

# CONVERGENCE OF SUSTAINABILITY REPORTING STANDARDS: CHALLENGES FOR EUROPE

Note written by Patrice Morot, PwC

## YES TO A CONVERGENCE OF SUSTAINABILITY REPORTING STANDARDS, RECOGNIZING PIONEERING EUROPE'S CONTRIBUTION

Sustainability issues are at the forefront in today's world. The pandemic, growing awareness of the climate emergency and stakeholders' increased sensitivity to environmental and social issues have called into question the relevance and viability of our economic models.

These new circumstances also underline the need to develop a long-term vision. Businesses cannot win in a world that is losing. A fundamental environmental and social transformation must be achieved over the next decade.

Sustainability reporting (formerly non-financial reporting) has a central role to play in the transition at hand. Corporate performance disclosures need to evolve to assess performance beyond financial results alone.

## SHAPING THE RIGHT SUSTAINABILITY REPORTING STANDARDS

Driven by these developments, the process of standardising sustainability reporting is under way. Stakeholders across the board agree on the need to develop sustainability reporting standards that are of equal quality to financial reporting standards.

A number of initiatives are moving in this direction:

- With its Green Deal, the European Union has set highly ambitious sustainable development and sustainability reporting targets. The European Commission has been particularly active since the 2018 launch of its Sustainable Finance Action Plan, which includes an objective of reorienting capital flows towards activities that are considered sustainable. Notably, it has tasked the European Financial Reporting Advisory Group (EFRAG) with developing European Sustainability Reporting Standards.
- In November 2021, the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB) to develop high-quality sustainability disclosure standards that meet investors' needs for information. The appointment of Danone's former chief executive Emmanuel Faber as head of the ISSB sends a strong signal given his vision and commitment to sustainability issues.

- In the United States, the Securities and Exchange Commission (SEC) published its strategic intentions on environmental, social and governance (ESG) issues in May 2020, confirming that firm guidelines on the subject would be of major interest to the US economy. The US government and the SEC in particular have been moving quickly on these issues since Joe Biden's election as president.
- Similar, though less advanced, trends are also developing in Asia, especially in China and Singapore.

The deployment of competing initiatives indicates the level of importance that governments are now placing on sustainability reporting and its regulation. However, there is much debate as to whether certain sustainability reporting standards should be prioritised, or even whether one single global standard should be applied.

## A NECESSARY CONVERGENCE OF SUSTAINABILITY REPORTING STANDARDS DRAWING ON EUROPE'S EXPERIENCE AND INTEGRATING ITS SPECIFICITIES

International standards are needed because ESG issues are global, and companies need consistency – and therefore a common set of sustainability reporting standards – to operate internationally. The ISSB's initiative aims to develop global standards, in the perspective of financial materiality of sustainability risks, including climate risks, that could affect investors.

Meeting the challenges of transition set out by the European Green Deal does however require implementing public policies, including sector-based regulations.

Sustainability reporting should then not only be a reporting on absolute sustainability performance but also on the alignment with these regulations in order to help Europe to monitor the contribution of businesses to the EU's transition pathway. Companies can then communicate to stakeholders about their related levels of compliance and performance. The level of alignment is likely to be among the factors that have the highest financial materiality and will therefore have increased importance in the future as these policies are further deployed and implemented. It should also be noted that these regulations are highly technical and reflect the ambitions and priorities of the various authorities, so the technical inputs from the local jurisdictions will be very important in any global standard setting process.

This means that compatible standards are needed at the global, European and other regions levels to ensure both international consistency and alignment

### **THE APPLICATION OF THE STANDARDS REQUIRES THE IDENTIFICATION OF EQUIVALENCES AND COMPARABILITY AS ILLUSTRATED BELOW :**

- There are already many references to jurisdictional regulations in current proposals. The TRWG (Technical Readiness Working Group - IFRS Foundation) recommendation to the ISSB, formalised in the climate reporting prototype was built on TCFD (Task Force on Climate-Related Financial Disclosures) but also industry SASB (Sustainability Accounting Standards Board) standards. It includes at this stage hundreds references to US norms and regulations and very limited references to EU regulations. This will certainly evolve over time so that equivalent EU regulations and norms are incorporated, which should require the inputs and collaboration of EU standard setters.
- The use of multiple references raises the issue of comparability, since one will have to ensure that equivalent norms are indeed equivalent, and do not provide misleading information about companies' relative performances. The same issue already exists within the EU where a directive can be transposed differently in the various EU countries. The Energy Performance of Building Directive for instance has led to non-homogenous, Energy Performance Certificates across EU countries reflecting different realities. To illustrate this further, the French transposition of an EPC relies on both an energy efficiency and Co2 emission measurement, while the US Home Energy Rating System index mentioned in the ISSB climate prototype relies on the sole energy efficiency indicator. A mechanism for equivalence recognition would be therefore needed as part of the global architecture, it would also ease the implementation of standards for global companies that will have to deal with multiple jurisdictions specificities or extra-territorial requirements.
- Jurisdictional regulation can require the production and the monitoring of specific indicators depending on their ambitions and priorities, this will require precise specifications on the jurisdictional level and also clarity on how they differ from global levels indicators. The double materiality approach and the European Taxonomy reporting requirement are two examples that illustrate these issues.
  - In Europe, the goal is for companies to report to a wide range of stakeholders based on the principle of double materiality: considering on the one hand their impact on society and the environment, and on the other hand, the impact of sustainability factors on the company. It will be necessary to articulate the double materiality approach of the EU and the financial materiality approach of the ISSB to provide clarity for the readers since in practice there might be a significant amount of judgement to draw the line between the two approaches.
  - The reporting requirements on the European Taxonomy alignment is currently generating multiple outstanding interpretation questions related to its practical implementation. Although the European Commission issued FAQs to address some of these questions, many remain open which ultimately might hinder the comparability of taxonomy alignment reportings, a specific standard designed to address this reporting in a more complete manner, is currently missing and could be developed by the European Standard Setter.

with regional public policies. In particular this requires co construction and standard setting capacities to define common concepts, take account of differing priorities and establish equivalences that allow for interoperability among standards.

### **ADAPTING GOVERNANCE AND RESOURCES TO THE CHALLENGE OF INTEROPERABILITY**

Working together to build interoperable standards is the main challenge (ie operate and coordinate the standards in conjunction with each other). Given its ambitions and the significance of its existing and draft regulations,

Europe must be in a position to contribute substantially to international standards. The right conditions must be created to make this possible, in particular through a governance system and an organisational model that foster interactive collaboration both at the operational level and the decision-making level.

The process of standardising sustainability reporting also requires mobilising financial and human resources to meet the ambition of developing internationally recognised standards of high quality. It is essential for Europe to allocate resources that are compatible with its targets and comparable to the resources that will be implemented at the international level.

**INVOLVING COMPANIES IN THE STANDARDISATION OF SUSTAINABILITY REPORTING**

The private sector must also play a part in the transformation of sustainability reporting. Standardisation aims to improve the quality of sustainability disclosures and make them as reliable as financial disclosures. But the quality of these disclosures will not solely depend on the standardisation processes; it will also require an investment on the part of the companies that will have to produce the information.

To achieve high-quality sustainability disclosures, related reporting requirements must be included in governance, management and supervisory bodies' scope of responsibility. The European proposal for a Corporate Sustainability Reporting Directive (CSRD) emphasises this point. The proposal also provides for the development of an internal control system for sustainability data, extended responsibility of the audit committee beyond financial reporting to include sustainability reporting, and the role of the auditor as a trusted third party.

Current regulatory discussions clearly indicate that financial and non-financial information will converge and become increasingly intertwined, as will the systems used to produce and verify that information. Regulators emphasise that companies must improve the consistency of the information presented in their financial statements and sustainability reporting.

Beyond the current standardisation initiatives, we can also anticipate that in the future corporate performance reporting will come to be defined by a concept of overall performance. This expanded scope will give new meaning to the words "corporate" and "performance", ultimately leading to a radical reform of historical accounting.

As we come ever closer to this new "big bang" for sustainability reporting, Europe has to take its rightful place in the global standardisation process, which will have significant consequences for its economy and businesses and the success of its transition path.

So, yes to a convergence of sustainability reporting standards — recognizing pioneering Europe's contribution.



# ADDRESSING ESG CONFUSION TO AVOID GREENWASHING IN ASSET MANAGEMENT

Note written by Matteo Le Hérissé

The urgency of climate change mitigation presents the unprecedented challenge of the transformation of our economies — and, by extension, of the global financial system — moving towards sustainability. However, holding green assets does not automatically ensure an impact, often measured based on the reduction in GHG emissions or CO2 equivalents. Furthermore, as we will demonstrate, there are concerns around the qualification and reporting of this green characteristic (i.e. the existence of greenwashing) that hamper sustainable investing.

## GREENWASHING TYPOLOGY

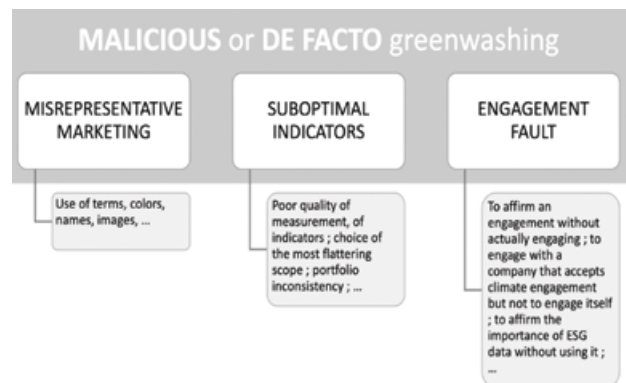
Greenwashing practices can arise from two kinds of stakeholders: at corporate level, or from banks and asset managers.

The most recognised and widely criticised form of greenwashing corresponds to the malicious aim of misrepresenting the reality of the situation so that it seems 'greener' than it truly is. However, this malicious aim would account for a minor part of the effective greenwashing carried out. It appears that greenwashing often takes place as the result of suboptimal methods and practices only, without stakeholders intending to mislead others. ESG confusion may therefore be the primary factor behind this.

We will then distinguish between different forms of greenwashing practices among these two drivers (that we will designate as *malicious* and *de facto*).

## CHART 1. Greenwashing Typology

Source: Eurofi



Firstly, greenwashing practices may be due to **misrepresentative marketing**, which involves presenting products or funds in a way that would suggest ESG performances that do not prove to be true or are less significant. Different methods may lead to this result, such as the use of colours (mostly green), names and expressions evoking nature or by image association. This type of practice is mainly found in corporate activities (see example below for Bayer) and is the most visible form of greenwashing.

## CHART 2.

### Illustration of Misrepresentative Marketing Greenwashing

Source: Eurofi

Note: The harming nature of pesticides (on the environment and human health) has been extensively demonstrated by scientific analysis and recognised worldwide. Such products are thus inherently 'brown' and do not comply with ESG criteria.





CHART 3.

### Illustration of Suboptimal Indicators Greenwashing

McDonald's Corp. MSCI's sustainability score improvement (2015-2019); evidence of suboptimal indicator use.

McDonald's Corp. is a large GHG emitter. According to Bloomberg, the company is "one of the world's largest beef purchasers [and] generated more greenhouse gas emissions in 2019 than Portugal or Hungary, because of the company's supply chain". That is 54 million tons of emissions for 2019.

Despite this poor environmental performance and increasing emissions, MSCI has upgraded McDonald's sustainability rating (on April 2019). MSCI considered good the "companies' environmental practices" after it dropped carbon emissions from its rating calculation.

This MSCI rating on environmental practices then fails to depict the sustainability degree of McDonald's Corp. operations.

McDonald's Corp. GHG emissions

(Source: Bloomberg, using company report and filing with CDP)

2015 2019

#### Scope 1 and Scope 2 (market-based)

1.5M CO<sub>2</sub>e

0.6

#### Scope 3 (supply chain)



CHART 4.  
Illustration of Engagement Fault Greenwashing

Note: BlackRock was vocal on its engagements but its assets managers voted in favour of about 10% of climate-critical resolutions in 2020 (according to EDHEC research with Proxy Insight data).

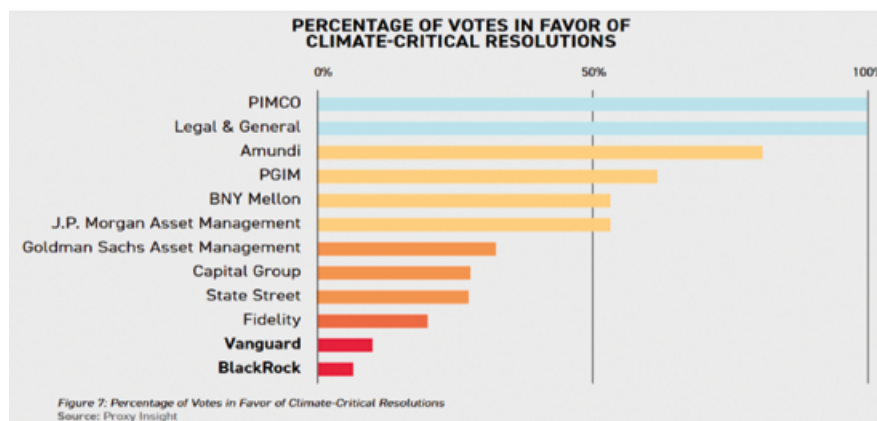


Figure 7: Percentage of Votes in Favor of Climate-Critical Resolutions  
Source: Proxy Insight

Secondly, greenwashing may arise from the use of **suboptimal indicators**. The latter may refer to different situations;

- When ESG claims are based on an indicator that measures an irrelevant criterion or focuses on the most flattering scope (see *example above*);
- When ESG claims do not hold up because of portfolio inconsistency (e.g. an 'ESG' fund that does not promote environmental impact);
- When ESG claims are based on an indicator that poorly measures its criteria (e.g. missing data, proxies issue, etc.).

Thirdly, greenwashing may occur due to an **engagement fault**. This corresponds to different situations in which there is a gap between the stakeholder's engagement and the engagement that is actually observed:

- When affirming engagement without actually engaging (see *example above*);
- When affirming engagement supported by effective collaboration with a partner that is truly engaged, but without engaging itself;
- When affirming the importance of ESG data without using it.

## 1. DEFICIENCIES IN COMMON QUALIFICATION OF WHAT'S GREEN GENERATES RISKS OF GREENWASHING SENTIMENT

The way sustainability is measured and reported lifts concerns so much so it is presented as the main impediment to ESG integration in investment decisions<sup>1</sup>.

### 1.1. Clear ESG metrics are a missing key element

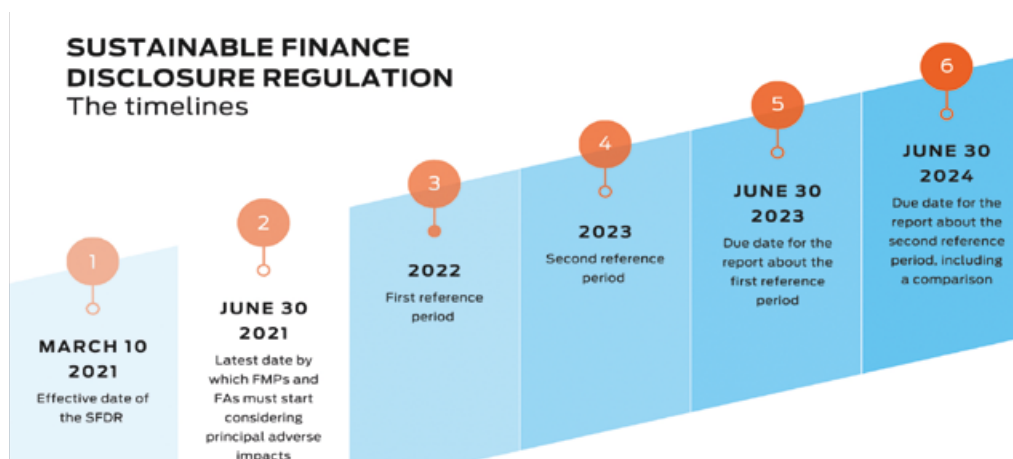
#### 1.1.1 Data availability is limited

EU regulations are still recent and not fully operational: the first elements of sustainability-related disclosures have been required since 10 March 2021, while extended disclosure requirements will be in place from 1 January, 2022. The biggest players are already publishing their data, so they should be well positioned for the extension of the disclosures required from January 2022. However, the EU Taxonomy and disclosure requirements set a more comprehensive selection of data, with ESG criteria in their scope, that are forcing them to rethink how they collect their data. Other smaller stakeholders may face difficulties with collecting and processing their data due to their limited resources.

1. A. Amel-Zadeh and G. Serafeim, "Why and How Investors Use ESG Information: Evidence from a Global Survey.", Harvard Working Paper, 2017.

**CHART 5.**  
*Most of the Non-Financial Reporting Architecture Is Not Operational Yet*

Source: BIQH



Data availability may also be limited by timeline constraints: financial market participants need the disclosure of investee companies' data in order to produce their own. As a result, the first reports can only be expected in the course of 2023, for the 2022 financial year (if the disclosure by investee companies happens during the first few months of 2022).

To overcome the lack of available data, important stakeholders have formed partnerships with fintech firms that use innovative methods to collect and process data (such as the use of AI). Although promising, these practices do not foster data availability. First of all, they support a system of privately-owned data, rather than a *perfect information* principle. The European Single Access Point (ESAP) project, expected to be launched in 2024, should address this concern. Secondly, the ability of fintechs to deal with data is itself limited by poor data availability. Data gaps are filled with proxies, making estimates less rigorous and sometimes even false.

One serious limitation with data availability appears to be a lack of standards regarding what to measure. If corporates and financial market participants do not agree on the same ESG factors that would be material to all long-term investors, they end up not measuring and considering the same things. In this case, data may be published, if it does not correspond to data users' observed metrics, is equivalent to missing data for them.

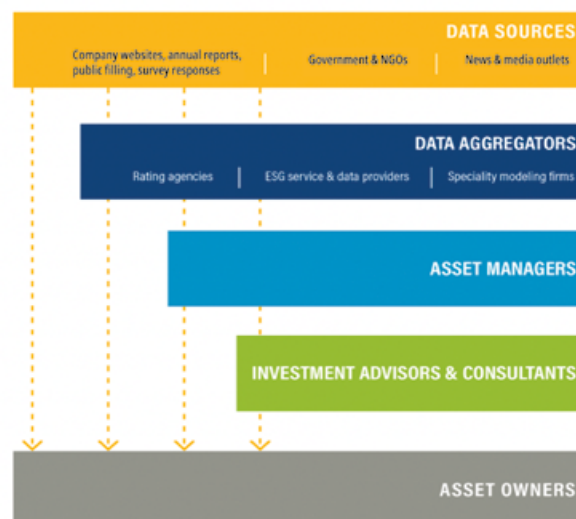
Many stakeholders already provide ESG metrics. However, GHG emissions are often the only indicators chosen for 'how green' assets and practices are. More comprehensive metrics considerations are then needed to provide resourceful measures for data users (e.g. including physical risks stemming from climate change<sup>2</sup>).

### 1.1.2 Reporting is heterogeneous and unreliable

While data to be reported appear to involve significant limitations, there are also concerns about how it is reported.

**CHART 6. Flow of Sustainability Data Across Market Players**

Source: World Resources Institute



Due to a lack of reporting standards, financial market participants and corporates have put in place their own reporting methods.

This results in standards that are either too sector-specific, or too broad to be practical as they are trying to meet the demands of too many parties. Bespoke standards result in heterogeneous global reporting, which limits comparability. Unverified reports, or reports that are self-audited but with opaque methodologies, fail to ensure trust, as they would invariably present sustainability metrics in the best possible light. Nevertheless, it appears that it is preferable to have audited reports — even with the limitations we discussed — than to not audit reports at all<sup>3</sup>.

2. Fulton and Weber, "Carbon Asset Risk: Discussion Framework", World Resources Institute, 2015.

3. Del Giudice and Rigamonti, "Does Audit Improve the Quality of ESG Scores? Evidence from Corporate Misconduct.", 2020.

**CHART 7.****Most Common  
Standard-Setting  
and Reporting  
Initiatives**

Source: Deloitte

	Year founded	Type	Audience	Form of report	Focus
<b>CDP</b>	2000	Reporting and rating	Investors and other stakeholders	CDP questionnaire	Provide investors with climate change, water, and carbon data
<b>DJSI</b>	1999	Rating	Investors	RobecoSAM questionnaire	Evaluate the sustainability performance of the largest 2,500 S&P firms through a family of indices
<b>GISR</b>	2011	Rating	Investors and other stakeholders	Center of Ratings Excellence (CORE) program	Steward an ESG ratings standard to accelerate the contribution of organizations worldwide to sustainable development
<b>GRI</b>	1997	Reporting	Broad set of stakeholders	Sustainability report	Empower sustainable decisions through established standards and a global, multi-stakeholder network
<b>IIRC</b>	2010	Reporting	Providers of financial capital	Integrated annual report or standalone report	Establish integrated reporting and thinking within mainstream business practice for both public and private sectors
<b>SASB</b>	2012	Reporting	Investors in US public companies	SEC 10-K, 20-F filings	Establish and improve industry-specific metrics for investors in the US

Data inconsistency is explained by the lack of disclosure standards, but stakeholders do not agree on the materiality of sustainability disclosures. Thus, and if not qualified as such, reports are not regulated by the Securities and Exchange Commission (SEC).

Existing sustainability standard-setting and initiatives are available to frame reporting practices (see Chart 7). However, these standards to be extended to include deeper ESG considerations that would be in line with net-zero objectives.

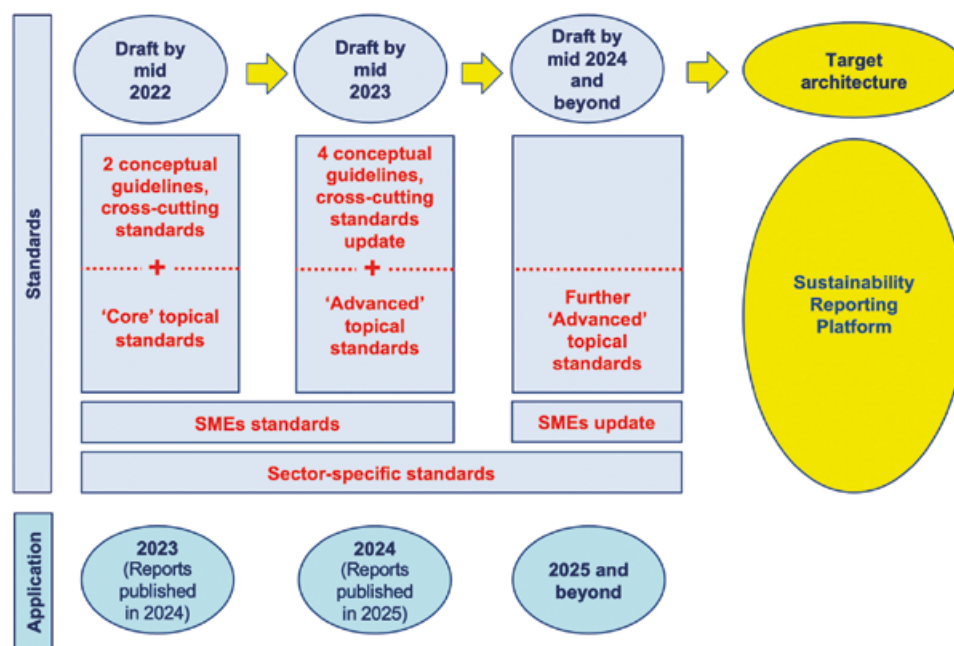
Work on further disclosure standardisation is ongoing. European Supervisory Authorities submitted a final report on draft Regulatory Technical Standards on

disclosures under SFDR<sup>4</sup>, but as long as the Commission doesn't state on reporting standards in a regulatory publication, financial market participants and corporates will not have a common standard ensuring the integrity, quality and transparency of their metrics.

To respond to substantial doubts concerning the quality of the data reported, report auditing is a proposed solution the CSRD aims to implement in the EU. The principle would be to require an EU-wide audit similar to the one already required for financial information. For financial information, statutory audits are carried out for public interest entities (PIEs) in the EU<sup>5</sup> and other developed economies, such the US<sup>6</sup>. Statutory auditing is estimated to be required for around

**CHART 8.****Standard-Setting  
Roadmap**

Source: EFRAG



4. Final Report on Draft Regulatory Technical Standards, ESMA, 2 February, 2021.

5. Directive 2014/56/EU of the European Parliament and of the Council.

6. Securities Exchange Act of 1934 / Sarbanes-Oxley Act of 2002 / U.S. GAAP, PCAOB and SEC.

**CHART 9.****Ranking of World's  
Stock Exchanges  
on Sustainability  
Disclosure***Source: Corporate  
Knights (2017)*

1	Helsinki Stock Exchange	46	Qatar Stock Exchange
2	Stockholm Stock Exchange	47	Saudi Stock Exchange
3	Euronext Paris	48	Frankfurt Stock Exchange
4	London Stock Exchange	49	Lima Stock Exchange
5	Oslo Stock Exchange	50	OTC Markets
6	Euronext Amsterdam	51	Pakistan Stock Exchange
7	Australian Stock Exchange	52	KOSDAQ
8	Copenhagen Stock Exchange	53	Hochiminh Stock Exchange
9	Johannesburg Stock Exchange	54	Egyptian Stock Exchange
10	Stock Exchange of Thailand	55	Caracas Stock Exchange

300 000 companies in the EU<sup>7</sup>. For other non-public companies, there is no statutory auditing and, barring exceptions, only tax audits are applied.

Due to the difficulties of implementing such audit requirements for small corporates (particularly for SMEs), the European Commission's approach is progressive. Following the financial information requirements example, mandatory ESG data audits may be implemented for PIEs first.

These new audit requirements on sustainability information nonetheless raise the question of the entity in charge of the audit. Several actors may perform this task: line ministries (that are already exerting control and differ regionally), national or supranational agencies (existing or to be created), external auditors, or rating agencies. The Commission's proposal for the CSRD would allow the recourse to "independent assurance service providers"; "Member States could choose to allow firms other than the usual auditors of financial information to assure sustainability information"<sup>8</sup>.

### 1.1.3 Lack of consistency worldwide

Data consistency is crucial to allow for comparison across firms, banks or asset managers, but geographic issues also arise.

Sustainability disclosure regulation is heterogeneous between countries and regions. In 2020, 90% of N100 companies reported on sustainability in the US. That is the highest percentage of all regions, and 31 pp more than for the Middle East and Africa. Eighty percent of N100 companies worldwide now report on sustainability, and global sustainability disclosure rates have seen rapid growth over the last 20 to 30 years (from 12% in 1993 to 80% in 2020 for N100). Despite that, some countries are still green reporting laggards: New Zealand (69%), Iceland (52%), Turkey (56%) or Saudi Arabia (36%) based on 2020 data<sup>9</sup>.

Overall, it appears that there is notably greater data availability in developed countries. For instance, this is shown in a 2017 ranking of the world's stock exchanges

on sustainability disclosure (*see above*<sup>10</sup>): the top 10 is composed of developed countries and concentrated in Northern and Western Europe. The bottom 10 countries are concentrated in developing countries (and oil-producers). This can be explained by both the facts that developed economies happen to have more important companies that are required to disclose sustainability information, and that developing economies often present a less comprehensive and efficient regulatory environment.

The European Union is deeply involved in the sustainability reporting agenda thanks to the Commission's work on the EU Taxonomy and SFDR regulation. While North America has a large number of companies reporting on sustainability, the EU regulation landscape is currently the most advanced for sustainability matters.

However, the new European regulation scheme is not the only reason for the EU's head start; there appear to be significant differences in terms of investment decision making and practices. A 2020 Harvard survey<sup>11</sup> reported statistically significant differences between the number of senior investment professionals surveyed considering certain ESG criteria to be material in their investment decisions, in the US versus the EU. European senior investment professionals were more (by 16.5 pp) to consider ESG criteria such as biodiversity to be material in their investment decisions, compared with their US peers (*see Table 1 below*).

Overall, European companies appear to be more engaged in climate mitigation and social responsibility with their strategies: 50% of European companies have outlined the United Nations Sustainable Development Goals (UN SDGs) on Climate Action as a priority; this is twice as many as in the United States<sup>12</sup>. In addition, 21% of US companies have explicitly identified the UN SDG on Gender Equality as an objective, compared with 58% of European companies.

7. Deloitte estimates (2015).

8. Questions and Answers: Corporate Sustainability Reporting Directive proposal, EC website, 21 April, 2021.

9. Figures from "The KPMG Survey of Sustainability Reporting 2020.", KPMG Impact, December 2020.

10. "Measuring Sustainability Disclosure", Corporate Knights, September 2017.

11. Amel-Zadeh, Amir, and George Serafeim. "Why and How Investors Use ESG Information: Evidence from a Global Survey." Harvard Business School Working Paper, No. 17-079, February 2017.

12. "Data Shows Broad Differences in ESG Reporting Between Europe and the US", Environmental Leaders, June 2021.



**TABLE 1. Senior European Investment Professionals' Opinion on ESG Criteria Materiality**

Source: Eurofi, with figures from cited Harvard survey

Note: Significance at the 1%-level

ESG criteria considered	Declared material by senior investment professional		
	In the US <sup>(1)</sup>	In the EU <sup>(2)</sup>	Difference <sup>(2)-(1)</sup>
Energy and fuel management	47.3%	63.7%	16.4 pp
Biodiversity	16.1%	32.6%	16.5 pp
Employee health, safety, well-being	40.2%	60.7%	20.5 pp

The global inconsistency with reporting disclosures is clear when looking at the number of different regulations on this matter worldwide (see table below). Europe's head start in sustainable regulation translates is nearly five times more ESG-inclusive reporting instruments for the continent compared with North America. Asia-Pacific comes second, with 77 less instruments than Europe.

**TABLE 2. Geographical Discrepancies of Sustainability Reporting Regulation**

Source: Eurofi, with Carrots&amp;Sticks data

Number of mandatory/voluntary reporting instruments by regions, currently in place, and including ESG criteria	
Africa & Middle East	53
Asia Pacific	131
Europe	208
North America	44
South America	40
International	0

Geographical biases in reporting directly impact stakeholder ratings. For instance, considering ESG criteria, we would fairly easily conclude that Tesla should be ranked higher than BMW. The latter has been pointed out in ecological scandals and accused of more severe and numerous violations<sup>13</sup>. On the other hand, Tesla has been leading the electrification of the

automotive fleet, making the company one of the best among the various automotive producers. However, a positive bias for Europe ranks Tesla far behind European auto manufacturers (see infographic below<sup>14</sup>). As European regulations require significantly more ESG disclosure, the BMW Group reports more ESG data than Tesla (which is under US regulations). This may be falsely interpreted as greater efforts made by BMW, so ratings that fail to catch geographical biases may yield counterintuitive results, such as ranking Tesla behind all European car manufacturers in terms of its ESG rating. The score divergence between BMW and Tesla is a telling example that reflects a global bias; a study by Sustainalytics ESG ratings<sup>15</sup> found that average ESG ratings in Europe are 32% higher than in the US.

**CHART 10. Sustainalytics Score for the BMW Group and Tesla**

Source: T.M. Doyle, "Ratings that don't rate: the subjective world of ESG ratings agencies", American Council for Capital Formation, July 2018

	BMW	TESLA
Sustainalytics Score	74	54
Score Percentile	93 <sup>rd</sup>	38 <sup>th</sup>
Relative Score	Well Above Average	Average

While sustainability reporting is now adopted almost universally in terms of its principles, the misalignment of reporting practices is a serious limitation for global comparisons and may spur the risk of greenwashing practices occurring.

#### 1.1.4 Aggregation distortions may lead to a green window dressing

Portfolio-level information inevitably presents aggregation distortions. Indeed, aggregation fails to account for differences between "greenness" strata.

Let's consider Green Asset Ratios as:

$$GARs = \frac{\sum \text{green asset}}{\text{total assets}}$$

It is possible that two asset managers present the exact same GAR for their portfolio (e.g. 0.6 which indicates 60% of their assets are 'green'). By itself, and being a mean, this GAR does not provide any more information. The remaining 'not-green' 40% of the total assets may vary considerably between the two stakeholders (e.g. comprising assets in light industries versus assets in oil companies). Aggregation can therefore be misleading and, by omitting details, result in greenwashing.

13. "Violation Tracker", Corporate Research Project.

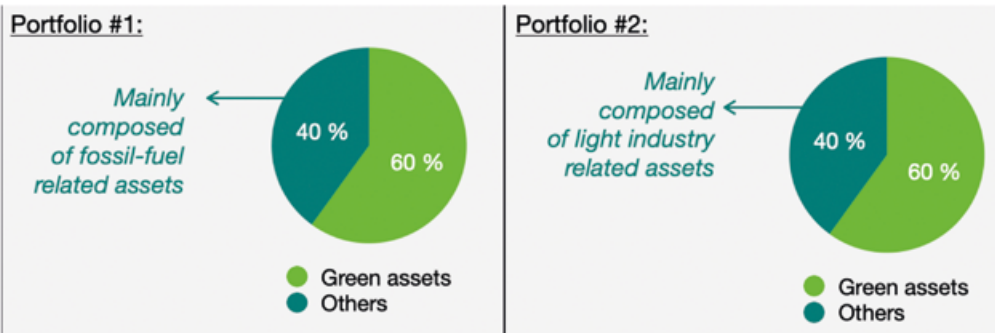
14. Extracted from T. M. Doyle, "Ratings that don't rate", American Council for Capital Formation, 2018.

15. Idem.

CHART 11.

**GARs' Aggregation  
Misleading  
Picture**

Source: Eurofi



The solution to this lack of detail in portfolio-level composition would be to scrutinise portfolios at stock level. Asset managers would then have the key metrics to decide how green a portfolio really is and if it complies with their (climate-positive) investment strategy. To do so, a great amount of data and significant data processing capabilities are nonetheless required.

Another (non-excluding) solution would be rigorous standards for defining what is 'green' and how to report data.

As we discussed earlier, these are major limitations.

### 1.2 Labels are not completely trustworthy

In order to be referenced as a 'green' stakeholder and to entice financial flows, financial market participants and corporates that have committed to incorporating ESG standards into their practices often display green labels. As demand for ESG financial products has grown significantly in the past few years, and in the absence of a well-defined denomination framework










at regional and global level, a plethora of labels and terms has appeared in the market to earmark sustainability-focused financial products. Nevertheless, they seem to fail to ensure trust in true ESG commitments and contribute to the global confusion surrounding ESG assets. First seen as a powerful and low-cost market-based instrument to ensure ESG alignment (see for instance the first OECD analysis of ecolabeling in 1991), they rapidly faced greenwashing concerns that are still seen today.

In 2020, an EC study tested the draft Criterion I for UCITS equity funds<sup>16</sup> and concluded that 3% of their sample was eligible for the EU Ecolabel. Despite this, 51 of the 101 funds were awarded national labels and 50 were marketed as "green" without a label. These results highlight the severe limitations involved with the current use of 'green labels' for finance.

CHART 12.

**Main European  
Sustainable  
Labels for  
Financial Products**

Source: Novethic

	Label	Governance	Attribution	Type of label	Annual cost
ESG	 <b>SRI Label</b> (France)	Standalone stakeholder committee, supported by the Ministry of Finances	Accredited auditors	SRI/ESG investment process	Fee including the audit and promotion costs
	 <b>FNG-Siegel</b> (Germany, Austria & Switzerland)	Expert committee under the stewardship of FNG <sup>1</sup>	GNG (FNG's labelling entity) & Uni. Hamburg	SRI/ESG investment process with climate exclusions. Point system	€3500
	 <b>LuxFLAG ESG</b> (Luxembourg)	LuxFLAG <sup>2</sup>	LuxFLAG	SRI/ESG investment process	€3000
	 <b>Febelfin QS</b> (Belgium)	Febelfin <sup>3</sup>	External auditor	Quality standard combining requirements on the investment process and exclusions	-
	 <b>Umweltzeichen</b> (Austria)	Austrian Federal Ministry for the Environment	Ministry	SRI/ESG investment process with climate exclusions. Point system	Variable annual fee
«Green» labels	 <b>Nordic Swan Ecolabel</b> (Nordic countries)	Nordic Ecolabelling Board <sup>4</sup> , on a mandate from Nordic governments	Nordic Swan	SRI/ESG investment process with climate exclusions & green reporting. Point system	€3000 + fixed charge
	 <b>LuxFLAG Environment</b> (Luxembourg)	LuxFLAG <sup>2</sup>	LuxFLAG	Thematic investments and ESG criteria	3000€
	 <b>LuxFLAG Climate Finance</b> (Luxembourg)	LuxFLAG <sup>2</sup>	LuxFLAG	Thematic investments and ESG criteria. Climate exclusions	3000€
	 <b>Greenfin Label</b> (France)	Standalone stakeholder committee, chaired by the Ministry for the Ecological and Fair Transition	Accredited auditors	Thematic investments and ESG criteria. Climate exclusions	Depending on auditor

<sup>1</sup> Sustainable investment forum (German-speaking countries)

<sup>2</sup> Standalone labelling agency for the financial sector in Luxembourg

<sup>3</sup> Belgian Financial Sector Federation

<sup>4</sup> Nordic Ecolabel is a voluntary label created by the Nordic Council of Ministers in 1989 and available for about sixty categories of retail products. The "Financial Products" category was introduced in 2017.

Source: Novethic

16. "Testing draft EU ecolabel criteria on UCITS equity funds", EC, 2020.

### 1.2.1 Many “green” labels exist

The asymmetric information issue, between asset managers and investors, particularly applies for ESG financial products. Indeed, asset managers not only have to provide financial information regarding their ‘green’ products, but also have to address concerns about the level of integration of ESG criteria, i.e. how green their products really are. The same asymmetry of information exists for producers of goods and services, with their customers and in their relationship with financial market participants.

In order to respond to this lack of complete transparency, labels have been developed and used as signals. These are often awarded by third-party stakeholders to mitigate scepticism. Nevertheless, the multiplication of labels in place seems to increase confusion and erode their credibility.

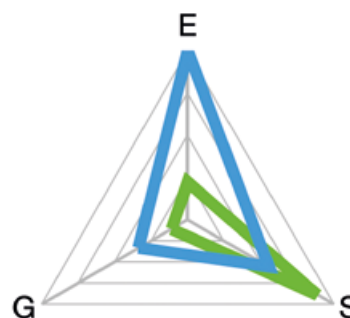
As of January 2021, “more than 400 sustainable labels exist around the world”<sup>17</sup> for all types of products. Consumers and investors are now used to their use. All of them are unique and may fall under different categories regarding their characteristics. They may be voluntary or compulsory, single or multi-product focused, socially or environmentally oriented, etc. For financial products, the same discrepancies in label characteristics apply.

In Europe, nine ESG-related labels lead the ‘green’ landscape in finance. These labels are issued by different emitters: financial markets, ministries, professional associations, or specialist organisations.

In addition to the growing number of green labels for financial products, the divergences among the criteria applied seem to be a key factor behind the ESG confusion that is partly responsible for greenwashing concerns.

**CHART 13. A Kiviati Diagram for Comparing ESG-Oriented Labels**

Source: Eurofi









### 1.2.2 Sustainable labels present important divergences

Under the sustainability dome, financial product labels may coexist despite major discrepancies in terms of their intrinsic characteristics.

While ‘sustainability’ usually refers to compliance with environmental, social and governance criteria, there are no proportions imposed between these three criteria. Then, a label focused almost exclusively on environmental issues is as legitimate in its ESG denomination as a social-oriented label. One could argue this may not *per se* be an issue given that investors are aware of this triple orientation. Nevertheless, to avoid contributing to any confusion, investors should be able to compare sustainability labels for financial products based on the extent to which they focus on “E”, “S” or “G”. As we highlight, this comparison — which may make it possible to produce Kiviati diagrams such as the one above — cannot realistically be carried out by investors due to information transparency limitations.

**CHART 14. Comparison of ESG Labels’ Exclusion Policies**

Source: Novethic

							
		Greenfin label <sup>1</sup>	Nordic Swan Ecolabel <sup>2</sup>	LuxFLAG Climate Finance	Umweltzeichen	FNG Siegel	Febelfin QS <sup>2</sup>
Exploration & extraction	Coal	Yes (5%)	Yes (5%)	Yes (30%)	Yes (5%)	Yes (5%)	Yes (10%), with expansion criteria <sup>3</sup>
	Non-conventional O&G	Yes (5%)	Yes (5%)	Yes, internal criteria apply	Yes (5%)	Yes (5%)	Yes (10%), with expansion criteria <sup>3</sup>
	Conventional O&G	Yes (5%)	Yes (5%)	Exploration only (30%)	No	No	Oil only (60%)
Electricity generation	Fossil fuels	Yes (5%)	Yes (5%)	No	No	No	Based on carbon intensity of the energy mix (gCO <sub>2</sub> /kWh) <sup>5</sup>
	Coal	Yes (5%)	Yes (5%)	Yes (30%), with expansion criteria <sup>3</sup>	No	Oui (30%)	
	Nuclear energy <sup>4</sup>	Yes (5%)	Yes (5%)	New projects only	Yes (5%)	Oui (5%)	

<sup>1</sup> Additional partial exclusion criteria apply to activities listed in this chart. Service companies and companies involved in the distribution / transportation and the production of equipment and services are excluded in so far as 33% or more of their turnover comes from clients from excluded sectors.

<sup>2</sup> Exceptions apply to companies that can demonstrate an ambitious low-carbon transition strategy (see below).

<sup>3</sup> A specific exclusion criterion targets companies which have announced “expansion plans”. Assessment is based on physical assets (building or modernizing coal plants, in the case of LuxFLAG) or on corresponding revenue growth (Febelfin).

<sup>4</sup> Besides the generation of nuclear energy, FNG & Umweltzeichen labels also exclude companies who supply components to nuclear plants, while Nordic Swan excludes uranium extraction. The Greenfin label excludes all the related value chain.

<sup>5</sup> Criterion based on energy mix projections as per the Energy Technology Perspectives 2017 scenario of the IEA. If data in gCO<sub>2</sub>/kWh is not available, thresholds of 30% fossil fuels, 10% coal and 30% nuclear energy apply.

17. As highlighted in Megaeva, Karina and Engelen, “A Comparative Study of European Sustainable Finance Labels”, January, 2021.

An eloquent example of the discrepancies lies in exclusion lists. ESG labels intend to offer a guarantee of not investing in sectors that are detrimental to the environment, social or governance conjunctures. On the negative screening side, this approach involves excluding sectors that do not comply with sustainability criteria (often regarding the DNSH criterion). These sectors usually comprise fossil fuels — coal in particular — or sectors such as the arms industry. However, exclusion lists are not identical for all sustainable labels. For instance, the Greenfin label allows a portfolio to comprise coal-related assets, under a 5% maximum threshold, while LuxFLAG's coal threshold is 30%, that is six times more.

Moreover, label providers do not apply the same methodologies to assess a portfolio's adequacy. Criteria are commonly process-oriented, focused on verifying whether ESG analysis is applied to select assets in the portfolio and ensuring that complete and comprehensible reporting is available to clients. Some ESG labels use a points system, either to ensure that minimum requirements are met (e.g. Nordic Swan or Umweltzeichen), or to distinguish funds whose ESG practices are more holistic (e.g. FNG). Labels also differ on the extent of the assets contained in a portfolio that are screened in the compliance analysis (e.g. SRI operates a screening for over 90% of the considered portfolio).

Lastly, the terms used in the name or description of labels also appear to be a factor behind ESG confusion. The proliferation of sustainability labels despite a strict framework has led to semantic dispersion. The following infographic highlights this: for example, a C&E-focused fund might correspond to different denominations of labels, such as "green", "sustainable", "ESG", "climate", "impact", etc.

### 1.2.3 Case study on the CAC40 ESG Index

Launched by Euronext on 22 March 2021, the CAC40 ESG Index is a selection of the 40 'greenest' companies from the CAC Large 60. This index was designed to spur ESG adoption by investors, creating a benchmark among the various green indexes, with a carbon footprint that is 43% less than the regular CAC 40 Index.

Despite being an index and not a label, it may be used as one. Indeed, it appears that, to include a company in the index may be perceived as a form of sustainability assurance for investors. This corresponds to the signal function of labels.

It is therefore interesting to wonder what the index selection methodology is and whether this can truly be used as an assurance of sustainability.

Selection has been made following a ranking based on 38 ESG criteria of the CAC Large 60, using the Equities methodology developed by Vigeo Eiris. Some CAC40 companies present an ESG score that is too low or have been excluded: *Airbus, Alstom, ArcelorMittal, Dassault-Systèmes, EssilorLuxottica, Hermès, Saint-Gobain, Thales, Total*. Some non-CAC40 companies were selected to fill the gap: *Accor, Arkema, EDF, Gecina, Klépierre, Sodexo, Solvay, Suez, Valeo*. The composition of the index is revised quarterly by an independent committee.

To account for sectoral heterogeneities, the 38 generic ESG criteria are assigned a weighting, from "not relevant" to "highly material". The latter is used to compute a global ESG score as a weighted average. Selection is then made with an exclusion list (for companies in the tobacco, coal, arms sectors, etc.). The index methodology is aligned with the SRI label (from the French Ministry of Finance) and the UN Global Compact Principles for exclusion lists.

Some might say the CAC40 ESG Index promotes a greenwashing of the CAC large 60 and accuse the index not to engage enough in green practices with a selection process too lenient. For instance, its exclusion list includes only 20% of the total investment universe (that is the minimum criterion to be qualified as 'ESG'). Also, critics highlight that it fails to induce a credible change in investment practices as it is still secondary to the regular CAC 40.

### 1.3 The reliability of climate ratings is also questionable

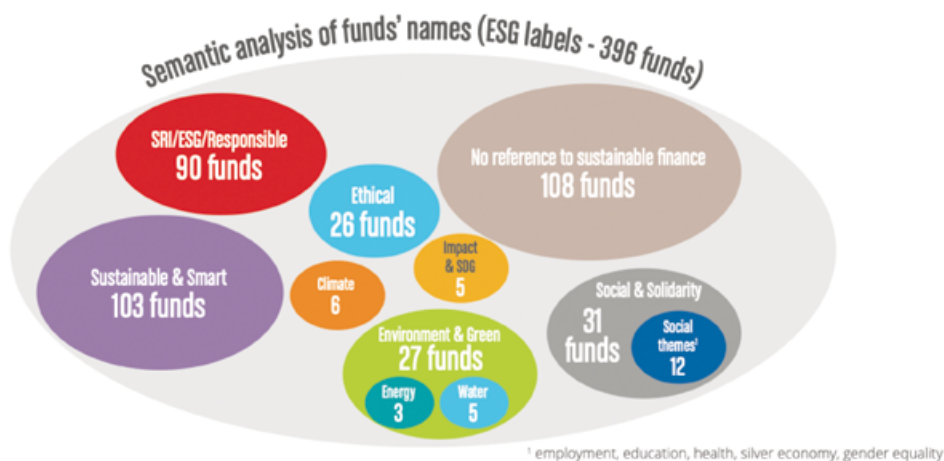
#### 1.3.1 Climate ratings may be more effective than labels

One solution to label discrepancies could be the use of climate scores. The latter have various advantages that might reduce ESG confusion and related greenwashing concerns.

CHART 15.

#### Semantic Dispersion of Funds' Names

Source: Novethic





While labels are obtained on the initiative of fund managers, fund ratings can be assigned to all funds, regardless of whether or not they have a dedicated ESG strategy. This therefore makes it possible to identify not only the funds that comply with a defined sustainable framework, but also those that do not: so-called *brown funds*. Funds can then be compared with one another and *best-in-class* funds can be defined.

The sustainability of assets may be scored based on an evaluation of the exposure to C&E risks, or an assessment of the impact of the activities financed with ESG criteria. These imply the use of either qualitative or quantitative indicators.

### 1.3.2 The methodologies used are also a concern and largely impact their power to define green

As highlighted in a 2020 OECD report<sup>18</sup>, “every provider ranks different aspects of the sustainability of the companies it assesses”. The chosen sub-metrics, once aggregated in broader metrics that enable the specificities of the rated corporate to be measured, are therefore specific to the score provider. The difference between two ratings (a and b) consists of their three components: scope, measurement and weights  $\Delta_{fa,b} = R_{fa} - R_{fb} = \Delta_{scope} + \Delta_{meas} + \Delta_{weights}$ <sup>19</sup>. What stands for

labels applies to scores too; it is obvious that measuring sustainability with different methods and criteria yields divergent results. Berg et Al. (2019) estimate that 50% of ESG ratings is explained by the scope selected. The table below lists the main ESG criteria used by market-leading ESG index providers, and we can clearly see the differences in the metrics considered.

Scoring methodologies should remain consistent throughout corporates and funds when they are made by the same provider. For investors, this would be positive as it allows for comparison.

Scoring methodologies should remain consistent across corporates and funds, when they are carried out by the same provider. For investors, this would be positive as it allows for comparison.

Nonetheless, it appears that scores are not consistent between providers. Correlations between ESG normalised scores on 823 companies were, in 2020, on average 0.54 (i.e. 54% of them were correlated)<sup>20</sup>. For comparison, credit ratings from Moody's Investors Service and S&P Global Ratings were correlated at 0.99. According to the study, measurement differences are the main factor behind this, followed by social metrics and differences in scope. Rater-specific bias is also a factor.

**TABLE 3. ESG Criteria Used by Major Index Providers**

Source: OECD with Refinitiv, Bloomberg, FTSE data

Pillar	Thomson Reuters	MSCI	Bloomberg
Environmental	Resource Use	Climate Change	Carbon Emissions
	Emissions	Natural resources	Climate change effects
	Innovation	Pollution & waste	Pollution
		Environmental opportunities	Waste disposal
			Renewable energy
			Resource depletion
Social	Workforce	Human capital	Supply chain
	Human Rights	Product liability	Discrimination
	Community	Stakeholder opposition	Political contributions
	Product Responsibility	Social opportunities	Diversity
			Human rights
			Community relations
Governance	Management	Corporate governance	Cumulative voting
	Shareholders	Corporate behaviour	Executive compensation
	CSR strategy		Shareholders' rights
			Takeover defence
			Staggered boards
			Independent directors
Key metrics and submetrics	186	34	>120

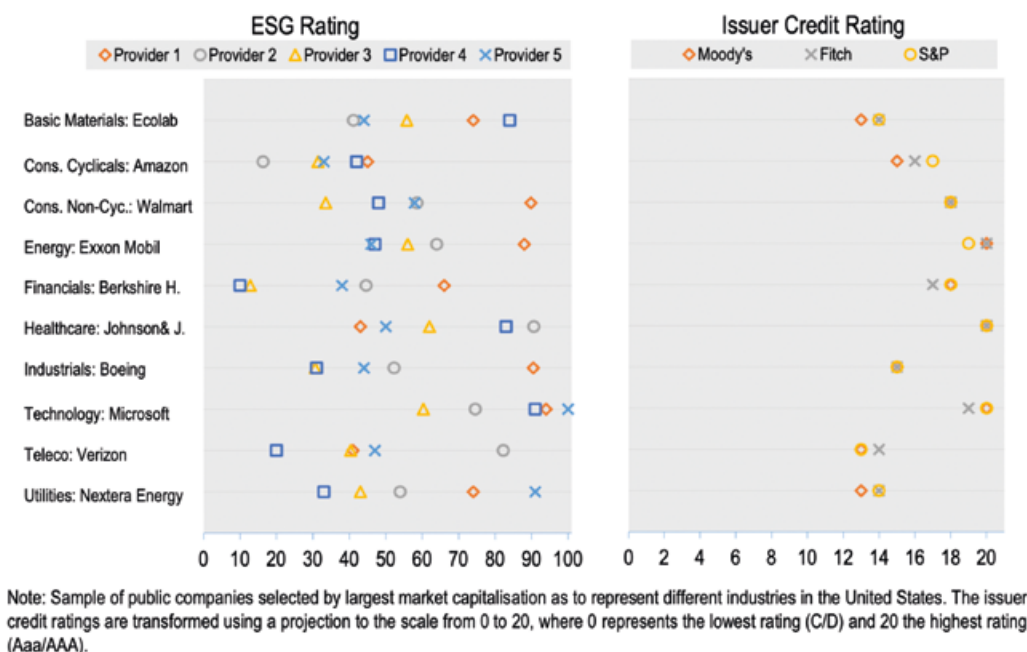
18. R. Boffo, and R. Patalano, “ESG Investing: Practices, Progress and Challenges”, OECD Paris, 2020.

19. F. Berg, J. F. Koelbel, R. Rigobon, “Aggregate Confusion: The Divergence of ESG Ratings”, MIT Sloan and University of Zurich, December 2020.

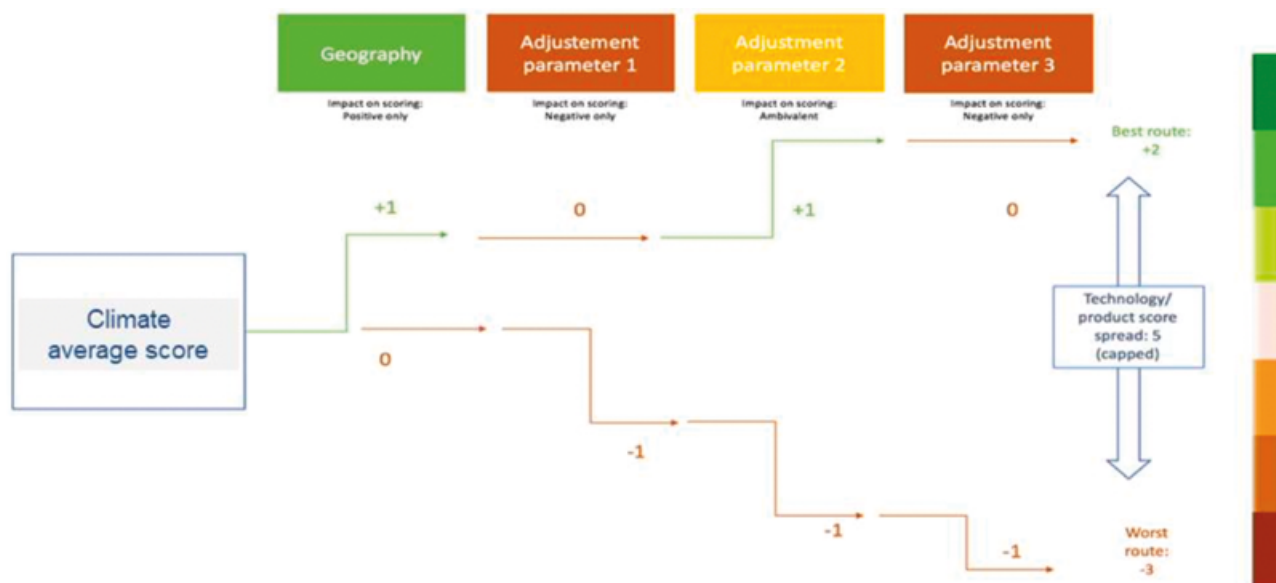
20. Idem

**CHART 16. ESG Ratings and Issuer Credit Ratings (2019)**

Source: OECD with Refinitiv, Bloomberg, MSCI, Yahoo Finance, Moody's Fitch, OECD data

**CHART 16.bis: Natixis Uses a Decision Tree to Score Assets (GWF, 2019)**

Source: Natixis



If scores may be more efficient than labels to account for corporate heterogeneities, a bias for larger companies exists. Indeed, the latter tend to obtain higher ESG scores as highlighted by a study of more than 4 000 Sustainalytics ESG ratings<sup>21</sup>. According to the study, there is a correlation between market cap and the average ESG rating: mega-cap firms present an average ESG score that is around 1.4 times the level of micro-cap firms (64 versus 46). Possible explanations for this competitive disadvantage for small and mid-sized firms are that larger companies are able to invest

more, to adjust to scoring criteria, and to dedicate more resources to non-financial disclosures.

The limitations with ESG scores may be illustrated by the following two examples:

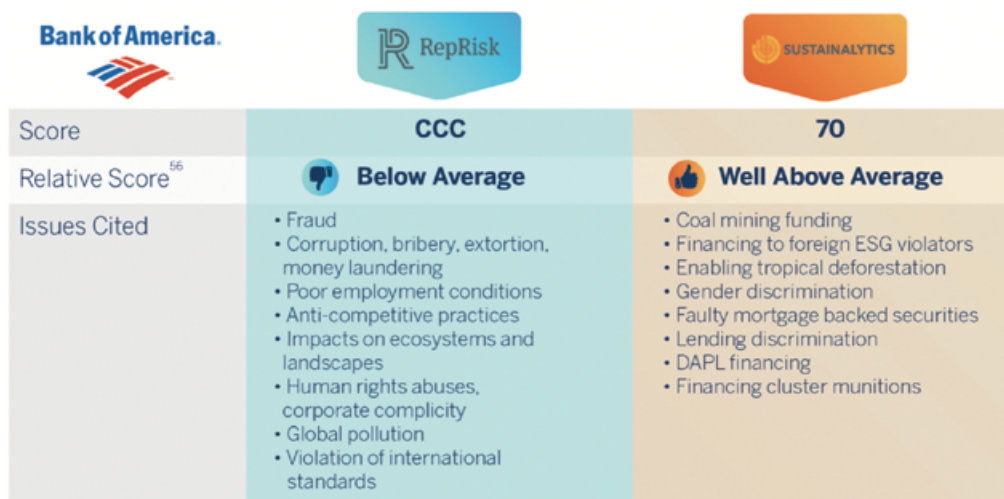
- First, Bank of America's ESG ratings by RepRisk on the one hand, and Sustainalytics on the other, expose an instance of rating inconsistency. We can see that, even though two raters may factor in similar matters, they can end up with conflicting scores and contribute to ESG confusion.

21. Study of 4 150 ratings, reported in T. M. Doyle, "Ratings that don't rate", American Council for Capital Formation, 2018.

CHART 17.

**Sustain analytics  
Versus RepRisk  
ESG Score**

Source: F. Berg,  
J. F. Koelbel,  
R. Rigobon,  
*Aggregate Confusion:  
The Divergence  
of ESG Ratings*,  
MIT Sloan and  
University  
of Zurich,  
December 2020



- Then, considering the case of *Adani Power Limited*, it appears that 'dark brown' companies could be rated green. Indeed, the latter is part of the Adani conglomerate and was India's largest publicly traded private coal utility company in 2020 (before being delisted). As of July 2020, the company displayed a CSR/ESG score of 94%. Even though *Adani GreenEnergy Ltd* is now the world's largest solar power developer, the sister entity *Adani Power Ltd's* activities rely heavily on coal. Its generation capacity is 99.7% coal-based<sup>22</sup>. The company should therefore not be able to score an almost perfect ESG metric and be best-in-class: "as a comparison, the Danish utility Orsted (ORSTED) which only ranks in the 85th percentile in the aggregator has 85% renewables capacity". Also, *Adani Power Ltd* appears not to be affected by exclusion lists given the conglomerate structure of Adani.

Standards heterogeneity has tangible consequences as it can lead to inconsistent ratings. In this regard, like labels do, climate scores fail to address ESG confusion and may foster greenwashing concerns.

## 2. GREENWASHING CONCERNS OCCUR WHEN STAKEHOLDERS LACK ENGAGEMENT IN GREEN TRANSITION

### 2.1 Corporate transition plans adequacy in question

While labels and scores have an important role to play in fostering access to information on sustainability for financial market participants, they remain metrics of corporates' activities. Greenwashing risks then arise when these metrics set standards in an unchanged economic world. In other words, as corporates face growing ESG disclosure requirements, they will be pushed to produce data on sustainability and transition plans. Under these conditions, some corporates may present ambitious plans that are not built on a realistic and credible basis.

Ambitious transition plans are drivers of ESG rating improvements, but this should not eclipse their primary goal: engaging a corporate in the mutation of its activities towards being carbon-free. Greenwashing (either *malicious* or *de facto*) does occur, if these goals are reversed.

Chart 18. Adani Power's ESG Rating

Source: "Top coal, top ESG?", Anthropocene Fixed Income Institute (2020)

Note: As displayed on Adani Power's website on 20 January, 2020



22. See Ulf Erlandsson, "Top coal, top ESG?", Anthropocene Fixed Income Institute, July 2020.

Transition plans are particularly important for brown corporates. In order to align with the Paris Agreement goals, these firms have to embark on an often radical transformation of their activities. To ensure they are included in this mutation process — and not only cut from financing sources, which would lead them to shut down their activities without mobilising their extensive resources to spur the transition — is primordial. Transition scenarios are thus a key monitoring tool to ensure that the transformation is planned in a credible, sufficiently ambitious and realistic fashion.

Nevertheless, in the absence of common ground frameworks for data production, reporting and ratings, it is complex and cost-inducing for investors and asset managers to assess corporates' heterogeneous transition plans.

#### Example: Greenwashing concerns around fossil fuel producers' transition plans

In January 2022, ExxonMobil (one of the world's largest fossil fuel companies) published its ambitions<sup>23</sup> to cut its GHG emissions to net zero for its oil, gas and chemical operations by 2050. On the surface, this seems to indicate the transition from *brown* to *sustainable activities* has been initiated and that investors engaging with Exxon are financing the transformation of its business to clean energies. However, this announcement has been widely criticised and associated with greenwashing. First and foremost, analytical reports<sup>24</sup> note Exxon's 2030 and 2050 plans only consider Scopes 1 and 2, which are negligible compared with its massive Scope 3 emissions (730 million tonnes of CO<sub>2</sub> equivalent in 2019). NGOs such as ClientEarth also highlight misleading figures and statements on green investment that qualify for greenwashing: a declared important investment in green energy that is not (representing 0.2% of its capital expenditure between 2010 and 2018), "CCS distraction" techniques, etc. The company's 2018 "\$210 billion investment plan, which would [...] increase its Scope 1 and 2 emissions by 17%, adding 21 million tons of CO<sub>2</sub> emissions annually (more than the CO<sub>2</sub> output of Kenya)" is also pointed out.

## 2.2 True climate-positive stewardship is needed

Stewardship is an inherent part of Asset Management. With growing environmental concerns, AM stewardship guidelines — that encourage financial market participants to act as long-term and responsible stakeholders — have been enhanced with a sustainability mission. Along with voluntary internal guideline updates, climate considerations have been incorporated into the Principles for Responsible Investment and specific regulations: in the EU, the UK, France or OECD countries<sup>25</sup>. Asset managers are then due to respond to these new stewardship principles in hard and soft laws by explaining how they incorporate ESG criteria into their decision processes. Pressure is also coming from their clients' growing interest in climate investment. Conversely, asset managers have the power to themselves promote ESG factors in

business and investment decisions. Other motivations than regulatory and fiduciary duties to clients are also pushing asset managers to undertake stewardship: universal ownership ("universal owners are incentivised to look beyond the interests of their individual investees to engage on systemic issues" — UNPRI) or traditional risk management.

Asset managers have indeed significant leverage when it comes to the inclusion of climate criteria, primarily through the "active ownership" of the companies that they are invested in. Influence over other stakeholders can be expressed in a variety of ways: by engaging with investors / issuers, engaging in public discourse and research, voting at shareholder meetings, filing shareholder resolutions / proposals, or litigating.

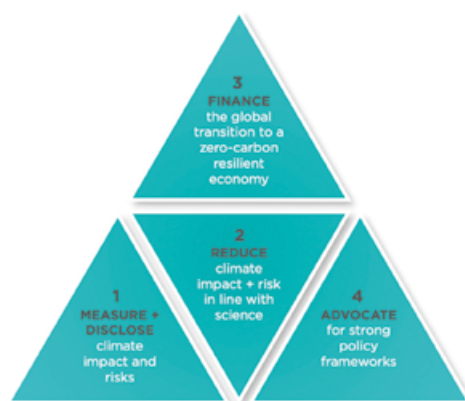
For climate stewardship to be complete and efficient within the green transition, four pillars on which it should rest upon may be identified.

- (i) First, asset managers should ensure that their own emissions and exposure are measured and disclosed properly.
- (ii) Second, a science-based reduction target should be defined along with a transition plan to reach it; guidelines for practices should be aligned with this transition plan.
- (iii) Third, asset managers should effectively mobilise financial flows towards green and transformative activities.
- (iv) Fourth, and finally, they should be advocates for the green transition in engaging with partners, contributing to research and promoting action.

However, considering these pillars exposes that stewardship is itself constrained by the abovementioned limitations on sustainability measurement and disclosure. As long as ESG confusion persists, the first pillar of climate stewardship will remain limited, restricting possibilities to adequately implement the other pillars.

#### CHART 19. The Four Pillars of Corporate Climate Stewardship

Source: Gold Standard, 2018



23. "The Advancing Climate Solutions 2022 Progress Report", Exxon, January 2022.

24. See for instance "ExxonMobil aims to cut oil and gas emissions to net zero by 2050", Financial Times, January 2022. And "Greenwashing Files: ExxonMobil", ClientEarth.

25. Respectively: EU SRD II (2017): Ib.3g.1a; UK Stewardship Code (2020): Principle 7; *Décret* n° 2021-663 (27 September, 2021); G20/OECD Principles of Corporate Governance (2015): V.A.2 (non-binding).



This also raises questions concerning corporate purpose within the AM industry. As companies' stakeholders seek to understand more about how the company defines and executes its purpose, it is likely that this purpose will be inextricably aligned with the company's ESG measurement and disclosure strategy. "Shareholders don't just want a formal statement pasted on the wall. They really want the corporate purpose to drive strategy, to drive value, policy decisions, culture: all of it" said John Wilcox (Morrow Sodali). However, some asset managers stress that while they embrace their important role in the transition towards a carbon-free economy, they do not want to include activism in their core purpose: they can promote their clients' sustainable practices and apply ESG criteria in their own day-to-day business, but will not oppose a client's reluctance to embrace ESG missions. Larry Fink (Blackrock) shared these insights on the matter, in its annual 2022 letter to CEOs: "We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients". As a side note, we should remark the important influence of this flourishing activist branch of asset management, which is contributing to a broader adoption of ESG practices among the AM industry (e.g. the implementation of a "say on climate" or support from leading institutional investors for the case of Engine No. 1 versus ExxonMobil).

There are other concerns surrounding stewardship best practices. For instance, regarding how to effectively practice "active ownership": some asset managers consider that to vote against resolutions that do not sufficiently include ESG criteria is more efficient than to vote for green resolutions (38% of the investors surveyed preferred to vote *against*)<sup>26</sup>. The same survey highlighted that a majority of asset managers (62% of those surveyed) would welcome a separate vote on sustainability at annual meetings.

Nonetheless, these limitations should not restrict asset managers' engagement in climate stewardship; it is important that sustainable practices and guidelines are implemented rapidly. When the ESG data confusion is cleared, the sustainable positioning of financial market participants should be established and efficient.

Not to engage in this ESG stewardship exposes the AM industry to charges of greenwashing. For instance, BlackRock was vocal about its engagements, but its assets managers voted in favour of about 10% of climate-critical resolutions only, in 2020<sup>27</sup>.

### 3. RESOLVING ESG CONFUSION TO LIMIT GREENWASHING RISKS AND ENSURE TRUST IN GREEN FINANCE: KEY RECOMMENDATIONS

As we have highlighted in this paper, significant limitations persist regarding the incorporation of ESG criteria into the activities of financial market participants. This results in confusion on ESG criteria and related practices, which may account for most of the greenwashing concerns expressed in relation to

the asset management industry. In order to mitigate this *de facto* greenwashing, as well as the existence of *malicious* greenwashing practices, several levers exist and should be implemented.

#### 3.1 For data

- It is critical to **define standards**. For financial market participants to be able to make efficient use of ESG data, they must adopt a common language on how to produce, channel, process and report these data. It is now up to standard-setters and regulatory entities to agree on this.
- They should also **define common universal baselines** around which to build regional standards. The latter would make it possible to consider regional heterogeneities, while ensuring that minimum standards are respected and a minimum level of global consistency is achieved.
- ESG scores and labels should be transparent concerning their positioning and incorporation of 'E', 'S' and 'G' factors.
- It is difficult to imagine strict standards that would apply for ESG scores. Nonetheless, the clarification brought by data standardisation and enhanced sustainable regulation may spur a repositioning of ESG scores and reduce discrepancies. ESG ratings should include new and improved metrics to consider geographic, company size and sector heterogeneities and biases.
- The implementation of a **European ESG label** may provide a reference point in the ESG label landscape, and be a sign of confidence for investors.
- **Enhancing the green assessment toolbox**, to complete GARs and other metrics, would make it possible to better include transitioning assets. A new label might be useful in this respect.

#### 3.2 For practices

- Stewardship guidelines and the day-to-day practices of asset managers should guide investors' perspective towards long-term products, and foster the inclusion of non-pecuniary criteria in the investment decision process.
- Portfolio construction standards should be revised to ensure that they align with the engagement of asset managers and investors.
- The AM industry should promote and implement education on green practices and climate change for financial market participants and corporate partners.



26. "Institutional Investor Survey 2021", Morrow Sodali, 2021. Survey of 42 international asset managers.

27. EDHEC research with Proxy Insight data.