CLARIFYING THE SUSTAINABLE INVESTMENT UNIVERSE

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Labels, a means of increasing trust in sustainable finance

Over the past decade the growth of so-called green, sustainable, ESG investment products has increased tremendously and so has the debate around the development of labels for financial products. Like ratings, labels aim to assess how ESG issues are integrated into investment decisions in order to convey a message on the sustainability of a financial product; nevertheless, there are some differences between ratings and labels, which make the latter a more interesting alternative for non-professional investors.

Labels are easy to understand, as they define minimum requirements for sustainable products and largely use the "pass or fail system". Once the label has been credited, they do not distinguish between labelled-products. Ratings, on the other hand, have a grading scale and not every investor know how to best use the specific rating given to a specific financial product. Additionally, information provided by labels is somewhat different from that provided by ratings, labels are normally focused on the "investment process" and reward a well-defined investment process that considers ESG criteria, whereas ratings are normally focused on the "portfolio" and evaluate all the holdings in the portfolio with the goal of providing investors with a comprehensive assessment of its environmental, social, and governance attributes. These differences have contributed to the development of sustainable labels for financial products, mostly in Europe where nine sustainable labels are currently in use, with France, Belgium and Luxembourg having extensively contributed. As of December 2021, more than 1700 funds on the European markets (which totals almost 60,000 funds) have been awarded with one or more of these labels. Labelled funds represent more than € 1,3 trillion of AUM (+90% compared to previous year).

Undoubtedly, labels can play a role in reducing the information asymmetry between providers of financial products (i.e. asset management companies) and buyers of these products (i.e. investors). Labels aim to help buyers selecting products that match their own investment goals and sustainability preferences. This is important if we consider that sustainability characteristics of an investment are extremely complex as they are based on a large variety of terminologies, metrics and practices. In its Action Plan for sustainable finance, the European Commission recognizes the merits of a label-system explaining that "labelling schemes can be particularly useful for retail investors who would like to express their investment preferences on sustainable activities". The Action Plan precisely enumerated a number of priority actions to support sustainability transition, one of which is the creation of labels for green financial products.

Whilst the Proposal for Regulation of the EU Green bond is at final stage of negotiation, the Commission is currently working on the EU Ecolabel for Retail Financial Products and on its alignment with the Taxonomy Regulation. The intent is to provide retail investors with a reliable and widely recognised label for financial products, alleviating some of the concerns about the lack of standardization of private labels.

The key point is that while industry has moved forward and has already developed a number of labels for financial products, these are highly heterogeneous. Existing labels differ significantly in their specifications: some are thematic (focusing on environment or climate), others are broader and integrate all ESG factors. Some are very strict, others set only minimum proportion of a portfolio total asset under management to be invested in sustainable activities.

While most labels use a "pass or fail" system to assess whether an investment is eligible, the threshold applied for the "pass-or-fail" vary significantly from one label to another. As a consequence, existing labels have little common ground as to what constitutes a sustainable investment product. If the intent was to help investors understanding the degree at which an investment funds sustainable activities, the result is that each label has its own criteria to assess whether an investment is sustainable or not.

Now, the big question is: do labels really help investors? Does this variety achieve the desired end of helping investor or does it encumber the market with uncertain signals? Academic research show that instead of simplifying the choice of agents, the multiplication of labels tends to increase the noise in the market and deteriorate confidence. The asymmetry of information increases as the number of labels grows and investors may lose confidence in sustainable labels and ultimately turn away from sustainable products. This topic is at the heart of discussion of regulatory community as the challenge for regulators is to ensure that investors are provided with reliable and comparable information on the sustainability characteristics of products. Labels are largely considered among the key elements of product-level disclosure.

In its Recommendation on sustainability-related practices published in November 2021, IOSCO recommends regulators to consider new requirements or guidances to improve product-level disclosure on sustainability. In particular, IOSCO recommends regulators to cover the labelling of the product providing clear parameters around use of sustainability-related label as this would promote the comparability of labelled financial products. In its Sustainability Finance Roadmap, the leaders of G20 made a call for International coordination on approaches to identify, label and verify sustainable investments. Along the same lines, ESMA in its roadmap highlights as priority action its work on labels for financial products. Clearly, regulators are very conscious that mis-labelling is one of multiple facets of green washing and mindful of the importance to watch on it. The challenge ahead is to design an effective regulatory framework for labels which could strike the right balance between the strictness of the criteria (so as to give label its credibility) and ensure a sufficient large pool of eligible investment opportunities.

Work is in progress and current discussion is mainly about scope and eligibility criteria of the label, verification and assessment of the criteria, time and content of information for the investors. I think the path is there. Time to take action is now.

PAUL
TANG
MEP, Committee on Economic and Monetary Affairs - European Parliament

Labels are omnipresent

From electrical appliances to food, our consumption is often rewarded with a green A-label, or punished with a red F or, god forbid, a G-label. And for a good reason. Without needing to dive into behavioural economics, we know that labels work. Who doesn't want to be rewarded with an A when buying something? Indeed, data from the European Commission confirms that energy labels for electrical appliances will save us some 230 million tonnes of oil equivalent by 2030.

An area lacking in the EU's labelling-drive is finance. With work on an Ecolabel for financial products put on the back burner, focus has been on transparency and disclosure requirements. Being accustomed to analysing significant datasets, the reasoning goes, disclosures are more appropriate for the financial sector than simplistic labelling regimes.

Additionally, the multifaceted impact investments have on our economy mean any labelling regime will be a drastic simplification of the ESG impact of a fund. As such, they may remove from financial market participants the responsibility to look at the broader picture and instead shield behind a label when marketing products to end investors.

Yet, a stamp of approval on a fund is exactly what end investors want. In the need to balance these two aspects – the need for detailed transparency and the user-friendliness of labels – the EU has veered then to the one, then to the other extreme.

The singular focus on transparency has exposed the Sustainable Finance Disclosure Regulation (SFDR) to abuse. This because instead of looking at what is being disclosed, the simple fact of whether a fund discloses according to article 8 or article 9 is seen as an indication of its green credentials. This had led to calls for limiting the types of funds that can use these disclosure regimes. While clarification is certainly needed as to what counts as the 'sustainable investments' that products using the article 9 regime can invest in, policymakers should be careful not to put limits to climate-related disclosures.

The more disclosures on sustainability strategies the better, so especially article 8 should continue to be a 'catch-all' regime for funds wanting to show how they take sustainability characteristics into account. Instead of using the SFDR itself as a labelling regime, the disclosed information should be used to give retail investors easy to understand and trustworthy information on the green credentials of their investments. This could go via labels, but also via limits on the use of ESG-related terms in fund marketing materials. Funds shouldn't, for example, market themselves as 'green' or 'sustainable' while investing in economic activities that significantly harm our environment.

Simplistic labelling regimes should therefore only be part of the regulatory efforts in sustainable finance.

While the unitary focus on transparency has created difficulties for the SFDR, the exclusive focus on labelling may limit the impact of the European Green Bond Standard (EuGBS) Regulation. The exponential growth of the green bond market in recent years has led to bonds with dubious green credentials entering the market. NN Investments estimates that a full 15% of green bonds constitute greenwashing. Creating a gold-standard label in this market may put pressure on market-based standards to improve. But then again, it may not. If investors don't have sufficient data to compare the green credentials of EuGBs with those of other green bonds, competition between them may be limited. What is more, by focussing on the EuGBS, the Commission proposal fails to close a remaining data-gap. The SFDR mandates fund managers to disclose the sustainability performance of their fund, but will, after the Corporate Sustainability Reporting Directive enters into force, only have access to company-level data. Data on the characteristics of the assets underlying Use of Proceeds bonds will not be available.

An equally big risk is that by focussing only on how a EuGBS is spent and not on the issuer, the label becomes a tool for greenwashing. If companies refinance their green assets through a EuGB and use the return to invest more in polluting activities, the 'additionality' of the EuGBS is more pollution. Issuers would pretend to be green while being brown, a schoolbook example of greenwashing. Mandating trustworthy transition plans for companies issuing EuGBs would counter this, while harnessing the power of the EuGBS to help any company transition to a more sustainable business model.

The impact of investments on our planet is more complex than that of electrical appliances. Simplistic labelling regimes should therefore only be part of the regulatory efforts in sustainable finance. Making information easy to understand for end investors should be coupled with disclosure regimes that allow for the myriad of sustainability impacts to be measured and monitored.

Whether it comes to financial products or the bond market, good regulation will combine both elements. But to get there, more work is still to be done.

BIRGIT
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Managing Director Securities Supervision - Austrian Financial Market Authority

Sustainability labels needed to prevent greenwashing

The market for sustainable funds has been growing strongly in both absolute and relative terms, in particular due to increased net cash flows in this segment. Consequently, the market for sustainable funds has evolved from a well-established niche market into the mainstream. Due to the high demand for sustainable financial products, an increasing number of funds promote themselves as "sustainable" or "green". This trend is observable not only for the Austrian market, but also for EU markets.

Given this market trend towards sustainability, potential greenwashing is a top priority for collective investor protection from a supervisor's perspective. There is even a risk that brown or CO_2-intensive investment products are somehow labeled as "green", although no material sustainability criteria are met. It is a paramount supervisory concern that financial products declared as "green" are actually and comparably "green".

As supervisors, we currently face challenges due to the non-harmonization of material (minimum) standards with regard to "sustainable" or "green" financial products, which are problematic for cross-border prevention of greenwashing.

EU legislation has taken fundamental steps by putting into force the Taxonomy Regulation (TR) and the Sustainable Finance Disclosure Regulation (SFDR). New rules require the inclusion of a description concerning the promotion of environmental or social characteristics and sustainable investments in pre-contractual information disclosures for financial products. Such harmonized regulation of disclosures on sustainability is fundamental in order to enable consumers and investors to make informed investment decisions, as the demand for green sustainable investments has been constantly rising.

The SFDR introduces product categories for the purpose of specific disclosure requirements. So-called "light-green financial products" (Article 8 SFDR) promote, among other characteristics, environmental or social characteristics while the objective of "dark green financial products" (Article 9 SFDR) is sustainable investment. Even though the categories for financial products provided by SFDR have not been envisaged as "labels", market participants effectively use them in this way. Furthermore, market participants in Europe are experiencing legal uncertainty with regard to the different "shades of green" as their understanding differs between national markets and jurisdictions.

A labelling approach is needed for financial products to prevent greenwashing.

If we compare the Austrian fund market to other European markets, the significance of different stances towards light and dark green financial products becomes apparent. They may lead to market distortions and fragmentations within the EU financial market and might give wrong signals to investors. Therefore, the market needs further guidance concerning classification on the application of European rules.

Moreover, there are several national eco-labels for financial products and funds already in place and an EU eco-label in development. For example, the Austrian eco-label on sustainable investment products promoted by the Austrian Federal Ministry for Climate Action is widely used, having been established in 2004, making it one of the oldest national eco-labels for funds in Europe. While eco-labels provide some standardization and are prominent in their national markets, they are only voluntary, vary in their requirements and are not within the remit of the financial supervisors.

These issues highlight market fragmentation due to insufficiently harmonized sustainability labelling. By setting clear standards, a label for sustainable financial products should be simple, transparent and easy to understand for investors. Harmonization should occur across different financial products (with the same criteria applying for funds, insurance-based investment products or pension products, etc.) and should not prevent market participants from setting even higher standards.

Ultimately, a label for sustainable financial products should be defined by EU regulation with specific mandatory criteria, as has already been the case for other specific fund classes such as money market funds, EuVECAs or EuSEFs. In the meantime, however, regulatory guidance is necessary to foster sound market development of sustainable financial products. This could be achieved by ESMA Guidelines on (minimum) standards for sustainable financial products such as funds.

In my perspective as a supervisor, a labelling approach appears to be a necessary tool to prevent greenwashing. I strongly believe that the harmonized application of "sustainable" financial products is the only way to achieve a level playing field in a sustainable European financial single market.

BENOÎT DE JUVIGNY
Secretary General - Autorité des Marchés Financiers (AMF)

Clarifying the sustainable investment universe, what is needed labels, ratings...

Today, needless to say that sustainable finance is booming. Regulatory activity has been extremely rich, and taking our European Union (EU) example, has led to an ambitious and complex framework that unfortunately lacks consistency and remains much to complex. Good progress has been achieved on the issuer side, where the political agreement on the Corporate Sustainability Reporting Directive (CSRD) is excellent news. However, investors and stakeholders will remain in need of reliable ESG data, and assessment based on robust and transparent methodologies.

Hence the need and temptation to rely on labels, ratings and data products, and the quick growth of providers to answer these demands. But are those compasses fit for purposes, and is the needle pointing towards the real North? Our responsibility as supervisor is to ensure the credibility of the ecosystem and the development of a green economy of trust. Avoiding greenwashing is key. And there are still key milestones to accomplish and to progress in bringing more credibility to the system, including in the regulatory area.

In the investment space, the Sustainable Finance Disclosure Regulation (SFDR) categories of article 8 or 9 are mistakenly used and promoted as labels, despite being designed only for disclosure purposes. Three competing definitions of sustainability investing coexist and are concurrently used in newly revised Markets in Financial Instruments Directive (MiFID) sustainability preferences. Regulators themselves find it hard to keep up with these concepts. It cannot be expected that investors will be able to do so. Therefore, we urgently need to simplify and clarify the landscape. The most direct route could be to create new categories with minimum requirements inside article 8 and article 9 SFDR categories. Indeed, labels targeted at retail investors are thriving in Europe since the Austrian Umweltzeichen one in 2004. Some have been quite successful such as the French ISR, or the Belgian Febelfin ones. However, the great diversity in geographical scope and contents, and the market fragmentation induced, has led to confusion for the investors.

Our responsibility as supervisor is to ensure the credibility of the ESG ecosystem.

Our AMF 2021 study on retail investors' preferences[1] demonstrated that 71% of the respondents do not know the French ISR or Greenfin labels and around 56% do not trust those labels. It is therefore time to join forces and promote truly European labels, potentially based on SFDR categories. Too narrow, they would only constitute niche products. Too large they would be a catch-all and potential vehicles for greenwashing. The alternative route that could be used as a first step would be to enforce common marketing rules.

Second, it is urgent to regulate both ESG rating providers and ESG data product providers. We have called for that for a while since our 2020 joint paper with our Dutch counterpart and the world of regulators is brewing with initiatives at international levels (IOSCO 2021 Report), and in several key jurisdictions, both in the EU but also UK, Japan or India. All these initiatives meet on the need for transparency on the objectives or the products (risk or impact), methodologies used, ESG preferences rated, underlying data sources and estimates, conflicts of interest management, proper governance... All very classical. Indeed, without such transparency, financial actors are bound to rely on "black boxes" not being able to identify providers that best suit their own ESG needs and adequately understand the products they use.

It is time to regulate ESG rating providers and data providers, this future regulation must cover the entire range of services from ESG data to ratings and services and not be limited to "ESG ratings" where no single definition exists as issues identified are common to all these products. But the diversity of approaches and innovation in this market is an asset and I am convinced we should not standardise methodologies in order to support innovation and market development to ensure financial actors' needs are met.

Last but not least, who better than European Securities and Markets Authority (ESMA) could ensure a harmonised consistent and European supervision?

As a conclusion, Christopher Columbus discovered the Americas by chance, let us not try the same method for our ESG journey, and make sure our compass can be relied upon to show the right path to sustainability.

[1] https://www.amf-france.org/en/news-publications/news-releases/amf-news-releases/sustainable-finance-76-french-people-environmental-impact-investments-important-issue

NATALIE WESTERBARKEY
Director & Head of EU Public Policy - Fidelity International

Common EU ESG labels - Can we get there quicker?

ESG labels in Europe have played a key role in guiding investors and represent a useful third-party validation of ESG credentials of investment funds beyond their self-declaration. Asset managers are increasingly seeking this type of external validation to mitigate the risk of green washing. Labels are welcomed by investors as it provides them assurance that ESG standards are being met by each fund. Investors trust labels to bring clarification to the sustainable investment universe, with some choosing only those funds with ESG labels. As a result, labels help increase and ease the distribution of ESG funds, so their growing importance is welcomed - in principle.

The positive impact of labels, however, does not come without challenges

The fact that label providers across EU member states tend to take different approaches, requiring differing sets of criteria for funds to qualify as ESG funds, is a major challenge. Some countries have more than one label provider, which adds to the confusion. In some cases, there is even a direct contradiction between countries' approach to sustainability. For example, nuclear and gas energy is considered to be sustainable in France, but not by the majority in Germany.

Secondly, the labels are not always aligned with ESG compliance requirements at an EU level. Some labels take an exclusion-based approach and require nuclear energy to be excluded, which is no longer in line with the most recent classification by the EU taxonomy. In addition, in many cases they require prospectus-type language to be included. This leads to diverging requirements across different jurisdictions and can even imply requirements beyond SFDR, the Sustainable Finance Disclosure Regulation. Consequently, it means greater complexity for asset managers, who as a result need to develop operational procedures around this.

The key goal however is to find an approach that works for investors

A self-regulatory approach by label providers has so far proven to be confusing for investors. Hence, label providers need to align their label criteria and approach with evolving EU ESG legislation. This would be in line with the ESG legislation applicable to asset managers and financial service providers generally. The alignment of a labelling approach and criteria with EU-level ESG laws are essential so to ensure simplicity and consistencies of a sustainable finance approach from the point of view of investors.

> Label providers need to align their label criteria and approach with evolving EU ESG legislation.

Even if EU member states choose to deviate from EU-level ESG laws, the label providers across Europe should be guided by regional principles with an EU-level label. If there is investor demand in local markets, they may add a label specific to that particular jurisdiction in addition to the EU-level label. This would allow investors to identify specific local market differences and make informed investment choices based on individual views.

EU legislative developments such as the EU Taxonomy and the SFDR are designed to generate increased disclosure, which will make ESG labelling inconsistencies more obvious. This should require label providers to continuously update the design of their label criteria to remain consistent with the taxonomy.

Such approach will also have a positive signalling effect beyond Europe for international investors. It would address the commonly perceived challenge within the EU to find agreement and act united. Whilst the democratic debate is important to shape its evolving common EU values, it is nevertheless equally important to arrive to a practicable solution - soon. Especially as we find ourselves in a climate emergency, with limited time to reduce global warming, protect biodiversity and prevent reaching irreversible tipping points.

Yes, it is debatable whether nuclear and gas can be considered sustainable: nuclear waste is considered harmful and non-degradable, and gas is a fossil fuel. However, nuclear energy emits almost no CO_2 and gas, as a transition source of energy, is still less harmful to the planet than oil and coal. Where gas is used as a replacement for more carbon intensive technologies, it is - at least comparatively - the more sustainable energy source.

The same principle applies to so-called renewable energies like wind and solar energy, which face challenges around carbon-intensive production and use of rare materials extracted under environmental downside effects.

We have yet to develop a truly sustainable and scalable energy source; hydrogen energy shows promise. In the meantime, we are best guided by relative sustainability criteria among the energy source choices we currently have. With the help of consistent labels across the EU, that are aligned with EU legislation, we have the greatest chance to get to the best possible result within the very short timeframe left to get it right.

CHRISTINA PAPACONSTANTINOU
Deputy Governor - Bank of Greece

The need for a robust framework for scaling up sustainable finance

In the current context of geopolitical tensions and the energy crisis, there is a profound urgency for accelerating efforts towards the transition to a carbon neutral economy. This transition requires the mobilisation of significant amounts of financial resources towards sustainable activities.

One of the main gaps for mainstreaming sustainable finance is the lack of common definitions, standards and labels for sustainable activities and financial products. An example is the absence of requirements for environmental, social and governance (ESG) ratings providers to disclose their methodologies and the low correlation of ESG ratings across providers.

Significant steps are being taken in the EU to address this gap, such as the introduction of the Sustainable Finance Disclosure Regulation (SFDR), the ongoing development of the EU Taxonomy of sustainable activities and the EU Regulation for a green bond standard. However, the comparability of the sustainable financial products offered across and within markets is limited. In particular, the legislative framework for sustainable finance is still under development and there is sometimes inconsistent application of the existing regulation. Market participants apply different frameworks and practices when labelling their offerings and regulators may take different actions at the national level to protect market participants.

Additional effort is necessary to create the conditions for scaling up sustainable finance. More specifically, markets need to be supported by the appropriate regulatory and supervisory framework in order to be transparent and credible, limiting the risk of greenwashing. A commonly applied mandatory framework could improve comparability and transparency of financial markets, protecting market participants, enhancing investor confidence and enabling the mobilisation of funds towards activities supporting sustainable transition. A labelling framework should include clearly defined and sufficiently detailed criteria for assessing sustainable financial products. These criteria could be science-based and applicable to a wide range of products and activities. In addition, a labelling framework could evaluate the transition pathway of the activities which are being financed, when these are not classified as sustainable at the time of the assessment.

The lack of common labels and standards is a major gap for mainstreaming sustainable finance.

Green and sustainable bond markets are dynamic and rapidly growing. The EU can already be considered a leader in green capital markets. EU green bond markets have a higher degree of integration and investors' preference for cross-border holdings (limited "home bias"), which may also be attributed to the lack of local supply of green bonds. Investment funds that meet ESG criteria appear to be more stable compared with other types of collective investment undertakings, as investments are less likely to be withdrawn after a negative performance.

However, more needs to be done in order to increase the depth of green and sustainable capital markets. The lack of transparency and of implemented taxonomies of sustainable activities, as well as the absence of regulation and supervision of sustainable markets and ESG ratings may increase the risk of greenwashing. This risk may be exacerbated by the urgent need to increase finance towards activities aligned with transition pathways.

In order to meet the ambitious targets for the energy transition we need to mobilise a significant amount of financial resources. The contribution of the financial system, both banking and non-banking, is of paramount importance. Financial institutions need to fulfil their role and support the financing of the real economy. In the context of the sustainable agenda this could become an area for the financial institutions to compete and grow.

Although the main responsibilities remain with the governments, central banks can undertake an active role in sustainable growth, within the remits of their mandates. The Governing Council of the ECB agreed last summer on a comprehensive action plan, to further incorporate climate change considerations into its policy framework, with further progress made towards this objective in July 2022, while also addressing climate-related and environmental risks in its supervisory work since 2019.

At the Bank of Greece, we started looking into sustainability issues in 2009 and we are among the first central banks to do so. Within our mandate, we have been supporting national and international efforts towards meeting sustainable growth targets and creating the appropriate conditions for scaling up sustainable finance. We plan to continue our work on this area and, together with other stakeholders, make this transition an opportunity for sustainable growth, towards a more fair and inclusive society.

JESSICA GROUND
Global Head of ESG - Capital Group

Bringing the focus on accessing relevant, reliable and comparable ESG data

We are already 5 years in the implementation of EU's framework on financing sustainable growth. What started with the European Commission's action plan in 2018 has been a tremendous effort from all sides – policy makers and market participants – to work towards setting and implementing an ambitious regulatory regime with investors at the centre of it. With the main building blocks now in place or close to finalisation (the Sustainable Finance Disclosure Regulation (SFDR), the Taxonomy Regulation, the Corporate Sustainability Reporting Directive (CSRD)), the experience drawn from the first implementation phase since March 2021 and in preparation for the second phase as of January 2023, this is the right moment to pause and assess. While there is undeniable commitment and remarkable progress in delivering on the requirements, it remains crucial to keep sight of the main goal: ensuring investors have transparent, relevant and credible data to direct their investment, should they wish, towards financing more sustainable economic activities.

This is a crucial "test" we need to apply prior to launching changes or new regulatory initiatives. The most useful lessons drawn by the industry so far are:

- The SFDR aims at enabling transparency in relation to sustainability-related claims and enhance investment products' comparability. However, this data ultimately comes from issuers, and many key elements are missing. Reporting under CSRD is only expected by 2025, meaning asset managers are struggling to meet their own requirements and provide information to investors that is accurate, non-misleading or avoid following estimations that differ among different actors in the market.
- The Taxonomy regulation is set to create a common language and understanding of the sustainable economic activities' universe. However, the complexity of the project together with delays and controversies as to defining its different objectives has rendered it an extremely difficult tool for asset managers to use and investors to understand.
- The MiFID rules on sustainability preferences created confusion on how they can apply in practice; in an effort to standardise compliance the industry ended up with overly detailed and lengthy boxes to tick. It is not clear how this collection of information will help end investors integrate their sustainability preferences into their decisions.

We need a framework that ensures transparency on the construction of ESG data and ratings.

Capital Group's ESG Global Study this year[1], surveying over 1,100 professional investors from 19 markets around the world, identified the main challenges in terms of accessing ESG investments:

1) While ESG adoption continues to grow, accessing relevant, reliable and comparable ESG data remains a key challenge for investors; hence fears of misselling and greenwashing are on the rise despite all of the regulation in this area.
2) Our survey revealed the challenges posed by inconsistent ratings lacking clarity as to their methodologies.
3) Investors seek a more holistic approach and recognise that social considerations are being overlooked, while the E of ESG continues to dominate investor allocations.

All findings and lessons drawn so far highlight the need for reliable and comprehensive ESG data accompanied by transparent methodologies employed by data providers. At Capital Group we seek to integrate ESG into our research process in a bottom-up fundamental manner using raw data over scores wherever possible. However, we still rely on third party providers to gather ESG data, in particular for some of the new areas like Taxonomy compliance and Principle Adverse Impact (PAI) reporting. We can assume the level of reliance is heavier for smaller-sized asset managers with less globalised expertise and resources.

Based on the main feedback to the European Commission's recent consultation, while the ESG data and ratings market is growing, there are persisting inefficiencies concerning its function. The lack of transparency and significant biases with the methodologies applied, as well as potential conflicts of interests are the main challenges reported. We need a framework that ensures transparency on the construction of ESG data and ratings. This should be focused on establishing clarity as to the methodologies used by third party providers, the sources of their data, the frequency of reviews, the controls applied etc. The objective isn't to diminish the divergence of ESG scores but to make them understandable, track and explain the reasons for divergence, and to easily assess accuracy of the ESG data.

We believe this need for relevant, comparable and reliable ESG data is the main priority the EU and regulators globally need to tackle moving forward. For the EU this would mean more effective disclosures under SFDR, improving usability of Taxonomy and shifting the focus on meaningful and more holistic information for investors.

[1] https://www.capitalgroup.com/institutional/about-us/esg/esg-global-study.html?cid=sm_og_tw_8660939299&sprinkl-rid=7238646222&linkId=172757235