ESG ISSUES IN THE ASSET MANAGEMENT AREA

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SFDR: what is it, and what should it not be considered to be?

The European Sustainable Finance Disclosure Regulation (SFDR) defines disclosure obligations for financial product manufacturers designed to ensure adequate information of end investors about sustainable investment objectives, in support of Environmental, Social and Governance investment principles, and requires the integration of sustainability risks in investment processes operated by financial market participants (FMPs).

The over-arching general regulatory obligation is not new for FMPs and is certainly not specific for ESG labelled products: (i) be precise and transparent on the investment objective of the product from its inception throughout its lifetime, (ii) disclose in a clear, fair, not misleading, simple and concise way to end investors the product features and potential negative consequences on environmental , social and governance factors caused by investment decisions and advice, (iii) design a product in a way to reflect faithfully the disclosure made, and (iv) implement risk management and compliance arrangements that guarantee the permanent management of the product in line with the pre-agreed investment objectives and restrictions. In other words: Explain without ambiguity what the product does (and what it does not do), and put investment and risk governance arrangements in place to ensure that promises made to investors are being honoured.

Irrespective of labelling a financial investment product as Article 6, 8 or 9 under SFDR, these general principles should guide FMPs in their product design, investment process and marketing/distribution activities. SFDR is thus not a “labelling regime”, but a disclosure regulation. SFDR is one major, albeit not the only, component of a regulatory framework aiming at avoiding mis-selling, also often named “green-washing” in the ESG space. Supervisory authorities, whose mission statement includes investor protection, will continue to focus on the correct implementation of SFDR by FMPs, by reviewing and analysing their product pre-contractual and marketing documentation before public release or ex-post, but always with the focus that FMPs should deliver what they have promised to end investors.

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All efforts deployed in relation to the implementation of SFDR level I, the Regulatory Technical Standards under SFDR level II, Taxonomy Regulation, and the development of a EU Ecolabel for retail financial products, pursue the same objective of channeling private savings to investment products following a sustainable finance strategy within Europe and beyond (commonly referred to as *“transition to a climate-neutral, climate resilient, resource efficient and fair economy as a complement to public funding”*). The intention to further stabilise, strengthen and harmonise the EU sustainable finance regime is supported by the need to clarify several fundamental concepts, such as the definition of a sustainable investment – which will logically also form the basis for defining “green-washing” –, the setting of investment thresholds to disclose under SFDR Article 8 and 9, and the resolution of inconsistencies existing between SFDR and the Taxonomy Regulation.

Acknowledging the fact that SFDR, ESG and Taxonomy still present significant legal, technical and operational challenges for FMPs and for supervisory authorities, we need to keep our attention focused on those factors which are urgent and which really matter as they will determine the success of making sustainable finance attractive to investors. One of these factors consists in the workability of the sustainable finance rulebook which would need to be further enhanced at EU level, so as to provide clarity on the interpretation and implementation questions raised by various stakeholders, including by not limited to investors, FMPs and supervisory authorities. The credibility of the sustainable finance rulebook risks to be negatively impacted by the lack of clarity on fundamental concepts which, in addition to creating legal uncertainty, complexifies disclosure by industry participants and supervision by national control authorities.

These challenges should, however, not overweight the benefits of a harmonised EU regime. One prominent example is the creation of European ESG disclosure templates which represent a notable step towards targeting standardised and comparable disclosures to end investors. By acknowledging at the same time that disclosure templates still need to be simplified to ease a comprehensive disclosure to end investors and most importantly retail investors.

To make this strategic European project successful, care must also be taken to remedy those initiatives which may create market fragmentation, such as the introduction of national “top up” SFDR and ESG rules and regimes, or differences in the application for different products under (the same) SFDR. Because such fragmentation puts into question not only the good functioning of the European passport for investment products, but of the EU Single Market as a whole.

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ESG rating regulation – A missing element of the EU sustainable finance agenda

Environmental, Social and Governance (ESG) ratings are widely used in the context of sustainable investing, despite the fact that no consistent definition or methodology exists for determining such ratings. An on-going debate concerns the lack of clarity about the objectives of these ratings and ESG investing in a broader sense.

In its Sustainable Finance Strategy, the European Commission recognised the growing impact of ESG ratings on the operation of capital markets and on investor confidence in sustainable products. A long-awaited proposal for regulating ESG rating providers is expected to be published on 13 June 2023.

No common underlying methodology

At present, there is no consistency on the market as to what the ESG ratings are aimed at measuring - impacts of products and businesses on environment and society, financial risks from ESG factors to products and companies, opportunities arising from ESG factors or all of the above. In turn, this undermines the concept of ESG investment.

Citizens and investors tend to care about the impacts of business on the environment and society and therefore often think of ESG ratings as reflecting those impacts. However, in most cases ESG ratings providers aim to capture only sustainability-related risks, i.e. financial consequences of sustainability factors for the companies and products. Further, there is neither transparency nor a consistent approach to how the Environmental, Social and Governance component scores are eventually aggregated into the final ESG ratings.

Ultimately, a 'standard' ESG rating does not exist. Every such rating is a different measure, defined by the specific provider. Unlike credit ratings, which compete in providing best estimates of probability of default of the rated entity despite using proprietary methodologies, ESG ratings do not have any common underlying metric. This makes a comparison between ESG ratings coming from different providers at best very difficult to impossible.

A recipe for greenwashing

Despite the confusions and absence of clarity, ESG ratings have proliferated: investors use them to make investment decisions, companies - to claim positive contributions to the environment and society, and; even supervisors explore these ratings when analysing climate-related risks incurred by the financial institutions.

> **Transparency, supervision and robust governance are key to combat greenwashing.**

The lack of clarity and diverging expectations on the objectives of ESG ratings is a recipe for greenwashing practices. Investors are misled by sustainability characteristics of the products they purchase and are increasingly losing trust in ESG investment as a tool to achieve positive environmental and societal impacts.

Companies using ESG ratings to design their sustainable product offerings increasingly struggle to substantiate such claims. Thus, there is a need to improve the quality of information on which investors, businesses and other stakeholders base their decisions. How such decisions are made, including the information used, is key to facilitating the transition to a sustainable economy.

What must the new legislation achieve?

Every ESG rating should follow three founding principles: 1) it must have a clear objective and be transparent about the methodology it uses; 2) it must be founded on reliable and identified data; 3) it must be unbiased. These principles are fundamentally important if ESG ratings are to be a reliable guide for investment decisions in the context of sustainable transition and, in particular, in the context of the EU ongoing work on defining and combating greenwashing. Thus, the backbone of the upcoming EU regulation should be:

1) **Transparency:** including minimum requirements for methodologies and data sources, clear description of objectives; and differentiation among the Environmental, Social and Governance components. It is misleading, therefore, and should be forbidden, to provide only a single metric without differentiation.
2) **Supervision:** including an authorisation process, a governance structure, resourcing arrangements, and procedures to prevent conflicts of interest.
3) **Prohibition of conflicts of interest:** such as prohibiting provision of ESG ratings and other related services to the same issuers, prohibiting ESG rating providers from holding equities in the entities being rated; mandating that providers have adequate internal control structures.

ESG rating regulation should carefully consider the existing and evolving ecosystem of sustainable finance. On the one hand, ESG ratings evolve alongside multiple voluntary ESG labels, ESG product characteristics defined by the Sustainable Finance Disclosure Regulation (SFDR), as well as definitions of sustainability preferences as per MIFID and IDD. On the other hand, ESG ratings which claim to assess financial materiality of ESG risks for an entity should arguably be considered as part of the traditional credit ratings, which are required to take into account all material risks.

The article is based on an upcoming Finance Watch publication.

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Unlocking the potential of the EU Sustainable Finance Information System

The EU Sustainable Finance Agenda has created a new sustainability information system. This system is complex due to its reliance on a number of pioneering and interconnected regulatory mechanisms including SFDR, CSRD, and the Taxonomy. However, this system holds the potential for ground-breaking insight: knowledge and tools to understand and manage how investments impact the environment and society. What steps are needed to unlock the potential of this system and to scale up real-world investments?

Two key challenges must be tackled to realise the potential of the EU system. First, guidance is needed on how essential components are intended to function in the real world. Second, a high degree of quality and integrity should apply to the production and use of sustainability information within the system. Information providers, companies, financial market participants, regulators, and policy makers must all work together to tackle these two challenges.

On the first challenge, to reach a 'steady state' and become fully operational users must understand how to apply the central mechanisms of the system. As with any new system, users have encountered difficulties when translating theory into practice. Firms are grappling with new rules on disclosures, thresholds, definitions, timelines, and product classifications. Even when provisions are clear, the time and resources needed to adjust processes are significant. When the rules are not clear firms are left with uncertainty which can lead to paralysis.

Elements of the system which have been identified as problematic should be tackled with urgency. Implementing guidance on how to interpret and apply key definitions should be prioritised. Clear explanations on how to apply accounting rules, interpret technical screening criteria, and determine significant harm under the Taxonomy and SFDR are needed. Where necessary, amendments to specific provisions should be considered to prevent unintended consequences. For instance, under SFDR the complex definition of Sustainable Investment and the potential for product classification categories to be misapplied as marketing tools have been identified as deserving attention.

The EU Sustainable Finance Agenda has created a new sustainability information system.

The second challenge relates to information quality. The success of the system will rely on the availability of high quality, assured, and accessible sustainability information. The system should apply high standards of quality and integrity to the data it generates through disclosure and uses as input data. However, much of the information required is not yet available due to a mismatch in timelines for financial and corporate disclosure regulations.

Solutions are on the horizon. The CSRD will – in time – provide many of the standardised and assured data points necessary for firms to fulfil their reporting obligations. Upcoming disclosure requirements for companies subject to the Taxonomy and CSRD should therefore be timely, clear, and attainable. Once established, ESAP should render that disclosure accessible in a machine-readable format.

However, given the specialised nature of sustainability data and the global nature of financial markets it is likely that information intermediaries will continue to play a role. In this context, sustainability information products have come under scrutiny. These products offer a range of analysis, research, technology, and data solutions on sustainability matters. It is important that they also have high quality production methods.

Again, solutions to meet this challenge are available. International standards for sustainability information providers have already been developed. IOSCO's Sustainable Finance Taskforce launched a dedicated workstream in 2019 which fostered a productive dialogue between policy makers and sustainability information product providers. This resulted in the publication of a detailed set of IOSCO recommendations for ESG ratings and data providers in November 2021 covering methodologies, transparency, governance, and managing potential conflicts of interest.

IOSCO's final recommendations for ESG rating and data providers are welcome. The recommendations focus on the promotion of high quality ESG ratings and data products. Consistent implementation of the IOSCO recommendations will support the production of high-quality products and will help to avoid fragmentation across jurisdictions. S&P Global will continue to contribute to this important dialogue as the EU looks to implement IOSCO's recommendations through potential regulation.

All new systems encounter implementation challenges. A system as complex as the EU Sustainable Finance Agenda requires active steps and interpretative guidance to remain aligned to its ultimate objective: facilitating capital to flow to real world projects aligned to the objectives of the EU Green Deal. Clarifying the rules and safeguarding the quality of information powering this system will be of paramount importance.

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How rules on funds' naming can clarify the SFDR framework

1 January 2023 was a key milestone in the implementation of the EU sustainable finance regulatory agenda with the entry into application of the so-called Level 2 measures of the Sustainable Finance Disclosure Regulation (SFDR). Accordingly, asset managers now have to disclose key indicators as defined under the pre-contractual templates for their Article 8 and 9 products and from June 2023, they will have to produce extra-financial data as required in the templates for annual reports. Mandatory Principal Adverse Indicators (PAIs) at entity level will also be requested in a quantitative manner by mid-2023.

BNP Paribas Asset Management welcomes all measures resulting in further transparency and better comparability between products for end-investors. The SFDR, as well as the Taxonomy Regulation and recently adopted Corporate Sustainable Reporting Directive (CSRD) should contribute significantly to the transition towards a more sustainable economy through enhanced harmonization and standardization, both at entity and product level. At the same time, it appears that structuring concepts and definitions to be applied by financial market participants have not yet been clarified by European policy makers, this leading to some degree of confusion and possibly additional claims on greenwashing.

BNP Paribas Asset Management believes that work should be pursued for establishing a framework addressing end-investor protection and meet their expectations in terms of sustainable preferences. ESMA's proposals on fund's naming guidelines can be a positive step forward in the fight against greenwashing, provided that a relevant approach is applied. BNP Paribas Asset Management recommends that instead of introducing absolute thresholds for the use of ESG and sustainable-related terms in funds' naming, a relative approach should be adopted. It would consist in making the use of ESG and sustainable-related terms linked to the proportion of sustainable investments in one fund compared to its benchmark or investment universe.

For example, if an investment universe has 40% sustainable investments, then a fund investing in that universe would qualify as sustainable if it has more than 50% sustainable investment (using the same methodology). This selective approach would allow to neutralise the lack of clear definitions as mentioned above and most importantly reward funds with highest standards in their selection.

Fund's naming rules can be a positive step forward provided that a relevant approach is adopted.

In addition, it is quite important that asset managers have the possibility to develop their own methodology for identification of sustainable investments while complying with common principles on calibration and criteria. Assessing sustainable investments at entity level is also essential, instead of having a look-through approach on the activities of this entity. Otherwise only taxonomy-aligned products would enter in the sustainable investment category while data on taxonomy remain scarce at this stage and taxonomy alignment is very low for most companies (today less than 1% of issuers are 100% taxonomy aligned). With such a narrow definition, investors will all invest in the same products, which would create a bubble on a few assets while not financing sufficiently the broader needs for the transition. This would be totally in contradiction with the initial purpose of the EU Green Deal.

BNP Paribas Asset Management also believes that regulators need to work on how derivatives can be included in sustainable strategies when these contribute to the ESG dimension of the investment funds. It is notably important that their use remains authorized and that they can be taken into account for the calculation of the minimum proportion of investments used to meet the sustainable investment objectives. In that case, as for the methodology and criteria used for selecting sustainable investment, high transparency standards should guarantee that manufactures design their sustainable strategies according to the objectives assigned under the SFDR.

BNP Paribas Asset Management is convinced that retaining such principles, alongside with the introduction of minimum criteria for Article 8 products and the streamlining of extra-financial information to be reported, would represent a great foundation for introducing a labelling scheme at EU level, easily accessible to all investors, including retail ones.

More globally it could be considered as a valuable option when assessing the SFDR as currently designed and thinking on how it could be improved for the benefits of both market participants and end-investors.