

Clarifying the sustainable investment universe

1. Importance and limits of national sustainability labels in the EU

1.1 National and EU domestic experience

A regulator stated that Austria has one of the oldest sustainability labels in Europe. In the last few years, the label has been tremendously important with growth rates of 50% every year in the last three years. It is well known, there is standardisation and investors rely on it. The national label gives the possibility for a national market to include certain sustainability preferences, such as, in the Austrian case, the exclusion of nuclear power. The Austrian label is also used in other countries, such as Luxembourg, Germany, Ireland and France, but of course this does not help European transparency or transparency for investors in European markets. The reason for that is not the label but the lack of a mandatory EU minimum requirement saying what is and is not a sustainable fund. What is needed is a mandatory European solution. European legislation cannot be changed so quickly, so maybe standards by the European Supervisory Authorities (ESAs) would be a good possibility to bridge the gap. The labelling approach is a good requirement to prevent greenwashing and to contribute to harmonisation and a level playing field.

A regulator noted that France has had the same experience with its national, ISR (Socially Responsible Investment) label, which has grown to more than 1,000 funds labelled and more than €650 billion assets under management. Although it is well known and used in France, it has also been criticised and is currently under review (according to a survey last year only 50% of the French general public believed that the French label is reliable). Besides, the non-French labels are unknown from a French retail investors' perspective. More coherence is therefore needed across the EU and truly European labels should be promoted. National labels should also connect much more with the new EU regulations, particularly regarding data which will come from the taxonomy regulation in the coming years and from the Corporate Sustainability Reporting Directive (CSRD). There will be more and more data available, and these local labels have to be much more current with the European approach in this respect.

A Central Bank official stated that there is no doubt that labels have the potential to influence, to a great extent, the success of the sustainability transition by helping to avoid misallocation of funds and greenwashing, thus protecting investors. Many efforts have been made so far, but more needs to be done. The market needs transparent, comparable and credible labels for financial products. The regulatory regime and the regulatory framework have to evolve accordingly. The prudential rules that have to be adopted need to

incorporate a dimension of financial innovation. Although the main obligations in order to fulfil the sustainability targets are with governments, central banks also have a role to play in sustainable growth. This is shared by the European Central Bank (ECB) and other central banks.

1.2 The Industry Perspective

An industry representative explained that it is incredibly important that regulators and asset managers do not lose sight of the end clients. Their company recently did a survey of clients, asking what they think should happen to tackle greenwashing. Surprisingly 'ESG labels' was the bottom answer. The solution people are calling for is much more fund-level transparency around what is inside the fund, and more transparency on how asset managers are making decisions. There were also calls for more regulation and enforcement. More transparency is something that everyone can make progress on in the near term.

2. The problem created by the use of SFDR for labelling

A regulator added that the SFDR is a disclosure regulation not a labelling instrument, but it is used as one. The Austrian regulators tried to map the Article 8 and Article 9 requirements with Umweltzeichen. There are 449 funds labelled Article 8, and 14 labelled Article 9. 11 of the 14 are labelled by the Umweltzeichen, and only 99 of the 449 are labelled by the Umweltzeichen, so there is a discrepancy.

A regulator noted that there are other areas where the EU needs to improve. Article 8 of SFDR was perceived as a label, whereas it is only an information tool, and so there is a void to be filled. Europe should be more ambitious. More than 50% of French funds are labelled 'Article 8', although it is not a label. Moreover, there should not be one single EU label; diversity in this field is unavoidable. Finally, oversight of the label producers and, despite the difficulty, some minimum EU thresholds, are also needed.

3. A need for EU harmonisation of labels?

3.1 The History of EU Harmonisation

Asked whether labels should be harmonised or coexist with an EU-level label, a regulator explained that the EU tried to build something with the Ecolabel, but it was never achieved. There could also be private industry

labels if public labels are not perceived as reliable enough by the general public.

3.2 Pros and Cons of Harmonisation for Industry Actors

An industry representative added that one of the biggest challenges in asset management is that much greater consistency is needed across the various label providers across the EU. It is important to harmonise the label space, because currently there is significant divergence. This creates confusion for the end investor, and risks putting investors off investing in sustainable products. This is especially risky in a high-inflation environment, and investors need to truly understand and have clear guidance from the label providers. If there is significant divergence that objective is defeated, so clear, easy to-understand labels are needed to protect from loss of value when investing in sustainable products.

From an asset management point of view it is very important that the label providers also apply all the EU ESG-level legislation. That legislation should be mandatory for label providers. In relation to the criteria which are currently in the law, the only step that that needs to be taken in addition is to make it mandatory, which would automatically minimise divergence and hence the end investors could rely more on the labels. That reliance and that trust is a key component to a stable market.

Political consensus across the EU needs to be sped up. It is good to have diversity, but time is running out with the climate emergency. What is more important now is to find the lowest common denominator and to act quickly, even if there is not a perfect solution yet. So-called renewable energy sources, wind and solar, are not necessarily as renewable or sustainable as would be liked, but they are better than fossil fuels.

An industry representative explained that as a product manufacturer, their organisation will look at the strongest areas of demand for a particular product within jurisdictions and try to look at the individual labelling regimes and find a common framework to apply to an individual product. It is inefficient to have five different funds, versus a single fund that can hit as many labels as possible. Implementation is where it becomes very challenging. Trying to solve for five different application processes and five different labels is enormously cumbersome.

A common label encompassing the majority or most significant of the EU labels is one approach, and one where there are challenges to try to find those common denominators. There are specific third parties that the ISR label works with to assign the label. It would make product manufacturers' lives significantly easier if those third parties could also act on behalf of some of the other jurisdictions of the other labels, to interface as a product manufacturer with a single third party to assign multiple different jurisdictional labels.

There has been talk about SFDR, and it has been highlighted that Articles 6, 8 and 9 are not a labelling regime but a set of disclosure parameters. Implicitly within SFDR there is a labelling regime. This is specifically when looking at the interface between the

SFDR framework and the Markets in Financial Instruments Directive (MiFID) preferences for end clients, where clients are asked to express preferences either on the basis of percentage taxonomy alignment, proportion of sustainable investments, or consideration of principal adverse impacts (PAIs). That is important because these are quantitative measures and are not well-defined at the moment under the SFDR regulation. For a given set of assets, if the panellists all managed exactly the same fund, different metrics could be used when it came to sustainable investments or consideration of PAIs. Everyone would agree with that focus on protecting the end investor. If the end clients are using that as a discrimination point between asset managers and between funds, some level of commonality of a definition of sustainable investments and consideration of PAI is desirable. It is, essentially, becoming an implicit label in the marketplace.

3.3 EU regulation and supervision

A public representative stated that with the SFDR the European Union has clearly aimed at transparency but it is very open to improvement. At that time the European Union wanted to have clarity and transparency, but also flexibility, because lawmakers were looking for transparency and flexibility, giving market participants responsibility to explain what they are doing. Looking at ESG, it is clear that not every metric is well developed nor is there a clear common understanding. Without this it cannot be standardised in the form of a label. It is very clear that the market is not functioning because funds should move towards sustainable investment. If there is greenwashing that may not happen and it may affect the credibility of and trust in the market. Greenwashing is a problem in SFDR and what was not intended as a minimum standard is developing into one. Transparency is still important, but minimum standards are needed for Articles 8 and 9. Additionally, more competencies can be given to the supervisors to go after deceptive names or deceptive marketing. There are steps that can already be taken and it should be done quickly.

A Central Bank official added that it is important to develop this very concrete and comprehensive regulatory and supervisory framework for sustainable labels. It is also important to be based on science-driven criteria which are clearly defined and sufficiently detailed. This will facilitate transparency and the aim of adopting these sustainable labels will be served accordingly. It is important not to forget the juncture at which Europe stand right now. There are unprecedented parallel challenges: pandemic recovery, geopolitical tensions and this climate/energy nexus that needs to be urgently addressed. What is important is not only regulation, but regulation that will give the right and the appropriate incentives for the financial system to allow financial market participants to maintain or contribute to the sustainability of their actions.

A policy-maker outlined that the European Commission (EC) is of the view it is too early to draw firm conclusions, but clearly there are issues and additional safeguards may be needed to complement the existing disclosure framework. The EC also does not want to rule out an EU

label at this point but to first take stock of experiences with a fully applicable framework, seeing how the additional implementing measures, the regulatory technical standards (RTSSs), are working in practice and then coming back to the issue.

4. Issues raised by the situation of ESG ratings in the EU

4.1 European Commission Initiatives on ESG

A policy-maker stated that the EC has been looking into the functioning of ratings and an extensive study was commissioned on this and published at the beginning of 2021. There are issues around the functioning of this market, in particular regarding clarity of operations and transparency of the methodologies that are being used for ratings. The EC is currently looking into what could be the best course of action and what type of intervention is necessary, not excluding regulatory intervention.

A regulator noted it is clear that ESG ratings have come to play a very important role in the sustainable finance ecosystem. The EC recently issued its summary report from its consultation, but the European Securities and Markets Authority (ESMA) also did a call for evidence and in November 2021 the International Organization of Securities Commissions (IOSCO) published a report on ESG ratings. The regulatory community is looking at this with care and interest. The information provided by ESG ratings is becoming more material for investment decisions and use of ratings by investors can only increase.

In the EC's recent initiative on the targeted consultation, 94% of respondents to the consultation considered that EU intervention is necessary. This is coming from the private sector. The first question is whether the investment world could go forward with a self-regulatory initiative or intervention. There are reasons for scepticism. First, as evidenced by the EC, the EU market is composed of a small number of large, mostly known EU-headquartered players and a large number of smaller EU-headquartered players. The market structure is so fragmented and not yet very consolidated, and a fast evolution to discourage potential self-regulation would capture the full universe of these entities. Secondly these similar steps for the credit rating agencies have already been experienced. The solution has been known in the end with a European regulation. Thirdly there is no time, so the investment world had to go straight to the ultimate endpoint.

4.2 Issues with ESG Ratings Data and Methodologies

An industry representative added that ESG ratings were always designed to be a measure of ESG risk, not to identify companies that are having positive environmental and social impact. Where they can be useful is identifying good governance or where there is no significant harm, but some funds not having very high scores on third-party ESG ratings does not mean that there has been a failure of SFDR. The quality of the

data is also important; it is very frustrating that ESG data is subject to more user error and less cleaning.

An industry representative commented that the answer is to use ESG ratings from third-party providers in a very limited fashion. The utility is largely in getting some sense of who are leaders and the laggards in a particular sector, which can then be the basis for pushing companies to improve. However, the danger is where third-party providers are essentially using the sum of the parts in their ratings to give a fund rating. The methodologies behind ESG ratings are somewhat opaque, which is why the investment world is increasingly moving away from ESG ratings and going back to first principles and looking at the data. One of the problems observed is essentially the application of proxy methodologies in filling data gaps. If using an undeveloped or very basic proxy methodology for something like carbon footprinting, it is astonishing how providers would disagree on the carbon footprint of a portfolio. The consequence of that is poor consistency in the results; there is a correlation of 50-60% between the providers. The data providers' explanation for this is that they are solving for different things. One solution could be to make sure that data providers and rating providers are solving for the same output and the same objective function in their methodologies.

5. What kind of regulation for ESG ratings?

5.1 Transparency and Comparability

A regulator stated that a proportionate legislative intervention should be introduced that would calibrate with necessary flexibility and cater for large as well as small. The second principle is avoiding over-reliance. There is reliance to some extent in investment decisions, but by simply creating the conditions across a number of different legislations the possibility of over-reliance should be avoided. The first pillar of this regulatory framework would be improving transparency of the methodology. Common rules around transparency of the methodology are critical. The second pillar is improving the reliability and comparability of the ratings. The third would be improving transparency of the fees charged by providers. The fourth point is about avoiding conflicts of interest. There is clear value in legislative intervention.

A regulator noted that their organisation had published a position paper 18 months ago in favour of a new regulation on ESG ratings, encompassing also ESG data & services/providers. Very often these are the same bodies that publish ratings or data with a lot of additional services. There are conflicts of interest and this can have an influence on investors. That is why there should not be a narrower meaning of ESG ratings, but rather a definition of ESG data and rating providers. Ultimately, a good endpoint to this would be a common ratings scale, in order to not be trying to translate between a numerical output and a letter output or a grade across data providers. There should be a

commonality in terms of their output and the assessments being given.

An industry representative explained that the challenge of the methodology is threefold. First of all, there is a lack of transparency; clearer disclosure is needed from the rating providers about how their methodologies are being implemented. The second problem is about the consistency of application of those methodologies. There is significant variance, particularly when looking at high-yield companies or emerging markets. The third part is the need to put more pressure back onto the providers to explain why those differences exist. Having a panel of representatives from those providers to understand where those differences exist would be extremely interesting.

An industry representative noted that it is healthy to have disagreement in a market.

5.2 The Political Realities

A public representative noted the difference between ESG ratings and data. Improvements are being made in the area of data since work is now taking place toward an EU single access point (ESAP) and a Corporate Sustainability Reporting Directive (CSRD). There was no progress in the ESG ratings because, in order to learn, transparency of the methodology is required. In academia methodologies are exchanged in order to learn and make progress. The differences in methodologies will not be removed, because the investment world does not learn from each other. Politically it is very helpful if there is broad consensus.

A regulator added that the interaction, links and relationships with the non-EU should not be forgotten. If a regime is established and principles designed, there may be a need for a supervisor. This role could be played by ESMA, given the nature of the matter.

6. Conclusion

A policy-maker confirmed that the EC is currently looking at the need for a measure and action on ESG ratings. Proportionality is key, as well as not disrupting a market that is still evolving and not mature. The EC would side with those emphasising the need to encourage transparency and sound operations, and that includes issues like conflict of interest and not interfering at this stage of the development of the market in substantive methodological choices that providers make. There is a broad consensus around this.