FCA Non Equities Securities - Engagement Paper 1 and Engagement Paper 4

IIGCC Draft Response

Executive Summary
The additional climate disclosures considered under both Engagement Papers would represent a step forward in non equities securities markets.

Engagement Paper 4

- Green, social or sustainability labelled debt instruments (GSS+) are a critical element in the net zero transition.
- IIGCC welcomes the FCA's Engagement Paper on Non-Equities Securities and proposals for enhanced disclosure requirements.
- IIGCC supports the proposal to require high-level connections between the bond prospectus and bond framework, as well as specific disclosures on Use of Proceeds bonds and Sustainability-Linked bonds.

Engagement Paper 1

- IIGCC welcomes the FCA's Engagement Paper on Admission to Trading on a Regulated Market, in particular the consideration paid to enhanced disclosure requirements for Environmental, Social and Governance (ESG) disclosures and the introduction of minimum content requirements for the prospectus.
- Enhanced climate disclosures for unlabelled bonds would provide decision-useful information for investors and foster an environment more conducive to bondholder stewardship, bridging the gap between equity and fixed income in this space.

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About Us

The Institutional Investors Group on Climate Change (IIGCC) is the leading European membership body supporting the European and UK-based investment community in making significant and real progress by 2030 towards a net zero and resilient future. IIGCC's 375+ members (over half of which are UK-based), representing £45 trillion assets under

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management, can affect real world change through their individual capital allocation decisions, stewardship and engagement with companies and the wider market, as well as through their policy advocacy.

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IIGCC Response

Introduction

IIGCC welcomes the opportunity to respond to the FCA's Non-Equities Securities Engagement Paper 1 and Engagement Paper 4, which provides a welcome exploration of how non-equities securities disclosures can be improved and made more decision useful for investors. IIGCC's response focuses on unlabelled debt instruments in Engagement Paper 1 and Engagement Paper 4's proposals for green, social or sustainability labelled debt instruments ('GSS+ instruments')

IIGCC supports the proposals to introduce additional ESG disclosure requirements for GSS+ instruments and unlabelled debt instruments as outlined by the FCA.

The importance of the non-equities securities market to the transition to a net zero economy ('the net zero transition') is recognised by IIGCC and its members. In 2022, IIGCC established its own Bondholder Stewardship Working Group in recognition of the crucial role bondholders play in providing the capital needed to fund the net zero transition. The working group was launched with the twin objectives of improving bondholder stewardship and enhancing net zero debt financing. Now comprising 20+ institutional investor members, the working group published Bondholder Stewardship Guidance in June 2023 and is developing a paper on Enhancing Net Zero Debt Financing with a particular focus on expectations for new labelled bond issuances. In both instances, improving disclosures from bond issuers is paramount.

Engagement Paper 4 – Green, Social and Sustainability Labelled Debt Instruments

IIGCC supports the proposals in the paper to enhance disclosure requirements for GSS+ instruments. We strongly support the high-level requirements and are broadly supportive of the second approach proposed by the FCA, namely including specific requirements for use of proceed (Up) and Sustainability-Linked (SLB) bonds SLBs.

IIGCC believes in the potential of sustainability labelled debt instruments to help provide the capital that is needed for the net zero transition. Sustainability labelled debt instruments provide accountability mechanisms for investors seeking to mitigate financial risk and decarbonise their portfolios through real world emission reductions, allowing investors to more accurately allocate capital to activities that will accelerate the net zero

transition, while also creating new pools of capital for companies seeking to participate in the net zero transition. With this said, we recognise increasing concerns about the longevity and efficacy of the sustainability labelled debt market. More work is needed to standardise best practice and accelerate the evolution from a nascent labelled debt market to a mature and sustainable one. Improved disclosure expectations are part of this evolution.

High-Level Requirements

We support high-level disclosure requirements specifying the alignment between the bond prospectus and bond framework. Those proposed in the engagement paper are a positive first step.

In particular, we welcome the FCA's focus on alignment between the issuer's climate strategy and the issuance, which was a guiding principle in the IIGCC Net Zero Bondholder Stewardship Guidance. Institutional investors want to understand "how the debt strategy supports the delivery of the corporate strategy [including how it] supports the issuer's transition plan and climate strategy". They want to understand how a specific issuance is aligned with the overall debt strategy, how that issuance is aligned with market expectations, and finally, in this example of labelled debt, how that issuance is aligned with relevant sustainability goals, including relevant net zero pathways.

This requires disclosures from issuers. Fragmented disclosure processes jeopardise the investor's understanding of the company's approach to climate. As identified by the FCA, this may lead to mispricing and failure to meet investors' sustainability goals. But it also risks misallocation of capital-capital that could otherwise be employed support the net zero transition.

It is important here to also note the importance of quantitative disclosures (for example, look back periods, KPIs and SPTs, and the financial impacts of the issuance or failure to meet targets). While we recognise the FCA's assumption that this information will be included, in particular for SLBs, we encourage the FCA to continue to monitor quantitative disclosures to ensure they are providing the robust and decision-useful information required by investors.

Disclosures for UoPs and SLBs

IIGCC also supports the FCA requiring specific disclosures for UoP and SLBs. This better recognises the unique traits of each financial instrument and will lead to more decision-useful information for investors.

Use of Proceeds Bonds

We broadly support the FCA's proposals for additional disclosures for UoP bonds. We encourage the FCA to further signpost relevant market standards and best practice expectations in the final consultation and requirements. Expectations for UoP bonds are

relatively developed and this is reflected in the expected disclosures proposed in the paper. The FCA can foster further harmonisation and good practice by aligning its prompts with existing standards, such as those produced by ICMA and the European Green Bond Standards, and, if developed, a UK Green Bonds Standard as recommended by the Green Technical Advisory Group.

Sustainability Linked Bonds

Since credible SLBs are general purpose bonds, they need to be bolstered by clear alignment with the issuer's strategy. In the case of a climate focused SLB, this means it needs to be aligned to the issuer's transition plan and net zero targets. An SLB that does not incentivise achievement of the transition plan risks being accused of greenwashing. This represents a risk to investors and issuers.

A number of observers, including IIGCC's Bondholder Stewardship working group, have identified two major weaknesses of the instrument:

- Insufficiently ambitious KPIs and SPTs
- Weak financial incentives.

Overcoming these weaknesses will require more than disclosure requirements. However, we believe the FCA's proposed prompts represent a solid starting point.

Investors need to be able to quickly scrutinize the KPIs and SPTs in the context of the company's transition plan and net zero targets. It would be beneficial for issuers to include the rationale and process for setting KPIs and SPTs, and explain how they fit with the organisation's wider sustainability and business strategy. The FCA should encourage issuers to leverage relevant existing disclosures, in particular the issuer's transition plan. The alignment between the instrument and the issuer's climate strategy, targets and actions is the critical element for any climate-related sustainability-linked bond. Indeed, many investors typically focus their assessment of labelled debt at the issuer level. Encouraging clear linkages between the instrument and the transition plan would help investors situate the KPIs and SPTs in the issuer's wider strategy, while also reducing the reporting burden on issuers, who could draw upon existing disclosures.

Requiring issuers to provide an explanation of why the financial consequences are deemed adequate incentives would be a healthy intervention in the market. Currently, the financial consequences of failing to meet the targets often lack a clear rationale. Rather than demonstrating the increased credit risk of failing to reach climate targets, the size of the issuer or issuance, or even the ambition of the targets, issuers have generally coalesced around a step-up coupon of 25bps[1], irrespective of all other considerations. The materiality

and relevance of this number will differ significantly by issuance, significantly altering the incentive for each issuer to meet their targets. As this becomes a more prevalent feature in the market, the step-up coupons legitimacy as an incentive may be further questioned.

Encouraging companies to provide an explanation of how the step-up coupon (or other financial incentive) was determined creates much needed transparency in this decision-making process. This should facilitate a more constructive dialogue between issuers and investors, and potentially lead to the adoption of more material, effective and bespoke financial incentives.

Finally, further solidifying expectations around post-issuance verification and reporting is of utmost importance; without post-issuance reporting, the bond's impact cannot be assessed credibly, exposing the instrument to accusations of greenwashing. For instruments to be truly sustainable, such reporting should apply a double materiality lens.

Engagement Paper 1 - Admission to Trading on a Regulated Market

In addition to the proposals in Engagement Paper 4, IIGCC supports the consideration paid to providing further direction on ESG disclosures for debt issuers. We would welcome further alignment between the FCA's expectations on the information required in the prospectus with the reporting requirements in the annual report.

IIGCC supports the proposals in the paper to enhance disclosure requirements for unlabelled debt instruments as part of Admission to trading on a regulated market. We strongly support the high-level requirements and are broadly supportive of the third approach suggested by the FCA, namely introducing minimum content requirements for the prospectus such as requiring them to include climate risk disclosures and/or incorporating by reference any existing TCFD-aligned disclosures and/or future ISSB / TPT standards when implemented.

IIGCC's recently published Bondholder Stewardship Guidance, developed in partnership with investor members, identifies data disclosures and quality as a significant challenge for bondholder stewardship. This is in part because of the gap that has emerged between disclosures by equity issuers and debt issuers. While there is inevitably overlap, this gap could be bridged further by the FCA. The IIGCC Guidance also notes the importance of engaging on what is considered 'good' or 'optimal' disclosure pre-issuance. This process would be streamlined by further guidance from the FCA on what types of disclosure are generally desired (namely, TCFD and, in the future, ISSB), facilitating more productive dialogue between investors and issuers.

We look forward to further discussions with the FCA regarding the shape of this guidance and how it can be calibrated to best suit debt issuers and investors.

IIGCC and the Bondholder Stewardship Working Group would welcome the opportunity to provide further input into how such a regime could be designed in practice and encourage the FCA to consult further.

Conclusion

IIGCC's *Enhancing Net Zero Debt Financing* paper will expand upon the institutional investor view on best practices for labelled issuances. IIGCC and the Bondholder Stewardship working group look forward to further engagement with the FCA on non-equity securities disclosure requirements.