Sustainable Finance in 2023 - "UK ESG regulatory requirements and scrutiny will continue to develop rapidly"

2023 will see further UK ESG regulatory requirements coming into force (having been previously consulted on) or being confirmed. These requirements will be across all financial services sectors and cover entity- and/or product-level disclosures. In summary key ones are:

- **UK TCFD disclosures for standard listed companies and larger asset managers** will begin to be reported in 2023.
- **UK TCFD disclosure requirements will apply to more asset managers, life insurers and pension providers** in 2023 for reporting in 2024.
- **UK Transition Plan Taskforce (TPT) to issue final framework and implementation guidance** in 2023 to assist financial services firms in preparing Transition Plans.
- **UK product level Sustainable Investment Labels and Sustainability disclosure requirements (SDR)** – An FCA Policy statement will be issued in 2023 and first reporting provisionally set for June 2024.

This article will focus on the more recent UK regulatory announcements (SDR and the work of the TPT). It will also briefly cover the UK government's Sustainable Finance announcements at the Edinburgh Reforms including the latest on ISSB Sustainability standards, and the PRA's recent publication of its insurance supervision priorities for 2023.

Sustainability Disclosure Requirements (SDR)

The FCA issued CP22/20 in October 2022 on Sustainability Disclosure Requirements and Investment Labels.

The SDR is explicitly targeting greenwashing concerns and how those concerns can hamper investment in sustainably targeted financial products. The primary aims of the consultation are to help consumers navigate the complex sustainability investment product landscape and to enhance consumer trust in a market where there are growing concerns that firms may be making exaggerated, misleading, or unsubstantiated sustainability-related claims about their products.

The FCA has further targeted greenwashing concerns by i) proposing restrictions on product names and marketing materials for products that do not have sustainable labels; and ii) proposing a general anti-greenwashing rule that would make it easier for the FCA to challenge firms that they consider are potentially greenwashing.

We are often asked how the SDR differs from the SFDR. The SDR and SFDR are different approaches for enabling consumers to identify investment products that contribute positive environmental or social characteristics/outcomes. The SDR is a label-focused approach containing detailed criteria that firms and products must satisfy before they can use a sustainable investments label. The SFDR is a disclosure-focused approach where all investment products describe how its stated level of sustainability ambitions are to be achieved or are achieved.

The approach taken by the FCA, to actively set criteria for classifying and labelling sustainable funds so that such funds can be easily identified in the investment landscape is an important approach to create consumer trust and direct greater capital to sustainable activities.

The key challenges for firms in implementing the FCA's proposals will be:

i. navigating the detailed criteria that firms must meet to qualify for certain sustainable investment labels (i.e., the five overarching principles and set of cross-cutting considerations) and ensuring that they have processes, policies, systems and controls to evidence implementation;
ii. being able to disclose meaningful information on those criteria in the subsequent disclosure documents; and
iii. producing a sustainability entity report.

The consultation closed on 25th January. The intention is to publish a policy statement in H1 2023 and for the rules to come into force from June 2023. The first disclosures would be reported in June 2024. These timelines seem quite feasible given that the FCA already published a Discussion Paper on investment labels last year and has reflected stakeholder feedback in CP22/20. Also, market mood-music towards the proposals is generally positive.

UK Transition Plan Taskforce (TPT)

The UK government announced the establishment of the TPT in November 2021. To align with COP27, in November 2022 the TPT published for consultation it's Disclosure Framework and accompanying Implementation Guidance.

What are Transition plans and why are they important? A climate Transition Plan forms one part of a firm's climate related disclosures. It sets out a firms' plan to contribute to and prepare for a rapid global transition towards a low GHG-emissions economy. Therefore, it creates greater transparency on financial services firms to explain their approaches, speed, and commitment towards funding a net zero economy.

To create a Transition Plan the TPT presents a disclosure Framework based on three guiding principles: *Ambition; Action and Accountability*.

The TPT recommends that a good transition plan should cover:

1. an entity's high-level *ambitions* to mitigate, manage and respond to the changing climate and to leverage opportunities of the transition to a low GHG and climate resilient economy. This includes GHG reduction targets (e.g., a net zero commitment);
2. short, medium and long-term *actions* the entity plans to take to achieve its strategic ambition, alongside details on how those steps will be financed;
3. governance and *accountability* mechanisms that support delivery of the plan and robust periodic reporting; and
4. measures to address material risks to, and leverage opportunities for, the natural environment and stakeholders such as the workforce, supply-chains, communities or customers which arise as part of these actions.

What management should consider

Accompanying the Framework document is an Implementation Guidance document, which firms should review very carefully. This outlines four key stages in preparing a Transition Plan:

STAGE 1: BASELINING CURRENT POSITION - Preparing a transition plan is about understanding an entity's current position using the foundations laid by the TCFD: performing a stocktake on the entity's exposure to climate-related risks and opportunities, its current emissions profile and the levers at its disposal to transition.

STAGE 2: SETTING AMBITION - Management examine their level of ambition to contribute to and prepare for global transition to a low-carbon economy that is resilient to the changing climate.

STAGE 3: DEVELOPING AN ACTION PLAN - In developing a transition plan, an entity can be expected to translate their long-term targets into concrete short-, medium- and long-term actions.

STAGE 4: ENSURING ACCOUNTABILITY FOR DELIVERY - Transition plans should be underpinned by clear accountability mechanisms to enable and monitor delivery.

The TPT consultation closes on 28th February 2023 and the Final Disclosure Framework and Implementation Guidance is expected to be published in Summer 2023. As one of the first countries to progress Transition Plans at a national level and an expectation that they will become even more formalised into regulations in due course, it is important that the UK is mindful that in being a first-mover it remains aligned with the international direction on the purpose and content of TPs for practical implementation and comparability.

Given the importance of transition plans to the climate disclosure agenda we will have a more detailed analysis of the TPT and what it means in a future publication.

The UK Government's *Edinburgh Reforms* and Sustainable Finance

In December 2022, the Chancellor of the Exchequer announced a set of reforms to drive growth and competitiveness in the financial services sector. These are known as the Edinburgh Reforms and Sustainable Finance is one of the four key themes. The steps that were announced were:

An update to HMT's Green Finance Strategy in early 2023. The strategy document will take stock of progress so far and intended next steps for the UK to become the world's first net-zero aligned financial centre. To substantiate this, we expect the document will emphasise recent regulatory policy proposals, such as those on Sustainable Investment Labels, Transition Plans, and provide more clarity on the UK's process to introduce UK-adopted ISSB's sustainability-related disclosure standards once the ISSB has finalised their standards in 2023. The ISSB made its announcement about finalising the standards at COP27 in November 2022. Also, the strategy document is likely to discuss how financial services can support UK energy security through financing clean energy solutions and developing natural capital markets for nature-based objectives."

ESG Ratings providers. In Q1 2023 we will see an HMT consultation on bringing ESG ratings providers into the financial services regulatory perimeter. The FCA has already indicated in a recent Feedback Statement that it sees a clear rationale for regulatory oversight of certain ESG data and rating providers – and for a globally consistent approach informed by IOSCO recommendations. To demonstrate that the FCA takes the role of ESG ratings seriously (but recognises that it will take time to pass through primary legislation and then an FCA consultation) the FCA has recently decided to convene and support an industry-led group to develop a voluntary Code of Conduct for ESG data and ratings providers.

PRA Insurance Supervision 2023 priorities and financial risks from climate change.
In January this year, the PRA published its supervisory priorities for 2023. This includes Financial risks arising from climate change. The PRA plans to assess Firms' ability to meet the PRA's supervisory expectations on an ongoing basis through supervisory engagement, firm-specific deep dives, and thematic work. Firms are expected to demonstrate how they are responding to PRA expectations and set out the steps to address barriers to progress. This follows on from the expectations set out in the supervisory statement SS3/19 and the Dear CEO letter published in October 2022.

What management should consider

ESG requirements have no sign of slowing and regulatory and investor scrutiny will continue to develop. So what do all of these developments mean for firms' ESG plans and implementation?

- Firms need to prepare now the systems, controls, governance, risk and data management practices, processes, and policies to ensure they can meet ever increasing ESG scrutiny. Identifying, embedding, managing, and reporting climate-related risks brings new challenges for firms compared to managing traditional business risks (e.g., reliable data and modelling scenarios), thus making it even more important that firms start preparing.
- Financial services firms will have to demonstrate deeper interaction with, and monitoring of, investee companies' ESG credentials. This is so they can use that information for their own regulatory reporting, satisfy investment label criteria and ensure they don't fall foul of greenwashing risks/concerns.
- The plethora of requirements means that firms are often subject to multiple ESG reporting requirements for different purposes. This results in ESG material being prepared for multiple public documents and in several locations (websites; financial accounts; capital raising material and product-level fund material). This emphasises how important it will be for firms to have robust risk management, governance, compliance, and data management processes in place to manage ESG disclosures across multiple locations.

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