ESG issues in the asset management area

1. ESG Labels: more convergence in the EU is needed

An industry representative stated that ESG labels can be an efficient tool to attract finance towards the transition of the economy, but the difficulty remains that there are diverging rules from one label to another. Their firm considers that there should be ESG labels developed for the European level, rather than various national levels. This would be very positive for the industry and end investors because it would provide clarity with common standards, principles, and constraints.

Consistency and coherence are essential for sustainable finance and ESG. There are different pieces of EU legislation and a lack of consistency, which means that there is a difficulty across Europe. The development of an EU labelling scheme within the SFDR framework would ensure more consistency. The European Commission is going to launch a consultation on SFDR improvements, and an EU labelling scheme should be considered within this because it would create consistency and simplicity for the end client. These are success factors for the development of ESG European labels.

An industry representative stated that ESG labels can solve the problem of information asymmetry, because they are a shortcut for the user to make a choice on the integrity and quality of a product, based on the work of others. The complexity of the EU sustainable finance system means that this is especially important in the retail sector. A recognised set of labels that are comprehensible to the end investor will avoid misallocation and potential greenwashing. From there, the market can scale around a specific standard.

The Article 8 and 9 classification designations are perceived as labels, but they are actually disclosure frameworks. Therefore, there is a problem with the sustainable investment definitions that incorporate the articles.

It is interesting to see the European supervisory authorities raise concerns about the mismarketing of the classification systems as labels, which shows that this is a risk that needs to be addressed. At national levels, there are existing labels that are not aligned or are incompatible with the taxonomy of the SFDR, which has created the divergence and fragmentation of the landscape with pseudo-labels. This is not a good thing from a risk perspective.

A pan-European labelling regime is one of the missing pieces in addressing the challenge of how best to move away from the current problems. A simplified and standardised labelling regime that communicates with the end user is another missing piece. If done correctly, the introduction of a labelling regime as an evolution of the SFDR would solve the information asymmetry for EU investors.

A regulator commented that the labels are currently self-regulated. Lux-FLAG in Luxembourg has been working on labelling for many years, and it has been encouraging that the integration of sustainability-related considerations has been discussed. It is a much broader debate than just labels and is also about having the right systems and risk management processes to deliver on commitments made to investors.

The sustainability labels play a key role in the regulatory landscape and make it easier for investors to compare products via a standardised process. They also provide some assurance on the greenness of investment products by introducing minimum requirements. Clarity and transparency are necessary so that is understandable and comparable for investors.

The Commission de Surveillance du Secteur Financier (CSSF) is not broadly in favour of creating a European regulation and supervision of sustainability labels by national control authorities supervising the financial sector. This should remain with national labelling agencies, but the CSSF strongly supports the Ecolabel that is being discussed at European level. It needs to be clear to the end investor, which is a common mission for all regulators both inside and outside of Europe.

In terms of the work of the European Securities and Markets Authority (ESMA) on sustainability issues related to ESG labels and ratings, and action on greenwashing, a regulator updated that the workstream on greenwashing had originated from a call for advice from the European Commission. ESMA as well as EBA and EIOPA are faced with the task to provide a report, which will be provided in a coordinated manner with the other ESAs at the end of May 2024.

The second ongoing workstream is a public consultation on the use of fund names. The public consultation has already finished, and ESMA is currently evaluating the answers and comments.

The third workstream is waiting for the proposed legislation on ESG ratings and scores from the European Commission. This is expected in June or July 2023.

It is very clear that labelling and fund names are important because they give easy to digest information to the customer. However, if the name or rating is wrong, then there is a serious problem. An ESA call for evidence has revealed quite a list of misleading qualities from sustainability claims. These include empty claims, omissions, lack of disclosure, vagueness, inconsistency, a lack of fair and meaningful comparisons, claims with no proof, outright lies, misleading imagery and sounds, irrelevant and outdated information, and a misleading usage of ESG terminology. As a result, there needs to be consistent regulation that gives correct and understandable answers.

2. ESG ratings: What should be the content of an EU regulation?

The Chair commented that the issue of ESG labels was connected to that of ESG ratings. ESG ratings delivered by different providers also creates divergent results which adds extra challenges to the credibility, comparability, and transparency of ratings.

A market expert stated that they welcome the European Commission's proposed ESG ratings regulation due on 13 June. This is because the ratings are being widely used by fund providers to underpin sustainability assessments, and they are being used by investors who think they will achieve a positive impact with their investment if they see a good sustainability rating. The ESG ratings have been mentioned by supervisors like the European Central Bank (ECB) when they try to come up with proxies that will assess ESG risks in bank portfolios. There is a wide disparity between these ratings because different concepts are being put into these ratings by rating providers. Retail investors have also looked at the ratings as an assessment of a company's impact in the ESG space, and investors have looked at financial materiality, i.e. risks that the ESG factors pose to the products and entities they invest in. The way that impacts and risks have been combined into a single metric is very different across different ratings.

'Environmental', 'social', and 'governance' are very different dimensions so that it is not meaningful to aggregate them into a single metric and the ways different rating providers aggregate them are also different. There is no single ESG rating. Unlike credit ratings which aim to assess probability of default of the rated entity, ESG ratings do not have a common underlying metric and are proprietary measures of different rating providers. These different measures are inconsistent among each other in what they assess: Some assess absolute performance, others best-in-class performance; some evaluate the positive or negative impact to a company from ESG factors (i.e., risks), others the impact that a company has on ESG factors. It is also possible to find companies that are harmful to the environment in some ESG-labelled portfolios. All of these create a recipe for greenwashing because of the misunderstanding and confusion that results, which undermines trust in the sustainable investments.

There is a clear need to regulate this area, so the European Commission's proposal is welcome. There should be at least three elements to the proposal. The first is transparency about what is being assessed. There should not be a single ESG metric, and instead there should be a clear distinction between 'environmental', 'social', and 'governance'. There should be requirements of how the ratings align with the taxonomy to achieve sustainability outcomes, and requirements on the data used and whether the data has been verified.

The second element should be the supervision. ESMA should be tasked with supervising ESG rating providers. There should be oversight over the governance structure, resourcing arrangements, and the procedures to prevent conflicts of interest.

The third element is the prohibition of conflicts of interest. ESG rating providers should not rate the companies that they provide other related services such as advice on sustainability-related matters. Shareholdings between ESG rating providers and the companies they rate should be limited to restore trust and give objectivity and clarity to the users of ratings.

An industry representative stated that the standardisation is not desirable at present because the market is not mature enough. Another concern is that there is a lot of indemnification by companies and investors who pick the provider that makes them look best, or do not have consistency because they do not use the same data source for the same reason. This is something that regulators should also clamp down on.

It is hoped that the legislation will cover data quality and ensure that there is more transparency, accountability and the managing of conflicts of interest. Often, the data that has been used is backwards-looking, and the question has to be asked whether that is relevant and means that a company is effectively managing the transition. The ESG rating does not provide any of that information, even though the information is critical to allocate capital to the right companies. There is no notification when a data point is updated or a methodology has changed, and it is instead the role of the asset manager to check with the data provider. Money is being paid for this service, and so it should be flagged when changes are made.

An industry representative expressed the view that ESG ratings have to have integrity and transparency. The methodology must be transparent and publicly available, and the ratings need to be produced in a way that they are not subject to conflicts of interest. There should be regulation for ESG ratings. Their firm has been constructively working on this with the International Organisation of Securities Commissions (IOSCO) for four years. A number of jurisdictions are already implementing the recommendations that IOSCO came out with in 2021. It is important to stay faithful to the principle of the IOSCO recommendations when they are implemented and codified.

It must be clear what an ESG rating means. There are NGOs and asset managers that provide this as a service, so this needs to be a level playing field. The independence of ratings providers should be prioritised. The homogenisation of and political interference in methodology should be avoided if there is going to be objectivity. If this is a service that going to be integrated into financial markets, there needs to be regulation like credit rating agencies.

It may be unlikely to see convergence in the ESG rating space because there is imperfect disclosure which may never be solved perfectly because this is a global capital market. The second reason is that ESG ratings measure a wider spectrum of issues than credit ratings. The amalgamation is a problem and disaggregation is a solution. Ratings providers are trying to unpack it and deep dive into the data to the source of the information of an ESG rating.

The methodologies of the ESG ratings are different. Some providers try to only measure financial risks, while others try to measure impacts on the environment

or society, and others measure both. It is critical that there is clarity as to what the product is measuring in the data and ratings spaces. There should be consistent regulation across jurisdictions that link to the IOSCO recommendations. There should be a minimum standard of quality.

3. SFDR: How to improve its implementation

A regulator stated that there are different steps in the implementation. The requirements by ESMA from the private sector and supervisory authorities had been shown in the ESMA supervisory briefing. Investors should be asked whether the broader transparency has been achieved. From discussions with asset managers, it was clear that there was still need for improvement. The SFDR has brought some level of transparency even though it may not have reached the stage ultimately desired, but there has been some clarity on the roles of financial market participants in the financial product levels.

There have been positive outcomes. This has triggered a lot of challenges for financial market participants and regulators. There needs to be a further stabilisation, strengthening and harmonisation at the European level. The European Commission has recently issued a Q&A on the definition of sustainable investments, but a clearer definition of that concept is still sought, and then we will ultimately have a clear definition of greenwashing.

There are other issues in the inconsistencies and interlinkages between the SFDR and the taxonomy regulation, where more work maybe needs to be done. This needs to be a European initiative that avoids the creation of market fragmentation, following-up on the work which has been done by ESMA. If rules are considered for product names using ESG or something similar, these rules should be introduced on all types of product fund names because SFDR relates to more than investment funds.

Having a range of different national interpretations should be avoided because there should be collaboration with the EU to find a better process. The creation of ESG disclosure templates is the important step towards targeting standardised and comparable disclosures. That is ultimately what must be achieved, and the disclosure templates need to be worked upon to enhance their comprehensibility and comparability. The disclosure templates have been reworked because of recent nuclear and gas disclosures. That was a very short-term measure to take and that is something which should be avoided in future in order not to put undue costs on end investors.

A regulator commented that prudential actions are not the main issues. The creative chaos around the ESG on financial markets should stop and clear rules were needed so that there is transparency and the removal of legal uncertainties. The right level to regulate that would be at the EU level so that there is a common definition of ESG across Europe.

For there to be transparency, there needs to be sufficient data. It should be easily recognisable whether a product is already green or in the process of becoming green, and investors should know whether they are in investing in green or best-of-class products in advance.

SFDR is not a prudential law in itself as it is a disclosure regulation. The Sustainable Finance framework must be made consistent, and therefore there needs to be a clear rule and system of what ESG means. The solution is not additional prudential buffers.

A market expert stated that there was a need for a clear definition of sustainable investment in the regulation. Different methodologies are being used by investment product providers to say what is sustainable and how the level of sustainability of a product is determined. This also applies to how the consideration of principal adverse impacts is assessed, which are currently part of the SFDR disclosures. Lack of consistent definitions impact sustainable investments do not ensure comparability between investment products of different providers.

From the perspective of the transition and growth of the sustainable sector of the economy, the grounding principle of the whole SFDR should be whether the products and instruments are allocating funds to real economic activities. There are many complex products and unresolved issues with respect to their sustainability assessment (such as derivative products), yet their resolution should follow the guiding principle that the goal of sustainable finance should be the allocation of funds to sustainable activities. This transition is rarely seen, and this is concerning.

The second element that should be tackled is the inconsistency and disparity between the definition of sustainable products per SFDR and of financial instruments per MiFID, because there are certain financial instruments that are not captured under SFDR. The question of the assessment of sustainability of those instruments remains open and at the discretion of product providers.

The question remains whether SFDR should continue to be a transparency regulation as intended, or whether it is a semi-labelling regulation where articles 8 and 9 are effectively being used as labels. There is clearly a lack of minimum requirements for article 8 and 9 products to be recognised as sustainable. There should be certain criteria with respect to sustainability performance, engagement policies, and the effective capacity of the instrument to allocate funds to economic activities. Addressing these issues is crucial to for the trust of investors into sustainable finance, because only then what is labelled or disclosed as sustainable will fulfil that role.

An industry representative noted that there is agreement that clarity was needed on many key concepts. Standardisation and comparability with other products should be allowed for to avoid diverging interpretations within the industry and by national authorities. The goal is to simplify the access of this product because intelligibility for retail clients is key. If there are concepts or products that are too complex, they are not going to meet the expectations of the end clients.

On funds naming, the ESMA proposal to introduce guidelines is welcome, but that this note should be done with absolute thresholds as they could have unintended consequences that lead to greenwashing. Instead, the actual proportion of sustainable investment should be looked at and compared to the investment benchmark. The ESG and sustainability-related terms can be applied if the proportion is above the benchmark. This is how funds naming guidance can be quickly fixed.

It is important to have the possibility to make the assessment of sustainable investment at the issuer level and not at activity level. There is ongoing consultation on the SFDR which includes the simplification of what is already in place. This consultation is welcome because it is necessary to simplify the templates. There is also a need to review the treatment of derivatives, which has not been done so far. It is important to see how they can be taken into consideration when they contribute to the ESG dimension of the product.

The availability and reliability of data is central to the issue. The proposals made on new indicators make sense, but the question is whether the data is available or reliable.