ESG Fund Labelling under SDR – What do the labels mean?

For a number of the asset managers we talk to, there are questions around the FCA's SDR fund/product labels, as detailed in their PS23/16 SDR paper issued in November 2023. We at ISC are encountering continued debate around the topic, including inconsistencies in interpretation, which are leading to asset managers being reluctant to pin a particular label to a given fund/product.

There are four ESG labels outlined by the FCA in their SDR Policy Statement, and these are: -

1. **Sustainability Focus** – defined by the FCA as being "invests mainly in assets that focus on sustainability for people or the planet."
2. **Sustainability Improvers** – defined by the FCA as being "invests mainly in assets that may not be sustainable now, with an aim to improve their sustainability."
3. **Sustainability Impact –** defined by the FCA as being "invests mainly in solutions to sustainability problems with an aim to achieve a positive impact for people or the planet."
4. **Sustainability Mixed Goals** – defined by the FCA as being "invests mainly in a mix of assets that either focus on sustainability, aim to improve their sustainability over time, or aim to achieve a positive impact for people or the planet."

The FCA considers that it was very clear in its PS23/16 SDR and Investment labels policy statement about what each of these labels denotes, and how it responded to questions/comments put during the consultation, and clarifying what these labels really mean.

The industry now has to take these labels and ask itself what it would include (in terms of assets invested in) if it were to build a fund/product with each of these specific labels. What would each fund look like in terms of assets held? Furthermore, and equally as important, to consider the investors who will be investing in these funds, and what they are looking for when looking to invest in funds with an ESG label? Let's look more closely at the four labels, and some of the practicalities associated with them…

Sustainability Focus funds/products need to invest in assets/companies that are already focusing on good ESG outcomes and already making a positive measurable ESG impact. These funds are expected to be available to all investors, including retail, and it is acknowledged that they will need to hold some assets for purposes other than pure sustainability (e.g liquidity, or risk management)

Sustainability Improvers funds/products need to invest in assets that may not have reached their sustainability goals yet but have clear demonstrable intentions to do so in the future. Again, these funds are expected to be available to all investors. However, if the sustainability goals that any asset hopes to achieve becomes unobtainable, then the asset manager will need to address this issue in its holdings. Similarly, any asset that reaches its sustainability goals may no longer be considered an "improver", so should it remain within the portfolio?

Sustainability Impact funds/products are required to invest in "solutions" to sustainability problems, and it is interesting that the word "assets" is not used by the FCA here (as it is with the other labels). Traditional stocks and shares are are not precluded, but "solutions" does imply something potentially different. There is a lot of talk around private assets with respect to this category, but the FCA is not saying that only private assets apply here.

However, if private assets are included, the issues around liquidity, long-term tie-ins, etc. must be considered, and perhaps this means there is less likelihood of sustainability impact funds being offered to retail investors.

Sustainability Mixed Goals funds/products is the easiest to explain. It is effectively any combination of 2 or more of the other labels outlined above. As such retail investors are potential investors.

It is important to note that for each of the above labels, the asset manager must be able to stand by their investment decisions and have robust evidence why each fund/product is entitled to use such a label. This is not a one-off exercise, and the asset manager must review both at the portfolio, and the underlying investment levels, to ensure that what they are selling remains appropriate to the fund label and strategy.

At ISC, we believe that the labels causing asset managers the most confusion are the “Focus”, and “Impact” labels, and establishing which of these two labels to choose for a fund/product. The “Improvers” and “Mixed Goals” labels are much clearer.

The FCA believes they have been clear already. So why are some asset managers still in a state of confusion? Is this a case of applying your own interpretation (backed up by an audit trail of the decision process in determining the appropriate label). We believe it is unlikely that the FCA will provide any further clarity, and asset managers may need to seek interpretation and/or assurance from elsewhere if they feel they need additional advice. It may even be that asset managers choose not to select a “Focus” or “Impact” label until they have seen others do so and get it right (or indeed…wrong!)

We at ISC are not in a position to offer definitive advice around these sustainability labels, but we are happy to share that individual asset managers are struggling, and wary of making a final determination as to which label to go with. If your firm is struggling to make a decision, you are not alone. We fully expect this topic to be raised at our next Regulatory Change Forum, where as many as 20 different asset management firms meet to discuss common issues in regulatory change, in April 2024.

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