Clarity and reliability of the sustainability framework

Introduction

The panel discussed the impact of the sustainable finance framework and the possibility to improve its clarity and reliability. The Commission, Council and the Parliament have worked hard in the last few years to develop at rapid speed a whole new framework to respond to the climate emergency.

Two recent additions are the first set of European Sustainability Reporting Standards and the proposal on environmental, social and governance (ESG) ratings.

1. Correcting greenwashing practices

ESMA highlighted that the new framework is gradually coming into place with new legislations, regulations and clarifications for the market. While implementation is progressing, a pressing concern for supervisors, investors and broader stakeholders is to ensure trust in the system and reduce the risk of greenwashing. Greenwashing concerns and occurrences have been observed during the first phase of the implementation. The immediate concern for supervisors and the financial industry is preserving trust in the system and the risk of greenwashing. That risk is material, real and no longer contested.

The three European supervisory authorities published their interim report on occurrences and sources of greenwashing in the financial markets in June 2023. They developed a common definition of greenwashing and have identified the types of practices that are most exposed to greenwashing risks.

The final report is due in May 2024. It will include reflections on whether the regulatory framework is enough to combat greenwashing or if additional policy developments are needed. The overall objective would be to enhance the reliability and legal certainty of the framework in order to build trust in sustainable investment and support the transition to a more sustainable economy.

The second angle in combatting greenwashing is to ensure proper supervision and enforcement by the national authorities. ESMA's role is to foster more convergence through consistent messaging.

2. Implementation difficulties for SFDR disclosures

CSSF remarked that significant efforts have been deployed by the industry and supervisors to ensure compliance with SFDR requirements. There is a lack of common understanding at a European level regarding some requirements, as well as diverging supervisory practices among national competent authorities (NCAs).

These divergences, mainly due to the lack of legal clarity within the framework leading to different interpretations amongst stakeholders, have resulted in low levels of comparability in disclosures.

That does not help in terms of comparability.

A regulator stated that as long as key concepts such as 'sustainable investment' are not further defined at (European) level one, there will continue to be comparability issues. SFDR is a disclosure regulation but has been conceived as a labelling regulation. It would be a good idea to extend the SFDR combine it with minimum requirements for labelling at the European level.

Supervisors have to be present. The framework is not perfect, but it can be perfectly supervised. To spot cases of greenwashing, the Austrian FMA started a quantitative greenwashing market screening this year and compared the description of sustainability-related aspects in different fund documents (image of sustainability) with the actual pursuit of the investment strategy (investing in sustainability).

To combat greenwashing, also eco-financial literacy has to be enhanced. The Austrian Institute for Advanced Studies did a survey based on a learning tool to provide relevant information about sustainable investing. The results show that on average only half of the questions on sustainable finance necessary for investments can be answered correctly by a representative sample (concerning age and gender) of the Austrian population.

3. Availability and quality of ESG data

An industry representative noted that the key issues that the regulatory framework seeks to address are around the quality and availability of core ESG data, which is critically important to the industry and for accelerating to a low-carbon economy. There has been significant progress under the Corporate Sustainability Reporting Directive (CSRD) and other regulatory measures, but there is still work to do. The implementation of the CSRD being seen as the end point could be concerning.

Greenwashing is the number one blocker for increased investment in sustainable products and assets. Among the investors who are not engaging with sustainable investment strategies, 40% say that the risk of greenwashing is holding them back.

Tackling greenwashing comes down to enhancing the quality of ESG disclosures. With the wider scope of the

CSRD, we expect is a large increase in the availability of ESG data. Corporates are facing challenges around the production of the data and the interpretation of some of the requirements. That is an area where improvements will be needed from everyone.

To reach the net zero goals and carbon neutrality by 2050, it is estimated that $100 trillion will be needed by 2050. The provision of accurate, reliable and robust data is key to accelerating this investment allocation. The ESG ratings regulatory framework will inspire the transparency needed in the industry. There is strong need for such tools and analytical frameworks to analyse ESG performance and profiles in the markets. It is very important for the input data to be transparently sourced. It is also important to have a focus on the independence of thought and research.

Financial market participants have been using proxies to cope with the lack of data. Some issues have emerged when using proxies, such as the lack of transparency on the methodology and metrics used. An industry representative highlighted that terminology confusion is a major problem in sustainable finance. It is broader than some of the terms highlighted and could also include doing no significant harm, sustainable investment, transition and greenwashing.

Markets and regulators need time to understand the terms and requirements of the framework, and to agree on their implications. It is also in part because people are looking to impose a meaning with terms that might be inappropriate or stretch language so far that it becomes misleading, which leads to greenwashing. ESMA, the European Supervisory Authorities (ESAs) and the NCAs have done excellent work with the interim report by identifying the nodes along the sustainable investment value chain. It is important to think about being part of that investment value chain.

Much of the greenwashing challenges come down to confusion around terminology and the ability to distort a version of a sustainability profile. In its report, ESMA identified the moral hazard. Beyond language, there is a problem around the high demand for sustainable investments in the market and the very low number of sustainable investments available. ESMA has found that, in the funds and equities space, and corporate bond holdings, only 1.4% is aligned with the taxonomy. An industry representative's firm ran its own exercise a year ago. Of 4,000 companies in Europe, only 0.02% were aligned. Only one company was completely aligned. Over 99% were not aligned. This is a fertile space for confusing and misleading terminology.

The terms listed in the question are distinct things along the sustainable investment value chain. Good guardrails are needed for all of them to be clear on what is being talked about.

The confusion about what an ESG rating is doing has to be resolved. Some have a double materiality lens. Some are purely impact focused. Some are financially material. There is a need to know what is being measured. The methodologies need to be transparent. The governance needs to be there. There should not be any confusion in two years' time on ESG ratings. Clear labels are needed in the space. ESG ratings and ESG scores are the same thing, so they should have the same name. There is a need for harmonisation, transparency and clarity in the ESG ratings market. There should be a regulation for them. The International Organization of Securities Commissions (IOSCO) has done good work there. An ESG rating is not the same as an ESG factor in a credit rating. There is the Credit Rating Agency Regulation. Credit ratings look at credit risk and although ESG factors can be relevant in credit ratings they not always are.

Applying the term ESG to information should be done with discretion. The question is whether this problem should be solved in the disclosure area via the CSRD, the International Sustainability Standards Board (ISSB), or assurance at source so that everyone gets comparable, reliable data. When an ESG data product has a rating or threshold, and is providing a judgement, going beyond the estimates, or representing itself as something beyond pure data, there is a need to know where the threshold should be drawn on regulation.

4. Priorities to improve sustainable transparency

A regulator emphasised that labels are the most important aspect to prioritise. A number of pieces has already been put in place, although not necessarily in the right order, so the situation is much better. When the Commission and the co-legislators reopen the framework, a forward-looking perspective is needed, taking into account what will be in place in three years. There will be the CSRD and the European Sustainability Reporting Standards (ESRS), and the hope is that there will also be the ESG rating proposal. There is strong support from ESMA on this. A key point that needs to be considered collectively is how to support investors with meaningful EU-level labels, rather than just going for disclosures.

A regulator remarked that the recent initiatives are important milestones towards transitioning to a sustainable economy. However, the foundations of the existing regime should be strengthened before moving forward. Defining sustainable investment is a core pillar of the framework. Without this, the threat of greenwashing will increase and the objective of investor protection will not be achieved. There is divergence between funds that are disclosing under Article 8 of SFDR today, which raises issues of the comparability of the products and of having a level playing field for different member states.

The objective of a sustainable finance framework is to transition to a sustainable economy, and there should be a coordinated EU response. The EU should remedy initiatives that create market fragmentation. For example, there is the introduction of national top-up SFDR regimes and differences in the application of SFDR for different financial products. This should be addressed in level 1 text and should concern all products that are in scope of SFDR.

A regulator agreed about the importance of the CSRD for completing the framework. There will be data, but the challenge there will be not only to get quantitative, but also qualitative data, where there is a common challenge in getting the resources and trying to clarify the likely inconsistencies. Regarding resources, it will be difficult to find sufficiently skilled personnel. Furthermore, inconsistencies and interpretation issues in the reporting standards as well as with regard to the application of CSRD will have to be clarified in a close dialogue between the regulators and the industry. An industry representative stated that there is a need to focus on the foundations. It is important to not be so prescriptive that the market is stifled. When it comes to CSRD, the focus must be on embedding and supporting corporates to produce better-quality data, recognising that there is a vast discrepancy in terms of levels of maturity and resourcing. Focusing on fixing the data quality and availability problems at source are the key activities where support from regulators and policymakers is sought.

An industry representative noted that categories of products should be created. A labelling regime in parallel to SFDR would help avoid the use a disclosure regime for labels. There is also a need to recognise that there is a spectrum of investment when it comes to the ESG space, from ESG integration all the way through to sustainable impact thematic strategies. Any future labels should take this into account. Many existing labels in the market are exclusionary-focused. Stewardship has a major role to play in achieving real-world outcomes, and labels also have to take that into account.

An industry representative emphasised that the sustainable disclosure revolution that is about to happen is extremely important. It is good that ESMA has identified this as an EU strategic supervisory priority to be coordinated as much as possible, and that fragmented implementation of the directive in different markets should be avoided, together with the application of the ESRS. It is regrettable that the materiality assessment will leave some gaps, but the implementation of that disclosure piece is extremely important and needs to happen.

The Chair noted that the SFDR will be reopened and there will be a public consultation soon that will run for three months. The issue is being considered with openness and from a global perspective. The intention is to launch a comprehensive project under the new mandate, subject to the political approval of the new Commission and college.