Environmental, Social and Governance (ESG) Division
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

12 April 2023

AFM Response to FCA DP23/1, Finance for positive sustainable change

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

- Comment on the proposals,
- Provide context from smaller insurers, and
- Explore the consequences for members of AFM and their customers.

About AFM and its members

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not-for-profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 32 million people in the UK and Ireland, collect annual premium income of over £22 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

[1] ICMIF and AFM, 2022: https://financialmutuals.org/wp-content/uploads/2022/10/UK-Market-Insights-2022.pdf
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

AFM comments on the proposals

4. We welcome the opportunity to respond to this discussion paper. The paper raises some very significant issues about the way that financial services firms are governed in the future, and how they re-set their strategies to add greater focus on sustainability.

5. As customer-owned organisations, many of which have been in business for 200 years or more, we have a strong commitment to working in the best interests of consumers and communities. Our response has drawn on a wide range of evidence from our sector of the actions our members are taking on ESG-related issues.

6. Where most of the FCA analysis, and the articles included in the Discussion Paper, are drawn from an analysis only of very large organisations, we consider it is vital that FCA undertakes more balanced research. We consider that FCA can only establish credible and realistic goals for financial services firms' sustainability work, once it has undertaken a much more extensive study, which considers differences in the business model, nature, scale and complexity of regulated firms, and the differing consequences new FCA interventions will have.

7. We have responded to the specific questions raised in the consultation below, and would welcome the opportunity to discuss further the issues raised by our response. We are happy to be included in the published list of respondents.

Yours sincerely,

Martin Shaw
Head of Policy
Association of Financial Mutuals

Our responses to the questions raised in the consultation

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.

One need hardly read the newspaper or watch the news to realise that it is increasingly necessary for all financial services firms to adopt active approaches to sustainability within their business strategy. This is not only due to the growing global concern over climate change and environmental degradation, but also because it makes good business sense. Customers, investors, and regulators are increasingly demanding that businesses operate sustainably, and those that fail to do so may find themselves at a competitive disadvantage.

In this way, the scope a firm adopts is likely to include not only the environmental impact of a firm's activities, but also its social and governance impacts. This means considering issues such as diversity and inclusion, human rights, and ethical behaviour. And to enable regulated firms to adopt an appropriate approach and to take effective action, the expectations should be clear and specific, and regulators should provide guidance to ensure that firms understand what is expected of them.

It is important to ensure that the regulatory approach adopted is proportionate and does not place an undue burden on small businesses. FCA should ensure that any new rules or guidance are practical and achievable, taking into account the business model, size and complexity of all regulated firms. It is also important to avoid creating a one-size-fits-all approach; instead, regulators should provide guidance that allows firms to tailor their approach to focus on high-level outcomes and to avoid controversial or contentious topics.

There is a plethora of agencies, both in the UK and beyond, exploring climate-related standards, and these are being quickly added to with other sustainability initiatives. Whilst the sheer weight of thinking in these areas is contributing to a better understand of what good ESG looks like, the vast amount of material produced risks being confusing and duplicative, and potentially contradictory. For example, a recent report by EY into the climate transition plans for FTSE 100 companies, showing that only 5 per cent had credible or detailed plans, received widespread media coverage[4], though other reviews have been more positive.

Given FCA and PRA are taking on a new regulatory principle in this area, it is vital that the regulators themselves provide a unified approach, and that they develop standards that are recognisably appropriate to all regulated firms, and which set

[4] For example, see: https://www.ft.com/content/5bc9bdf5-1e13-4a53-ab90-e71d9fb6c759

overall standards for firms; for small firms in particular this is the only way to ensure a co-ordinated and consistent effort.

It is important in so doing that standards established by FCA/ PRA are not an accumulation of 'best of breed' standards developed elsewhere, but are instead a credible set of goals that reflect differences in business model, scale and complexity of businesses.

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.

Yes; guidance on how a firms' culture and behaviours can better support change will help inform commitments to sustainability. Guidance though should take account of the natural disposition and commitments firms, including mutuals, might already have to sustainability, and should not therefore imply that change to the existing culture is necessary.

While FCA's ongoing work on diversity and inclusion, as well as the Consumer Duty are important, it does not yet ensure that all firms are fully committed to sustainable practices. For example, most of the current focus of work on diversity and inclusion is directed towards larger firms, and it is not yet clear whether and how FCA will extend that to all regulated firms.

Regulatory expectations might seek to embed sustainability considerations into firms' business objectives and strategies, as well as to promote transparency and accountability. FCA should provide guidance on the specific actions that firms can take to create such a culture, and they should monitor and enforce compliance with these expectations.

Guidance and expectations should be proportionate and not overly prescriptive, as this may be difficult for smaller firms to implement. Regulators should also consider providing support and guidance to smaller businesses to help them develop a culture of sustainability, rather than imposing regulatory requirements that may be difficult for them to meet.

As customer-owned organisations, mutuals have a clearly stated purpose, that reiterates how their strategy is geared towards delivering good outcomes for their members. The values of a mutual business clearly align with this, in a way that is not possible in a shareholder-owned business. Any FCA guidance therefore needs to account for business model if it is to provide proper clarity and context.

Amongst AFM members we have taken a strong interest in culture, as well as in diversity and inclusion. The AFM Corporate Governance Code sets out a model of good governance that fits the business model of mutuals, by transposing the

PLC-centric FRC Code, and PRA's board responsibilities, into a mutual framework[5]. AFM members set out in their report and accounts how they have applied the Code in the previous 12 months. In addition, the Mutual Diversity Alliance supports the members of AFM in making meaningful progress on diversity and inclusion[6]. It includes an expectation of members to report each year on progress, and recently we agreed to make it a sectorwide initiative.

In our view, greater transparency, on sustainability, culture and diversity are the areas where greater regulatory guidance would be most valuable. This preserves the role of the Board in setting the right tone and agreeing internal policy, but also anticipates that the board will give a proper account of its work. The AFM Corporate Governance Code adopts an 'apply and explain' basis, and we believe this is an effective way of encouraging firms to explore constructively a range of governance issues.

Some firms are reluctant at this stage to publish significant material via their report and accounts, as this may bring an expectation that voluntary reporting will be incorporated into the formal external audit. As the cost of audit is accelerating at an alarming rate, our members are reluctant to overcommit and add extra costs that are not mandated. However, where we are committed to high standards and transparency, formal guidance will give firms greater confidence. For example, the Government mandated requirement for large firms to publish their tax strategy has brought welcome clarity to how organisations structure their tax affairs, and is largely principle-driven[7].

Whilst only one of the AFM members we reviewed for last year's report had received a formal audit review of its climate change statements, we expect that more will do so in future.

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?

Amongst the steps firms might take, to ensure that they have the right skills and knowledge available to their board are: appointing directors with relevant expertise and experience; providing training for board members; and establishing internal reporting mechanisms to ensure that the board is informed about sustainability issues. We believe it would not be appropriate for FCA and/ or PRA to set quotas for board members with these skills: in many cases, the requisite skills can be provided by expert advisors to the board rather than directors themselves. In any

[5] https://financialmutuals.org/wp-content/uploads/2022/09/AFM-corporate-governance-code-jan19.pdf
[6] https://financialmutuals.org/events-training/mutual-diversity-alliance/
[7] https://www.gov.uk/guidance/large-businesses-publish-your-tax-strategy

event, the lack of recognised qualifications in this area mean that firms have to apply a subjective assessment of an individual's capacity.

While it is important for firms to have the right skills and knowledge of sustainability-related risks available to their board, the burden this may place on smaller businesses is significant, both in recruiting new directors and in meeting their remuneration expectations. It is important to ensure that regulatory guidance is proportionate and practical, taking into account the business model, size and complexity of the business. It should be noted that the Deloitte's report referred to in paragraph 3.28 results from a review of FTSE 100 firms, whose governance structures have very little in common with a small mutual.

A board should be expected to assess for itself the skills and knowledge of its directors, and to satisfy itself that the board can effectively monitor the effectiveness of a sustainability-led strategy. Ultimately it will be for the management of the organisation, rather than the board, to execute the strategy, and the right skillset within the executive team is equally important.

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?

Embedding climate- and sustainability-related considerations across a firm's operations requires a comprehensive and integrated approach. Initiatives such as the appointment of functional 'champions' and the creation of dedicated working groups or forums can be effective in ensuring that sustainability considerations are integrated into decision-making processes. These initiatives can provide a platform for employees to share ideas, collaborate, and drive change.

The potential benefits include improved employee engagement, increased innovation, and enhanced reputation. To enhance the value of these initiatives, firms should ensure that they are adequately resourced, that there is clear leadership and accountability, and that they are integrated into the broader business strategy. FCA can also play a role in encouraging and supporting these initiatives, for example, by providing guidance on good practice, and by recognising and rewarding firms that demonstrate leadership in this area.

Whilst initiatives such as the appointment of champions and the creation of working groups can help embed sustainability across a firm's operations, FCA should be wary of overloading the business. There are already prescribed champions in many areas, and for small firms there is a risk that a small number of people wear too many champions' hats, and that the role is devalued as a result, or that there is conflict between the champion and the comparable SMF role.

It would be very helpful if FCA could develop some examples or analysis of smaller firms that are leading the way on this, since the exclusion in the analysis of anything but the largest listed companies does little to help small mutuals to understand what is achievable, or to incentivise them to act. We recommend FCA sets aside some of its existing project resources to considering corporate diversity and its impact of adopting the standards FCA is exploring.

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?

In paragraph 3.10, the paper highlights that "it is increasingly expected that firms include Scope 3 emissions in their targets". We recognise the significance of this: in its 2021 ESG report, the insurer AIG estimated that 1% of its emissions came from operations (i.e. scope 1 and 2), 48% from underwriting, and 51% from its investments[8]. Unless other insurers produce similar analysis, it is difficult to judge whether those ratios are typical of insurance more generally (as a general insurer, the emissions from underwriting are likely to be significantly greater than for life companies).

For small insurers, obtaining useable data on scope 3 emissions is very difficult. All AFM members outsource investment management, and therefore rely on data from their asset manager to set out the emissions of their investment portfolio; for insurers with a significant property portfolio, there are added difficulties in collecting data.

Even if that data was available, there is little consistency between asset managers on the presentation of data, and too many competing systems for assessing emission levels. Hence, even the data supplied by AIG, as featured above is heavily caveated.

Amongst AFM members, we undertook a review of reporting on climate change and social impact in our members' 2021 report and accounts, as part of a wider review of corporate governance standards in the sector[9]. The analysis should that most climate change reporting was quite rudimentary, and that the approach varied significantly. This is undoubtedly because TCFD standards and similar do not apply to small businesses, but also because regulatory standards, such as PRA SS3/19, are high level.

[8] https://www.aig.com/content/dam/aig/america-canada/us/documents/about-us/report/aig-esg-report_2021.pdf.coredownload.pdf, p.39
[9] https://financialmutuals.org/wp-content/uploads/2022/10/AFM-Report-on-Corporate-Governance-2022.pdf, pages 14-20

In our analysis, we found 18% of members had applied a TCFD-based approach, but that none were able to review all elements. 22% explicitly committed to making their overall business net-zero by 2050, though we would expect this to rise once there is acceptance that insurers should be making that commitment explicitly in their report and accounts. There was also significant variation in the nature of action being taken: for example as the table below shows, 55% indicated they were acting to increase energy efficiency, but only 5% stated in their report and accounts how they were acting to reduce their water usage.

Activity	Action	*Example or explanation*	What proportion of reports referenced
Operational	Increase energy efficiency	*Also includes use only of green energy*	55%
	Recycling and use of sustainable products	*Such as banning single use plastics*	41%
	Reduced use of paper and waste	*And moving to sustainable print options*	64%
	Business travel	*Includes fleet and working from home*	36%
	Reducing use of water	*Within the business*	5%
Investment portfolio	Manager's strategy	*Working together to develop strategy*	73%
	Manager's reporting	*Securing the information needed to inform decisions*	45%
	Manager's voting	*Setting out expectations on issues to vote on*	5%
	Property portfolio	*Insulation or other action on rental estate*	18%
Products	Changes to own products	*Including new products or funds, and changes*	41%

Reporting on their social impact was more variable still, with most AFM members focused on summarising the range of stakeholders that they engage with or account to (as per s.172 requirements), and rather less on how.

In preparing the AFM report, we also collected data from members on their board remuneration and on board composition, including a focus on D, E& I at Board level. We also collected data on gender pay rates: as almost all AFM members are too small to meet the 250-employee threshold for publishing this data, the results were only produced in aggregate.

We conclude from our report and analysis that firms are constricted in what they can confidently disclose, both by lack of agreed standards, and a lack of suitable data; furthermore, the cost of obtaining data is another complication. As a results, AFM members- in common with most small firms- take a cautious approach to reporting, and do not have access to much of the data that FCA's analysis of large banks and insurers refers to. As a result, we see little value at this stage of setting guidance on the use and controls on MI, or of imposing audit trails.

Instead, we conclude a more helpful focus for FCA is in seeking solutions to the significant gaps in data availability and standards, and for producing templates to extract that data. This is particularly necessary within the asset management sector: small insurers currently only have reliable access to scope 1 and 2 emissions data, and if the AIG analysis is correct (as well as the x700 multiple from CDP quoted in the FCA paper), this is a minute fraction of the total. In other words, however many energy-saving bulbs firms fit, and however many plastic cups they banish, those efforts sit at the tip of a very large iceberg that needs to be uncovered.

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.

As the paper notes, for dual-regulated firms, including AFM members, there is an existing governance structure for managing climate change risks, and PRA's assessment is that this is working effectively. We consider that PRA and FCA should agree whether this structure can be extended to cover sustainability risks, rather than the climate change specific risks currently covered. If it does, firms may need to consider whether any change to the SMF holder is necessary: for example, where extra layers of risk are added, it may be better to expect the CRO (in firms that have one) rather than the CEO to take day-to-day responsibility.

The announcement by the Chancellor, in the Edinburgh Reforms, to review SMCR means any broader proposals here should be considered in light of that review. In the meantime, the suggestion in paragraph 3.48 that the CEO should be the leader on sustainability topics, and that firms should have a 'Sustainability function', is unlikely to be practical except in the largest of financial services firms.

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?

The treatment of products with sustainability characteristics should be discrete and specific. In many ways it is like the standards set for organic produce in supermarkets: the Food Standards Agency may seek to set standards for all food producers to raise production standards, but not for the same standards to apply to organic and non-organic production.

In financial services, firms that do not offer products marketed as being sustainable would not expect their own product governance rules to be affected by new standards set for those firms that make sustainability claims. Equally, for a firm that markets a mix of sustainable products and more traditional products, its governance approach should differ, and separate standards for sustainable products should not set higher standards for traditional products, which are likely to be more cost-sensitive.

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:

- *the case for linking pay to sustainability-related objectives*
- *whether firms should break down their sustainability-related commitments into different factors, allocating specific weightings to each*
- *whether short-term or long-term measures are more appropriate, or a combination of both*
- *whether sustainability-related incentives should be considered for senior management only, or a wider cohort of employees*
- *how firms could consider remuneration and incentive plans in the design and delivery of their transition plans*
- *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.

There is a growing interest in how firms develop sustainability plans, and how they incentivise employees to drive them forward. A more sustainable business is likely to be lower cost, and managers may therefore be inclined to reward good behaviours. For insurers, sustainability may be enhanced by a 'prevention rather than cure' and a 'right first time' approach, which reduces resources allocated to business processing and claims, and as a result lowers costs and increases profitability.

More work is needed to help firms identify measurable sustainability-related objectives, and how these can be applied to individuals. More detailed case studies from FCA on firms that have already done this would be useful.

AFM Associate member Fidelity has developed a measurement solution to assessing ESG factors in investments, and weights a range of environmental, social and governance factors to produce a rating. We had begun to explore with them how a similar methodology could be used within a business, to measure its current ESG effectiveness, and to set targets and measure progress[10].

Data collected as part of the AFM Corporate Governance Report 2022 indicated that within the sample of firms responding, 73% of female, and 71% of male employees received a bonus during the year. Across the 2,000 employees included in that sample, the total spent on staff bonuses was less than £3 million.

Across the senior leadership team, different organisations have different approaches: for example around one-third of CEOs are not paid a bonus, as this contradicts the purpose and values of the organisation. For others, the amount of bonus paid in 2021 averaged £50,000. In quantum therefore the levels of performance related remuneration amongst AFM members is far less than it is for PLC banks and insurers.

In only a small number of instances had AFM members linked remuneration to climate-related measures in 2021, though others indicated, in their report and accounts, that this was under review for the future. More commonly, due to the mutual ownership structure, AFM members included a set of quality and value-driven measures as part of their remuneration structure for the Executive team.

We recognise the risk, as set out in the paper, of firms adopting a ‘tick box’ approach to including sustainability measures in incentive arrangements: this is often seen in culture and compliance overrides for salespeople. However, the difficulty in developing consistent and verifiable MI on sustainability measures makes a target driven approach more problematic. It would be helpful for FCA to provide more detailed examples of how this operates in some of the large insurers it is currently engaged with.

It is worth highlighting that suggestions for incentivising the workforce, such as share ownership schemes (paragraph 3.73), do not apply to unlisted companies. Non-financial incentives might include extra days’ holiday, an extension to the normal benefits package and peer recognition, as well as the ‘simple thank you’ suggested in the text. However, we are also mindful of the ‘99% rule’: i.e. incentivising positive change on scope 1 and 2 emissions is only likely to influence 1% of emissions, and does not touch the 99% of emissions classified as scope 3. This in turn means that incentivises may actually have a perverse impact on the total emissions of an organisation, if managed badly.

In summary, at this stage we consider that there is limited scope or relevance for FCA to establish guidance or expectations on sustainability-related remuneration,

[10] To illustrate further how the social impact might be measured, see the slides presented by Fidelity to AFM’s 2022 Conference: https://financialmutuals.org/wp-content/uploads/2022/10/P2-AFM-Goodall-FIL-social-measures.pdf

until there is effective agreement on the right measures for making a positive contribution.

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.

We agree that additional regulatory measures are required to ensure effective stewardship. We consider these should be directed at asset managers predominantly, but also that asset owners should be more active in setting expectations to asset managers.

As small insurers who outsource investment management, AFM members operate in the expectation that the burden of effective stewardship falls mainly on the asset manager. This is particular the case as most portfolio holdings by AFM members are small, and tend to be part of a collective investment: the asset owner therefore has no active engagement with the companies invested in, and no realistic influence on the components of the fund selected.

Asset owners are accountable for the investments selected, and have a responsibility for establishing an investment strategy, which should take account of the firm's approach to sustainability. Asset owners rely on data from asset managers, and as highlighted above, this is the least precise element of the climate change approach at present, as good, measurable data and a consistent framework have yet to be developed.

In our report on corporate governance, we reviewed to what extent AFM members set out in their report and accounts, how they were working with asset managers, with regards to managing the risks of climate change. As the table below shows, most engagement is on agreeing an investment strategy[11].

[11] Ibid, page 15

Activity	Action	*Example or explanation*	What proportion of reports referenced
Investment portfolio	Manager's strategy	*Working together to develop strategy*	73%
	Manager's reporting	*Securing the information needed to inform decisions*	45%
	Manager's voting	*Setting out expectations on issues to vote on*	5%
	Property portfolio	*Insulation or other action on rental estate*	18%

As per the article by Robert G. Eccles (Article 4 in the DP), we agree that the first step for an asset manager in delivering sustainable products and effective stewardship, is in setting a purpose for the organisation that reflects sustainability and enables the firm to develop meaningful principles and values, as well as measurable goals to support the purpose.

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.

Financial services firms will have different capabilities and knowledge of sustainability factors for various reasons. Until now it has not been necessary to undertake a gap analysis, and only when that occurs and with a clearer set of expectations, will firms understand what gaps they have. Firms will also need to compare what knowledge they have within employees, and how they would normally draw on professional support to address their shortcomings: for small firms it is vital that part of their gap analysis takes accounts of imported skills and knowledge.

The nature of those gaps will inevitably vary across individuals within firms. It would be useful for FCA to develop templates to help firms identify what knowledge they should or might have, and to assess their current circumstances. We also suggest FCA leads by example, by publishing its own assessment of current knowledge and gaps.

As organisations, we tend to be wary of the credentials of firms who purport to have strong ESG capabilities, as well as individuals who seek roles, such as NED where their knowledge of ESG is expected/ essential. The absence of widely recognised qualifications means that on the whole people present their experience as acquired on the job, and in our view it would be helpful for firms to seek evidence to support the claim of competence.