The mark of true leadership: the UK's intelligent but demanding financial services rule-making

The UK is seeking to extend its global leadership in green finance by way of intelligent but demanding financial services rule-making – a topic at the forefront of the COP26 talks, chaired by the UK.

This is a praiseworthy ambition that partly reflects global demand from investors for products that better take account of environmental, social and governance (ESG) risks and opportunities. But, for the UK to get it right, it will be vital to craft rules in a way that reflects the diversity and global profile of the nation's investment management sector and its investor base.

This challenge is evident in recent proposals from the Financial Conduct Authority (FCA), the City's regulatory watchdog, to oblige investment managers to report publicly on how they quantify and manage climate risks. The rules will be finalised by the end of 2021 and should go live in January 2022 for firms with the largest investment portfolios.

The focus on climate risks is sound. Investment managers recognise the enormous societal challenges posed by climate change and have invested significant resources in recent years to assess risks that were historically considered 'non-financial' but are now increasingly seen as material to firms' bottom lines. Some companies have hired ESG specialists and many now purchase data to track the performance of their investments from a sustainability perspective. This trend is likely to continue as the analytical tools continue improving.

The FCA plans to base its rules on the guidelines of the international Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) – a well-regarded framework that marries narrative reporting on companies' approaches to climate risk with quantified reporting on key climate-related metrics.

The FCA's suggestion of orienting its approach to the TCFD is a good call, particularly given the global nature of the industry. Moreover, allowing firms to combine metrics with an explanation of their approach is important to give investors a complete picture of how their investment managers are looking after their money.

But we at the Alternative Investment Management Association (AIMA) believe that a prerequisite for the effective implementation of this framework is the availability of better data from corporate issuers, for both shares and bonds. Without meaningful, comparable data on their underlying investments, investment managers will be unable to give investors a true account of their risk exposures. We're pleased to see that the FCA is taking steps to tackle shortcomings in corporate data, but it must also allow time for improvements in corporate reporting to become fully embedded before turning its attention to reporting by investment managers.

Another challenge is how to ensure that the rules are workable for the wide set of firms to which they will soon apply under the UK's regime. Keep in mind that these enterprises differ widely in scale, global footprint, resource base and investment philosophy. For example, the rules will need to address investments outside the corporate sector, such as government debt, currencies, interest rates and other instruments. It's worth mentioning that the EU's own reporting rules for investment managers don't fully address these difficult issues, leaving asset managers and investors scratching their heads.

Another key element is the treatment of short selling. The AIMA and Principles for Responsible Investment have both provided guidance on how to embed short selling in a sustainable investment framework, but we await a response from the regulators.

If the UK wants to live up to its ambitions to become an ESG leader, it must stand ready to tackle some of the thorny questions about how to apply its standards to the widest range of real-world investments. This will be the mark of true leadership.

Jack Inglis
CEO, Alternative Investment Management Association