegated to a specific management-level position or committee and how oversight is exercised over that position or committee. The description shall include information about whether dedicated controls and procedures are applied to management of sustainability-related risks and opportunities and, if so, how they are integrated with other internal functions

Transition planning

2.18 At COP26, the Chancellor, committed to making the UK the world's first net zero financial centre. To deliver on this commitment, the TPT was launched, with a mandate to develop a 'gold standard' disclosure framework for credible transition plans.

2.19 The TPT launched its draft recommendations for consultation at COP27. The draft framework integrates with, and builds from, the TCFD's recommendations (having regard also to future implementation of the ISSB's standards). We have been actively involved in the work of the TPT and intend to draw on the TPT's outputs, once finalised, to strengthen our own expectations of listed companies and regulated firms in this area. In the meantime, we have encouraged listed companies, especially those making net zero commitments, to consider the TPT's draft outputs when making their transition plan disclosures.

2.20 The TPT's Disclosure Framework recognises the need for fundamental transformation in how firms set their climate ambition and the strategies to deliver on their ambition. While developed in the context of the net zero transition, we consider that the conceptual underpinning and the key considerations in the Framework may also be relevant to firms' approach to other sustainability topics and objectives.

2.21 In considering delivery of the plan, the Governance pillar of the TPT's Disclosure Framework, emphasises:

- *Board oversight and reporting*: arrangements for Board-level governance of the transition plan, including its processes for Board-level review and approval of the transition plan, and for the oversight of monitoring and reporting of progress against the entity's stated objectives and priorities
- *Roles, responsibility and accountability*: senior management roles and responsibilities for the execution of the transition plan, as well as the entity's wider control, review and accountability mechanisms
- *Culture*: the steps that the entity has put in place to build a culture aligned with the strategic ambition in its transition plan, including through leadership and training programmes, HR policies and procedures and wider workforce engagement
- *Incentives and remuneration*: arrangements to align remuneration and incentive structures with the stated objectives and priorities in its transition plan
- *Skills, competencies and training*: skills, competencies and knowledge across the organisation to effectively design, develop and deliver the transition plan

2.22 The TPT encourages a strategic and rounded approach to transition planning across the real economy and financial sector, grounded in the principles of ambition, action and accountability. The TPT identifies three channels: (i) decarbonisation; (ii) responding to climate-related risks and opportunities; (iii) contributing to economy-wide transition.

2.23 The third channel captures an entity's 'sphere of influence': actions that it may take to diffuse sustainable practices and amplify positive real-world change by supporting, complementing or influencing the actions of others. For a financial services firm, this includes its financing and stewardship activities. These three channels can be generalised to other environmental or social themes and imperatives.

2.24 The Elements of the TPT's Disclosure Framework align with the components of the guidance on net zero transition planning published by GFANZ ahead of COP27. The work has also been informed by engagement with the standards for net zero emissions pledges by non-State entities developed by a United Nations High Level Expert Group.

2.25 Consistent with the strategic and rounded approach to transition planning set out in the TPT's Disclosure Framework, GFANZ guidance encourages companies to consider not only reducing their financed emissions, but also financing emissions reduction.

2.26 The guidance also includes a helpful conceptual approach to transition finance that delineates between four key financing strategies: climate solutions; financing or enabling entities that are already aligned to a 1.5°C pathway; financing or enabling entities that are committed to transitioning to a 1.5°C pathway; and managed phaseout.

2.27 Both the TPT's Disclosure Framework and the GFANZ guidance emphasise that a credible transition plan should include a robust engagement strategy – spanning engagement with the value chain (including, in the case of financial services firms, clients and portfolio companies), industry peers, and governments, public sector and civil society. This recognises the systemic nature of transition goals and the strong potential for collective voice, coordination and collaboration to drive positive change.

2.28 The focus on official sector engagement is consistent with the message in Tom Tayler's article in this DP (pg38) and the article, Act now (co-authored with Steve Waygood) that 'we need to bring together multiple, diverse stakeholders from all geographies to create, steward and ultimately deliver a roadmap at the global financial level, as well as at the individual institutional level.'

Chapter 3

Sustainability-related governance, remuneration and incentives in regulated firms

Summary

3.1 In this chapter we look at how firms embed sustainability-related considerations into their objectives and purpose, and how these are then reflected in its culture, business strategy, governance and incentives. We look at how robust board governance, clearly defined responsibilities and accountability are essential to manage a firm's approach to climate change and sustainability. And we explore whether and how remuneration can help to drive the effective delivery of firms' sustainability approaches over the short, medium and long term – including by integrating meaningful measures to assess performance. With a particular focus on asset managers and asset owners, the final section considers the governance and organisation of investor stewardship and the role it can play in influencing positive sustainability outcomes.

Objectives, purpose, business and strategy

3.2 Given the important role finance can play in supporting a market-led transition to a more sustainable future, we want to understand how far firms are setting sustainability-related objectives and building these into their business models and strategies. By encouraging dialogue and exploring better practices, we can help the industry as it develops capabilities in these areas.

3.3 Tom Gosling, in an article in this DP (pg42), states 'sustainability and ESG are central to business strategy in the 2020s'. By widening their purpose, business, strategy and culture to align with climate and other sustainability related objectives, financial services firms can support positive environmental or societal change.

3.4 Where a firm has made public sustainability-related commitments, it is reasonable to expect that it will develop and articulate a credible strategy to deliver on those commitments. A credible strategy would typically include a suitable timeframe and milestones, detail the interaction with other parts of the business plan, identify roles, responsibilities and accountability, and link with incentive structures – potentially including remuneration.

3.5 Articulating its sustainability-related objectives clearly and embedding them in business and financial planning, governance and organisational structures, can reinforce a firm's message to all relevant stakeholders – employees, customers, shareholders and regulators – that these are fundamental and material to its business.

3.6 For instance, under its 'strategy' pillar, the TCFD recommends that firms disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning. And the frameworks that GFANZ and the TPT have developed on transition planning (see Chapter 2) emphasise the importance of translating long-term commitments to near-term actions against which the organisation can be held to account.

3.7 Flowing from a well-designed action plan, robust metrics and targets can provide internal focus and discipline, while also helping stakeholders track progress. A robust process will build in regular review of targets and measures to ensure they remain consistent with meeting stated objectives and the delivery of the action plan.

3.8 Tom Gosling notes that 'long-term climate commitments like net zero 2050 are meaningless without short-term goals to get there.' Tom Tayler's article (pg38) similarly makes the point that the focus is shifting from commitments to implementation, with robust transition plans being the next crucial step. A transition plan can be used to demonstrate milestones and track short-term actions to achieve long-term net zero aims. The article written by authors from the London Stock Exchange Group (LSEG) (pg47) finds that more than two-thirds (68%) of FTSE All-Share companies publish some form of net zero target, though less than half (45%) have also set interim goals for 2025-2035.

3.9 Non-profit organisation CDP, which runs a global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts, found that greenhouse gas emissions associated with financial institutions' investing, lending and underwriting activities (all of which fall within Scope 3) are on average over 700 times higher than their direct emissions (which relates to Scope 1 & 2).

3.10 Therefore, it is increasingly expected that firms include Scope 3 emissions in their targets. The TPT's draft Disclosure Framework, which applies across sectors, recommends that entities 'include interim and long-term targets to reduce GHG emissions over time across emissions Scopes 1, 2, and 3…' If the entity excludes any relevant scopes or categories of emissions from its GHG reduction targets, it should state the reason for omitting these scopes or categories and outline any steps it is taking to enable target-setting for relevant scopes or categories.' In its financial sector specific guidance on net zero transition planning, GFANZ recommends that firms '… cover Scope 3 emissions associated with clients or portfolio companies in sectors that are significant climate change contributors or where company Scope 3 emissions are material and can be incorporated based on data availability'.

3.11 The article by Robert Eccles explores how an asset manager's statement of purpose can help to provide clarity to its investment approach (pg54). The author argues that 'The concept of business purpose can improve the asset manager's credibility and authenticity in constructing ESG and sustainability investment products', going on to describe the key pillars for implementation of purpose-based principles.

Q1: **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.**

Culture as an enabler

3.12 A healthy culture is at the heart of driving operational performance which will meet the needs of customers and drive shareholder or owner value. We expect senior leaders to take responsibility to nurture healthy cultures in the firms they lead.

3.13 A healthy culture is one that, among other things, is purposeful, that has sound controls and good governance, where employees feel psychologically safe to speak up and be listened to, and where remuneration does not encourage irresponsible behaviour that can ultimately damage the business and wider markets. The Corporate Governance Institute emphasises that even a well-designed strategic plan will fail if the organisation does not have an appropriate culture in place.

3.14 The FRC's Corporate Governance Code requires that the board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. The PRA, in Supervisory Statement SS5/16, expects that 'the board should articulate and maintain a culture of risk awareness and ethical behaviour for the entire organisation to follow in pursuit of its business goals'.

3.15 The FRC's 2016 report on Corporate Culture and the role of boards examines how boards and executive management can steer corporate behaviour to create a culture that will deliver sustainably good performance. The report observes that a healthy corporate culture is a valuable asset.

3.16 When assessing culture, we focus on four key drivers: purpose; leadership; governance; and a firm's approach to rewarding and managing people.

3.17 To embed purpose and enable employee understanding and buy-in to it, firms need to articulate it clearly and make it visible in their actions. Corporate purpose in relation to sustainability and positive change may be described in different ways. For instance, in 'Paying well by paying for good', PwC describes purpose in terms of 'how a company benefits society while creating value'. And in their article in this DP (pg58), Deloitte describes purpose as 'a firm's explicit drive to create value beyond profit, specifically for people and the planet'.

3.18 However a firm describes its purpose, we would expect evidence of its commitment to achieving its stated purpose, including consistency in its messaging and its actions, and evidence of how its purpose is embedded throughout the firm.

3.19 Individual purpose is where an employee has a meaningful connection and sense of fulfilment to their work. When this individual purpose is aligned with company goals it can be powerful in addressing change through an engaged and motivated workforce.

3.20 In a similar vein, in its Disclosure Framework (p25), the TPT elaborates the steps that an organisation may take to build a culture that supports the successful implementation of a transition plan. These may include 'information on actions to review systems, processes, communications, HR policies and procedures (including compensation and benefits), company values, leadership and manager training programmes and workforce engagement strategies to ensure the culture supports the behaviours and ways of working needed for the transition'. These are potentially fundamental changes that could lead to transformation in a firm's 'ways of working'.

3.21 Deloitte also encourages senior management to lead by example and 'be role models for the behaviours that exemplify the culture they want to create.' Alongside a strong tone from the top, middle managers are also important role models for desirable behaviour. If middle managers are not supported from the top, they may not be able to play the role that they should in creating a healthy culture. The International Association of Insurance Supervisors (IAIS), in its Issues Paper on Insurer Culture, highlights the importance of middle management and frontline staff taking ownership of their roles in order to implement the insurer's business objectives and strategies in line with the cultural tone set by the board and senior management.

3.22 Deloitte suggests that 'where staff can speak up without fear or repercussion, firms are also more likely to identify, at an early stage, potential instances of greenwashing or misconduct, or flush out weaknesses with the implementation of firm transition plans, for example, risks, conflicts, or practical application problems.'

3.23 The Consumer Duty, when it comes into effect, will focus firms' minds on their culture and will require them to think about how their culture and behaviours support positive outcomes for consumers, including the most vulnerable. This needs to be driven from above with strong senior championing and oversight. We included guidance on governance and culture in the non-Handbook guidance for the Consumer Duty.

3.24 There is growing interest from investors for firms to disclose and improve D&I practices. We also believe that moving towards a more diverse and inclusive industry will be beneficial for firms and will help us advance our statutory objectives by supporting better outcomes for consumers. The article by Deloitte recommends that 'firms should ensure diversity and inclusion, and the desired mindset, are considered as part of recruitment, retention, and succession planning'.

3.25 As noted, our recent multi-firm review of D&I in financial services found that 'all were early in the development of their approach on diversity and inclusion'. Many were unclear on the purpose of their D&I initiatives and didn't understand it as a fundamental cultural issue.

Q2: **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.**

Governance, responsibility and accountability

3.26 Good governance with board oversight, clear board-level accountability and independent challenge are essential to manage and oversee all material risks, opportunities and impacts, including those related to climate change and wider sustainability.

3.27 It should be clear which roles at the firm are responsible for driving change and ensuring that the entire organisation is aligned to the firm's priorities and commitments – including on environmental and social matters, such as climate transition, biodiversity, human rights, health and safety, D&I and fair pay. Clear buy-in will be essential for this.

3.28 Deloitte's wider report on enhancing governance and culture to support the net zero transition sets out a combination of actions that firms can take to ensure they are working towards meeting their climate and sustainability-related objectives. This includes clearly assigning responsibility for the design and execution of the transition plan to individuals and updating board and/or committee mandates, roles and terms of references to reflect this.

The role of the board and senior management

3.29 The board is ultimately responsible for the firm's business strategy, with its role being to provide oversight and open, constructive and robust challenge in respect of the delivery of the strategy. For the board to function effectively and be equipped for long term success, members need to have the right skills, knowledge and expertise. The PRA sets expectations in SS5/16 that an effective board needs to include individuals with a mix of skills and experience that are up to date and cover the major business areas in order to make informed decisions and provide effective oversight of the risks.

3.30 This may include having members of the board with a background or expertise in sustainability-related matters, or facilitating access to that expertise either internally or externally to support decision making on these issues.

3.31 Julie Baddeley from Chapter Zero recognises that there remains a gap in expertise on many boards. The author argues in this DP (pg64) that firms should ensure that people with the right range of skills, including competence on climate-related matters, are appointed when board vacancies arise. That said, Julie recognises that board members are not typically experts in sustainability. Rather, these members need to gain an understanding of the issues so that they can actively provide challenge and debate. Board members may do this by seeking guidance from others with the relevant technical expertise.

3.32 The Institute of Directors identified a number of ESG priorities for UK companies in 2022. These included the need for an urgent assessment of whether board members and senior executives have the skills, know-how and commitment to oversee the transition of the enterprise to net zero. Potential remedies included board training or changes to board composition.

3.33 As part of the Consumer Duty, we expect firms to have a champion at board (or equivalent governing body) level who, along with the Chair and the Chief Executive Officer (CEO), ensures that the Duty is being discussed regularly and raised in all relevant discussions. In this case, the champion should be an Independent Non-Executive Director (INED), where possible.

3.34 Julie's article notes that a lot of 'the ESG heavy lifting for many companies is carried out by a sustainability committee', which is typically chaired by either the CEO or Chief Finance Officer (CFO) and supported by specialists. In 2021, half of FTSE 100 companies reported that they had a sustainability committee in place, providing information and support to their board. A sustainability committee is of course only one organisational approach to deal with these matters. With the right composition, expertise and terms of reference, other approaches could be equally effective.

3.35 Ultimately, the whole board is responsible for having the appropriate skills and knowledge to effectively lead and challenge the company on its wider sustainability-related risks, opportunities, and ambitions. Furthermore, the contribution of the committee should ideally be complemented by further steps to embed climate and sustainability across the organisation.

3.36 In addition to sub-committees, firms may benefit from creating climate working groups or forums to focus on the strategic direction for the firm, oversee the embedding of the firm's ESG strategy and track progress. Will Martindale's article (pg69) highlights learnings on how a CEO chaired business-wide steering committee can ensure key sustainability milestones are reviewed and met.

3.37 Konstantina (Tina) Mavraki's article (pg74) makes the point that many banks have established basic climate governance, but that translating this coherently into the business strategy requires further work. The article provides some thoughts on governance interventions across all three lines of defence. Tina's article also discusses the importance of the 'tone from the middle', noting that 'operational business reviews and tracking performance data are key for minimising operational risk events and for safeguarding consistent climate performance'.

3.38 In a similar vein, Will stresses the role of 'champions' across the organisation as key to embedding the sustainability agenda and making it a success, 'it is important to embed sustainability across the organisation, so that it becomes part of 'business as usual'. The author goes on to say that 'ultimately, there will be collective responsibility for achieving sustainability aims, rather than responsibility resting solely with the sustainability function'. Building knowledge across the organisation is a key part of embedding.

3.39 In Chapter 4, we discuss the importance of training and competence and the need for genuine capability building across the financial sector. Supporting sustainability objectives, notably in relation to climate change, may require fundamental changes in firms' decision-making processes. In addition to new committee and working group structures, firms may need fundamentally to refresh their management information systems. They may also need to set up new systems and controls to ensure adherence to sustainability-related policies and conditions, as well as an audit trail to measure performance against sustainability-related action plans.

3.40 This chimes with the recognition in the TPT's Disclosure Framework that firms should set out senior management's roles and responsibilities for the execution of the transition plan (see below), as well as the firm's wider control, review and accountability mechanisms. This should include, among other things, how relevant corporate procedures, systems and decision-making processes have been amended to support delivery of the plan.

3.41 We would like to understand the governance and organisational structures that firms have put in place to manage sustainability-related risks, opportunities and impacts, and to drive their sustainability agendas. We also welcome input on any practical challenges that firms have experienced in embedding sustainability across their organisations.

3.42 In particular, we welcome feedback on the following questions.

Q3: **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?**

Q4: **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?**

Q5: **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?**

Accountability

3.43 The Senior Managers and Certification Regime (SM&CR) applies to both dual-regulated and solo-regulated firms. The SM&CR provides a framework to drive a culture of accountability within firms with clear lines of accountability and responsibility for senior management functions (SMFs). The SM&CR aims to ensure that staff at all levels take personal responsibility for their actions and can help to ensure that the firm and staff clearly understand and can demonstrate where responsibility lies.

3.44 Deloitte's article notes that roles and responsibilities should be clear, with individual accountability to create a culture where individuals are 'personally incentivised to act in the way the Board and senior executives want.' Consistent with this, in our 2022 letter to Remuneration Committee Chairs, we emphasised that individuals should be held accountable for their conduct and competence.

3.45 For dual-regulated firms, the PRA's Supervisory Statement (SS3/19) sets the expectation that firms should allocate responsibility for identifying and managing financial risks from climate change to an appropriate existing SMF within the firm's organisational structure. Furthermore, this activity should be included in that SMF's Statement of Responsibilities (SOR).

3.46 In a recent supervisory letter to CEOs, the PRA observed that banks and insurers had generally been able to implement an effective level of climate governance and also that the majority of firms now include an allocated SMF with responsibility for the financial risks from climate change.

3.47 This is consistent with the findings in a recent survey of financial services firms' TCFD disclosures by Deloitte, which found that at the executive level, the Chief Risk Officer (CRO) was most commonly cited as the individual responsible for climate-related matters. Our analysis similarly shows that banks and insurers have typically allocated responsibilities for climate risk to SMFs within their firm, with the CEO and/or CRO typically accountable for delivery of climate- or wider sustainability-related commitments (Box 1).

3.48 Will's article argues that it is important to establish the CEO as the leader on sustainability topics with support from the Sustainability function, arguing also that the head of this function should report directly to the CEO, giving them the mandate necessary for fast-track implementation.

3.49 For solo-regulated firms, we do not have prescribed responsibilities for delivery of climate- or other sustainability-related objectives. Responsibility for these objectives could extend across various roles in the organisation, and it is up to firms to consider who is responsible and accountable. In the case of climate in particular, which is widely accepted as a financial risk to many firms we regulate, we consider it reasonable that CEOs, CROs and other appropriate members of senior management can already credibly articulate how climate related risks and opportunities are identified and managed within their firm.

3.50 We would like to gather feedback on whether we should consider additional regulatory expectations or guidance to enhance individual ownership and responsibility for sustainability-related matters within regulated firms.

Q6: **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.**

Governance of products and services

3.51 A key aspect of robust governance within a firm overall is maintaining appropriate oversight of its products and services. As set out in our product governance sourcebook (PROD), this refers to 'the systems and controls firms have in place to design, approve, market and manage products throughout the products' lifecycle to ensure they meet legal and regulatory requirements' (PROD 1.1.2).

3.52 We expect all firms making sustainability-related claims about their products or services to maintain appropriate governance arrangements to deliver the product in line with these. And we expect firms to have appropriate arrangements in place to ensure those claims reflect the sustainability profile of the product.

3.53 Firms may have specific governing bodies in place in relation to their products and we expect those governing bodies to have appropriate oversight of and accountability for the delivery of the product.

3.54 However, there is some concern that there may be a lack of clarity as to the role of governing bodies in relation to sustainable products. For example, the Fund Boards Council published research into the oversight of sustainable investment funds, which highlighted key challenges and areas for improvement for Fund Boards. In particular, it found that some Fund Boards are currently unclear as to the role they should play in the delivery of funds' commitments to their investors: some are relatively remote from activities impacted by sustainability-related rules and guidance; some may not have considered how sustainability risk is managed in portfolios or included in their risk management frameworks; and some may not yet have developed appropriate sustainability-related knowledge and expertise and established flexible ways to understand newer sustainability issues.

3.55 While our product governance requirements apply to all products, we recognise that there is currently no explicit reference to sustainability in relation to product governance in the FCA Handbook. We emphasise the importance of ensuring appropriate governance around sustainable investment products in our consultation on a disclosure and labelling regime for those products (CP22/20).

3.56 In our Consultation Paper (CP), we proposed that one of the core principles of the criteria to qualify for a label should be to ensure appropriate resources, governance and organisational arrangements to support the delivery of a product's sustainability objective, including oversight by a governing body, where appropriate. We are currently considering the feedback to these proposals.

3.57 More broadly, in this DP, we welcome feedback on whether there is a need for specific regulatory expectations and/or guidance on product governance and oversight in relation to the sustainability characteristics of products and services offered by regulated firms. This includes whether there is a need to consider setting specific expectations around the roles and responsibilities of governing bodies.

Q7: **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?**

Box 1. Governance, responsibility, incentives and remuneration: What we found

To understand how firms are embedding sustainability-related considerations into their business objectives, strategies, governance, remuneration and incentive arrangements, we reviewed a sample of regulated firms' public disclosures (e.g. annual reports, sustainability reports and TCFD reports). Our sample included 15 large firms, spanning banks, insurers and asset managers.

Objectives

We found that firms' sustainability-related objectives and priorities are currently primarily related to climate change. All firms considered had made at least one voluntary climate-related commitment, backed by a target, to achieve net zero by 2050 (or sooner), sometimes accompanied by a commitment to cut emissions by a certain percentage by 2025 and 2030. Firms' targets variously relate to emissions reduction in their own operations and in their financed or facilitated carbon emissions. The majority of firms in our sample are GFANZ members.

Examples of firms' targets include:

- Reduce absolute Scope 1 and 2 (location based) GHG emissions by 46% by 2030
- Net zero carbon emission intensity in the group portfolio by 2050
- Cut carbon intensity of assets by 60% by 2030; 40% reduction in business travel emissions by 2030
- Halve the carbon footprint of investments by 2030, on path to net zero by 2050
- Reduce waste per colleague to 40kg per year

Some firms referenced other sustainability-related commitments and targets, although often these did not extend materially beyond traditional corporate and social responsibility considerations.

All firms referenced human rights considerations, such as fair pay, child labour and safe working conditions, both within their own operations and in their value chains. For instance, the majority of firms in our sample are signed up to the UK living wage

charter; and firms often referred to supporting vulnerable consumers and financial inclusion (e.g., providing access to saving for low-income families). Further, as we had found in our multi-firm review of D&I in financial services, firms continue to develop their D&I approaches. We saw reference, for instance, to the Women in Finance Charter.

Governance, responsibility and accountability

Across the sample, the CEO and/or CRO are accountable for the delivery of climate or wider sustainability-related commitments.

Firms typically allocate climate or wider sustainability-related responsibilities in line with the SM&CR. In banks and insurers subject to the PRA's SS3/19, firms will have had regard to the PRA's expectation that they should allocate responsibility for identifying and managing financial risks from climate change to an appropriate existing SMF within the firm's organisational structure.

Consistent with our 2022 multi-firm review of listed companies' TCFD-aligned disclosures, many firms' public disclosures do not provide sufficient detail of accountable individuals, or the processes by which management is kept informed about climate or other sustainability-related issues. Through this DP, we are interested in learning more about the management information that senior management uses to monitor and oversee climate and sustainability-related developments, and to monitor progress against public commitments.

In their disclosures, firms confirmed that the board is ultimately responsible for the oversight of social and environmental matters, including climate-related risks and opportunities, explaining that climate change in particular is a regular agenda item for the board, with support from various board committees (in line with those committees' Terms of Reference). CROs typically provide regular verbal and written updates to the Board, including on matters such as scenario analysis and stress testing.

Most often, climate and sustainability-related matters are considered by the Risk Committee and Audit Committee, in turn supported by dedicated sub-committees, working groups or other specialist fora. For instance, we saw examples of climate risk, reputational risk and ESG committees. Many firms referenced the recruitment of individuals with specialist skillsets.

Remuneration and incentives

Firms are increasingly aligning remuneration incentives to their sustainability-related strategic priorities. Most firms reviewed have linked reward to ESG-related factors, by allocating some weighting to an ESG related metric, either within annual bonus or long-term incentive award. Where this was observed, the weight attached to ESG-related metrics ranged from 7.5% up to 30%. Examples of the approach to integrating ESG into annual bonuses include:

- 30% non-financial weighting, including progressive narrowing of gender pay gap, portfolio carbon emission intensity reduction and operational carbon footprint

- 30% non-financial weighting, linked to strategic measures including succession planning and diversity, carbon reduction and sustainable finance
- 10% linked to climate, referencing carbon emissions from own operations, climate/sustainable finance, development of the firm's climate transition plan

All but one of the firms considered include sustainability-related measures in their long-term incentive plan (LTIP). We found that where firms have done so, the sustainability-related measures form part of a balanced scorecard, and the firm applies a qualitative approach to measuring performance against them. For 11 firms, these awards are subject to the firm's malus and clawback policies. Examples observed include:

- *Climate and sustainability* (weighted 10%). Four key objectives: Progress towards green financing commitments; reduced operational and supply chain carbon footprint and increased use of renewable energy; progress towards achieving firm's ambition to be a net zero by 2050 and aligning financing with the Paris Agreement; and continued investment in local community projects.
- *Operations and climate*. Reduction in property emissions of 10 per cent annually; reduction in flight emissions of 25 per cent; offset 95 per cent of all residual emissions from own operations; develop and implement a framework to align financial services with net zero emissions by 2050 and deliver 2023 targets consistent with that plan; provide project financing services for renewable energy.
- *Strategic performance*. Includes: one climate (7.5% weighting); one customer (7.5%); and two diversity and inclusion metrics (each 2.5%).
- *Sustainability* (weighted 20%). Includes: percentage of Executive Council and Leadership Team that are female at the end of 2023 (6.25%); no significant conduct/culture/governance issues that result in significant capital add-ons or material fines (6.25%).

The link between sustainability and pay is a relatively new one and our analysis did not find any examples of firms' applying performance adjustments to bonuses based on performance against sustainability-related metrics. Most of the firms in the sample have introduced forward looking metrics. All firms said they have the ability to apply discretion to reduce awards.

Integration, remuneration and incentives

3.58 A firm's approach to remunerating and incentivising staff can both enable and reinforce its culture. We believe that remuneration policies can be effective when they are aligned to a firm's business strategy, purpose and values, promote effective risk management and support positive behaviours and healthy firm cultures.

3.59 Our Remuneration Codes require that remuneration policies promote effective risk management, helping to identify and manage risks and support a strong risk culture in the firm. Where a firm has made climate or sustainability related commitments, linking reward outcomes to these could – if appropriately designed – play a role in supporting delivery.

3.60 Firms are already moving in this direction, and increasingly linking rewards to sustainability-related metrics. The Financial Stability Board's (FSB), 2021 Compensation Progress Report highlighted this as an emerging practice globally but advised caution that this should be underpinned by robust governance. This trend is further demonstrated by PwC in Paying for good for all which found that the prevalence of sustainability-related targets in pay increased rapidly rising from 45% two years ago, to 86% today in the largest 100 UK companies. PwC found that targets are more commonly found in the annual bonus (75%), than the long term incentive plan (LTIP) (50%).

3.61 The FRC's Review of Corporate Governance Reporting, published in November 2022 and including insights on listed companies across sectors, demonstrated an increase in material sustainability-related metrics being included in annual bonuses and/or LTIPs.

3.62 Of course, sustainable development, including progress towards net zero emissions, is a long-term undertaking. It will take time to observe meaningful change. Hence, as we have already noted, credible sustainability-related objectives will be translated to short and medium-term targets and milestones. This will be especially important where targets play a role in remuneration and incentives plans. And when long-term commitments extend beyond the tenure of incumbent executives.

Our existing expectations of firms

3.63 Our Remuneration Codes provide a regulatory framework to support prudential soundness and risk management in firms and ensure appropriate outcomes for customers and markets. A firm's remuneration policy should be aligned with its purpose, long-term strategy and values. Under the MIFIDPRU Remuneration Code (SYSC 19G), this should also include consideration of ESG risk factors and the firm's culture and values.

3.64 In Box 1 we presented some examples of how firms link ESG factors and remuneration usually through including ESG related metrics as non-financial metrics in a balanced scorecard of measures. The Remuneration Codes require that individual performance should be assessed on both financial and non-financial criteria, and in some cases go on to specify that metrics relating to conduct should comprise a substantial portion of the non-financial criteria.

3.65 Guidance in our MIFIDPRU Remuneration Code provides a non-exhaustive list of examples that MIFIDPRU investment firms may wish to consider when assessing individual performance. This list includes achieving targets relating to ESG factors and D&I (SYSC 19G.6.6 (3) G). Other firms may also find it helpful to refer to these examples.

3.66 We believe that well-designed mechanisms to link progress on sustainability-related commitments to a measurable proportion of pay could play a role in encouraging individuals to take accountability for positive change. This was underlined in our letter to the Remuneration Committee Chairs of large banks, building societies and investment firms in August 2022. The letter set our expectations on the importance of a strong link between behaviours and remuneration outcomes.

3.67 More specifically, we said that firms may wish to review whether incentives for their senior leadership and other material risk takers are aligned to ESG risk factors. We went on to say that firms may wish to consider the short and long-term milestones towards achieving these goals. The messages in the letter may also be relevant for a wider range of firms to consider.

Linking remuneration and incentive plans to sustainability-related metrics

3.68 The effectiveness of mechanisms linking remuneration and long-term incentive plans to sustainability-related metrics will rest on precisely how these mechanisms are designed, including the selection of appropriate metrics and the weights allocated to them.

3.69 In particular, firms may wish to consider whether remuneration and incentive plans emphasise the most important sustainability-related objectives. Tom Gosling's article suggests choosing the strategically most material issues that require a step change, using transparent and clearly measurable Key Performance Indicators (KPIs) and setting meaningful and stretching targets. Tom warns that linking pay to sustainability is not always straightforward, highlighting the risk that more pay is awarded without driving the right outcomes. Soft targets or metrics that could be perceived as easy can lead to executives being paid extra just to do the 'day job'. In our view, this could amount to little more than greenwashing.

3.70 Deloitte's article also emphasises that measures should be meaningful, stretching, and transparent. We would agree that firms should not remunerate based on metrics that are easily achievable through normal business (e.g., health and safety related targets). It is for firms to define the most relevant metrics to use but when selecting the most appropriate measures to use, firms may wish to be mindful of the risk of including too many metrics. To do so could lead to the link between performance and pay becoming diluted and meaningless.

Incentivising the workforce

3.71 While firms may consider linking executive pay to a firm's sustainability-related commitments to incentivise behaviours and decision-making that aligns with these commitments, they may also wish to think about how the whole organisation is mobilised towards delivery. Firms may therefore consider performance measures linked to sustainability-related factors for their wider workforce or for cohorts of staff.

3.72 However, once again, it is important that this doesn't become a tick box exercise. Furthermore, metrics used in executive bonus structures are unlikely to be relevant for all incentive participants. If sustainability-related metrics are incorporated into rewards for wider cohorts of staff, they would need to be within those employees' influence and control.

3.73 Firms can use many ways to incentivise their workforce to achieve corporate goals, such as offering participation in share ownership schemes. These encourage a sense of ownership in the firm and can be used as a recruitment and retention tool. Other non-financial incentives may be equally successful and can range from a simple 'thank you' to recognition of examples of good behaviour for others to follow.

Q8: **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.**

Please explain your views.

Q9: **Should we consider additional regulatory expectations or guidance in any of the areas considered in Q8? Please explain your views.**

Governance of investor stewardship to influence positive change

3.74 Investor stewardship can play an important role in influencing positive sustainability outcomes. We are therefore interested in gathering further feedback on how asset managers and asset owners organise and govern their stewardship activities to support firm-wide sustainability objectives.

3.75 In the UK Stewardship Code (the Code), the FRC defines stewardship as the 'responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries, and sustainable benefits for the economy, environment and society' (see Box 2). We have a comply or explain rule for firms managing institutional investments to explain the nature of their commitment to the FRC's Stewardship Code (COBS 2.2.3).

3.76 In 2019, we introduced additional rules (PS19/13), implementing the revised Shareholder Rights Directive (COBS 2.2B). These require firms to set out their engagement and voting policies and report annually on how they have applied these policies. In the same year, we began to signal our deepening supervisory and policy interest in stewardship in a joint DP with the FRC (DP19/1).

3.77 The DP identified four key attributes of effective stewardship, which were refined in the final Feedback Statement (FS 19/7): (i) a clear purpose; (ii) constructive oversight, engagement and challenge; (iii) culture and institutional structures that support stewardship; and (iv) disclosure and transparency of stewardship activities and outcomes. These remain relevant and continue to support our thinking in this area.

Box 2. Principles of the FRC Stewardship Code 2020 related to governance and organisation of investor stewardship

Several principles of the Code address matters relevant to how the governance and organisation of investor stewardship can support its effectiveness in driving positive change:

- Principle 1 expects signatories to explain the actions they have taken to ensure that their purpose, investment beliefs, strategy and culture enable stewardship that creates long-term benefits for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.
- Principle 2 asks that signatories explain how their governance, resources and incentives support stewardship.
- Principle 3 requires signatories to disclose their conflicts of interest policy as it relates to stewardship, explain how they have managed actual or potential conflicts and provide recent examples.
- Principle 4 includes an explicit expectation that signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial. This Principle also encourages signatories to collaborate with each other and the wider investment community to achieve change.
- Principle 7 requires that signatories systematically integrate stewardship and investment, including ESG issues and climate change. This includes identifying the issues they have prioritised, explaining how integration differs across asset classes and geographies and how these align with their responsibilities to clients and beneficiaries.

Research commissioned by the FRC on 'The influence of the UK Stewardship Code 2020 on practice and reporting', and the FRC's Effective Stewardship Reporting 2021, demonstrate that many firms have taken significant steps to successfully embed the key attributes within their organisation.

3.78 DP19/1 also identified several barriers to effective stewardship (FS19/7, p29), many of which were confirmed in stakeholder feedback. There has been good progress by the investment community to deal with some of these barriers, including in Investing with Purpose and Investment Relationships for Sustainable Value Creation.

3.79 One of the barriers identified in DP 19/1 was that firms' governance arrangements may not place sufficient value on effective stewardship. In FS 19/7, we said that we would consider further the role of firms' culture, governance and leadership on climate change and the net zero transition, including wider senior management accountability for stewardship.

3.80 In this DP, we are seeking further input on these areas. Further to a commitment in the Government's response on audit reform and corporate governance (p163-164), in 2023 we will work with the FRC, Department for Work and Pensions, and the Pensions Regulator to review the framework for effective stewardship regulation. Feedback to this DP will also inform the direction of this review.

Governance and resourcing

3.81 By adopting robust governance arrangements, a firm can ensure that there is appropriate oversight and accountability for stewardship, and that the approach taken is consistent with and integrated into its investment approach. Robust governance also ensures that conflicts of interests are effectively managed to ensure the best interests of clients and beneficiaries are served.

3.82 The FRC's commissioned research on the influence of the Code, referenced in Box 2, found strong evidence of material changes in stewardship practice since the Code was revised, including in relation to governance and resourcing. The research found that all signatories surveyed and interviewed had undertaken some form of organisational restructuring to better integrate stewardship within their investment decision making.

3.83 Christine Chow's article (pg80) discusses how, to be effective, governance of stewardship should be designed to cover all asset classes. The article suggests that asset managers may consider setting up asset class level committees. The article goes on to consider how conflicts of interest can be dealt with through effective governance.

3.84 As referenced earlier, the Code requires that signatories manage conflicts of interest to put the best interests of clients and beneficiaries first. The FRC notes mixed reporting quality against this Principle. Conflicts policies are often generic, and do not specifically consider issues as they relate to stewardship.

Market-wide and systemic risks

3.85 Stewardship has its origins in shaping the governance and performance of individual issuers of listed equity. In recent years, the focus of stewardship has extended to a wider range of asset classes, as well as to influencing the functioning of financial markets (so-called macro or systemic stewardship).

3.86 This is increasingly important as asset allocation to non-listed equity grows, and as asset ownership becomes increasingly fragmented and intermediated. Furthermore, market-wide and systemic risks are non-diversifiable and therefore have an important impact on returns. This is particularly important for universal owners that are exposed to the whole market.

3.87 By dealing with market-wide and systemic risks and opportunities, investors can simultaneously improve the stability of portfolio investments and broader market systems. However, systemic stewardship is arguably harder and more complex, giving rise to conflicts of interest that are more difficult to manage.

3.88 Tom Tayler's article (pg38) encourages positive engagement to influence policy development and correct market failures. Tom also emphasises stewardship of the net zero transition. The Principles for Responsible Investment's (PRI) recently published a Toolkit for Sustainable Investment Policy and Regulation, which similarly encourages investors to engage with policy makers and regulators to drive change.

3.89 Collaborative investor engagement is an important tool to influence positive market-wide and systemic sustainability outcomes.

3.90 The Investor Forum provides a structured and safe mechanism to engage collaboratively with companies. However, we still hear anecdotal concerns from investors about barriers to collaborating with others because of fears of falling foul of Market Abuse Regulations or competition rules.

3.91 This was identified as a barrier to effective stewardship in (DP19/1), and in (FS 19/7). We have been presented with some examples and are exploring whether further clarification to encourage collaborative engagement on sustainability outcomes would be helpful.

3.92 We recently reiterated, in Primary Market Bulletin 42, our view that shareholder engagement can be an important mechanism to challenge and influence corporate issuers' strategies and decisions, for the benefit of investors and society. We noted that we are keen to ensure that concerns about the operation of the Market Abuse Directive 'do not inhibit or stifle high quality engagement' between issuers and their shareholders. We also said that we intend to 'provide clarity so as to aid issuers, directors and shareholders in understanding the FCA's concerns and rationale'.

Q10: **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.**

Q11: **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.**

Chapter 4

Training and competence on sustainability in regulated firms

Summary

4.1 Financial services firms are increasingly incorporating consideration of sustainability matters into their operations, products, and services. The breadth and complexity of sustainability often requires specialist expertise and technical knowledge. We recognise the need for genuine capability-building across the financial sector, including staff training on climate change and net zero, and sustainability more broadly. This chapter explores good industry practices, where knowledge gaps arise today and whether further regulatory measures are necessary to help deal with them.

Evidence on firms' arrangements for training and competence

4.2 Our wider training and competence requirements support consumers and enhance market integrity by making sure the financial services workforce is appropriately qualified and well regulated. The regime includes a high-level competence requirement (SYSC 5.1.1), applying to individuals engaged in the regulated activity in all UK authorised firms and more detailed requirements for certain retail activities set out in our Training and Competence sourcebook (TC 2.1).

4.3 There are five FCA Accredited Bodies who provide qualifications for regulated activities and issue Statements of Professional Standing (SPS). These Accredited Bodies help advisers to maintain our required professional standards in line with our Training and Competence sourcebook (TC).

4.4 In January 2022, we held a roundtable with the Accredited Bodies to consider sustainability-related training and competence issues and how the industry has been responding to knowledge gaps in this area. The main gaps identified were on ESG data and metrics, key definitions (eg, 'responsible investment', 'impact investing') and a lack of expertise that cuts across sustainability topics.

4.5 For example, an expert on environmental issues is not necessarily an expert on social issues. Even a professional with expertise on climate change may have limited knowledge on other inter-related environmental topics, such as biodiversity. Collective knowledge and ongoing training can help create a work environment where different expert views are shared. Knowledge gaps, including a failure to identify interdependencies between sustainability issues, may hinder a firm's ability to make informed decisions.

4.6 There was also agreement that an interest in sustainability or a desire to 'make a difference' is not sufficient. Subject matter expertise needs to be developed. We are keen to avoid 'competence washing' in firms in an effort to improve their ESG performance. Kim Schumacher correctly reminds us of the need for genuine capability-building among firms in a 2021 interview on competence washing.

4.7 There was consensus that familiarity with material sustainability-related matters should be part and parcel of how financial services professionals undertake their role. The discussion also focused on whether introducing new qualification requirements and/or guidance can help to build sustainability-related capabilities within the financial services sector.

4.8 We have been engaging with the UK's Green Finance Education Charter (GFEC) and the Department for Business, Energy and Industrial Strategy (BEIS) to discuss developments in this area. We met with the GFEC in June 2022 and agreed to continue our engagement by attending sector-specific (Retail Banking & Lending, Insurance, Investment) roundtables in 2023. These roundtables will bring together the FCA, GFEC members, firms, and other key stakeholders to discuss sustainable finance skills and training, including the training and competence matters considered in this DP.

4.9 Through our wider engagement internationally, we note that other jurisdictions have identified gaps and challenges relating to climate risk training and education within the banking sector. The embedding of climate-related risks, staff training and development, and low levels of awareness among employees on sustainability solutions were among the issues identified. There is growing consensus that training and upskilling at all levels within firms is needed.

4.10 Similarly, we have identified UK and global initiatives relating to training and competence in this area. For example, the Monetary Authority of Singapore (MAS) set out 12 technical skills and competencies needed for professionals to perform various roles in sustainable finance.

4.11 Another example is the recent launch of the Principles for Responsible Banking Academy with the aim to support banks' alignment with the objectives of the UN Sustainable Development Goals and the Paris Agreement. The Academy was founded through a partnership between the United Nations Environment Programme Finance Initiative (UNEP FI), The Chartered Banker Institute, and the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).

4.12 We know that some firms are considering how to expand their sustainability-related capabilities, and many are already providing relevant staff training. Professional qualification and training providers have been responding to this demand and we have seen an increase in ESG-/sustainability related qualifications and training.

4.13 Deloitte's article, discussing the FTSE 100 financial services companies' disclosures aligned to TCFD, highlights that 72% of firms provided training on climate and sustainability to the board and 50% provided training more broadly across the firm to specific teams (e.g., risk or relationship managers) or staff wide.

4.14 Simon Thompson's, article (pg86) highlights that GFEC signatories have all incorporated ESG into professional qualification and CPD programmes – another example of how the industry has been rapidly building ESG-related capabilities. Will Martindale's article also emphasises the importance of organisation-wide training and references hosting external speakers as part of staff training and awareness-building. Organisation wide training could also be used as a metric to compare consistent knowledge building within firms.

4.15 As highlighted earlier in this chapter, we recognise that when the appropriate skills, knowledge or expertise are missing, potential harms may occur. Firms may not be able accurately to identify and analyse sustainability issues, leading to poor decision making and potential harm to consumers. So, in our role as regulator, we want to see that the financial sector is appropriately equipped with the relevant skills and expertise. We welcome views on how to promote genuine capability building and ensure our expectations about sustainability-related skills, knowledge and expertise are clear.

Q12: **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?**

Q13: **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.**

Q14: **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?**

Q15: **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.**

Chapter 5

Next steps

5.1 In this DP, we have explored how firms' sustainability-related governance arrangements, incentives and competencies can support the role of finance in driving positive sustainable change, and delivery in line with firms' sustainability-related objectives.

5.2 We are grateful to the authors of the commissioned articles for their interesting and diverse views and their contribution to what we hope will be a lively debate. We encourage stakeholders to engage with the topics considered and contribute their feedback.

5.3 With the benefit of feedback to this DP, as well as ongoing analysis and supervisory engagement with firms, we will consider how we can better support the industry in this evolving field and whether there is a case for further regulatory measures in the area of firm governance, incentives and competencies to support the role of finance in contributing to positive change. This will further our work in support of the Government's expectation that we 'have regard to the Government's ambitions for the provision of sustainable finance'.

5.4 We also encourage firms to reflect on the matters discussed, and consider, as appropriate, incorporating them as they review and refine their current approaches to governance, remuneration, incentives and training.

Chapter 6

Collection of articles

6.1 This chapter includes a collection of articles authored by external experts in different aspects of the topics considered in this DP.

6.2 The views expressed in this chapter should not be interpreted as reflecting the views of the FCA. The purpose of the articles is to encourage debate by providing different perspectives on aspects of governance, remuneration, incentives, stewardship and competence. The articles are the sole responsibility of the authors and any errors and omissions are the authors' own.

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4 Pg 54-57	Adding purpose to principles and products	**Robert G. Eccles**, Visiting Professor of Management Practice	Saïd Business School, University of Oxford
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8 Pg 74-79	Governing climate transition implementation at banks	**Konstantina (Tina) Mavraki** Portfolio non-executive director and adviser	Ingenios Ltd
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9 Pg 80-85	Effective governance of investor stewardship to support net zero: a practitioner's view	**Christine Chow**, Board member	International Corporate Governance Network (ICGN)
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10 Pg 86-89	Preventing greenwashing: time to stop marking our own homework	**Simon Thompson** FCBI Author, Green and Sustainable Finance: Principles and Practice	Chief Executive, Chartered Banker Institute and Chair, Green Finance Education Charter

Article 1

Joining the dots – taking a holistic and purpose-led approach to net zero

Tom Tayler, Senior Manager, Aviva Investors Sustainable Finance Centre for Excellence

Aviva Investors

In 2015, in the Paris Agreement, the Parties to the United Nations Framework Convention on Climate Change agreed to increase action to limit climate change by seeking to limit temperature rises to 'well below 2 degrees above pre-industrial levels' and 'pursuing efforts' towards limiting that warming to 1.5.

In 2018, the Intergovernmental Panel on Climate Change (IPCC), the collection of the world's leading climate scientists, published its Special Report on Warming of 1.5 Degrees. This report, set out the significantly greater impacts of 2 degrees of warming compared to 1.5. This led to a shift of focus on efforts to limit warming to 1.5 degrees, culminating in an emphasis at COP26 in Glasgow on 'keeping 1.5 alive' and the Glasgow Climate Pact in which Parties 'resolved to pursue efforts to limit the temperature increase to 1.5 °C', an ambition that was reiterated in the Sharm el-Sheikh Implementation Plan at COP27.

The IPCC have stated that to give a 66% chance of limiting end of century warming to 1.5 degrees, greenhouse gas emission must fall rapidly to reach an equilibrium between emissions and the removal of greenhouse gases (whether through natural or as yet unproven technological means), or 'net zero' emissions by no later than 2050.

Net zero focus

This focus on net zero has seen countries and private sector institutions (both financial and non-financial) making commitments to achieve net zero for their own emissions. The proliferation of these commitments has been such that the Net Zero Stocktake from June 2022 finds that 83% of global emissions and 91% of global GDP is now covered by some form of net zero commitment.

This is great progress and a welcome starting point. However, the robustness and integrity of these commitments varies considerably, as does the target date for their achievement. Many are focusing on 2050, but some are only committing to achieve it at a later date (including key national commitments such as 2060 from China and 2070 from India). Equally, some are pledging to aim for an earlier date. Germany revised its national target to 2045 following a court challenge to its previous commitment that successfully argued that its previous target unfairly compromised young people. And more than 375 corporates with over $15 trillion of market capitalisation committed to net zero by 2040 or earlier under the Climate Pledge, which would make them collectively second only to the USA in comparison to national GDP.

From promises towards implementation

In 2022, the focus moved from making net zero commitments to implementing them, and there is certainly a growing implementation gap. At a country level, the difference between promises made in documents like the Glasgow Climate Pact and countries' Nationally Determined Contributions to the global decarbonisation effort on one hand, and the implementation of policies to achieve these aims on the other remains a real cause for concern. This has been highlighted by the UN Environment Programme's Emissions Gap report. Geopolitical and economic headwinds mean that there are always short-term pressures threatening to drown out longer term issues like climate change. Similarly, there is the risk that for private sector pledges, there is a long time between a pledge made in 2021 and a target date in, say, 2050. To close the implementation gap and to incentivise immediate as well as long-term action on climate change, a number of key elements of best practice are emerging.

These include prioritising taking immediate steps to decarbonise rather than reliance on offsets and the setting of meaningful interim targets for decarbonisation that are consistent with a scientific pathway to net zero. These mean that while answering the ultimate question of whether a target for 2050 is achieved might be one for the CEO several appointments down the line, the current leadership can be judged on whether action is being taken now. For example, the Net Zero Asset Owner's Alliance requires 2025 interim targets from its members and the Net Zero Asset Managers suggests 2030 at the latest.

Transition plans a crucial next step

In addition, 2022 has seen the emergence of a focus on the publication of transition plans to support net zero commitments, with annual reporting on progress. Transition plans and reporting on their implementation are a crucial tool to bring future ambitions into boardroom decisions of today. The UK is leading the way following the announcement at COP26 by then Chancellor and now Prime Minister Rishi Sunak of the ambition for the UK to become the world's first net zero aligned financial centre by mandating the publication of transition plans from UK corporates and financial institutions. This led to the establishment of the UK Transition Plan Taskforce which published its initial guidance for consultation in November 2022. Similarly, the Glasgow Financial Alliance for Net Zero (or GFANZ) has published best practice guidance for financial sector transition planning across its global membership.

Taking a comprehensive approach

The alignment of decarbonisation efforts with science-based trajectories to net zero, are now far more 'black run' than 'nursery slope' in trajectory due to how late we have collectively left seeking to make this pivot. To achieve alignment, institutions will need to ensure that their net zero target is not just part of another initiative to which the business has signed up but set within the context of the whole purpose of the business. Firms will need to evolve to both contribute to the overall transition to net zero and continue to thrive as the transition occurs by managing risks but also taking advantage of opportunities. To do that, consistency across all parts of its business and its spheres of influence is important.

For example, institutions should not only consider what their most appropriate target date for net zero should be, consistent with acting in the best interests of their customers, shareholders and the integrity of the market, but also set interim targets and prepare and report progress against their transition plan. The transition plan also needs to build upon the firm's TCFD report and be consistent with the findings and disclosures that it contains. The progress and the incremental steps towards achieving the transition plan that are reported can then be used to judge corporate progress on long-term targets and metrics can be incorporated into management incentives and remuneration. Putting disclosures and plans to an advisory shareholder vote can also provide a mechanism for both feedback and accountability.

The influence of net zero committed businesses can also spread throughout the financial and real economy ecosystems in which they operate. This will particularly be the case where they prioritise net zero commitments, transition plans and annual reporting in their operational supply chains and with service providers. For financial firms that might include depositaries, financial accountants, auditors, custodians, counterparties, sell side research providers, brokers, index providers, credit rating agencies, and yes, their regulators. The enabling regulatory and policy environment is critical to achieving net zero aims, but firms should not pretend that they are unable to influence that environment. They should positively engage to seek the policy that they need and the correction of market failures that threaten to undermine their ambitions. Firms should be seeking to use their influence to embed a culture focused on net zero across the ecosystem in which they operate because in finance, just as in nature, everything is connected and a system is most resilient when its component parts are working together in harmony.

The crucial role for finance

Financial firms, more than most, have an out-sized opportunity to positively influence the achievement of the transition and have a core self-interest in its successful achievement. Our financial system will not be able to operate as it currently does in the 3-degree world that 'business as usual' is taking us towards. Financial firms are crucial to the real economy – underwriting its risks, lending it capital, and investing in its activities. For most financial firms, the biggest part of their climate impact is in their portfolios through the companies that they invest in, underwrite, lend and provide other services to. So, the achievement of net zero ambitions is dependent on real economy businesses as well as governments making a successful transition. Firms can use their influence to encourage commitment to the net zero transition in their investees and clients, and encourage them to align their own supply and service chains and their policy and lobbying activities.

The focus on net zero is a relatively recent phenomenon; it is, after all, only 4 years since the IPCC Special Report. However, given just how late we have left committing to the transition to a low-carbon economy to limit global warming, the transition and its governance is necessarily being implemented as we go. We are, to coin a well-used phrase, building this plane while flying it. It is apparent, though, that working towards taking a holistic and comprehensive approach to net zero implementation is going to be crucial. There is little point in a firm sending out a press release to mark its successful achievement of a net zero goal if the rest of the world has not also transitioned and

that press release is sent out into a world on fire. We need to work together, albeit with each making the decisions best suited to their own circumstances (or, to borrow from the Paris Agreement 'common but differentiated responsibilities') in the interests of all our present and future customers, clients, shareholders, stakeholders and collectively commit to all play our part and do what we can.

Article 2

Using pay to create accountability for ESG goals

Tom Gosling, Executive Fellow

London Business School and European Corporate Governance Institute

Strong momentum towards linking pay to ESG targets

Sustainability and ESG are central to business strategy in the 2020s. With this being the decade when short-term targets need to start aligning with long-term aspirations on net zero, biodiversity, or diversity, there are increasing calls for boards to put their money where their mouth is and to pay CEOs based on achievement of ESG targets. Regulators are increasingly hinting that this would be a good idea and some investors are getting more explicit. Cevian Capital and Allianz AG recently joined forces to demand for a link between pay and climate goals. Legal & General have a new section in their UK executive remuneration guidelines requiring firms in key industries to have 20% of their long-term incentive plan devoted to climate goals from 2025. The thesis: long-term climate commitments like net-zero 2050 are meaningless without short-term goals to get there. And executive pay can be used as a forcing mechanism to create accountability for action this decade to ensure we get where we need to be by mid-century.

The market seems to agree. Research by PwC and academics at London Business School recently found that 82% of senior executives globally have ESG targets in their pay. Senior leaders and investors show strong agreement on the motivations for the practice: to focus on non-financial drivers of long-term value; to signal to internal and external stakeholder the importance of ESG factors; and to help create accountability to set short-term targets towards long-term goals.

Linking pay to ESG is not always straightforward

It certainly sounds like a no-brainer. You get what you pay for; we want more ESG; so we need to add ESG targets to pay schemes. It sounds simple, but there are prominent critics. Professor Alex Edmans of London Business School (LBS) believes that pay should not be linked to ESG targets. Complex and multifaceted ESG issues cannot be reduced to a small number of measurable KPIs. This gives rise to the risks of 'only counting what can be counted' or 'hitting the target but missing the point'. Moreover, focusing on ESG above other intangible factors critical to business success risks distorting the focus of executives towards just one set of important factors at the expense of others. For example, factors relating to innovation, strategy, product quality, cyber security are non-financial factors that may have equal or greater importance than ESG factors in some companies.

Some of these problems are reflected in practice. Earlier research by the same PwC-LBS team in the UK found that nearly half of ESG metrics used in pay were not material to the company concerned. As You Sow found that climate goals in pay in the US are frequently

non-specific and lacking transparency. As a result, ESG goals generally pay out at a high level. A recent PwC-LBS publication shows that within the largest 50 European companies, climate goals in pay are on average paying out close to maximum, despite aggregate progress on climate change being clearly inadequate.

Variable quality

Most financial firms are now including ESG targets in pay. These generally fall into 4 categories:

- the firm's own carbon footprint
- diversity and inclusion (required for signatories to the women in finance charter), particularly representation goals at board and senior management level
- sustainable financing
- financed emissions

Every firm should be looking to its own actions on climate, but for most financial firms, the firm's own carbon footprint, while important, is hardly of sufficient strategic (or for that matter climate) materiality to warrant inclusion in pay.

Diversity and inclusion is a worthy goal. But progress on board diversity is not being reflected in the management ranks. Perhaps there has been too much focus on representation goals as opposed to creating a culture of inclusion. Such goals can encourage short-cuts that focus on the symptom rather than the disease: hitting the target but missing the point. Greater sophistication is required if efforts to promote under-represented groups are to be sustainable. These will require nuanced efforts to measure the inclusiveness of culture.

Commitments on sustainable financing and financed emissions are increasingly where the action is at. For financial services, climate impact is generally in Scope 3. Here we are seeing banks set targets on financing solutions such as renewable energy or withdrawing finance from problems such as coal. But the definitions on sustainable finance vary. Some banks have a detailed definition covering green bonds or tightly defined sustainable activities. Others are much looser, including client investments in 'sustainable' funds, which may be of questionable validity. At the moment, the suspicion is that too often these goals lack ambition or are based on definitions that are too loose. This is reflected in high pay-outs for modest achievements.

These criticisms are real and valid. So turning the negatives into positive insight, what principles should be followed when linking pay to ESG to make the practice effective?

Choose the strategically material ESG issues requiring a step change

There is a tendency in the world of ESG to urge every company to act on every issue all of the time. Climate, biodiversity, diversity, inequality, human rights, anti-microbial resistance, and more, have all at various times been cited as 'systemic' risks that companies should act to reduce. These are all important issues and companies surely need to be able to multi-task.

But ESG factors are just a subset of the many important intangible factors that companies need to focus on. Many of these activities like, or even perhaps more reliably than, ESG produce positive spill-overs: research and development, innovation, employee training, or simply product excellence. Yet not everything can be included in pay. Seeking to measure everything that moves leads to excessive complexity as well as distorting executive focus in a multi-tasking environment.

Two important questions should be asked before including an ESG measure in pay:

- Does this measure reflect one of the most critical issues facing the company at a strategic level?
- Does the company need to make a step change in performance in relation to this measure?

The first question reduces the risk of unintended consequences from skewing executive attention towards this priority. The second question ensures that executives aren't just paid extra for the day job of maintaining expected standards of ESG performance. The first and second questions together increase the likelihood of shared shareholder and stakeholder understanding of what progress is required and what a challenging target looks like. Firms should explain to shareholders why they have chosen these factors and how they link to the company's strategic priorities.

Use transparent and clearly measurable KPIs

If ESG metrics in pay are to enhance accountability to shareholders and stakeholders on ESG priorities, then they must be transparent and measurable. Transparency requires the objectives or targets to be clearly described together with their connection to the level of pay-out. The transparency should be prospective: the targets should be disclosed at the start of the performance period, whether in a bonus or long-term incentive. For most ESG targets, questions of commercial confidentiality do not arise, and investors should be able to engage up front about the nature and stretch in performance targets. For metrics relating to long-term goals such as net zero, the short-term targets set should be referenced against the company's intended pathway towards that long-term goal.

The goal should be clearly measurable, including objective and auditable KPIs where possible. Given the difficulty of capturing the full richness of ESG goals in a few KPIs, judgement and discretion are quite acceptable, indeed should be expected, in the measurement of goals. But they should be applied from the start point of an objectively measurable outcome. A weakness of many ESG measures is that they read as advocacy: a list of good works done, deserving of reward. As opposed to a structured assessment against goals set.

Set meaningful and stretching targets

Signing up to GFANZ should not trigger a bonus. Showing 'climate leadership' needs to be defined. Developing an ESG strategy does not sound like a stretch goal.

The credibility of ESG targets rests upon their stretch and rigour. High bonus pay-outs against ESG goals cannot continue alongside limited progress on real-world ESG outcomes. This requires boards to be prepared to sharpen their pencils when it comes to signing off targets. Given that bonus targets are (rightly) tethered to strategic intent, the increased challenge may need to come at the point of strategy formulation.

We need a concerted effort to ensure that targets are challenging and linked to significant real-world outcomes on material ESG dimensions. Otherwise, the conclusion will be that including ESG targets in pay has led to more pay, not more ESG. Once again, executive pay would have served to undermine the credibility of business.

This is where engaged anchor shareholders play a crucial role. Through their knowledge of the business, they can provide constructive challenge to boards, who through dialogue with those same shareholders can ensure that suitably stretching targets are set.

Get the governance right

One of the lessons of incorporating risk and conduct into bank pay after the financial crisis is the importance of governance. Risk and remuneration committees became closely aligned in the performance measurement and target setting processes.

These governance improvements were a positive spill-over from making the connection to pay. They will need to be mirrored in the sustainability arena if linkage of ESG target into pay is to be successful. Sustainability and remuneration committees need to interact in an appropriate way through the remuneration cycle.

Given their experiences with incorporating risk measures, financial firms may be at the forefront of this practice. But there is also experience to draw on from the natural resources sector, where health and safety committees are often closely woven into the remuneration process. Done right, this will enable the insight from sustainability committees to be integrated into assessments of shorter-term performance as well as longer-term strategic planning as is currently the focus.

Recognise the limitations as well as the benefits

Linking pay to ESG will not solve the world's problems. Pay targets will only be as ambitious as the business strategies on which they are based. However, including ESG targets in pay can be useful, if the conditions I've outlined in this article can be met. Using such targets can be useful for crystallising and demonstrating the level of ambition in corporate strategy, and for holding companies accountable for shorter-term commitments towards longer-term goals. Within companies, CEOs use ESG targets to mobilise their organisation towards new priorities. ESG targets can ensure that critical short-term and non-financial priorities are not overlooked in favour of short-term financial performance.

Be focused

But the conditions for success are not universal. Sometimes the juice isn't worth the squeeze. Regulators and shareholders should not assume that ESG targets are always appropriate or that all ESG issues should be included in pay. By focusing on the most material measures at the companies where they are most clearly critical, we will set better measures, shareholders will have the time and resources to scrutinise them properly, and we can learn what good practice looks like before we spread it across the market.

We shouldn't let the perfect be the enemy of the good. But nor should we let quantity be the enemy of quality.

Article 3

Transitioning to net zero: increasing investor confidence in corporate carbon commitments

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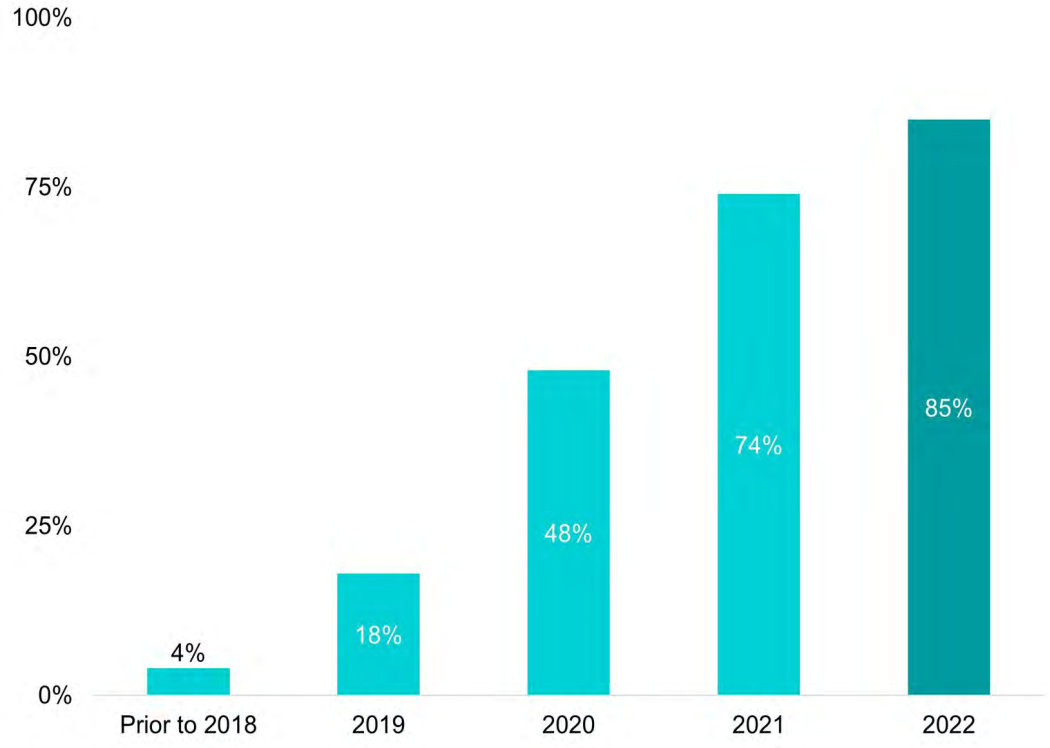
Target data: a critical element in investors' climate toolbox

As asset owners and managers continue to set 'net zero by 2050' or '1.5°C alignment' goals at the portfolio level, the need for forward-looking data is increasing. Metrics to assess the present-day carbon footprint or risk exposure of a portfolio are abundant, while very few consider emission changes over time to assess future alignment. Greenhouse Gas (GHG) emissions reduction targets are in many cases the 'missing link' to compute forward-looking metrics and portfolio analytics, which are critical for assessing portfolio level climate risk exposure and net zero goals.

While not yet a regulatory requirement, corporate reporting of voluntary GHG emissions targets has increased rapidly in the past 5 years. In the UK, ambitions to become the 'world's first net zero-aligned financial centre' included a government commitment to move towards making disclosures of transition plans – including GHG targets – mandatory, to meet an aim of increased adoption by 2023. One year after the publication of FTSE Russell's latest paper on carbon targets, the rate of FTSE 100 companies disclosing net zero commitments has risen from 74 to 85% (Figure 1).

Figure 1. Share of FTSE 100 companies with any net zero target as of September 2022.



Target data: a critical element in investors' climate toolboxes

Building on these increased disclosures, a new set of Portfolio Alignment tools or Climate Transition Risk metrics have been designed to help investors to focus on climate risk and decarbonisation. They all rely on datapoints related to specific GHG emissions target details in their calculations. For example, FTSE Russell's Implied Temperature Rise (ITR) tool establishes a temperature score for each constituent based partially on its public GHG emissions reduction targets and the Transition Pathway Initiative's Carbon Performance (TPI-CP) data assesses companies' alignment with a Sectoral Decarbonisation Approach (SDA) pathway using their public decarbonisation goals.

Making corporate targets data fit for purpose

However, corporate target disclosures lack standardisation and key information is often missing. There is an urgent need to improve net zero target disclosures to increase accuracy and reliability of portfolio alignment tools and transition risk metrics. To this end, there have been a number of recent efforts to provide better guidance around the appropriate reporting of corporate net zero objectives. The Taskforce on Climate-related Financial Disclosure (TCFD), for example, has highlighted the LSEG Carbon targets disclosure template (Figure 2) as best practice for concise but material disclosures on corporate GHG reduction targets (see the 2021 TCFD Guidance on Metrics, Targets and Transition Plan). More recently, the UK's Transition Plan Taskforce (TPT) began to develop a 'gold standard' transition plan disclosure framework which was published for consultation in November 2022.

Recent guidance from a number of other industry initiatives (eg, CA100+, SBTI and GFANZ) and regulators (ISSB, EFRAG, SEC) echoes these data requirements and put additional focus on disclosures around implementation plans to achieve these targets, including Transition Plans and the alignment of capital expenditure.

Figure 2. The LSEG Carbon targets disclosure template

GHG emissions reduction target disclosure template				
Target ID				
Overall number of active GHG emissions targets:	4			Include interim targets in the count.
Target number:	1 (of 4)			
Target type:	Absolute (interim target)			Indicate whether this is an interim target (e.g. a short-term milestone between the organisation's mid- or long-term target and current period).
Date the target was set:	08/02/2019	Date that the target was last revised:		14/01/2021
Target Information				
Scope(s) covered	Scope 1 & 2 (market-based) + 3 (cat 11: use of sold product)			For scope 2 emissions, indicate if calculations are location- or market-based. For scope 3 emissions, indicate the GHG protocol categories that are covered.
Percentage of in-scope emissions covered by the target:	99%			
Base year:	2015	Base year emissions:	75 000 tCO2e	For intensity targets, provide activity measure (e.g. tCO2e/Mwh or tCO2e/tonne of cementitious product).
Target year:	2030	Target year projected emissions:	30 000 tCO2e	
Targeted reduction from base year (%)	60%			
Targeted reduction from current year (%)	50%	Current emissions:	60 000 tCO2e (2020)	Please indicate the most current year for which emissions data is available.
Target Methodology				
Verified by an independent third party.		Yes. SBTi		Please indicate the name of the independent third party that verified the target.
Source that describes how the percentage of in-scope emissions covered by the target has been calculated.		Sustainability Report 2020 (p.8, p.12)		Please indicate the title(s) of publicly available documents and relevant page numbers where information can be found.
Source that describes transition plan outlining how this target will be met.		Roadmap to Net-zero 2050 (p.1 -10)		Please indicate the title(s) of publicly available documents and relevant page numbers where information can be found.
For Scope 3 targets, source that describes the methodology used to calculate the Scope 3 emissions covered by the target.		GHG Emissions Methodology (p.15-16)		
Indicate the % of the target to be achieved through offsets and provide a source that specifies their type and the offset provider.		20% will be achieved through CCS. Roadmap to Net-zero 2050 (p. 8)		
For intensity targets, source that describes the methodology used to calculate the carbon intensity.		Sustainability Report 2020 (p.89)		

Looking across these various standards helps to define best practice and to identify the key features of robust and ambitious corporate net zero targets. These include:

Net zero target fundamentals

1. **Including Scope 3 emissions** (when material) alongside Scope 1 & 2 in the commitment boundaries.
2. **Setting interim decarbonisation targets** eg for 2025 and 2030 to define the companies' transition pathway and allow investors to assess progress towards the long-term net zero target.
3. **Disclosing the share of offsets** that the company intends to use to reach its target (for example, SBTi allows companies to offset only 5-10% of their total emissions through high quality carbon removals).

Net zero target implementation

4. **Formulating and disclosing a transition plan** to explain how the company intends to achieve its net zero targets.
5. **Committing to align capital expenditure plans** with the net zero target (a recent focus from investors given the significant investments needed in many cases to achieve net zero objectives).

Figure 3. Comparison of the Net Zero target features included in different standards.

	NET ZERO STANDARDS	TCFD	ISSB	SBTI	TPI-CP	EFRAG	SEC	CDP	CA100+	GFANZ	TPT
Fundamentals	Interim targets disclosed	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
	All Scopes covered (Scope 1, 2 & 3)	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
	Role of offsets disclosed	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Implementation	Transition plan disclosed	✓	✓			✓		✓	✓	✓	✓
	CapEx alignment disclosed					✓			✓	✓	✓
		Upcoming SDR									

Climate targets of UK-listed companies

In Figure 4, we assess the GHG emissions reduction target disclosures of UK companies. Our analysis includes all constituents of the FTSE All-Share Index and focuses on the extent to which their net zero targets include the best practice features we identify above.

Figure 4. Share of the FTSE All-Share whose net zero targets have interim targets, cover all emissions scopes, distinguish between removal and reduction (lower bound), have an associated transition plan, and align with CapEx, respectively.

We find that more than two-thirds (68%) of FTSE All-Share companies publish some form of net zero target, and almost half (45%) have also set interim goals for 2025-2035. In contrast, only 20% of the FTSE All-Share companies have a net zero commitment which covers all emission scopes, including Scope 3.

Companies are even less likely to make public disclosures around other key features of ambitious and robust net zero targets:

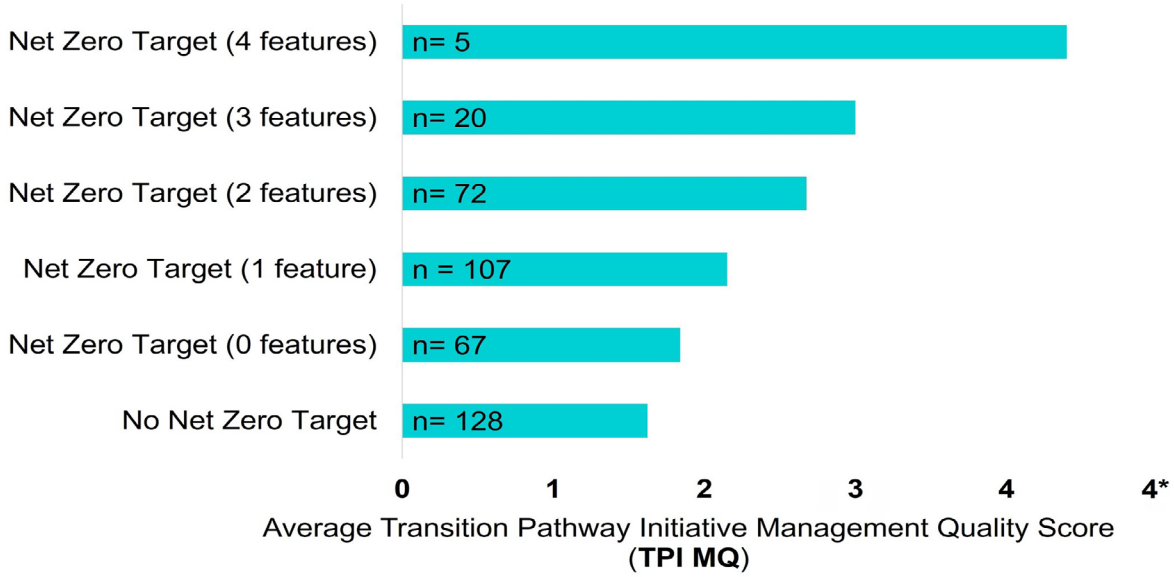
- Transition plans (16%): Less than 1 in 5 FTSE All Share companies have formulated and published a transition plan.
- Offsets (11% lower bound): Around 1 in 10 FTSE All Share companies provide clarity to what extent they intend to use offsets to meet their net zero targets.
- CapEx Alignment (3%): Less than 1 in 30 companies have made a commitment to align their capital expenditure plans with their net zero commitments.

We explored these data at sector level. We find that companies in the financial sector – the sector with the largest weight in the FTSE All-Share index – are least likely to have set net zero targets, with only 61% of the sector disclosing a net zero target for 2050 or sooner. Sectors with particularly high exposure to Scope 3 emissions – including energy, financials, basic materials, technology, and industrials – all have below average likelihoods in including Scope 3 emissions in their target boundaries. Interestingly, we also find that energy companies performed relatively well in disclosing transition plans – with half of utilities companies and one third of energy companies disclosing this data point.

Does better transition management mean better target data?

We also examine how Management Quality Scores (MQ) from the Transition Pathway Initiative (TPI) – which is designed to assess the quality of a company's emissions reduction strategy and its overall progress in transitioning to a low-carbon economy – correlate with the likelihood of companies setting a net zero target, and the comprehensiveness of such targets, for 379 companies in the FTSE All-Share Index. The 'best practice' features included in this analysis are both fundamentals (interim targets, covering all emissions scopes) and implementation features (transition plan and CapEx alignment). Offset distinction is not included in the features due to incomplete data.

Figure 5. Comparison of TPI Management Quality (TPI MQ) scores with the number of 'best practice' features of Net Zero target for the All-Share studied universe – including interim targets, all scopes covered, Transition Plan and CapEx alignment



We show in Figure 5 that, overall, there is a strong correlation between companies with a better TPI MQ score and companies with well-developed net zero targets. In fact, companies with a net zero target with at least 3 additional favourable features, have an average MQ score of 3.00. From this level, requirements for high Management Quality scores include those that set the foundations for robust net zero targets (disclosure of Scope 3 emissions, setting of long-term commitments, establishment of board responsibility, etc.). The 5 companies with targets with all fundamental and implementation features tested have a minimum score of MQ=4.

On average, the higher the number of features is, the higher the MQ score is. There are, however, companies that lack an overall net zero target, but may have made significant progress on transitioning to a low-carbon economy. The average MQ score of companies having a net zero target with no specific features (MQ= 1.84) is slightly but not significantly higher than companies that have not disclosed any (MQ= 1.63).

Conclusion

Improving the management of climate risk and portfolio-wide targeting in the financial sector requires forward-looking metrics and monitoring tools. A key input to such metrics is robust data on corporate greenhouse gas emissions targets in general and net zero targets in particular. Our analysis of net zero targets data for the UK shows that target disclosures are developing rapidly, even if there are still considerable gaps around a number of critical target features, including particularly Scope 3 targets, offsets, transition plans and capital expenditure alignment. 'Gold standards' for preparing and reporting on transition plans and their associated targets, such as those in development by the Transition Plan Taskforce (TPT), could help to bridge these data gaps.

Article 4

Adding purpose to principles and products

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An asset manager's statement of purpose provides the foundation for ESG integration and for applying principles and rules for ESG products. The purpose statement should be tied to board fiduciary duty, address the interests of key stakeholders, and discuss timeframes for evaluating both strategy and purpose itself. Purpose also gives rise to an asset manager statement of responsible investment principles that includes a belief statement, guidance on how the firm will integrate ESG factors and a framework highlighting specific ESG topics and issuer types to guide both evaluation of investments and active stewardship. These principles operationalise the statement of purpose in the everyday business of investing and fund product creation.

Regulators around the world are working to address the problem of 'fund greenwashing' in which claims about how a fund is 'ESG' or 'sustainable' or 'climate focused', etc, may be overstated. As the experience with the roll out and implementation of the Sustainable Finance Disclosure Regulation (SFDR) in Europe shows, some investors using only exclusionary screening rules can at times game existing requirements to imply the product is seeking long-term sustainable outcomes.

This is an important problem to address. At the heart of this are the multitudinous forms and objectives of the industry's practice of 'ESG integration'—the incorporation of material risk factors which can be applied to investments across all asset classes. For example, an investment portfolio may choose to focus on companies with strong ESG performance if there is conviction that strong ESG practices correlate with outperformance over a long-term holding period. Or it may choose to focus on companies with weak ESG performance if there was conviction that improvements should correlate with improved financial performance. Or it may merely consider ESG information alongside all other types of investment information with no particular systematic emphasis on it, as is today's common practice in the investment industry.

Given the various ways in which ESG integration can interact with portfolio outcomes, regulators are responding to the need for further disclosure among asset managers about their portfolio-level ESG implementation and objectives.

While asset managers receiving clarification about how ESG investment strategies should be disclosed and labelled is important, it may call into question the relationship of disclosures and the intentions of the asset manager itself. Most asset managers focus to varying degrees on the meaningfulness of the long-term societal purpose of their portfolio companies, however few investment firms have been public about their own purpose.

A clear statement of purpose by an investment firm can translate to a set of investment principles and product design principles. A publicly disclosed purpose statement will help asset managers in both disclosing their ESG integration practices and in developing products according to, for example, the SFDR. A statement of purpose is particularly necessary given there are many methods and data sources an asset manager can use to execute ESG integration. For example, in one form of ESG integration, the identification of an asset as sustainable may include some combination of gathering data provided by a company in a sustainability report, leveraging ratings from an ESG data vendor, deploying proprietary ESG and or sustainability rating scores or assessments developed by the asset manager, or negative screening of certain industries. In another form of ESG integration, norms might be developed that define company performance 'improvement', how stewardship will be conducted, and how the effectiveness of this stewardship is evaluated. The concept of business purpose can improve the asset manager's credibility and authenticity in constructing ESG and sustainability investment products. Using the term 'responsible investing' to cover both ESG integration as well as investment strategies with an impact focus, I suggest the following as a basic template for a responsible asset manager's 'Statement of Purpose':

The fiduciary duty of the firm's board of directors is to serve the sole interest of the ultimate beneficiaries of the firm's investments, which involves preserving and growing the value of those investments over the long-term while considering the impact of firm operations on its employees, investors in the firm, communities where the firm operates and suppliers to the firm.

The firm's board feels that the long-term interest of ultimate beneficiaries is best served by seeking to invest in companies and other issuers that provide positive leadership in the areas of their business operations and overall activities that are material to improving both long-term investor value and societal outcomes. Within this investment approach, the firm will further seek companies and other issuers that balance the needs of financial and other stakeholders and demonstrate a commitment to the global commons as well as to the rights of individuals and communities. The board has determined, in its independent business judgment, that this investment approach is the best way to serve the long-term interest of ultimate beneficiaries.

The board has directed firm management to issue a set of investment principles that provide a more detailed framework for the firm's evaluation of investments and to guide its stewardship activities on behalf of ultimate beneficiaries through active engagement with companies and other issuers. These principles should also identify key issuer stakeholder groups whose interests may be important to portfolio companies' long term value creation.

The board will review the firm's corporate purpose and its investment principles once every ten years, or sooner if the board so decides.

An example of a shorter version of such a purpose statement put into practice is Newton Investment Management, which has published a statement of purpose that states 'Our purpose at Newton is to improve people's lives through active, thematic and engaged investment which strives to deliver attractive outcomes to our clients, and to help foster a healthy and vibrant world for all.'

The asset manager purpose statement also provides the foundation for robust ESG integration in investment processes. I propose that such integration practices should be guided by a set of responsible investing principles that provide more specific direction for the firm's ESG investment integration activities. These principles, based on the firm's purpose statement, should set out the alignment of investment objectives and ESG factors over both long-term and short-term investment horizons. The following outline could serve an asset manager in developing a purpose-based principles of responsible investing:

1. Begin with a belief statement about how portfolio companies deliver value.
2. This is followed by statements about how the firm will integrate ESG factors into the selection of investee companies. For example, in terms of factors, priorities, processes.
3. Next should be a description of the overall responsible investment framework for the evaluation of investments and that guides the firm's stewardship on behalf of clients, including through active engagement with companies and other issuers.
4. The principles should conclude by naming the specific issuer types that the firm could have no or limited exposure to, which can vary by different ESG integration methods and strategies, based on the principles' beliefs and enumerated stewardship framework.

One such example of a firm-wide, purpose-based set of principles are The Calvert Principles for Responsible Investment.

A responsible asset manager's purpose-based principles for using material ESG factors in investing could also guide the creation of specific ESG themed products, strategies, and funds. I see 4 pillars for the implementation of purpose-based principles in this context:

1. **Disclose and implement clear investment objectives**

    a. how success is measured at the fund and individual security level (eg, financial returns, risk targets, climate metrics, natural capital goals, and social impacts)
    b. over what timeframe
    c. how a security is approved to be eligible for an investment strategy
    d. what is done when a prior approval/disapproval turns out to have been wrong

2. **Implement longer time frames to measure achievement of investment objectives**

    a. absolute return targets should be 5-7 years out ... or longer
    b. fund-level performance must be measured both using financial and the appropriate ESG and impact metrics (where relevant) to assess attainment of investment objectives
    c. there must be flexibility to allow for the rapid pace of innovation around relevant ESG and impact performance metrics

3. **Transparency and accountability in disclosures**

   a. all holdings of funds in public markets and the rationale for their inclusion should be published (allowing for customary delays for trading/compliance purposes)
   b. disclose an acknowledgement of any significant/contrary ESG risks/issues that will be monitored
   c. maintain a centralised firm ESG research team that is not encumbered by fund-specific pressures that can operate as investment guardrails oriented toward the firm's purpose and principles

4. **Active stewardship**

   a. include a statement of how the firm will engage with portfolio companies to ensure progress is made on material ESG and long-term issues
   b. set and monitor engagement objectives, milestones, and time horizons
   c. issue regular disclosures on actions taken and progress for both engagement activities and proxy voting
   d. ensure that resourcing of stewardship of teams matches the gravity of the issues facing companies, as well as the imperative to preserve individual and community rights, in line with the firm's corporate purpose and investment principles

The author hopes that the above asset manager purpose template, the guidance for drafting purpose-based responsible investment principles, and the 4 pillars for creating specific ESG themed products, strategies and funds provide useful input to future FCA policy making.

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The author would like to cite Daniel Godfrey, Visiting Fellow, Global Systems Institute, University of Exeter for his thinking behind the 4 pillars.

Article 5

How to build an effective culture to support climate- and sustainability-related objectives in the financial sector

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In recent years, there has been a massive shift in the importance society attaches to climate change and sustainability. A broad range of stakeholders expect financial services firms to lead and support the transition to a fundamentally different and more sustainable economy.

Amid these changing expectations, many firms have made climate and sustainability-related commitments, most notably on net zero.

Unless a firm's culture supports its strategy, commitments, and objectives it will not achieve them. This is because culture is about a firm's values, attitudes, and behaviours – what people say and do.

There is no silver bullet that can transform a firm's culture. Boards will need to make a sustained push on a number of fronts.

While climate and sustainability may pose significant and new opportunities and challenges, firms can draw on previous experiences of large-scale culture transformation (eg, to support digital innovation, or how they treat their customers). They should also identify where they need to improve their approach.

Firms need to embed their purpose and values across business strategy, products and services, risk management, finance, and operations, so that sustainability is integrated into decision-making.

This article outlines the key building blocks and actions firms can focus on to develop a culture that supports their climate and sustainability-related objectives.

Purpose

We define purpose as a firm's explicit drive to create value beyond profit, specifically for people and the planet. Purpose helps to shape culture, while at the same time, culture is essential to embed purpose.

Many firms have already defined their purpose. But it is only authentic and delivers value when it is embedded within the business and visible and understood externally.

Actions to consider

- The Board will need to define the firm's purpose, ideally drawing on a range of stakeholder views and resolving any regional or divisional divergences. A consultative approach works best.
- The Board should ensure that the firm's values, strategy, and business model are aligned with the purpose and that the purpose is embedded across eg, decision-making processes, accountability, brand, products and services, supply chain, and operations.
- The Board should receive management information (MI) on the extent to which the purpose is understood and has been embedded and take follow-up actions where necessary.

'Tone from the top'

Culture is shaped by what leaders say and do – and by what they don't say and do. Boards and executives need to be role models for the behaviours that exemplify the culture they want to create.

Where business priorities emerge, the Board should consider how these align to their sustainability objectives. For example, if the business is seeking to cut costs, it should strive to do so in a sustainable way, consistent with reducing emissions and acting responsibly with suppliers.

The Board needs to drive discussion where profit is seen to conflict with people and planet, and on the tough decisions that need to be made (eg, on transition finance and when to divest). It should also identify and emphasise the opportunities and benefits that the business should focus on.

Actions to consider

- Communicate frequently the firm's purpose and values and how they relate to the sustainability objectives. This can help to change the workforce's perception of 'desired behaviours'. Messaging must be consistent and is more effective when it can tap into people's emotions, values, and ambitions.
- Positive user stories work well. These might provide practical examples of where leaders have turned down a client, transaction, or supplier as they judged the work incompatible with the firm's purpose, or where they are pursuing commercial opportunities or partnerships to support their sustainability objectives.

Expertise

To drive the culture a firm wants to achieve, the Board, senior executives, and workforce will need to understand the firm's purpose and climate and sustainability objectives, and how they relate to their day-to-day roles.

This will require a step change in Board and workforce expertise, where individuals can continue to evolve their knowledge, skills and experience.

Training, development, and support to people managers to ensure the right 'tone from the middle' will also be crucial.

In our survey of the disclosures of FTSE 100 financial services companies aligned to the Taskforce on Climate-related Financial Disclosures (TCFD) (Deloitte, 2022), most firms (72%) disclosed that they had provided training on climate and sustainability to the Board and 50% disclosed that they had also provided training more broadly across the firm, typically to specific teams (eg, risk or relationship managers) or staff wide.

We anticipate that more firms will invest more in training and increase disclosures.

Actions to consider

- Identify knowledge, skills, and experience gaps in the Board and across the workforce (eg, relationship managers, product specialists, and compliance, risk and finance professionals) and ensure a plan is in place to address them, backed up by sufficient resources.
- To ensure the firm's purpose and strategy are cascaded across the firm, firms should consider firm-wide training for all staff. At a minimum this could include e-learning, but training that uses a range of techniques is likely to be more effective eg, leader-led or face-to-face training.

Challenge and diversity of thought

Firms need a culture which encourages challenge and diversity of thought.

An informed and engaged workforce is more likely to identify opportunities which support a firm's sustainability objectives.

Where staff can speak up without fear or repercussion, firms are also more likely to identify potential instances of greenwashing or misconduct or flush out weaknesses with the implementation of firm transition plans, for example, risks, conflicts, or practical application problems.

If the firm receives external challenge (e.g., stakeholders perceive that a firm's actions conflict with its purpose), it should address the concerns in a transparent manner.

Actions to consider

Open escalation channels and hotlines for staff to offer their feedback (e.g., through town hall meetings or anonymous feedback sessions), with a prescribed process for management and senior staff to deal with matters raised.

- Facilitate workshops where staff can raise and discuss specific opportunities or challenges (e.g., where pursuing sustainability objectives may have perceived negative implications on profitability).
- Consider appointing culture champions or ambassadors to help communicate the firm's purpose and values, empower the workforce, and identify potential red flags.

- Ensure diversity and inclusion, and the desired mindset, are considered as part of recruitment, retention, and succession planning. To support challenge and debate, Boards and Executive Committees should also ensure that they have individuals with sustainability expertise.

Governance – roles and responsibilities

To create a culture where individuals are personally incentivised to act in the way the Board and senior executives want, it will be important to ensure that roles and responsibilities are clear and there is individual accountability. For example, firms will need to identify an executive with overall accountability for the design and execution of the transition plan.

According to our survey of the TCFD disclosures of FTSE 100 financial services companies, the individual(s) responsible for overseeing delivery of the climate ambition or transition to net zero at the executive level, below CEO, was typically not disclosed (55%) or was not entirely clear (28%); this disclosure is not an expectation in TCFD guidance. Where disclosed (3 firms), the individuals had specific sustainability or climate roles (e.g., Chief Sustainability Officer).

Firms also need to encourage teams to work together, not in silos. This is likely to uncover new opportunities as teams share ideas. For example, incorporating sustainability into documented customer journeys will help identify previously hidden barriers to the transition. It will also help to 'join the dots' on data to minimise client data requests and make links to other initiatives, such as implementation of the FCA Consumer Duty.

Actions to consider

- Translate climate and sustainability objectives into specific and credible plans, with clear targets and deadlines. To achieve the plans, update roles and allocate responsibilities to executives and across the 3 lines of defence. As a major change programme, accountable Senior Management Functions will likely be required for each in-scope regulated entity. If a target is missed, it needs to be clear which individual is responsible.
- Identify critical decisions and who needs to be involved in sign-off. Firms should consider whether to update delegated authorities or 'RACI' decision-making matrices (ie, which set out roles and responsibilities for specific tasks).
- Board, Board Committee and Executive Committee mandates, roles, terms of references and reporting packs should be updated to reflect responsibilities and enable oversight of progress on achieving sustainability objectives.

Remuneration and incentives

If culture is to thrive, remuneration, incentives, and performance management all need to be aligned to promote behaviours consistent with it and, in this case, with achieving sustainability objectives and the firm's purpose.

In our survey of the TCFD disclosures of FTSE 100 financial services companies, most firms (72%) disclosed that they included climate or sustainability considerations in the executive scorecard, with some firms also starting to look at executive long-term incentive plans (50%) and wider staff incentives (17%).

While this progress is positive, the Remuneration Committee and Executive Committees will need to consider the extent to which they have the information needed to assess performance objectively.

Actions to consider

- Update performance criteria and remuneration policies throughout the organisation to align with the climate- and sustainability-related objectives.
- Where executives and staff have specific responsibilities for climate- and sustainability-related objectives, link remuneration to those responsibilities. Ensure that the measures used are meaningful, stretching, and transparent.
- Collect the necessary MI to demonstrate individual contributions.

Feedback and review

Firms may have set sustainability goals but not assessed what their staff and other stakeholders think about them. They should find out – not second guess or make assumptions.

The Board and senior management will also need to assess the firm's culture on a regular and consistent basis. They should also strive to measure and track the effectiveness of their interventions to improve culture. Assessments must be data-driven, looking across numerous data points. In doing so, firms must overcome IT systems challenges and complex global structures to 'join the dots' across different functions.

To help the firm develop a targeted engagement strategy, data should be segmented. For example, there are likely to be generational differences; 64% of Gen Zs would pay more to purchase an environmentally sustainable product, and sustainability has a direct impact on job loyalty of Gen Zs and Millennials (Deloitte, 2022).

Actions to consider

- Determine the MI the Board and senior management should receive eg, on whether the firm's climate and sustainability-related objectives are being met, whether their desired culture is being achieved, and what external perceptions are on the firm's purpose.
- HR can broaden staff engagement surveys to find out how staff feel about sustainability, what they know about the firm's objectives, and whether and how they feel that they can support them. Firms can also undertake pulse surveys, dedicated culture surveys, leader interviews, workshops and focus groups.

- The Board can request 'deep dive' assessments on sustainability culture eg, from Internal Audit, HR, Ethics, Risk and Compliance. 'Deep dives' could also focus on specific topics e.g, the impact of the firm's operations on communities and small business owners and how quickly suppliers are paid, or how inclusive the design of products are, looking at age, disabilities, or other vulnerabilities.
- Following a review, the Board and senior management need to address any identified shortcomings with clear and timely follow-up actions and feedback to stakeholders.

Conclusion

Unless a firm's culture supports its strategy, commitments, and objectives it will not achieve them.

There is no silver bullet that can transform a firm's culture. Firms will need to dedicate sustained effort across the themes outlined in this article. They need to understand their market and what clients want, as well as what their workforce and other stakeholders think, rather than make assumptions. They should also 'join the dots' within their organisations, so that teams do not work in silos.

To shape their culture, firms can leverage existing approaches, innovating where necessary. They should also measure, as best they can, the effectiveness of what they do. This will help them overcome the significant and new challenges posed by climate and sustainability, as well as realise the benefits they want to achieve for their stakeholders, society, and the environment.

Article 6

Board-level governance of climate-related matters

Julie Baddeley, Chair, The Directors' Climate Forum

Chapter Zero

Four years ago, climate was rarely on the agenda for boards. Yet in 2022 there cannot be a board in the country that hasn't discussed its impacts – even if some may still be unaware of how significant the physical and transition risks and opportunities are likely to be.

In late 2018, in an informal poll of about 150 directors only a handful said their board had considered potential climate risks. Few had even heard of the Taskforce on Climate-Related Financial Disclosures (TCFD). Directors cited the long-term nature of the potential threat, and the fear of being a first mover in such an uncertain world, as reasons not to engage with the issue. Many felt, it wasn't relevant to their companies, and even the 2018 Intergovernmental Panel on Climate Change (IPCC) report warning of catastrophic global warming didn't fully hit home.

A group of us UK non-executive board members realised that board understanding needed to move up several notches. At the time the broader ESG agenda was better embedded, with diversity and inclusion, and issues like plastic waste and treatment of workers in supply chains, under board scrutiny. So, we established Chapter Zero to build a network of engaged non-executive directors and chairs equipped to deal with the biggest threat of all: climate change.

This article looks at the development of board engagement with climate change as a business issue, how we are helping address the knowledge gap, the role of regulation and closes with a call to accelerate transition planning and action.

Addressing the climate knowledge gap

When Chapter Zero was formed, the prevailing narrative wasn't helping attract directors' attention. Board time horizons are short: next year's budget, the 5-year plan, and, for those with big investment programmes, possibly a 20-year view. A risk of a 4 degree rise in global temperatures by 2100 didn't force the issue into an already packed board agenda.

This lack of understanding was systemic. Those to whom the board and its committees would typically turn to for support, such as auditors and consultants, also lacked the capacity and technical knowledge. In-house expertise was often poor, or siloed in a specialist Corporate Social Responsibility (CSR) unit. Essential skills in the Finance and Strategy Departments were largely lacking.

Everything changed in 2019. The UK Government set a legal 'net zero by 2050' obligation with a 2030 interim target; TCFD reporting was about to become mandatory; the narrative moved to keeping temperature rises to below 1.5 degrees; the early focus on risk started to embrace opportunity and innovation. This all served to bring the need for action forward and the CCC reports of 2019 and 2020, giving performance against the UK's carbon budget pushed the topic much higher up the board agenda.

Investors have also had a major influence. The annual open letters from Larry Fink of BlackRock are awaited with interest, and Sarasin's recent announcement encouraging votes against directors who fail to put companies on a 1.5 degrees pathway will get people's attention.

The Stewardship Code has a significant part to play in the relationship between boards of financial institutions and corporate boards. Access to capital – whether it be equity investment, bonds or straightforward working capital financing – is one of the biggest drivers of change for many companies.

When we launched Chapter Zero there was immediate interest from non-executive directors and chairs across all sectors, and particularly those on the boards of financial services companies. Many recognised early on that ESG, and climate in particular, was going to be a key boardroom issue.

Board engagement today

Three years on, Chapter Zero has a membership of more than 2,000, with a substantial proportion of members from financial services firms, who are highly active and engaged. Our Financial Sector Hub runs roundtables and events especially for those serving on these boards. Importantly, climate considerations are becoming embedded in overall strategic planning and operational management. At board level, most non-executive directors would say that climate action is an issue for the whole board, but that board committees also have a major role to play.

Audit and Risk Committees are increasingly focusing attention on the scenario work needed to support risk assessment. The data is hard to come by and verify, and the Committees are on a journey to fulfil their disclosure obligations. Audit committees are also recognising the need to reflect climate risk and action in financial statements. This includes going concern and long-term viability statements, asset valuations and potential impacts on profits. There is little agreement, however, on an appropriate internal carbon price to use for these calculations.

Remuneration committees are drawing on the company's net zero plans and other ESG metrics to create management incentives which drive the right sort of change without unintended consequences. As well as looking for clear disclosure on how net zero is integrated into overall business strategy, assumptions used in transition planning and metrics and milestones showing robust short-term as well as longer-term targets, investors are increasingly focused on incentives for management.

Performance incentives have always been key to business transformation, but setting measurable targets for ESG matters, and climate in particular, is something boards and their remuneration committees are tussling with. According to a Deloitte report on the

2022 reporting season, 70% of FTSE 100 companies have ESG targets in their annual bonus including 37% on carbon emissions, and 45% include them in their long-term incentive plans.

Equally there is much debate about achieving targets through offsets, and how to incorporate the Scope 3 emissions, which dominate many companies' carbon footprint, when measurement remains such an inexact science. We are in transition, and remuneration committees are at the heart of the debate.

For financial institutions setting climate targets is possibly harder taking their remuneration committees into debates about divestment or using leverage to influence change.

The ESG heavy lifting for many companies is carried out by a Sustainability Committee. This is usually chaired by a non-executive director and ideally includes the CEO or CFO in its membership, supported by specialists to help with the complexities of the issues under debate. According to their Annual Reports, 50% of the FTSE 100 had a Sustainability Committee in place in 2021. These committees are able to give the time to do a deep dive into the issues and report back to the board as a whole.

The evolving debate in the boardroom

For many directors these boardroom discussions are moving into new territory. We have spent the last few decades on a relentless search for growth; increased process efficiencies which have often created long, complex supply chains; and decisions which have unknowingly contributed to the challenges we face today. Who thought at the time that making free plastic bags available in supermarkets would fill the oceans and damage wildlife? Or that allowing returns of unlimited numbers of items of clothing bought online, would result in huge numbers of items being purchased, delivered and transported back and 30% ending in landfill. For many of these decisions it will be hard to put the genie back into the bottle without a much better understanding among the whole population of why change needs to happen. The climate crisis is demanding scrutiny of all aspects of our business models and asking directors to challenge many decisions they have themselves been part of in the past.

This, combined with a continued lack of sufficient expertise in the boardroom makes the task sometimes feel overwhelming. Chapter Zero has seen a big growth in climate understanding and capability over the past 3 years. But there remains a gap in expertise on many boards; both financial services and in the real economy. The job is not yet done. We are tackling it by providing education, tools and peer-to-peer knowledge sharing for existing directors through our membership, and by working to ensure that people with the right range of skills, including climate competence, are appointed when board vacancies arise.

The role of regulation

Unusually, where climate action is concerned companies are calling out for more regulation rather than less. Boards realise that their decisions must be in the context of a level playing field – climate change requires courageous action and significant investment.

Regulation in the financial services industry in the UK is at the leading edge, consistently encouraging ESG action. But many other aspects of our regulatory framework – planning, transport, energy, water – are not yet linked to the overall net-zero by 2050 requirement. Boards tell us that more joined up government would make it much easier to take the decisions required to keep 1.5 degrees alive and build a resilient economy.

Society seems to have moved its theoretical perspective on the need for change. But, as yet, that isn't translating into changes in buying behaviour and the willingness pay for it. This has been exacerbated by the energy crisis which has switched people's attention from the long-term risks to the immediate. Business has a huge role to play in communicating with employees, customers and, ultimately, voters as without them understanding what has to be done and why, it will be impossible to achieve change at the pace required.

The evidence we see suggests that financial services boards are well engaged with the issue. And there is an appetite for education and sharing of good practice to help them on the journey. But these organisations are dependent on the real economy companies they invest in, lend to and insure to provide robust and, as yet, that isn't sufficiently widely available.

Debate has also raged around divestment. Most of our members see the positive use of capital to drive change a better approach than pushing companies to take funding from less socially responsible sources. The same applies to considerations of real economy portfolios. Divestment of their high emitting businesses to, potentially, less well governed organisations doesn't contribute to the decarbonisation of the global economy, even though it may improve the company's own performance.

Those of us who have served on financial services boards are not typically experts in sustainability, nor do we need to be. However, the Chapter Zero mission is to elevate all board members' understanding of these issues so that they can actively challenge decisions as they would in any other strategic debate for their companies. The executives develop the plans, supported by internal and possibly external experts, but the board as a whole must be able to assess the strength of the ambition and its deliverability and monitor performance against it in the short as well as longer term.

Transition planning is the key to delivery

The Race to Zero tells us that one third of the largest publicly traded companies globally have made net zero pledges. However, many acknowledge that these commitments are not backed up by a credible, rigorous implementation plans based on a thorough review of potential scenarios, clear short, medium and long-term targets and built-in opportunities to recalibrate as the context changes. The Net Zero Tracker stock take published in June 2022 questioned the quality and trustworthiness of many of the published plans. That is the challenge of the next few years, and one that the UK Transition Plan Taskforce is designed to tackle, with its TPT Disclosure Framework, launched at COP27.

In a recent Kantar survey for Chapter Zero, 94% of respondents said that they had taken boardroom action as a result of their membership. However, even among our members, 43% said that their boards had not yet approved a net-zero transition plan.

Also, delivering net zero across Scopes 1, 2 and 3 requires a huge engagement programme with employees, suppliers and customers on a scale most organisations have never experienced. Difficult decisions require taking people with us, and some will unpick the performance drivers which people are used to and comfortable with. Interestingly, most of those with transition plans see cross-sector collaboration as key to driving successful change.

Call to action

In summary, much progress has been made. But there is still a long way to go for boards, both in financial services and among their real economy customers, to translate ambitions into concrete plans and fast action. We frequently remind our members that there are only about 2,500 days to halve global emissions if we are to keep what the UN Secretary General in September called a 'fast failing' target of restricting warming to 1.5 degrees. Over that period most companies will have about 60 board meetings, so we need to speed up both decision making and action.

Article 7

How a Chief Sustainability Officer can most effectively support a firm in achieving its climate- and sustainability-related objectives

Will Martindale, Co-Head of Sustainability

Cardano Group

I joined Cardano, in December 2020, as Group Head of Sustainability before Cardano's acquisition of sustainable asset manager, ACTIAM. Cardano is a fiduciary manager and adviser, investing in different ways – we invest ourselves and via third-party managers.

Based on my experience from my time in the role, here are my top 10 learnings on how a Chief Sustainability Officer (CSO) can most effectively support a firm in achieving its climate and sustainability objectives.

1. Lead from the top

It is important to establish the CEO as the leader on sustainability topics. The head of sustainability should report directly to the CEO. This provides the head of sustainability with the mandate necessary for fast-track implementation, while the CEO remains responsible for ensuring that sustainability objectives are met or being progressed.

A CEO-chaired, business-wide steering committee allows for oversight and regular engagement on sustainability activities to ensure that key milestones are reviewed and met. A short weekly meeting, coordinated by an experienced project manager, can be effective to ensure that there is regular business-wide engagement and oversight on sustainability matters.

2. Identify gaps and establish a project plan

To make progress towards sustainability objectives, it's important to first understand the baseline, identify the gaps that exist and establish a project plan to meet them. The project plan should assign responsibility for tasks and clearly define who is accountable for achieving them.

Among the potential workstreams that could contribute to a project plan are the following:

- beliefs and policy
- sustainability data
- regulation
- investment decisions
- security-level exclusions, such as coal
- stakeholder groups, such as PRI or IIGCC
- education
- client training
- reporting and disclosure

It is important for the head of sustainability to provide the expertise and technical oversight – but not necessarily to assume responsibility for all of the actions arising under the project plan. To be effective, it is important to embed sustainability across the organisation, so that it becomes part of 'business as usual'. This means that all teams will be responsible for delivering on sustainability-related objectives, including those that do not have 'sustainability' in their team name or job title.

Ultimately, there will be collective responsibility for achieving sustainability aims, rather than responsibility resting solely with the sustainability function.

3. Ensure business-wide involvement

To ensure sustainability is embedded across the organisation, an organisation may consider establishing 'sustainability champions' in relevant teams. From experience, there may be more candidates than roles, given genuine employee interest in sustainability and a desire to help with delivery against long term aims.

The champions may then be assigned tasks within the project plan. To underpin delivery, these should also form part of the champions' objectives and performance review. Not only will this ensure progress against actions, but it can also be an opportunity for the champions to demonstrate the company's values and desired behaviours.

The project manager can speak with each champion, and their manager as necessary, to check progress and ensure their sustainability tasks are adequately resourced. Each task should be sponsored by a member of the management team who is ultimately responsible for overseeing the work.

The champions may then be supported by organising training sessions on a range of topics. These could be simple short teach-in style sessions run by colleagues in the organisation with relevant knowledge and expertise, but equally may be more formal.

Firms may, for instance, consider inviting external speakers, such as PRI, IIGCC or human rights NGOs to host a session. A sustainability reading list, as well suggested podcasts and films could also be useful tools to enhance individual knowledge. Maintenance of a list of resources could be managed by one of the champions with a regular request for new relevant content which is then shared with other champions and interested parties.

Examples of useful content could include:

- How to Avoid a Climate Disaster, by Bill Gates
- Just Business: Multinational Corporations and Human Rights, by John Gerard Ruggie
- Doughnut Economics: Seven Ways to Think Like a 21st-Century Economist, by Kate Raworth
- Impact: Reshaping capitalism to drive real change, by Sir Ronald Cohen
- The Truth about Modern Slavery, by Emily Kenway
- Making the Financial System Sustainable, Edited by Paul G. Fisher

Most companies have periodic 'all-staff' calls or meetings, which are often an important vehicle for senior leadership to communicate and engage on a firm-wide basis. Ensuring that sustainability is a frequent agenda item can help to drive business-wide commitment and involvement and encourage staff to be part of the journey.

4. Establish beliefs and policies

Establishing sustainable investment beliefs ('the why') and sustainable investment policies ('the how') will help link the firm's sustainability agenda with its business objectives.

In my experience, it is important to first review the evidence base on financial materiality. More studies than not show that incorporating ESG issues into investment decision-making and excluding certain companies or economic activities with unmanaged ESG risks, at worst leads to comparable results but at best, leads to superior risk-adjusted return.

The firm may also wish to review terminology and approach. For instance, what is the firm's approach to 'real world sustainability impact' or 'double materiality'? To define what is meant by key terms, such as 'sustainability' or 'stewardship', a firm may wish to refer to definitions from the United Nations Brundtland Commission and the UK Financial Reporting Council, respectively.

To support the development of beliefs, a firm may find it useful to organise internal workshops, as well as discussions – and perhaps training sessions – with clients, to explain what is meant by sustainability, the rationale for the firm's approach and the implications for investment decisions.

In Cardano's experience, our investment decisions followed our beliefs and policy. We increased our investments in green, social and sustainable bonds, invested in low-carbon ESG-screened equity, and some months earlier, we invested in base metals necessary to support the energy transition. We also began a project to invest in social housing.

Finally, to demonstrate beliefs, a firm could consider making a commitment to decarbonise its portfolios, and joining the relevant GFANZ alliance for its sector.

5. Support portfolio managers with data and metrics

ESG data can be overwhelming. ESG data itself is not useful unless it is understood by investment decision-makers and integrated in investment and client-reporting processes.

To identify which metrics are likely to be relevant, a firm may wish to consider a range of industry initiatives, frameworks and standards, including:

- PRI's inevitable policy response to inform climate change scenarios
- IIGCC's Paris Aligned Investment Initiative to inform GHG emissions metrics
- a combination of PRI programmes, Share Action, PCAF and PBAF, as well of course, own areas of interest to inform your ESG metrics

It is important that investment teams undertake their own GHG and ESG analysis of investments, before decision-making – and on an ongoing basis.

It is useful to review frameworks, both voluntary and regulatory. Examples include: the PRI reporting and assessment framework; the UK Stewardship Code 2020; the PLSA voting template; DWP and FCA TCFD reporting requirements; and the ICSWG guides.

For the voluntary frameworks, a firm should consider what makes sense in light of its sustainability objectives, beliefs and policies. For the regulatory frameworks, a firm should undertake a gap analysis to baseline what it is currently doing, and where it needs to evolve its approach.

Where possible, a firm should consider aligning with relevant industry groups and initiatives. We think there are benefits to industry standardisation. Cardano participates in a range of industry groups, including PRI, IIGCC and UKSIF, to provide our input and commitment to a consistent approach. This is where, as head of sustainability, I was able to add value, helping direct our investment and client staff to contribute to – and learn from – industry groups.

6. Set out your approach to real world sustainability impact

Investors increasingly commit to 'double-materiality' and want to incorporate both ESG integration and real-world sustainability impact into their investment processes. However, there is little clarity as to what is meant by 'influence', 'real-world sustainability impact', and how to measure it.

At Cardano we developed our own 'model of influence'. This comprises 3 key forms of influence, based on how direct an impact these actions may have. We have worked with our investment teams to develop our influence across all 3 tiers when constructing portfolios, with the aim of maximising our influence to achieve real-world sustainability impact.

One important vehicle for high impact influence is collaborative stewardship. We partnered with a stewardship provider to enhance our stewardship activities. We select companies based on our holdings, our priority sustainability issues and our ability to contribute to the engagement. As head of sustainability, I lead our enhanced stewardship activities, supported by colleagues across our investment, client and advisory teams.

7. Where there is already expertise, step aside

Undoubtedly, there is more work to do than people to do it. So, where there is already expertise, step aside. For example, before I joined, our manager research team had integrated sustainability into third-party manager assessment processes. While this was an area of interest for me personally, progress was well underway. So, as head of sustainability, I joined meetings on an 'as needed' basis, freeing time for where I could have more direct input.

8. Report

There should be regular reporting to a wide range of stakeholders both internally and externally. This includes regulators, clients and stakeholder groups, among others.

Cardano undertakes a range of reporting activities: reporting to clients; public reporting on our website; a partnership with Pensions Expert (where we deliberately empowered our sustainability champions to author articles on sustainability topics relevant to their roles); an end of year sustainability report.

We also run a series of events. This included an event about COP26, with a spokesperson from the PRI, and an event on stewardship with a spokesperson from the FRC. We also organised client events on topics such as inequality, gender equality and impact investing.

9. Innovate and change

To drive the long-term sustainability agenda, change must be considered and innovative opportunities explored. As an example, in January 2022, Cardano acquired ACTIAM, a firm with extensive sustainability experience with a focus on social foundations and planetary boundaries. Through the course of 2022, we've integrated our sustainability staff and our policies.

10. Invest in relationships

Sustainability can be exclusive. Terminology changes and expectations evolve. There are new groups, new requirements and new reporting to be done. These are all barriers that need to be addressed. It is the head of sustainability's role to consider them, take responsibility for them or to assign the tasks to others.

The head of sustainability should seek to earn the respect of colleagues, by providing expertise, technical support, coaching and training, and challenging the views of others while giving them the opportunity to speak up and provide their own views for a richer dialogue.

Final words

This article speaks to the role of the chief sustainability officer. But however smart or hard-working the sustainability officer, progress against the firm's strategic sustainability agenda relies on organisation-wide contributions as well as clear leadership and commitment from the organisation's management team.

When meeting with graduates or students, or more senior investment professionals considering a change in career, I'm often asked for my views on what to study or read: 'What about the CFA sustainability qualifications?' 'What about the Oxford or Cambridge sustainability course?'

Studies are of course important. But in my view, the most important characteristic is passion. To be successful as a head of sustainability, the starting point has to be passion to change markets, economies and societies to be more sustainable – to make the world a better place – and a belief that investment is a key conduit to achieve that change.

Article 8

Governing climate transition implementation at banks

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1. Introduction

This article draws on insights from 61 leading banking practitioners and builds on established climate governance guidance. This includes the Corporate governance principles for banks, Good practices for climate-related and environmental risk management, and the 'Environmental, Social & Governance (ESG) governance blueprint for banks' by the author of this article, forthcoming by the European Bank for Reconstruction and Development (EBRD).

The article proposes 3 operating principles to help respond to the adverse current macro environment and the early stage of development of climate infrastructure. Specific proposals are examined for the first, second and third lines of defence of banks respectively, all of which lead back to the pivotal role of a competent, engaged, and effective board. Finally, culture is identified as the driving force behind effective accountability.

The most important take-away is that without proactive leadership, a clear line of ownership, effective accountability, and successive checks and balances, banks will likely be hindered in effecting their climate transition.

2. Risks and headwinds

Climate risks continue to unfold at pace. **Physical risks** are materialising more frequently, severely, and non-linearly, as captured by insured losses globally. **For transition risks**, the World Energy Outlook (WEO) 2022 by the International Energy Agency indicates sweeping changes ahead across sectors and activities. Interestingly on **liability risks**, interviews suggest that greenwashing is taking an overwhelming proportion of board deliberations on climate. These have intensified on account of landmark cases pursued by the US Securities Exchange Commission (SEC) and material investigations. An equally important increase has been noted in precedent cases against shortfalls in discharging corporate fiduciary responsibility and statutory duty on account of climate. In weighing liability risks, banking leadership may aim to ensure that legitimate fears of greenwashing sharpen, yet do not derail the bank's greening process, lest this may lead to 'green-squashing' and consequent company, director, and officer risk events.

3. The state of the banking transformation progress

Overwhelming feedback on climate transition is that it is sweeping and holistic across the bank's businesses, operations, physical footprint, and ultimately its culture. In essence, it transforms fundamentally the bank's 3 lines of defence.

Basic climate governance has been established at many banks, in the form of revised board and executive structures, ESG metrics in executive remuneration, and climate representatives across the bank. However, the process of translating these governance interventions into a coherent business strategy, operational budget, and internal control environment remains significant work in progress.

4. Three operating principles to refocus governance

Three operating principles to help guide a renewed governance mandate include: (a) treating climate as a business and longevity issue; (b) gearing up to operate under a high degree of uncertainty; and (c) displaying a proactive and deliberate leadership style.

a. Treating climate as a business and longevity issue

At a practical level, banks are commercial entities. To play a value-additive role in financing climate transition, they need to be able to translate their business values and strengths into a clear, single-point, profit-oriented, short and medium-term business plan to support their clients' and their own transition. Because it needs to be rooted in the reality of clients' needs, this plan will most likely help to increase profitable client touchpoints, create a strong green franchise, and reduce cumulative transition costs.

b. Gearing up to operate under a high degree of uncertainty

Given the nature of climate and the early stages of implementation, operating conditions are bound to remain less structured and information-deficient for the near future. In fact, positioning for the future, and opacity in price and path discovery are the types of conditions under which banks would normally thrive financially.

This means operating under strategic horizons, which involves nurturing emerging businesses at scale, and planting sufficient and diverse seeds for new markets. Horizons can include instituting next-generation energy coverage teams, sophisticated transition lending solutions, and greening equity investing and first-loss capital solutions.

Moreover, banks may seek to approach their clients' businesses through the prism of product and service value chains instead of vertically through industry sectors. Making more informed assumptions about emission interdependencies and launching new greening products to address them.

c. Displaying a proactive and deliberate leadership style

Navigating uncertainty requires proactive and thoughtful leadership interventions, to build resilience, retain organisational coherence, and, guide the bank's future deliberately. This requires promoting executives who are able to: (a) manage change without disrupting business continuity; (b) convince their teams and strengthen

followership consistently; and (c) cascade and translate plans into tangible and profitable results.

At the operating level, proactive leadership requires: (a) a committed and cross-functional participation in decision-making to prevent disjointedness; (b) efficient direct management feedback loops; (c) and leaning on big data (both business and operational) to inform choices at the business and the operating level.

5. Potential governance interventions

Based on these operating principles, below are suggested interventions for the first, second and third lines of defence at banks.

i. First line of defence

For climate to become a core strategic business objective, it needs the visible and decisive sponsorship of the executive management, and the personal leadership of the Chief Executive Officer (CEO). In practice this means that the bank's executive sustainability committee (which is a sub-committee of the executive committee) is responsible for all core climate implementation decisions and has direct sponsorship from the CEO and the board of directors. These levels of seniority together send a clear message to the bank's governance structure about the bank's commitment to climate.

The effectiveness of this committee rests on:

- **Cross-functional collaboration.** It is staffed with the most senior executive ranks of the bank's business divisions and core functions, including risk, finance, and operations.
- **Trade-off management mechanisms.** It articulates trade-offs clearly and proposes a business stance to avoid confusion and conflicts.
- **A sense of ownership.** It has clear effectiveness and functional participation metrics to help optimise the decision-making process, and it cascades and integrates climate business and risk metrics across the executive governance structure, including transaction, product approval, strategic clients, credit, reputation, etc.
- **A commercial and nimble central sustainability function.** This function supports the committee, ensures that businesses and functions own their transition plans, and coordinates internal and external intelligence to help speed up implementation progress.

Divisional heads implement a strategy of pivoting, in consultation with the central sustainability function and dedicated climate product experts. Importantly, climate product experts are not token sustainability representatives and do not have an administrative role.

Client engagement is structured through a clearly referenced framework. It is conducted directly and statistics are monitored and reported systematically. Client grading is done systematically and is a rich process; it makes reference to the client's product/service value chain and is forward-looking.

ii. Second line of defence

There is abundant guidance on integrating climate into the banks' risk management framework. This includes from the UK Prudential Regulation Authority (PRA) the GARP Risk Institute and the UNPFI. Interviews have stressed the importance of integrating climate consistently and comprehensively into the bank's risk policy, risk framework, systems and processes, and governance structure, to create a single point of reference and a 'single version of truth' for risk at the bank. Moreover, since climate risks are being significantly underestimated, the risk function can reflect this through questioning scenario model assumptions deliberately and investing in model validation capabilities.

Banking leadership (ie the board and the executive committee) clarifies consciously a meaningful climate-adjusted risk appetite statement. The climate-adjusted risk statement is all-encompassing, covering capital planning, liquidity, data, governance, and public disclosures.

Standardising competency-building and procuring minimum levels per banking function and seniority level will safeguard the quality of climate risk management and climate enabling strategies. It follows that banks should consider how to reflect climate matters in statutory conduct regimes including the FCA's Senior Managers and Certification Regime and Conduct Rules, and the PRA's expectations on managing the financial risks from climate change (Supervisory Statement 3/19), across front line and support functions. Climate matters should also form part of competence and capability considerations under the FCA's Fit and Proper Test.

The legal framework and operational complexities of managing climate data also requires that banks establish solid data governance escalating to a board committee which guides business, planning, and operational performance climate data at the bank.

Equally important as the tone at the top is the tone in the middle, as execution will eventually condition the success of climate transition. Operational business reviews and tracking performance data are key for minimising operational risk events and for safeguarding consistent climate performance across the bank.

iii. Third line of defence

The internal audit function checks the bank's performance against its targets and policies with reference to the internal control framework, for accuracy, consistency and completeness. Areas of cover abound. Indicatively, the internal audit function reviews:

a. for finance, annual disclosures and processes for adopted climate frameworks
b. for risk, the modeling validation process and the successful incorporation of stress-tests feedback
c. for compliance, the embedding of systems and processes on the basis of the bank's climate policies and statutory obligations
d. for executive remuneration and the group remuneration policy, the process of setting targets and awarding executive incentives

e. for business, the governance process of setting KPIs, plans and targets, and checking annual performance against them
f. for the board, the accuracy and process of updating dashboards and the bank's risk map

In instances where statutory frameworks are not available, the internal audit function checks that the bank has adopted credible alternative processes.

Issuing an audit report should be viewed as the beginning of an audit review, with subsequent stages comprising engagement, communication and tracking of prioritization of remedial action by executives.

Given the critical role of the internal audit function in climate transition, the board will want to sponsor visibly significant capacity and capability upgrades and a commensurate budget.

6. Back to the board

The 'tragedy of the horizon' also applies to climate implementation at banks. Reporting cycles are short and the pressure for results is intense. Average executive tenures have declined and turnover has increased. To counter this, banks can lean more heavily on the active steering and monitoring of a climate-competent and engaged board, whose 9-year layered tenure should cover the biggest part of the medium-term timeframe to 2035.

Chairs who encourage the practice of non-executive directors 'walking the floor' and engaging across ranks note an elevated level of confidence to influence the climate board agenda and to mandate additional content in board papers.

On a more experimental note, financial services firms note the benefit of instituting junior boards. This is a body of middle-management executives who feed to the main board recommendations from the tone and demographics they represent. Collateral benefits include deeper workforce engagement and alignment.

Building further on learnings from adjacent industries, bank boards may draw valuable lessons from the deeper engagement practices of successful private equity-led boards. Well-functioning majority-independent private equity-led boards tend to have a much deeper understanding of the affairs of their portfolio companies, and procure more timely and relevant interventions. Time availability and the level of director fees are practical matters that banks can address with an eye to a successful transition.

More engaged boards may also want to track statistics about the nature of their deliberations, also known as the 'meta-data' of board meetings. This can help to gage, among other things,: (a) executive failures, major executive target misses, and points of contention that are brought to the board for genuine deep-dives, honest feedback and effective steering; (b) topics for approval that are sent back to the executive body for further work; (c) time allocation to steering versus monitoring; and (d) deep-dives with the executive body's core advisers to get up to speed with material issues at the bank. Metadata can help to shed light to the nature, depth, and impact of board interventions on climate.

Remuneration has frequently been cited as the main avenue to influence climate implementation at banks. However, without clear targets, detailed plans, and robust internal controls, remuneration alone is bound to create conflicts within the first line of defence (eg, judging what should constitute priority), and between the first line and the other two lines of defence (eg, specifying and measuring risk-adjusted returns).

7. A final note on climate governance – the central role of culture

By all accounts, while governance is a critical component of climate implementation at banks, it is not a one-stop solution. Instead, governance may be better described as the 'cladding' of corporate culture. It is the thread of accountabilities that translates intentionality into specific actions and tangible results at the bank.

Banking leadership can exert considerable control over its culture for climate, by monitoring the authenticity, permeability and longevity of the corporate narrative. A dedicated culture dashboard can track positive leadership traits and innovation metrics towards climate; interviews confirmed a causal relationship with climate performance.

8. Conclusion

Governance for climate implementation at banks is a multi-dimensional subject that requires deep and lateral business thinking, and assertive initiatives to make climate targets effective. Banks can take the time to decide consciously which of the aforementioned proposals will fit their idiosyncratic circumstances best and help their organisations to gear up for what is expected to be a long and uneven path towards successful climate management.

Article 9

Effective governance of investor stewardship to support net zero: a practitioner's view

Christine Chow, Board member

International Corporate Governance Network

Introduction

In this article, we argue that effective governance within asset managers emphasises **outcomes above and beyond processes**, with

i. a values-based culture where qualified individuals throughout an organisation are empowered to address clearly, succinctly, honestly and timely the material issues identified
ii. an oversight process that sees through to solutions and/or remedial actions, and completed with adequate reporting and disclosure

Our views are based on ongoing learning in investment stewardship.

Key considerations of effective governance for investor stewardship

Effective governance starts with culture

The FCA considers the culture of a firm to be central to the way it regulates financial institutions (see Mills S (2021) and Teasdale M (2020)). Firms with a healthy culture have values-aligned decision-making processes and demonstrate strong governance that supports the daily delivery of their essential purpose.

Potential approaches: Promoting a speaking up culture is necessary but not sufficient. It needs to be combined with processes that enable the 'speak up' mechanism to deliver change with impact.

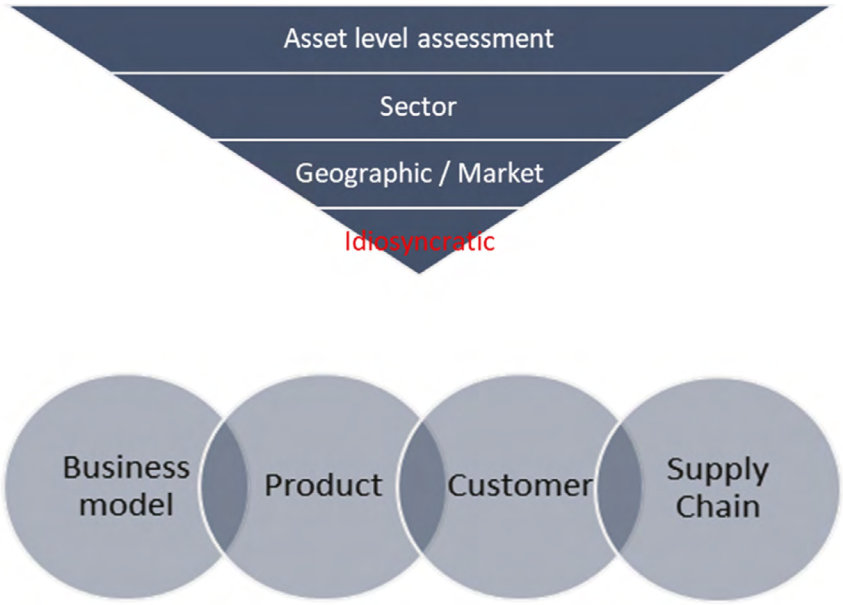
Within a global investment platform, some investment teams are likely to be more advanced on ESG knowledge and practices due to products they manage. Having regular forums where investment teams put forward 'engagement cases' for 'clinics' and even 'operations' can encourage a values-based culture that embraces ESG knowledge and deepens ESG integration, showcasing how collaboration and integration work in practice. The forum can be led by stewardship specialists curating a targeted problem-solving approach, acting as a hub of excellence for action. Discussion can highlight where success can be achieved from change, based on collective wisdom, and build further rapport among colleagues. These forums should have a structure that encourages open dialogue.

From a net zero perspective, forums like these help build on the foundational Net Zero Investment Framework (NZIF). This includes requirements to define beliefs, set investment strategy and performance objectives for portfolio managers, analysts, and other relevant personnel. A structured environment for investment teams to share best practices ensures consistent interpretation and application of net zero strategies across the business. It is important to recognise that net zero strategies will impact the entire structure of an asset manager. So all functions of an asset manager are likely to need education and continuous learning on the application and consequences of a net zero commitment.

Effective governance within asset managers covers all asset classes

The 2020 UK Stewardship Code (the 'Code') applies to all capital invested. Effective stewardship takes asset class, sectoral, geographic and idiosyncratic factors into account. To be effective, best practice would be for governance arrangements to be designed to ensure systematic, consistent and integrated assessment of all 4 levels (Figure 1).

Figure 1 Asset class based stewardship approach



Asset classes have distinctive characteristics in terms of rights and negotiation power, which impact the leverage that one can have when engaging for change.

Voting is a powerful tool for listed equities. But it is only powerful as a leverage for change if the voting rights structure reflects the economic interests of its shareholders, and if the director nomination, selection and election processes support effective governance oversight of its shareholders.

For fixed income assets, investors have the best leverage when refinancing needs are identified, and before the design phase of a bond issuance. Bonds are often issued at the local legal entity level with a distinct set of market specific challenges. In the context of achieving net zero, engagement must consider local market considerations.

For real estate and infrastructure, new and redevelopment projects should consider, for example, biodiversity due diligence and human impact assessment, according to the UN Guiding Principles for Business and Human Rights. Governance oversight can extend to indicators that reflect tenants economic progress, health and wellbeing. Further idiosyncratic considerations apply to other asset classes, including (but not limited to) private equity and venture capital.

Potential approaches: Asset managers should consider setting up asset class level committees and design an asset level investor stewardship strategy for engagement with relevant stakeholders.

Asset class level committees should have qualified members who oversee the consistency of ESG integration across asset classes. A management information (MI) dashboard should allow committee members to assess consistency in scoring methods, where applicable, such as governance assessment at group and entity levels. The MI dashboard should cover engagement objectives that reflect thematic priorities and consistency set by the asset manager in their investor stewardship strategy, plan or blueprint.

Sector research teams should identify financial materiality (ESG-in) and impact materiality (ESG-out) sustainability or saliency related issues specific to each sector. Sector research teams should also design and implement ESG proprietary scoring methodologies, if any, and oversee sector checklists that inform forward-looking sector outlook.

From a net zero perspective, high carbon intensive sectors should have specific engagement objectives. This includes engagement objectives on decarbonisation targets setting, adequacy and robustness of transition plans, appropriate climate policy advocacy, disclosure of assumptions used in scenario analysis, from issue identification, assessment, solutions and/or remedial actions to reporting and disclosure, carbon pricing and offsets strategy. A just transition approach should also be included in engagement objectives, especially if potentially stranded states or cities are involved that require large scale re-training and/or relocation. Best practice enhanced due diligence activities often involve on the ground and independent investigations. An exemplar is the Government Pension Fund of Norway. Its Council of Ethics routinely assesses companies and takes a proactive approach towards forensic investigation on thematic issues.

Geographic and market specific considerations have a material impact on outcomes of investor stewardship which are often under-estimated. From a net zero perspective, engaging with sovereigns on the availability and accessibility of renewable energy; ambitions of national determined contributions (NDC) and transition incentives are vital. Sovereign[s] engagement can be conducted in a collaborative manner, such as through Emerging Markets Investor Alliance (EMIA). It provides a shared engagement platform for investor documentation and audit purposes. Sovereign[s] engagement is highlighted as an expectation in the 2022 IIGCC Investor Statement.

Idiosyncratic risks are issuer specific conditions that impact the last mile delivery of investor stewardship outcomes. The normal process of reviewing issuer level engagement plans with regular 'clinics' conducted by experienced stewardship specialists helps to address challenges.

The overall harmonisation of all the committees identified is key. From a net zero perspective, driving a strong and clear central strategy as an asset manager would unify the committees and help with the monitoring of progress towards net zero in their respective asset classes.

Effective governance addresses conflicts of interests

Under Principles 2 and 8 of the FCA's Principles for Businesses, asset managers are required to conduct their business with due skill, care and diligence, as well as manage conflicts of interest fairly.

Asset managers are obliged to disclose their conflicts of interests' policy online. The content covered varies depending on the complexity of the asset managers' business and whether it is part of a larger financial services group. In general, asset managers that are part of a banking and/or insurance group should have more detailed policies and procedures to ensure appropriate information barriers are in place for separate businesses.

From a net zero perspective, the global banking and markets businesses of a financial services group could be an underwriter or book runner of a high carbon emissions issuer. While issuer specific details should never be shared, it is beneficial for debt originators, investment bankers and buy side investors to align on disclosure expectations within a compliant framework that upholds client confidentiality.

For the asset management business to achieve net zero, the goal is synergy between asset managers and portfolio companies to have alignment to net zero commitments. Engaging with companies to align their interests towards net zero is an opportunity to clarify asset managers' expectations of corporate management while encouraging management to take concrete actions.

Potential approaches: Effective governance can focus on alignment around the use of proceeds of green bonds and sustainability-linked bonds, pre-investment due diligence expectations and post-investment reporting requirements. This will improve resources planning at the issuer level and avoid conflicting messages on investors' expectations.

If there are different views on voting and/or engagement objectives among different investment teams, including stewardship teams, that may or may not sit in the investment function, best efforts should be made to come to an agreed position. The discussion and conclusion should be documented for audit purposes. If different views cannot be reconciled among the relevant teams, there should be a clear escalation path as part of the governance oversight.

Regular training for relevant staff should cover case studies on potential conflicts of interests tailored to the asset management business. This should cover different types of conflicts of interests, including but not limited to:

- potential conflicts with the parent company, if the asset manager is part of a large financial institutions group
- when an asset manager has to make an investment-related voting decision on both sides of a proposed merger and/or acquisition transaction
- where an employee of the asset manager is a director or influential person in the business decision-making process of an investee company
- when exercising voting rights and/or undertaking engagement activities over holdings or shares in a company that has a commercial relationship, interest, and/or connection with the asset manager and/or its affiliates
- potential conflicts with clients

Conflicts of interest policies generally state that if a client has a material impact on the business, such conflicts would need to be managed/addressed. How materiality is defined, and how often this is reassessed and reviewed, remains an open question. It is normally exercised at the discretion of each asset manager and by each investment professional within the asset manager. There should be enhanced disclosure on how such discretion is exercised, possibly with case examples to show that the conflicts of interest policies in place are functioning as intended.

Effective governance requires an appropriate incentive structure

Principle 2 of the UK Stewardship Code requires signatories to explain how performance management or reward programmes have incentivised the workforce to integrate stewardship and investment decision making.

Sustainability targets can be part of the performance scorecards for the Management Committee, including the CEO. In evaluating portfolio manager performance, the extent to which they integrate ESG can be explicitly referenced in evaluating the qualitative aspects of performance, which supports performance rating, a key input to variable remuneration alongside behaviours.

Potential approaches: Relevant incentives should be introduced to staff at all levels. This is to ensure that the way an asset manager fulfils its fiduciary duties to clients is timely and correctly reflected in the whole process.

Introducing engagement objectives within recommended performance targets for analysts and portfolio managers, for example, will require individuals to align to the asset manager's engagement approach.

Incentive-based approaches encourage a transformational investment mindset that stewardship duties and driving real-world change are an integral part of delivering holistic return to asset owners.

For asset managers committed to the Net Zero Asset Management (NZAM) initiative, growing Paris-aligned responsible investment assets should be included in the objectives, appraisal and reward of senior management, investment analysts and responsible investment staff.

When do we need more regulation?

As a result of greater commitment to ESG and responsible investing, investors, asset managers, and companies are changing their reporting practices to better reflect their commitment to sustainability. From a net zero perspective, investors may expect regulation to support accountability and transparency throughout the whole value chain. Currently, regulation is focused mainly at the role of the asset manager, such as the Sustainability Disclosure Requirements (SDR) and investment labels classification system currently being consulted on by the FCA. Consumers and investors face broader challenges when it comes to accountability of service providers involved at different stages of the value chain, eg index data providers and ESG rating agencies. Investors may look out for increased oversight of internal controls for those involved in the value chain, and governance is needed around the way data is sourced, used and communicated to investors and regulators in reporting.

Conclusion

Many in the asset management industry have embraced net zero commitments, but this is only the beginning of a long transition to net zero by 2050. We are confident that all stakeholders (public and private sectors) will continue partnering to ensure net zero targets are reached, and the effectiveness of governance in investor stewardship is a key factor for a successful transition.

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Article 10

Preventing greenwashing: time to stop marking our own homework

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Pressure is mounting on firms to ensure credible, meaningful and accountable net-zero pledges. This was underscored by the United Nations Secretary-General Antonio Guterres at the recent UN Climate Conference (COP27), who stated 'We must have zero tolerance for net-zero greenwashing.'

As Chair of the UK's Green Finance Education Charter (GFEC), which brings together 14 leading professional bodies representing nearly 1 million finance professionals I welcome recent regulatory initiatives – including those from the FCA – that aim to deter and prevent greenwashing. They will help root out instances of deliberate greenwashing, but I am afraid this is only the tip of a rapidly melting iceberg. Inadvertent greenwashing should be of much greater concern. In my view this is a much greater threat to the integrity of sustainable finance, and to the objective of aligning finance and sustainability to the point where, as UN Special Envoy Mark Carney stated in the COP26 Private Finance Strategy, '... every professional financial decision takes climate change into account.'

Inadvertent greenwashing

To address inadvertent greenwashing we first need to recognise it. Inadvertent greenwashing can take many forms. It is perhaps best understood as occurring when professionals and firms unknowingly mislead consumers, clients, investors and others; and/or fail to consider the full range of ESG factors and associated benefits and harms. For example:

- Highlighting positive environmental or broader sustainability benefits and impacts while failing to consider associated environmental and/or social harms (for example, the biodiversity and community impacts of a large onshore wind development).
- Describing an activity, product or service as 'green' or 'sustainable' without adequately measuring, monitoring and verifying outcomes – or relying on the unverified claims of others – so the environmental and sustainability benefits (and harms) are not truly understood.
- Making public commitments to sustainability that are not backed by consistent action and/or are contradicted by an organisation's activities elsewhere (for example. where a global bank makes public commitments to increasing its green lending, but a subsidiary continues to fund businesses that engage in large-scale deforestation).

This doesn't of course, excuse greenwashing, but can help explain it. In an ideal world, inadvertent greenwashing would not occur, because finance professionals would have the requisite ESG knowledge and skills needed to inform their professional judgement and scepticism and act accordingly. As the examples above show, however, this is a complex area; the world does not divide neatly into 'green' and 'brown' and the ESG sector continues to evolve rapidly, adding to this complexity, especially as wider issues of biodiversity, social factors and the just transition (moving to a more sustainable economy that is fair to everyone) come to the fore. Ensuring that finance professionals have the knowledge and skills required to support decision-making and understand the financial and sustainability outcomes these lead to is essential. As is building firms' capacities, capabilities and cultures to support the fast-growing and constantly evolving ESG sector.

Building ESG capacity, capability and culture

This does not mean, however, that all finance professionals need to be ESG specialists – far from it. Finance professionals should continue to be finance specialists first and foremost. An appropriate knowledge of climate change and sustainability should be included within training and competency requirements for accountants, actuaries, advisers, bankers, insurers, investment managers and others. Professional bodies, including the GFEC signatories, are already doing this; in fact, other bodies and educators from around the world look to the UK professional bodies for direction and guidance.

The objective is not for finance professionals to become experts in sustainability themselves – firms will employ ESG specialists, build specialist climate and ESG teams and work with a wide range of external experts, as necessary. Rather finance professionals need to develop and demonstrate an understanding of sustainability relevant to their role, and apply this in areas including:

- Working with a wide range of subject matter experts, knowing when external expertise is required, identifying the right questions to ask and understanding responses.
- Identifying and managing climate and sustainability risks both to their own firms, and those faced by customers and clients.
- Supporting the development and implementation of customers' and clients' transition plans and helping them take advantage of opportunities from the transition.
- Understanding the potential outcomes – environmental and sustainability impacts, and financial impacts – of alternative courses of action, and lending and investment decisions.
- Forming and communicating the professional judgements required to avoid both deliberate and inadvertent greenwashing.

Working with firms and their members, GFEC signatories have all incorporated ESG into professional qualification and CPD programmes and – given the pace of change in this area – continue to rapidly develop these. We are currently conducting research with a wide range of UK employers to understand evolving knowledge and skills requirements, with the aim of updating these further. Results should be available early in 2023. While specific knowledge and skills requirements vary between professions, a common core of knowledge for all professionals has already emerged. Some examples are provided in the box below.

Box 3

ESG knowledge requirements for finance professionals

- a basic understanding of the science of climate change (and, increasingly, wider environmental issues such as biodiversity)
- awareness of the impacts of climate change on the environment, economy and society
- an understanding of the cross-cutting nature and importance of climate, environmental and social sustainability risks (physical and transition)
- knowledge of the impacts and opportunities of the transition to a sustainable, low-carbon world
- cognizance of the evolving regulatory and standards frameworks
- familiarity with the financial products and services that support the transition
- appreciation of the role of the individual professional in supporting clients and customers and taking active steps to prevent inadvertent or deliberate greenwashing

ESG skills requirements for finance professionals

- **collaboration** – to work in partnership with a wide range of environmental and other professionals to develop climate and sustainability solutions, verify impacts and targets, identify and disclose climate, environmental, social and governance risks and support their customers and clients
- **communication skills** – to support the collaboration required to work with a wide range of customers, clients, communities, partners and stakeholders
- **creativity** – to design the innovative climate and financial solutions we need
- synthesis – to bring together and make sense of the wide range of data, knowledge and information required
- **data analysis and visualisation** – to use the increasing array of sustainability data to effectively support lending, investment and decisions
- **leadership** – to align organisational strategies and cultures with society's goals as expressed in the UN Sustainable Development Goals and the Paris Climate Agreement; not just leadership in the boardroom but at all levels throughout organisations

This developing body of knowledge and skill does not necessarily imply new qualification requirements for finance professionals, although these may be required in some specialist areas. Rather, these topics should be included in updated professional qualifications for those joining the finance sector; existing professionals can develop their knowledge via CPD. As we demonstrate in our first Progress Report, GFEC signatories have led in this area. Nearly 110,000 professionals enhanced their green and sustainable finance knowledge and skills in 2021, building the ESG capacity, capabilities and sustainability-aligned cultures within firms and professions.

Competence greenwashing

Alongside professional bodies, many firms undertake their own education and training to build capacity and capabilities to support customers and clients and take advantage

of opportunities in the fast-growing ESG sector. There has been rapid growth in training provision, especially 'bite-size' and 'just-in-time' training designed to be delivered quickly, when required. All education and training in this area is welcome, but the approach of some firms and providers leads to accusations of 'competence greenwashing'. This term was coined by Kim Schumacher, in 2020, to describe where short, foundational training that raises awareness of ESG issues is oversold as developing competence and expertise, damaging integrity and eroding trust.

Examples of this include a consultancy firm offering 45-minute online sustainability training programmes to all its employees, and a bank that gives its employees a 1-hour e-learning course. On the one hand, this is as a positive start, but on the other, finance professionals need to know much more than this, as set out above. Would you trust someone to sell you a mortgage or pension if they had only completed a 1-hour training course? My guess is probably not. We must be mindful of individuals rebranding themselves as sustainability experts, as well as firms who rebrand consultants and advisers as sustainability specialists. Competence greenwashing is as serious a threat to the integrity and future growth of ESG as greenwashing itself. In fact, it enables and facilitates the latter.

Enhancing trust and transparency

There is an opportunity to address this through regulatory levers both in the UK and internationally, however, by ensuring that firms are no longer allowed to 'mark their own homework' by certifying the ESG competence of their staff themselves. If we want to ensure finance professionals are genuinely competent in ESG-related areas relevant to their role – and I think we should, for the reasons outlined above – there needs to be independent, expert assurance, verification and (where appropriate) certification of ESG training and competence.

This is consistent with the general approach to the assurance and verification of environmental and other sustainability outcomes that underpins many of the regulatory and market standards, frameworks and guidance in the ESG sector. It is also consistent with two of the themes in the FCA's ESG Strategy; '... building trust and integrity in ESG-labelled instruments, products and the **supporting ecosystem**' [my emphasis], and '... promoting transparency on climate change and wider sustainability ...'.

Collectively the UK's professional bodies have the appetite, expertise and resources to support this, complementing firms' education and training activities to certify that individuals have the requisite ESG knowledge and skills relevant to their role. This also supports the FCA's objectives of ensuring the integrity of the ESG sector and maintaining consumer, client and counterparty confidence and trust. Similar partnerships between regulators and professional bodies are emerging in other leading financial centres, and the UK must not fall behind if we are to achieve the Government's and finance sector's ambitions to make the UK the world's first net-zero aligned financial centre and the global hub for sustainable finance.

Annex 1

Questions used in this paper

Chapter 3 – ESG governance, remuneration and incentives in regulated firms

Q1: 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.

Q2: 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.

Q3: 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?

Q4: 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?

Q5: 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?

Q6: 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.

Q7: 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?

Q8: 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.

Please explain your views.

Q9: Should we consider additional regulatory expectations or guidance in any of the areas considered in Q8? Please explain your views.

Q10: 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.

Q11: 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.

Chapter 4 – Training and competence in regulated firms

Q12: 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?

Q13: 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.

Q14: 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?

Q15: 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.

Annex 2

Abbreviations used in this paper

Abbreviation	Description
BEIS	The Department for Business, Energy, and Industrial Strategy
CA100+	Climate Action 100+
CCC	Climate Change Commission
CDP	Collateralized Debt Position
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CP	Consultation Paper
CPD	Continuing Professional Development
CRO	Chief Risk Officer
CSO	Chief Sustainability Officer
CSR	Corporate Social Responsibility
D&I	Diversity and Inclusion
DP	Discussion Paper
DWP	Department for Work and Pensions
EBRD	European Bank for Reconstruction
EFRAG	European Financial Reporting Advisory Group
EMIA	Emerging Markets Investor Alliance
ESG	Environmental, Social and Governance
FCA	Financial Conduct Authority
FRC	Financial Reporting Council

Abbreviation	Description
FSMA	Financial Services and Markets Act 2000
FSB	Financial Stability Board
FTSE	Financial Times Stock Exchange
GARP	Global Association of Risk Professionals
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GFANZ	The Glasgow Financial Alliance for Net Zero
GFEC	The Green Finance Education Charter
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
IAIS	The International Association of Insurance Supervisors
ICGN	International Corporate Governance Network
ICSWG	Investment Consultations Sustainability Working Group
IIGCC	Institutional Investors Group on Climate Change
INED	Independent Non-Executive Director
IOSCO	International Organization of Securities Commissions
IPCC	Intergovernmental Panel on Climate Change
ISSB	International Sustainability Standards Board
ITR	FTSE Russell's Implied Temperature Rise
KPIS	Key Performance Indicators
LBS	London Business School
LSEG	London Stock Exchange Group
LTIP	Long Term Incentive Plan
MAS	Monetary Authority of Singapore
MIFIDPRU	The Prudential sourcebook for MiFID Investment Firms

Abbreviation	Description
MI	Management Information
MQ	Management Quality Scores
NDC	National Determined Contributions
NGOS	Non-Governmental Organisations
NZAM	Net Zero Asset Management
NZIF	Net Zero Investment Framework
PBAF	Partnership for Biodiversity Accounting Financials
PCAF	Partnership for Carbon Accounting Financials
PLSA	Pensions and Lifetime Savings Association
PRA	Prudential Regulation Authority
PRI	Principles for Responsible Investment
PS	Policy Statement
PwC	PricewatershouseCoopers
PROD	Product Intervention and Product Governance Sourcebook
RACI	Responsible, Accountable, Consulted and Informed
SBTI	Science Based Targets Initiative
SDA	Sectoral Decarbonisation Approach
SDR	Sustainability Disclosure Requirements
SEC	US Securities and Exchange Commission
SFDR	Sustainable Finance Disclosure Regulation
SM&CR	The Senior Managers and Certification Regime
SMF	Senior Management Functions
SOR	Statement of Responsibilities
SPS	Statements of Professional Standing

Abbreviation	Description
SYSC	Senior Management arrangements, Systems and Controls
TC	Training and Competence Sourcebook
TCFD	Taskforce on Climate-related Financial Disclosures
TPI	Transition Pathway Initiative
TPI CP	The Transition Pathway Initiative's Carbon Performance
TPI MQ	The Transition Pathway Initiative's Management Quality
TPT	Transition Plan Taskforce
WEO	World Energy Outlook
UK	United Kingdom
UKSIF	UK Sustainable Investment and Finance Association
UNEP FI	United Nations Environment Programme Finance Initiative
UNPFI	United Nations Programme Finance Initiative

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