Sustainable labels and sustainable rating providers in the European Union: dynamism, diversity, complexity and reforms

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The volume of sustainable or ESG (Environment, Social, Governance) finance is continuously increasing. Last year for instance, the issuance of sustainable bonds (Green bonds + Social bonds + Sustainable-linked bonds) exceeded $ 1.000 Bn, up 75% from 2020. The EU-domiciled ESG funds have also very much increased to € 1.600 Bn at the end of 2021, up 60% from the end of 2019.

But there is also a growing suspicion of "greenwashing" and a couple of financial actors are under investigation for this reason or have even been penalized in Europe and the United States.

Moreover, it is often not clear for investors why a financial product is said to be sustainable.

Sustainable (or ESG) labels and sustainable rating providers have the goal to help the investor who wants to assess the sustainability performance of corporates or of financial funds.

Due to the rapidly increasing interest for sustainable investments, there is a real dynamism in sustainable labels and sustainable ratings. But there is also a big diversity and a great complexity for investors when they see the difference of sustainability assessment for the same corporate by different labels or sustainable rating providers.

The sector has also been impacted by greenwashing suspicion. For instance, Bloomberg at the end of 2021 has questioned the adequacy of ESG marks given by the giant sustainability ESG rating agency MSCI.

Two recent documents clarified the situation and the trends of sustainable labels and sustainable rating providers in the European Union:

A study by Novethic on the most used EU ESG labels.

A report from the European Securities and Markets Authority (ESMA) on sustainable rating agencies in the EU, which followed a wide consultation.

1. The Novethic study on ESG labels underline their dynamism, their similarities and differences and the trend of their reforming process in line with the EU regulation

Novethic, a subsidiary of the Caisse des Dépôts specialised in sustainable analysis, publishes each year a review of the most important EU sustainability labels. Their last annual document, published in March 2022, specifically reports on the six more important ESG labels *i.e.*, ISR (France), Towards sustainability (Belgium), Lux Flag (Luxembourg), FNG Siegel (Germany, Austria, and Switzerland), Umweltzeichen (Austria) and Nordic Swan Ecolabel (Nordic countries). They also address 3 Green labels: Greenfin (France), LuxFlag Environment and LuxFlag Climate finance (Luxembourg), although they operate on a much less important number of funds.

The study underlines the dynamism of the 6 ESG labels, their similarities and differences and their reform process generally linked to the EU regulation.

1.1 The dynamism of the EU sustainable labels:

The two leaders are ISR (€ 77 Bn) and Towards sustainability (€ 578 Bn), far ahead of LuxFlag ESG (€148 Bn), FNG-Siegel (€115 Bn), Umweltzeichen (€60 Bn), Nordic Swan (€34 Bn), and of the 3 Green labels: Greenfin (€31 Bn), LuxFlag Environment (€2 Bn) and LuxFlag Climate change (€1 Bn).

The outstanding volume of labelled funds doubled in 2020, from € 288 Bn to € 675 Bn, and doubled again in 2021 to reach € 1.304 Bn. Between end 2019 and end 2021, the number of funds with at least one label has grown from 775 to 2.022. There is also an increase of funds having two labels (250) or more.

1.2 Similarities, differences, and complexities:

There are many similarities between the 6 ESG labels on their general orientations:

- All of them are assessing the ESG selection process of funds, and look at a large part of their portfolios (up to 90% for ISR and 100% for Towards Sustainability, FNG-Siegel and LuxFlag ESG),
- All of them have defined criteria regarding the engagement of the funds as shareholders,
- 3 out of 5 labels (FNG-Siegel, Umweltzeichen, Nordic Swan) base their analysis on points scale, based on a limited number of criteria (between 4 and 7).
- All except ISR have today an exclusion policy.
- Exclusion policies are similar regarding their two broad options: corporates and States, which are controversial (human rights, environment, etc), and sensitive sectors (fossil energy, weapons, tobacco). But the underlaying criteria are not the same. For instance, Towards Sustainability excludes corporates which do not respect the Global Compact and the minimum social safeguards of the EU Taxonomy, while FNG-

Siegel only excludes corporates, which do not respect the Global Compact and Umweltzeichen and Nordic Swan have their own policy. 5 ESG labels exclude the exploration and production of fossil energy, but 2 of them derogate (Towards Sustainability and Nordic Swan) regarding those corporates who heavily invest in renewable energy and who are reducing their production of fossil energy (Towards Sustainability) or do not increase it in non-conventional fossil energy (*e.g.*, shale gas, tight gas and coalbed methane according to Nordic Swan).

- There is a clear "double materiality" approach by Towards Sustainability and Nordic Swan, but not so by the other labels. Nordic Swan is also the only label to include biodiversity as a criterion for the analysis of corporates in sectors known to exert pressure on biodiversity.

Finally, however, although Novethic has made a great effort to compare these labels' priorities, criteria and methodologies, a number of important criteria and methodologies are not transparent enough and the comparability is far from being easy.

1.3 A continuous reform process in line with EU regulation:

4 out of the 6 ESG labels have been reformed in 2021 or at the beginning of 2022, notably because of the implementation of the SFDR (Sustainable Finance Disclosure Regulation) in March 2021. The most important ESG label, ISR, has launched a long reforming process, which is not yet finished.

SFDR has introduced the classification of sustainable funds in Article 8 or Article 9 of SFDR. The implementation of the SFDR has complicated the landscape, because some sustainable funds have used the article 8 or 9 of the regulation as new labels even if it is only a self-declaration. To overcome this new complexity, 4 of the 6 ESG labels have included an obligation of the fund to conform to the Article 8 and/or Article 9, what allow them to assess this conformity.

The concept of "double materiality" is also progressively introduced in labels' analysis, especially by Towards Sustainability and Nordic Swan. Finally, the points scale of Nordic Swan gives preferences to funds with a focus on EU taxonomy and on respect of biodiversity in sensitive sectors.

It is to be expected that the reforming process of these labels will continue in line with the incoming EU regulation: CSDR, the development of the EU Taxonomy etc.

EU investors would welcome more comparability and convergence between the 6 ESG labels, and as soon as possible a pan-EU and robust label which seems today unreachable. It is to be hoped that this reform process will also deliver progress in this regard.

2. The ESMA report on sustainable rating providers in the European Union: a concentrated market with a number of shortcomings

ESMA has made the fight against greenwashing and for making sustainable finance more transparent one of its priorities.

It is well known that the differences between the ESG rating providers outcomes are acute, contrarily to credit-ratings delivered by credit rating agencies[1]. In this respect McKinsey recently highlighted that "while credit scores of S&P and Moody's correlated at 99 percent, ESG scores across six of the most prominent ESG ratings and scores providers correlate on average by only 54 percent and range from 38 percent to 71 percent"[2]. Most of users and rated entities think that the ratings are generally not transparent enough and not easy to compare.

In June 2022, ESMA published a letter to the European Commission providing its finding from a call of evidence to gather information on the market structure for ESG rating providers in the European Union. Based on the 154 responses (including the responses of the 59 rating providers), ESMA report describes the market structure and underlines the shortcomings of the activities of these rating providers in the EU.

2.1 A market structure of numerous rating providers but dominated by 3 non-EU giants

Most of the 59 sustainable rating providers in the EU are very small (median turnover €5 million) but there is also three non-EU headquartered giants (MSCI, Sustainalytics and ISS) having the larger share by far. There are only two medium-sized EU data providers: Ethifinance and Scope. A large majority of these rating providers also offer other ESG data products.

Users of ESG ratings are generally contracting for these products from several providers simultaneously, on an investor-pay basis. Their reasons for selecting more than one provider are most notably to increase coverage, either by asset class or geographic, or in order to receive diverse ESG assessments. However, the majority of users contract with a small number of rating providers, indicating a degree of concentration in the market.

2.2 The responses to the consultation show several shortcomings

The responses of the users show that most of them are not satisfied with the level of methodological transparency. Methodologies are deemed as often too complex and unclear. Sometimes providers were not able to clarify how their results had been determined.

The responses of the rated entities to the ESMA survey, underline their communication difficulties with rating providers. Commenting or report feedback by the rated entities can be a cumbersome and difficult process and is made also more difficult by the lack of transparency around the key inputs in the rating process.

1. Eurofi : addressing ESG confusion to avoid greenwashing in asset-management, Matteo Le Hérissé, February 2022
2. p17. Florian Berg, Julian Kölbel, and Roberto Rigobon, "Aggregate confusion: The divergence of ESG ratings," Review of Finance, forthcoming, updated April 26, 2022

Some rated entities question also the "American bias" resulting from the increasing concentration of US-based ESG rating providers. "Respondents had the view that some methodologies are consistently biased towards larger and/or listed companies, as well as US industries, while EU companies, whose operations are more strictly correlated with their geography and their national regulations, are penalised by the methodologies.

In December 2020, the French and the Dutch markets authorities (Autorité française des Marchés and Autoriteit Financiële Markten) had asked for a regulation on ESG rating providers to prevent greenwashing and ensure the protection of investors. They pleaded for more transparent methodologies, control of conflict of interest and a better dialogue with rated entities. This initiative seems to be comforted by the ESMA study.

In her letter to the European Commission transmitting this report, Verena Ross, Chair of ESMA, wrote: "We consider the feedback we have received on the market for ESG rating and data providers is indicative of an immature but growing market, which, following a number of years of consolidation, has seen the emergence of a small number of large non-EU headquartered providers. In our view this market structure bears some resemblance to that which currently exists for credit ratings. Similar to that market, there are a large number of smaller more specialised EU entities co-existing with larger non-EU entities who provide a more comprehensive suite of services. We trust that you find this input useful for a possible assessment around the need for introducing regulatory safeguards for ESG rating products."

The logical conclusion of the ESMA report is that the biggest rating providers should be supervised as the credit rating agencies, in order to avoid conflict of interest and to make their rating process and their methodologies clearer.

Bibliography

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