Sustainability trends in asset-management and potential ESG confusion

1. ESG confusion is real. Addressing this issue might alleviate greenwashing concerns and engage the green transition

A regulator stated that there is confusion in the asset management industry around how to address environmental, social and governance (ESG) issues and even more confusion on the investors' side around the effective ESG reach of their investments. With its higher ambitions in ESG matters, there is more confusion in the EU than in other jurisdictions. Commitments are numerous but often rather vague and difficult to compare. However, there is no reason to be overly pessimistic. Much progress has been made and it is understandable that, at a time when new standards, datasets, analyses, and methodologies have to be elaborated, and new competencies have to be acquired by the whole financial ecosystem and end investors, there will be some confusion.

An industry representative commented that there are several areas of confusion. The context of profound mutation is important. Investor demand is growing more quickly than the collective capability to adapt the system, even if progress is fast in Europe in particular. The subsequent confusion creates a perception of greenwashing that must be tackled to protect trust in the system.

An industry representative stated that the ESG confusion must be addressed urgently. A climate emergency has been declared and it is not known if a tipping point has been reached from a climate science perspective. A positive tipping point has been reached from a policy perspective. A tipping point is the point after which there is no return and acceleration.

A regulator commented that it is courageous for the title of the panel to be 'ESG confusion'. ESG issues have been discussed for some time and nobody dared called it 'ESG confusion' previously. The constantly evolving framework can indeed be challenging. Investor demand is growing and evolving, while political decisions around regulatory requirements are still being made, with an ambitious agenda in mind. At this moment, there is not yet a comprehensive framework. The policy approach started with disclosure requirements without having framework for corporate reporting. We recognise that there needs to be some practical guidance provided to market participants.

An official stated that greenwashing is a reality. A lot of greenwashing is unintentional, but there are undoubtedly cases where it is less than entirely unintentional, and the full range of supervisory techniques should be used. The International Organization of Securities Commissions (IOSCO) issued a report last year that explained a number of ways in which it can happen and is happening. Because of the scale of ESG-focused investor mandates and enthusiasm in Europe, the scale of greenwashing rises proportionately.

An industry representative commented that sustainability can encourage people to invest and promote engagement with new parts of the market, particularly younger people. However, there is a mismatch between what clients state their appetite for investing is and how they are investing. The broader landscape and how different parts of the value chain interact must be considered. Asset managers sit in the middle of different competing forces, including distributors and other parts of the value chain, such as ESG ratings providers, benchmark providers and corporates. There is a need for common definitions and datapoints when marketing a product. When considering broader disclosures for clients, sustainability should be at the core, not considered as a separate exercise.

2. Several sources of ESG confusion exist and should be addressed for it to be alleviated

2.1 Good quality data on ESG is still lacking

An industry representative stated that there are usually three motivations to invest: investment in sustainable funds or mandates, alignment to values, and seeking sustainable outcomes. In all three cases, data analytics is still missing. Issuer-level data is critical. Limited or poor-quality data leads to confusion. Identifying which activities are aligned with green or transition enables investors, asset managers and the industry to build products based on this alignment at the issuer level. For corporate CEOs or investors investing in the future, the more clarity about the future and the more certainty of investments, the less risk reward and the less data is needed. Greenhouse Gas (GHG) Scope 3 emissions are critical, because, without Scope 3 it is possible to maximise at the micro level, but not at the macro level. Private assets and issuers are important. If only public issuers disclose, there will be more and more public issuers selling what they do not want to sit on their balance sheets to private issuers.

An industry representative stated that data and transparency is a major barrier to sustainable finance. Institutions need to be able to prove that their product does what it claims to. The Sustainable Financial Disclosure Regulation (SFDR) will be great, but it is crucial that the metrics do what they say they will. Upstream data is needed to ensure that data is valuable. It is important to mainstream the impact of sustainable investing and how it interacts with performance and risk. ESG is not an add-on but should instead be integral to the way sustainable investment is discussed with clients. ESG data issues are global. Investments are not just in companies but also in sovereigns, infrastructure, and real estate. A comprehensive system must be built to obtain data across all of these elements. If a very high bar is set for the data needed for ESG products in Europe, that data will never be obtained in emerging markets or for private assets. Building an interoperable system will be a huge challenge.

A public representative commented that how the market for sustainability and data is going to develop and work and what the role of the public sector is, are all concerns. Data could be seen as a public good where the marginal cost is zero. The private market for sustainability data, and what the public good should be, should be considered. Some private parties have taken advantage of this opportunity and are trying to collect the data and sell it for a high price. The European Single Access Point (ESAP) is a splendid opportunity. A joint effort from the financial sector would be wonderful.

An official said there were three elements in any approach to the current situation: i) supervisory action against greenwashing, ii) mandating the structuring data to help investors find good ESG investments and iii) prescribing standards for issuer information. Prescribing standards for issuer information will take time but is underway. Mandating the structuring of data before that is challenging. Europe has approached this through Articles 6, 8 and 9, taxonomies and work on benchmarks. Every single issue around sustainable finance is part of an inverted pyramid, with good quality issuer data at the base. In the meantime, there must be an acceptance that sustainable finance regulation will be in containment mode, relying on supervisory action, until there is good, audited or well assured data from issuers that everybody else can process, distribute, assimilate, and act on. In this regard he noted that the amendments to the Alternative Investment Fund Managers Derivative (AIFMD), Undertakings for the Collective Investment in Transferable Securities (UCITS) and MiFID to create process requirements has helped to put supervisors in a better position to undertake supervisory action.

An industry representative stated that it is not just the amount of data but the quality and comparability of the data from the issuers that ultimately drives investment decisions. However, asset managers cannot wait for perfect data but instead need to decide today where to invest. As such, asset managers need to not only consider the reports from the corporates or the ESAP that become available next year or the rating agencies that sell data, but, through active management, engage with the companies and assess the credibility of the data that they publish.

An industry representative commented that data is a struggle currently, but there is a need to start somewhere and be pragmatic. The next step will be to shift from a world of the actual picture to one of a capacity to forecast. There are different angles of methodology and different outputs, but this is also important when considering some indication of future commitment.

A regulator stated that the European Securities and Markets Authority (ESMA) does not want to standardise methodologies for ESG data and rating providers but is calling for some form of oversight of such activities, so that there is more transparency on the applied methodologies and robust arrangements for prevention of conflicts of interest. In this context, recently ESMA sent a call for evidence on the market's characteristics for ESG rating providers, which is complementary to what the European Commission is expected to do.

2.2 Challenges in reporting, labels and ratings

A regulator stated that the relevance of ESG ratings is difficult to assess.

An industry representative commented that there is confusion between disclosure and definition. Disclosure is the main way to facilitate transparency and avoid greenwashing. The establishment of categories 8 and 9 has led to a perception that there is some sort of qualification in terms of what is and is not ESG. There is a risk of giving the impression that Article 8 could be some sort of qualification. There is currently plenty of disclosure and there will be more. The SFDR does not cover the definition aspect, so those who choose an ESG product will have to assess what is or is not ESG-intensive. They will have information but not a complete grid of analysis. The objectives between full disclosure or some sort of minimum threshold for qualifying what is and is not ESG need to be clarified.

An industry representative stated that the lack of knowledge and confusion around how products are labelled and talked about is a major barrier. The industry often talks about impact, responsibility or sustainability and uses these terms interchangeably. Articles 6, 8 and 9 are a great improvement, but the average retail investor does not understand what they are.

A regulator added that interpretation is a challenge, as there are disclosures available but not labelling or name conventions. In the absence of detailed guidance, it could be said that there is unintentional greenwashing happening. Even with well-intended disclosures, if sustainability or ESG is in the name, it can be confusing for the end investor.

2.3 Consideration of the transition aspect

An industry representative noted that transition is key to achieving the net zero objectives for 2050. The investment industry is looking at ESG data depicting the companies as they are today, while buying the future. Shareholders invest to support and accompany a trajectory. In addition to data on carbon emissions, the commitment that the company has made to be on the right trajectory and whether that has been validated by the Science Based Targets Initiative (SBTi) can be considered. This is already done by about 20% of companies worldwide. The industry must reinforce its ability to engage in order to be at the very beginning of the story and to ask for clear key performance indicators (KPIs) from the invested company, with timelines and escalation processes.

A public representative stated that the transition plans are a crucial concept that have been introduced in the EU Green Bond Standard and will avoid greenwashing. It is possible to have green activities in a very brown company that do not achieve net zero by 2050. These companies should not be invested in, but there should be opportunity for investment in activities that are not sustainable but may become sustainable. Long-run views that are not green or brown are needed. It is the transformation of the companies and the economy that really matters.

An industry representative commented that there is a risk that an ESG solution focused on the transition and investing in solutions that are not aligned but intend to be aligned will not be considered as ESG, because it is not yet exposed to aligned activity. The notion of transition is therefore not really captured. There is a risk that, to shift the capital, this effort by the industry with the existing equipment, in terms of disclosure, is not being recognised.

An industry representative commented that, whether it is called green or light brown, a framework for transition finance is needed to help investors to channel capital to drive the transition.

2.4 Consistency worldwide is an issue

Comparing the ESG approach between EU countries, a regulator noted the difference in regulatory and supervisory approaches, contrary to what should be a Capital Markets Union (CMU), since ESMA does not currently have the tools to implement any real convergence in that field.

An industry representative commented that clients invest across asset classes, geographies and sectors, so global consistency is needed. Regions, companies, and countries can build their own additional frameworks on top of that global consistency framework, but global consistency is critical. There are also sector-specific aspects. Investors consider companies within the same sector and globally, so data must be relevant at the sector level.

A regulator noted the importance of global consistency. The expansion of the ESG market is a global challenge and thus global responses are needed. The EU has been advancing and will need to ensure as much consistency as possible. ESMA will remain committed to encourage compatible, interoperable, and consistent solutions.

An industry representative noted that small and medium-sized enterprises (SME) will not be able to report at the same level as a multinational corporate. The minimum baseline of core data metrics for everyone to report on should be a gold standard to move towards. The issue must be addressed holistically, because investments are not just in single jurisdictions or asset classes.

An official stated that, if there is not a clear distinction between developing local regimes and participating in the development of global standards, there is the threat of fragmentation. There is a difference between developing a local corporate reporting regime and participating in developing an effective global set of standards. Global standards will greatly help with the SFDR and the other obligations that Europeans who hold assets all around the world have to comply with.

2.5 Financial education is an area for progress

An industry representative stated that the lack of support from the industry, particularly from financial advisors, is a major barrier. Clients must be educated on these topics. An industry representative stated that a consumer mindset tipping point is urgently needed in retail. The necessary level of consumer awareness could be achieved through investor education. Financial literacy must be grown for retail consumers and institutional investors, and sustainability literacy developed, and this must be done quickly. Initiatives aiming to develop this financial and sustainability literacy have already been developed. There will never be a final definition of ESG and there will also be disagreement on some places, for example nuclear and whether it is a sustainable or transition energy. Ultimately, the client will decide if an energy source is sustainable. The most important means of addressing ESG confusion quickly is to empower the consumer to make choices. The consumer must realise that they can make a difference for the planet if they allocate capital in line with their ethical and environmental objectives.

A regulator stated that investor confusion and a lack of investor education is another challenge. There might be a mismatch between the value proposition that a well-intentioned provider is offering and what the investor is seeking.

An official stated that ESG confusion can be addressed with education of investors and intermediaries. The financial competence framework issued by the European Commission, which includes a sustainable finance part, is particularly impressive in this regard, and there are a number of other initiatives, but these will not be enough to address the issue in the short term.

3. The regulatory perspective

A regulator noted that regulation on sustainable finance is unfinished and almost impossible to properly implement at this stage. With the introduction of Article 8 and Article 9 funds by the SFDR, there was a realisation that investors have been investing in green funds all along. The regulatory framework in Europe will be complete in another two or three years.

An industry representative stated that regulation has brought clarification. The package of regulation, as well as SFDR, has been a strong, significant, and positive gamechanger for the industry. It has established the notion of double materiality, which clarifies the previously vague ESG definition. It has also set the standard of disclosure and helps the industry to shape its offering through categories 6, 8 and 9. The evaluation grid written by the second Markets in Financial Instruments Directive (MiFID II) delegated act will provide additional information and is a major improvement. However, the grid is based on percentage of alignment on green activities according to the taxonomy and SFDR definition, and only depicts the current situation.

An industry representative stated that, from a retail investor perspective, SFDR taxonomy and the Corporate Sustainability Reporting Derivative (CSRD) are confusing but are an enormous opportunity. The upcoming MiFID sustainability preferences are of great importance. The reference in the draft guidelines to needing to translate these very technical elements of taxonomy, sustainable investments, and principal adverse impacts (PAIs) into language that an investor can understand is strongly appreciated.

An industry representative commented that the industry does a lot but also acknowledged that only the public sector can truly deliver financial education in a holistic and neutral way. The CMU action plan point number 7 is very much welcomed. That states that there will be a greater role for the European Commission to coordinate this at member state level. The regulatory community is very conscious of the challenges that the industry is facing while it tries to navigate through the evolving framework. Public authorities are fully mobilised to support the implementation of the framework. There is a desire to support the ambitious European approach but also a need to be pragmatic. The framework will not start to function overnight. There are inconsistencies, challenges and a need for clarification.

A regulator noted that sustainability is now an integral part of ESMA's mandate and is very high on the agenda of all national authorities across the EU. Preserving trust in the system is a collective challenge. ESMA aims to provide more guidance, considering the applicable rulebook, and working with the national competent authorities (NCAs) to develop a common view of the expectations, including regarding transparency, and addressing fragmentation. Building capacity is also a big task looking ahead. The framework is evolving, and the ambition level is high, but the retail investor is not sustainability literate yet. This is also true for regulators, providers, and advisors, so a collective effort is needed. Market developments are evolving fast, and the regulatory community wants to ensure it continues to monitor trends and incorporates relevant risks.

A public representative commented that regulation on this issue is a work in progress. Financial institutions are asked to share ideas for improvement with legislators. The framework is being built but pieces of the puzzle are missing. The framework needs to be adjusted because the legislators learn along the way. Financial institutions are asked to combine their efforts and come to the supervisors and the legislators. Sometimes different players in the financial sector all work on the same problems individually.

An official commented that it was also important to have a clear view on how to reconcile the European approach to corporate reporting with a global approach in a way which both allows Europe to adopt its own approach and encourages information to be developed across the world on the ESG characteristics of assets which is capable of being analysed comparatively. Achieving that will be a substantial prize and Europe should think carefully about how it can be a positive agent in promoting good global standards as well as pursuing its own goals.