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Public Response to FCA CP21/17

From Morningstar Inc. and Sustainalytics, a Morningstar Company

Submitted by email to CP21-17@fca.org.uk

10th September 2021

Dear Sirs,

Morningstar welcomes the opportunity to comment on the proposed climate-related disclosures and ESG topics in capital markets. We bring several perspectives to this comment letter. First, we have a long track record of categorizing and rating mutual funds that pursue different sustainability strategies. Second, our equity analysts use environmental, social, and governance (ESG) analysis as part of their approach to assessing investments. Third, Sustainalytics, which is now part of the Morningstar family, is a leading global provider of ESG ratings, research and data to asset owners, investment managers, financial institutions, issuers/corporates, and a variety of other financial intermediaries. For the avoidance of doubt, references in our response to either Morningstar or to Sustainalytics apply equally to both entities.

Our response draws from our experience evaluating environmental, social, and governance (ESG) risks associated with equity issuers and pooled fonds. To provide more background information on the questions you posed, we attach recent Morningstar research papers to this response letter –

1. Measuring Transition Risk in Fund Portfolios: The Morningstar® Portfolio Carbon Risk Score.
2. Investing in Times of Climate Change: A Global View of the Expanding Choice Available to Climate-Aware Investors
3. Corporate Sustainability Disclosures: An Improving Picture, But Regulation Would Induce a More Complete and comparable baseline of material information for investors.

Yours faithfully,

Andy Pettit

Director, Policy Research (EMEA)

Morningstar

Q1: Do you agree with our proposed scope of firms, including the £5 billion threshold for asset managers and asset owners? If not, please explain any practical concerns you may have and what scope and threshold would you prefer.

Morningstar support the broad scope of firms and proportionate approach.

Q2: Do you agree with our proposed scope of products? If not, what types of products should, or should not, be in scope and why?

We are supportive of including the wide scope of products and their being put on a level playing field for information provision to investors, subject to specific concerns about the practicality of the implementation proposals in respect of model portfolios, covered in our response to Q10.

Q3: Do you agree with our phased implementation and timings? If not, what approach and timings would you suggest and why?

The principle of a phased-in approach, commencing as soon as January 2022 is realistic. We would question the value of permitting firms to select their own 12-month reporting period within a maximum, but realistically, less than 6-month window. A fixed reference period for all firms would provide investors with more consistent and comparable data. In the absence of that, we would recommend that at worst, firms be required to report in alignment with their financial reporting period.

Q4: Would there be significant challenges in using proxy data or assumptions to address data gaps? If so, please describe the key challenges and implications as well as any preferred alternative approach.

We foresee some potential challenges with the use of proxy data or assumptions. Firstly, it perhaps lends itself to use by larger firms that may be better resourced and further down the track, versus smaller firms. Indeed, it may be less attractive for other firms to start investing in such work now, if parallel proposals to enhance more consistent and complete issuer disclosures continue to progress.

Further, the value of proxy data or assumptions is questionable if different firms use different models, leading to lack of consistency and comparability. These issues may be further exacerbated when factoring in international (non-UK) issuer data, where the underlying raw data on which models are based, may be reported on different basis'.

Taken together, these issues could further fuel charges of greenwashing and for these reasons, would favour the issue of data gaps being addressed by expedited progress toward mandated standardised issuer disclosures.

Q5: Do you agree with our proposals for the provision of a TCFD entity report, including the flexibility to cross-refer to other reports? If not, what alternative approach would you prefer and why?

We support the embracement of the TCFD framework for disclosures because (i) its disclosure requirements align well with the needs of outside sustainability ratings organizations as well as asset managers and other institutional investors; (ii) it is already in widespread use, which will reduce the burden on firms who need to comply; and (iii) regulators around the world have embraced the TCFD.

Cross-referencing where appropriate avoids duplicating information but parameters may be necessary to guard against multiple links to different report components, making it difficult for investors to access a complete picture. A potential solution would be to require an annex within the annual report that provides the information in one place.

Q6: Do you agree with our proposed approach to governance, strategy and risk management, including scenario analysis? If not, what alternative approach would you prefer and why?

We agree with the governance, strategy and risk management approach. Including how climate-related scenario analysis, in which firms try to project the impact on their revenue under various policy interventions, technological changes, or environmental changes is incorporated in their investment and risk decision-making process, is important.

Such analysis can help investors assess the value at risk in an organization if, for example, regulators introduced a carbon tax, new technology allowed other firms to produce similar products with fewer emissions, or a warming world increased the price of natural resources. Simply put, these analyses show investors under what circumstances value is at risk, and how a company's strategy will move them forward toward long-term profitability and sustainability despite carbon risks. Investors can then evaluate whether, despite a company's current emissions, they have a credible plan for a low-carbon future.

The provision of quantitative examples that demonstrate the approach to climate-related scenario analysis should also be encouraged, accepting that approaches are continuing to evolve.

Highlighting exceptions at an individual product level is also an important requirement.

Q7: Do you agree that firms not yet setting climate-related targets must explain why not? If not, what alternative approach would you prefer and why?

We are supportive of minimum standards even for firms that do not yet need to comply with broader disclosure requirements, or do not yet set climate-related targets. Doing so increases the focus on the issue and helps ensure comparability across firms and helps investors in evaluating their portfolios or describing the carbon risks associated with a pooled investment. The “comply or explain” approach has been an important and positive development in various ESG disclosure regulations, but we are at a stage that it should be giving way to mandatory disclosure.

Q8: Do you agree with our proposals for AFMs that delegate investment management services to third-party portfolio managers? If not, what alternative approach would you prefer and why?

This is a pragmatic approach. Particularly in the case of host AFM's, the strategy will in many cases be set by the delegated fund manager or sponsor.

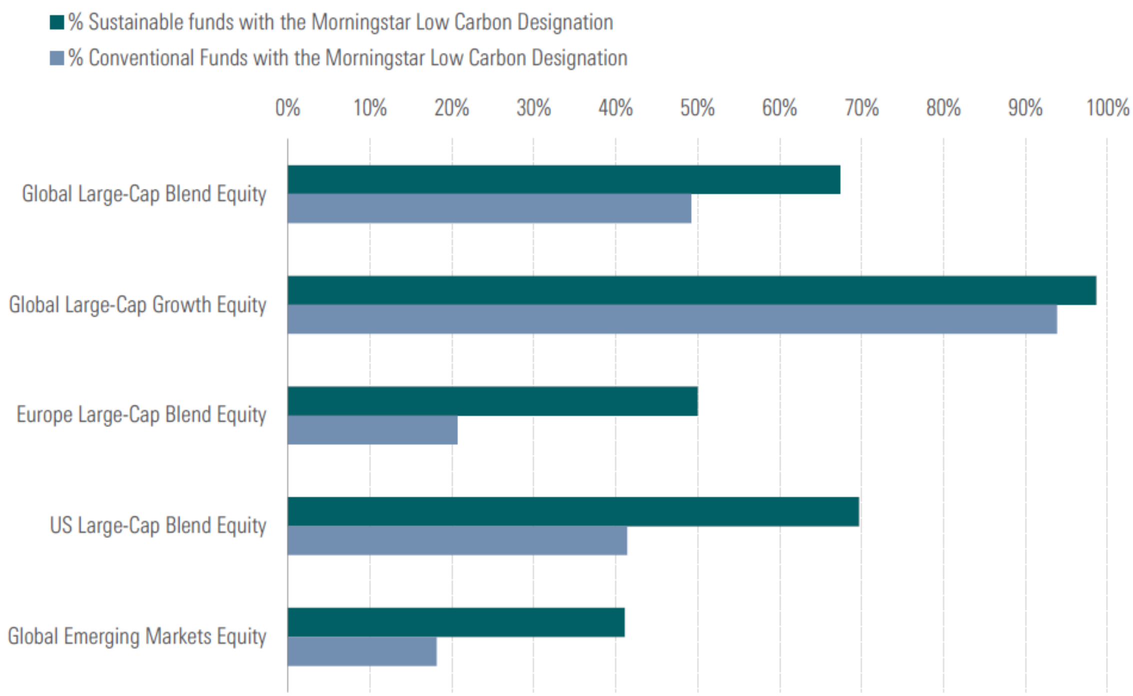
Q9: Do you agree with our proposals for asset owners to cross-refer to group-level, third-party or delegate reports, where relevant? If not, what alternative approach would you prefer and why?

The proposed approach limits duplication and redundant disclosures, though should account for the distinction where an asset owner is taking investment decisions that alter the blend of a packaged product, in which case they should either need to make their own disclosures or ensure they are consistent with the underlying product info.

Q10: Do you agree with our proposed requirements for product or portfolio-level disclosures, including the provision of data on underlying holdings and climate related data to clients on demand? If not, what alternative approach would you prefer and why?

As sustainable strategies proliferate, the FCA should ensure that fund disclosures help investors understand what their sustainable product does to manage carbon and climate risk. We believe that improving issuer-level disclosures will help asset managers improve their disclosures to individual investors; but our data shows important differences in how funds approach carbon and climate risk, which the FCA should consider as it contemplates new disclosures. For example, we analysed European funds across five categories to establish whether sustainable funds exhibited lower carbon-risk than the rest of the fund universe. The following chart shows this to be the case, albeit with considerable differences across regions and investment styles.

Exhibit 25 European Sustainable Funds With Low Carbon Designation by Morningstar Category



Source: Morningstar Direct, Morningstar Research. Data as of December 2020. Only funds with carbon risk scores available are used for the calculation of percentages.

We believe the FCA should focus on disclosures that will help investors identify which kind of carbon-aware strategy they are investing in, so investors can choose funds that match their goals. In a recent analysis, Morningstar identified five kinds of funds that focus on carbon risk or promoting transitions to a low-carbon economy: Low Carbon, Climate Conscious, Climate Solutions, Green Bond, and Clean Energy/Tech.

The analysis went on to compare the five climate strategy groups using the following Morningstar metrics: Carbon Intensity, Fossil Fuel Involvement, Oil & Gas Production Involvement, Thermal Coal Involvement, Carbon Solutions Involvement, and Carbon Risk, against a benchmark of Morningstar Global Target Market Exposure Index. (For each metric, Morningstar uses Sustainalytics' company-level carbon metrics, which it aggregates at the fund's level on an asset-weighted basis).

Within this cohort of funds, we found that Low Carbon funds provide the greatest shield from carbon risk but will offer little in the way of carbon solutions. Conversely, Clean Energy/Tech funds offer high exposure to carbon solutions as expected but also currently hold the greatest carbon risk in the bunch. This range of outcomes across a relatively narrow subset of funds is indicative of the need for product level climate data to be made available to investors. (For more information on the specific categories please see the attachment, "Investing in Times of

Climate Change: A Global View of the Expanding Choice Available to Climate-Aware Investors.")

The proposed open-ended 'on-demand' disclosure requirement seems overly onerous, since, for example, a firm with twelve clients could conceivably receive one request per month. A requirement to produce the disclosures either for a common reference period, or at least once (or twice) per annum, at a date agreed between the firm and its clients would seem to offer a more practical solution.

Further, it is unclear to us whether the reference to providing data on underlying holdings relates to what the holdings are, or specific metrics pertaining to each of those holdings.

Q11: Do you agree with the list of core metrics, including the timeframes for disclosure? If not, what alternative metrics and timeframes would you prefer and why?

Morningstar support the concept of a baseline set of core mandatory metrics for products to disclose, supported by contextual information. Climate risk disclosures must include standardized, comparable data on carbon emissions, which can be quantified, measured, and used by investors in a variety of ways. For example, some investors already look at the total carbon footprint of their portfolio, or the carbon footprints of otherwise similar companies. Investors also sometimes generate their own carbon-intensity metrics by dividing carbon emissions by a company's revenue, profits, or material produced.

We recommend reporting on scopes 1 and 2, and on individual categories of Scope 3 emissions by 2024 in accordance with the GHG Protocol (specifying which of the categories are covered). Further, we propose the inclusion of climate targets and senior level remuneration into core metrics. For entities not setting targets, a reason should be provided for why they have been omitted.

We welcome the direction of the PCAF and WACI methodologies to facilitate comparable financial sector disclosure (including proportionate exposure), and encourage further clarification of their applicability, comparability and fit with wider reporting requirements. We support further collaboration and alignment of regimes across key organizations and regulatory frameworks, such as the TCFD and SFDR, to reduce the burden of reporting similar information more than once.

Q12: Do you agree that firms should calculate metrics marked with an asterisk according to both formulas set out in columns A and B of Appendix 3? If not, please explain why, including any challenges in reporting in accordance with either or both regimes.

While requiring products to report according to both the TCFD and SFDR regimes may be necessary in the near-term, that should be considered against the potential to confuse investors with two similar but different sets of data, and for use of it to be cherry-picked for different purposes.

The issue is compounded by reporting not only values based on market cap and enterprise value, but also in euros and US dollars.

Q13: Do you agree that, subject to the final TCFD guidance being broadly consistent with that proposed in the current consultation, our proposed rules and guidance should refer to:

a. The TCFD Final Report and TCFD Annex in their updated versions, once finalised

b. The TCFD's proposed guidance on metrics, targets and transition plans and the proposed technical supplement on measuring portfolio alignment

If not, what other approach would you prefer and why?

Morningstar supports the embracement of the TCFD framework for disclosures because (i) its disclosure requirements align well with the needs of outside sustainability ratings organizations as well as asset managers and other institutional investors; (ii) it is already in widespread use, which will reduce the burden on issuers who need to comply; and (iii) regulators around the world have embraced the TCFD.

For information, we attach a copy of our response to the recent TCFD consultation, which was in general supportive of the proposals and included some further recommendations and comments.

Q14: Do you agree with our approach to additional metrics and targets? If not, what alternatives would you suggest and why?

Climate VAR has been applied to assess portfolio risk, evolving from value-at-risk financial modelling (VAR). We support consistency in science aligned metrics, and specificity about what information should be included. Given potential limitations of VAR, it may be beneficial to explore enhancements or alternatives across the financial sector, for example via the CFRD, NGFS or net zero alliances (e.g. NZAOA, NZIA, NZBA, GANFZ).

We support the use of portfolio alignment tools that best suit the institutional context and capabilities, albeit we caution against sacrificing transparency when adding complexity. There is risk of such complexity detracting from action to support low carbon transition. Additional metrics may include both absolute and intensity targets, to track progress irrespective of economic fluctuations while highlighting expansion plans that surpass intensity reductions.

Q15: Do you agree with our approach to governance, strategy and risk management, including scenario analysis at product or portfolio-level? If not, what alternative approach would you prefer and why?

We concur with having firms explain any differences in their approach, if it differs materially from any overarching approach described in the entity-level TCFD report, albeit further specificity may be required to define "materially different".

Regarding scenario analysis, we recommend shifting guidance towards a 1.5-degree pathway, rather a "below 2 degree" trajectory (along with the proposed net zero 2050 intention). Standardization and transparency will be paramount for the effective use of scenario analysis, which should contain and disclose a temperature ambition. For the purpose of comparability, we recommend mandating a preferred scenario pathway, as well as consistent metrics.

Q16: What form(s) could quantitative scenario analysis outputs at product or portfolio-level take? What do you consider the cost and feasibility of producing such outputs might be? How useful would such outputs be for users' decision-making?

A temperature rating is crucial to address the adverse impact issues raised in the latest IPCC Working Group I contribution to the Sixth Assessment Report. Scenarios analyses would have to updated periodically to reflect the evolving future position, including potential risks of misalignment. This will also allow the FCA to pinpoint and shift financing priorities as needed.

Q17: Do you agree with our proposed approach that would require certain firms to provide product or portfolio level information to clients on request? If not, what approach and what types of clients would you prefer and why?

We refer to our response to Q10, where the same issues are relevant, such as allowing a single request within an accounting period potentially resulting in data production requirements at multiple different dates to support multiple different clients. We would also highlight that any requirements to use proxies and assumptions be aligned with those consulted on in Q4.

Q18: Do you agree with our proposed approach for life insurers when mirroring an external asset manager's strategy? If not, what alternative approach would you prefer and why?

We agree and see the requirements as analogous to those consulted on in Q9.

Q19: Do you agree with our specific proposals for asset owners, including the proposed threshold to exclude the smallest default schemes? If not, what alternatives would you prefer and why?

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Q20: Do you agree with the analysis in our CBA? If not, we welcome feedback in relation to the one-off and ongoing costs you expect to incur and the potential benefits you envisage. Contextual information about your firm's size and structure would be helpful.

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