A CRITICAL LOOK AT THE ESG MARKET

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CEPS Policy Insights
No 2022-15 / April 2022

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Abstract

Environmental, social and governance (ESG) investing has been practised in Europe for more than two decades, during which it has moved from niche to the mainstream market. The rapid growth in the number of sustainability-related financial products and service providers over the past decade has also attracted regulators' attention. The EU's regulatory capacity on sustainability represents a hidden treasure that echoes the realisation that to achieve the EU's environmental and social goals, a sharp departure from the current predominant model of capitalism and corporate governance is required. It has been argued that an increasing amount of capital is misallocated due to the inadequacy of ESG criteria and the ESG services market's lack of transparency. The rankings produced by ESG rating agencies create a false sense of security, and investors who buy into ESG funds with dubious credibility need protection. Considering the potential implications of ESG exposures for long-term financial stability, it is in the public interest to critically evaluate ESG criteria and reporting requirements to clear a path for more meaningful and more operational corporate objectives that contribute to the green, digital and just transition. Whilst in the context of the EU sustainable finance package many regulatory measures are already underway, it is imperative that the Commission fixes the blind spots and completes the additional steps needed.

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This paper was written under the Hidden Treasures Programme.

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1. Introduction

Environmental, social and governance (ESG) investing has been practised in Europe for more than two decades, during which it has moved from niche to the mainstream market. The rapid growth in the number of sustainability-related financial products and service providers in the past decade has also attracted regulators' attention. To date, the European Union (EU) has developed the most comprehensive policy agenda on sustainable finance, and has been a first mover in establishing global standards with a taxonomy of sustainable activities and disclosure rules for financial market participants and large companies. The EU's regulatory capacity on sustainability represents a hidden treasure that echoes the realisation that to achieve the environmental and social goals set by the EU, a sharp departure from current predominant model of capitalism and corporate governance is required. The European Commission has estimated that to meet the EU's 2030 climate and energy targets, EUR 480 billion additional annual investment is needed[1]. The Commission's 2018 action plan on financing sustainable growth and the 2021 new sustainable finance strategy emphasised that the private sector needs to play a key role in financing the green and just transition by reorienting capital flows towards sustainable funds. Simultaneously, the Commission's regulatory approach aims to guarantee financial stability by integrating ESG factors into financial firms' risk management practices.

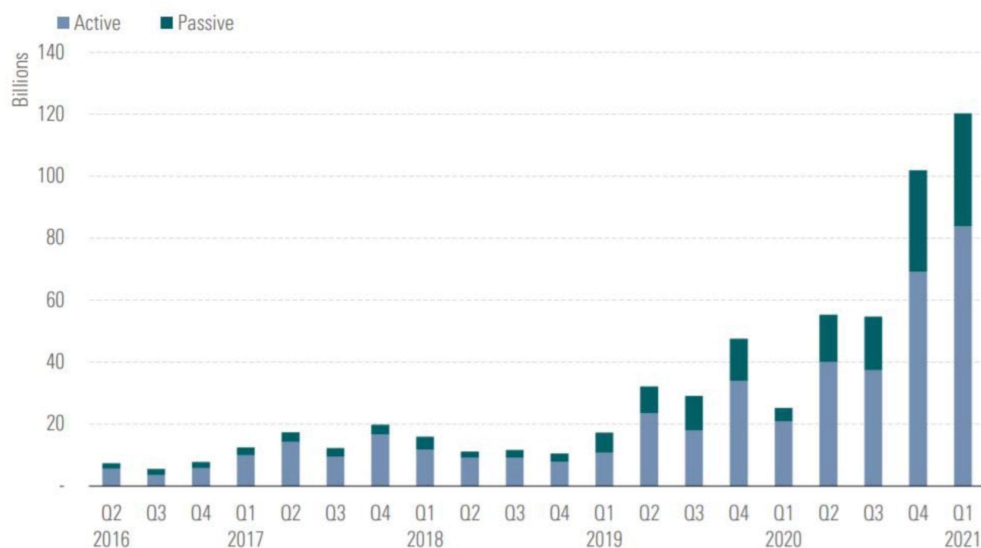
Although the empirical evidence on returns has been mixed in the past decade, there is a growing body of academic literature and industry research showing that ESG funds can perform as well as – or, under certain circumstances, exceed – traditional market-weighted investments (Boffo and Patalano, 2020). Against this background, the COVID-19 pandemic uncovered the fragility of national economic systems and exposed the growing resilience of ESG funds and sustainable business models (Barbéris and Brière, 2020). Some evidence suggests that, at least during the pandemic, ESG risks matter for investment performance, and sustainable investing can perform and deliver stronger risk-adjusted returns (Whieldon and Clark, 2021). As a result, in the first quarter of 2021 alone, capital investments in European sustainable funds reached EUR 120 billion, 18% more compared to the same period in 2020, representing 51% of all European fund inflows (Graph 1)[2]. The number of available sustainable funds also increased substantially, reaching 3 444 by March 2021 compared to 3 196 at the end of 2020[3].

[1] European Commission (2021), Strategy for financing the transition to a sustainable economy | European Commission (europa.eu).

[2] Morningstar, 'European Sustainable Fund Flows: Q1 2021 in Review'.

[3] Ibid.

Graph 1. European sustainable fund flows (EUR billion)



Source: Morningstar Direct, Manager Research. Data as at March 2021.

Whilst almost all sectors in the euro area increased their holdings of green funds in 2020, it appears that the so-called 'greenium' (i.e. green premium), though shrinking somewhat, is not disappearing (Belloni et al., 2020). Overall, recent trends in the ESG market indicate that there is no evident trade-off between sustainable investing and financial performance, and there is a growing appetite in the private sector for supporting sustainable and resilient business models by accounting for the interests of various stakeholders.

Investors play a catalyst role in applying pressure on companies to improve their corporate behaviour in line with societal goals. On the one hand, investors looking to improve their sustainability risk profile might exclude certain companies or entire sectors that violate specific norms or soft laws (e.g. those contained in the OECD Guidelines for Multinational Enterprises or the Ten Principles of the United Nations (UN) Global Compact) because their behaviour does not align with basic environmental and social values (the so-called 'exclusion' or 'avoidance' investment approach). Alternatively, investors can realign their assets by ESG scores, tilting their portfolio towards issuers with higher ESG scores and away from those with lower scores (the 'rebalancing' or 'weighting' approach). However, to do so, they need extensive high-quality quantitative and qualitative data about how sustainable and resilient their portfolio companies are (Eltobgy, Brown and Picard, 2021). For this, investors, asset managers and financial institutions increasingly rely on ratings and reports produced by ESG rating agencies. ESG ratings measure and evaluate companies' long-term exposure to ESG risks, and the robustness of their strategies for managing those risks compared to their industry peers. These ratings and metrics guide investor decisions on capital allocation and risk management. Whilst the role and importance of ESG ratings have grown rapidly over the past decade, the fragility of rating methodologies and the lack of quality ESG data highlight the need for the regulation of ESG service providers and common non-financial reporting standards.

The main frustrations related to the ESG data industry include the subjectivity, opacity and unreliability of ESG data and ratings as a result of the lack of regulatory oversight[4]. Multiple high-profile scandals have drawn the public's attention to the challenges of third-party ESG rating systems, including the case of the fast-fashion brand Boohoo, which was caught in a major forced labour scandal at the start of the COVID-19 pandemic. The brand had previously received outstanding scores from multiple rating agencies, which has called into question the reliability of such ratings. Simultaneously, greenwashing allegations are increasingly jolting the investor side of the financial industry, as asset managers are accused of exaggerating their claims of ESG investing. Recently, Deutsche Bank AG's asset-management branch, DWS Group, was caught in a greenwashing scandal for having excessively overstated its ESG credentials. DWS came under scrutiny just weeks after the former Blackrock Sustainable CIO, Tariq Fancy, came forward with strong claims about the ESG investment market, calling it a 'dangerous placebo' that can distract the public from meaningful climate and prosocial action. Having managed the world's largest asset management company's sustainable investment portfolio between 2018 and 2019, Fancy now argues that financial institutions have a strong incentive to push ESG products, given that they have higher fees, which improve their profits. At the same time, investment companies are not held accountable for overstating the extent to which they integrate sustainability criteria into their investment strategies.

In reaction to these events, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the World Bank have urged regulators to protect investors from greenwashing. The IMF's recent semi-annual Global Financial Stability Report argues that the sustainable investment sector is an essential driver of the transition to the green economy, but proper regulatory oversight is needed to ensure the availability of high-quality sustainability data, and to prevent financial companies from misleading investors regarding their environmental credentials[5]. Whilst the EU has already taken steps towards establishing a taxonomy of sustainable activities and proposed initiatives for more extensive corporate sustainability reporting, commentators argue that these measures 'offer little immediate benefit to investors and data providers' (Lehmann, 2021).

2. Outstanding challenges and the need for comprehensive regulation

The growing interest in ESG investing has created tremendous demand for ESG data in virtually all segments of the market. Companies are increasingly realising the need to incorporate and roll out well-structured ESG strategies that align with market expectations and investor interests, without which they might find themselves at risk of being excluded from investment portfolios and other market opportunities. In addition to the 8 966 stock-listed companies on European stock exchanges[6] that are ranked by ESG ratings and indices, ESG performance scores are also increasingly relevant to non-listed companies. Therefore, it is also in the interest of

[4] European Commission (2021), Study on sustainability-related ratings, data and research.

[5] IMF (2021), Global Financial Stability Report.

[6] FESE Statistics, information retrieved on 18 November 2021.

non-listed (large) companies to produce ESG reports – often with the help of consultancies and ESG rating agencies. The growing importance of ESG reporting for both listed and non-listed companies is also reflected in the changing scope of recent EU legislative initiatives. Whereas the reporting rules in the Non-Financial Reporting Directive (NFRD) only apply to large (500+ employees) listed companies, banks and insurance companies, the forthcoming Corporate Sustainability Reporting Directive (CSRD) extends the scope of the reporting requirement to all large companies (without the 500-employee threshold), regardless of whether they are listed (or not), and to listed small and medium-sized enterprises (SMEs), with the sole exception of listed micro-enterprises. It is estimated that under the CSRD, almost 50 000 companies would need to comply with reporting requirements, compared to the 11 000 companies covered by the NFRD.

On their way to becoming the new 'North Star' for investing, it is important to assess the value and quality of the sustainability-related data, ratings and research produced by third-party providers. In light of the information available, there are important material challenges with regard to ESG data in terms of transparency, timeliness, accuracy and reliability, bias and low correlation across different ratings by market participants, and potential conflicts of interest associated with providers (as they are paid advisory services) whilst evaluating them. A growing number of studies show that the lack of coherence among the indicators used in ESG disclosures and the lack of clear and consistent terminology pose challenges for the comparability of ratings across the industry (DG FISMA and ERM, 2021). Furthermore, in contrast to the well-established literature on financial ratings, the body of literature on how regulation can strengthen the reliability of ESG ratings is still embryonic (Siri and Zhu, 2019). The lack of consolidation of the ESG services industry creates exposure to greenwashing claims and weakened investor protection, which, if left unchecked, can put important societal goals in jeopardy by distracting resources and attention from real sustainable action (Lovisolo, 2021). The following section will introduce the main challenges and methodological biases of the ESG rating services market identified in the literature. These concerns represent the basis for the ongoing review of the EU's framework for sustainable finance disclosures and non-financial reporting, including the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR) and the proposed CSRD.

2.1 Diverse rating methodologies leading to conflicting ESG scores

Over the past decade, the size, relevance and complexity of the ESG-related products and services market has increased considerably. The number of ESG standards, metrics, third-party data providers, ratings, rankings and indexes has expanded, with currently more than 600 ESG ratings and rankings available worldwide[7]. The products and services offered by ESG rating providers have similar goals. However, due to inconsistencies between the methodologies and metrics used by rating agencies and consultancies, their ratings tell very different stories about companies' sustainability credentials. Table 1 contains information on some of the largest ESG rating agencies and illustrates the differences between their approaches.

[7] SustAinability (2019), 'Rate the raters 2019: Expert views on ESG ratings', February.

Table 1. Overview of main ESG rating agencies

ESG rating agency	Description	Rating
MSCI ESG Research Rating	Assigns firms ESG scores calculated by aggregating the weighted average of the key issue scores.	Rating system ranges from best (AAA) to worst (CCC).
S&P Global ESG Rank	Yields a total sustainability percentile rating derived from the total sustainability score and based on the S&P Global ESG Rank.	Offers a percentile score with 1 being the worst and 100 being the best.
Sustainalytics Industry Rank	Provides a percentile rating to companies based on their ESG total score relative to their industry peers. Aggregate ESG performance encompasses a firm's level of preparedness, disclosure and controversy involvement across all three ESG themes.	Offers a percentile rating with 1 being the worst and 100 the best.
Carbon Disclosure Project (CDP) Score	Reflects a company's degree of commitment to climate change mitigation, adaptation and transparency. The only firms rated are those that respond on time to a questionnaire sent following an investor request.	CDP climate scores range from 0 (failure) to 8 (A).
Institutional Shareholder Services (ISS) Governance Score	Assesses a company's governance practices.	ISS scores range from 1 (best) to 10 (worst).
Bloomberg ESG Disclosure Score	A proprietary rating derived from the extent of a company's ESG disclosure.	ESG disclosure scores range from 0 (no information provided) to 100 (all possible information provided).

Source: Prall (2021).

Given that there is still no regulatory definition for ESG criteria, rating agencies use a wide variety of definitions for the environmental, social and governance aspects they actively consider. To mention but a few, MSCI considers 35 key ESG issues selected annually for each industry, and 10 themes (climate change, natural capital, pollution & waste, environmental opportunities, human capital, product liability, stakeholder opposition, social opportunities, corporate governance and corporate behaviour). S&P attributes ESG scores for up to 30 focus areas across sub-industries for 130 sustainability topics overall. Sustainalytics assesses more than 250 ESG indicators underpinning 20 material ESG issues across three dimensions: preparedness, disclosure and performance. Having such diverse sets of indicators across the ESG market makes these ratings barely comparable. In addition, ESG rating agencies do not disclose to the public their (complete) methodological guides and the assessment tools they use, including how specific indicators and factors are weighted (Doyle, 2018). This aggravates the lack of transparency and prevents the emergence of best practices.

Due to the lack of standardisation and transparency regarding methodologies in the ESG ratings industry, there are large discrepancies between the scores that individual companies receive from different rating agencies (Kotsantonis and Serafeim, 2019; Pyles, 2020; Dimson, Marsh and Staunton, 2020; Lopez, Contreras and Bendix, 2020; Berg, Kölbel and Rigobon, 2020). One

study analysed selected ESG rating agencies' scores for over 400 companies in 24 industries (Prall, 2021). Table 2 shows the weak correlation between the ratings of different agencies. Prall argues that the lack of consistency between ESG ratings limits their usefulness for extracting meaningful information about companies' long-term resilience and non-financial performance. However, the reconciliation of methodologies is unlikely, since rating agencies' business models are based on product differentiation: in other words, it is in their interest to maintain opaque and non-comparable rating criteria and indicators.

Table 2. Correlation between ESG ratings (%)

	MSCI	S&P	Sustainalytics	CDP	ISS	Bloomberg
MSCI		35.7	35.1	16.3	33.0	37.4
S&P	35.7		64.5	35.0	13.9	74.4
Sustainalytics	35.1	64.5		29.3	21.7	58.4
CDP	16.3	35.0	29.3		7.0	44.1
ISS	33.0	13.9	21.7	7.0		21.3
Bloomberg	37.4	74.4	58.4	44.1	21.3	

Source: Prall (2021)

2.2 Inconsistencies (and the moral hazard) of ESG self-reporting

Most information used for drawing up ESG rankings is sourced from companies' voluntary (and mostly unaudited) disclosures, or from their responses provided to rating agencies' surveys and questionnaires. Further data sources include unstructured company data (e.g. media reports, non-governmental organisation (NGO) reports) and third-party data. One of the main critiques of ESG ratings relates to the dubious sources and questionable quality and reliability of the data used to establish them.

Compared to financial reports, ESG data released by companies are largely unstandardised, often unstructured, difficult to compare and in need of more interpretation. For these reasons, ESG disclosures tend to be more subjective than financial reports. Furthermore, self-reported data raise doubts regarding reliability. Alexandra Mihailescu Cichon, Executive Vice President of RepRisk, argues that 'self-reported data is opaquely one-dimensional and often does not account for ESG risks that have bottom-line compliance, financial, and reputational impacts for companies.' This is confirmed by a Deloitte report that studied over 4 000 ESG reports over the course of four years and found 'a significant number of data omissions, unsubstantiated claims, and inaccurate figures'[8]. In contrast, it notes that 'sustainability reports that are audited tend to include more environmental information compared with those that are not audited'[9].

Some EU legislative initiatives are currently emerging to standardise companies' ESG disclosures (such as the forthcoming CSRD), which can tackle this challenge in the long run. However, a large volume of investment is already being guided through the lens of ESG service providers, whose rankings are inconsistent and difficult to compare. The lack of comprehensive

[8] Deloitte (2013), 'Disclosures of long-term business value – What matters?'.

[9] Ibid.

reporting standards also forces rating agencies to fill data gaps by relying on the opinion of industry members, making assumptions or collecting missing information through third-party sources such as utility providers – further worsening the subjectivity and reliability of the scoring process (Berg, Kölbel and Rigobon, 2020). A recent study highlighted that the big discrepancies between different rating agencies' scores for the same companies are often due to the fact that ESG researchers use very different methods to fill data gaps (Kotsantonis and Serafeim, 2019).

In addition to the issues related to the quality of the input data provided to rating agencies, there are concerns related to the practices by which investors integrate the ESG ratings of their portfolio companies into their investment processes (Bernow, Klempner and Magnin, 2017). Many of the recent ESG corporate greenwashing scandals, such as the one surrounding DWS, draw attention to the lack of accountability mechanisms for checking how investors integrate ESG criteria into their investment processes. Given the motivation of 'green investors', this issue can be described as a 'moral hazard' (Darwyne, 2021). A moral hazard arises if agents, banks, institutional investors or non-banking entities can use the 'green fund' label with little or no possibility for investors (i.e. savers) to check the validity of asset managers' ESG claims. This is due to the fact that the cost of checking on the level of ESG compliance of the funds is (perhaps prohibitively) high, which creates an ideal breeding ground for greenwashing. If green investors agree to higher fees for financial agents, incentives for greenwashing are even stronger. Finally, considering that ESG rating providers both evaluate companies and get paid for their services, it is argued that the potential for collusion and conflicts of interest is high[10].

2.3 Common biases in ESG metrics and methodologies

The most prevalent biases in ESG metrics and ratings relate to: (i) company size; (ii) geographical bias; and (iii) oversimplification of industry weightings (Doyle, 2018).

2.3.1 Company size bias

There is a growing body of literature confirming that ESG ratings are skewed towards larger-sized companies (Giese et al., 2019; Ratsimiveh et al., 2020). In other words, bigger companies are awarded better ratings than SMEs, despite not necessarily demonstrating a superior performance in economic, social and governance factors. The reasons for the size bias can be attributed to the better availability of resources for reporting, and more advanced know-how for implementing sustainable management tools (Drempetic, Klein and Zwergel, 2020). One study found that the extent to which company size biases the ratings is dependent on the kind of data that agencies use: those relying more on survey data tend to exhibit larger company size bias compared to those relying on third-party data sources (LaBella et al., 2019). The

[10] European Commission (2021), Study on sustainability-related ratings, data and research.

expanding regulatory scope is a welcome development in this respect, but reporting standards should also take into account the needs of SMEs.

2.3.2 Geographical bias

Another source of bias is related to the company's location. Some studies have shown bias towards markets outside the United States (US), and especially towards European companies (LaBella et al., 2019). The bias is not attributable to the quality of ESG practices but to the quality and availability of data due to mandatory reporting requirements in the EU (Doyle, 2018). Currently, there is a large divergence in regulatory standards for non-financial reporting between countries. For example, in the EU, there are already mandatory reporting requirements on environmental and social issues under the NFRD and the forthcoming CSRD, whereas in the US, for example, no such non-financial reporting requirements are in place. Attributable to the greater availability of data as a result of legally required non-financial reporting, rating agencies tend to award companies operating in Europe higher ESG scores compared to their peers, which primarily operate in other jurisdictions, such as the US.

2.3.3 Industry bias

Key ESG indicators for materiality are generally determined by rating agencies on an industry basis. Rating agencies use specific weightings for industries based on the assumption that companies in the same sector have similar business models and are therefore exposed to similar ESG risks in their business operations. While the emergence of more industry-tailored approaches is a positive development, many argue that ESG agencies still oversimplify industry weightings by not adjusting the scoring methodology to company-specific risks (Doyle, 2018). Overall, while it is important to standardise the disclosure methodology and the metrics used within industries, especially considering how materiality varies across sectors, without individualised weighting, the scores might still be biased and thus mislead investors.

3. Policy solutions: five ways forward

It is argued that an increasing amount of capital is misallocated due to the inadequacy of ESG criteria and the lack of transparency of the ESG services market. The rankings produced by ESG rating agencies create a false sense of security, and investors who buy into ESG funds with dubious credibility need protection. Considering the potential implications of ESG exposures for long-term financial stability, it is in the public interest to critically evaluate ESG criteria and reporting requirements to clear a path for more meaningful and more operational corporate objectives that contribute to the green, digital and just transition. The 2021 EU sustainable finance package, building on the 2018 action plan on financing sustainable growth, outlines the Commission's approach to tackling the challenges of ESG investing. Whilst many regulatory measures are already underway, other EU initiatives such as the Taxonomy Regulation, the SFDR and the revised non-financial corporate disclosure regime have suffered considerable delays due to intense political bargaining and difficulties encountered in the development of

technical standards. Considering that most initiatives are interconnected and build on each other, it is imperative that the Commission fixes the blind spots and completes the additional steps to be taken. The following recommendations address these gaps.

3.1 The Taxonomy Regulation should be based on science-based criteria, be applied exhaustively, and cover all social and governance components, rather than only looking at the (crucial) environmental dimension

It is imperative that the forthcoming legislative EU initiatives in the field of sustainable finance introduce greater transparency in ESG disclosures and strengthen investor protection. However, before regulatory oversight and audits can play a role, it must be clear how ESG factors can be measured. This requires a comprehensive understanding of what attributes of economic activity count as sustainable or ESG compliant. Establishing common indicators is complicated by the fact that the potential number of variables to be measured could be so high that the costs of checking them are higher than the benefits. If so, one has to select a relatively small number of indicators that proxy the intentions of ESG initiatives to an extent that they can be considered comprehensive. On top of having such indicators, there is need for an agreement on measurement methods.

In the context of the sustainable finance package, it appears that the Commission was (or is) not ready to confront some of these difficult issues. This is illustrated, for example, by the overall architecture of the Taxonomy Regulation. This piece of legislation left the concrete definition of sustainability indicators to delegated acts, which, from a scientific point of view, are failing. As a result, many argue that the Taxonomy Regulation, representing the backbone of the sustainable finance strategy, has opened the door to more greenwashing. Furthermore, whilst the current taxonomy already incorporates the social and governance dimensions to some extent[11], more could and (hopefully) will be done when the Commission adopts the social taxonomy in 2022. The Platform on Sustainable Finance's draft report on social taxonomy, published in July 2021, contains promising building blocks for a proper social dimension in the EU's sustainable finance legislative package, based on global social and human rights norms. Regarding the governance criteria, it is advisable that the taxonomy be aligned with the forthcoming sustainable corporate governance proposal, which is expected to be published in the first quarter of 2022.

Finally, the effectiveness of the EU taxonomy and other labelling initiatives will depend to a large extent on the voluntary uptake of the criteria. Whilst in general the EU taxonomy and other initiatives in the sustainable finance package are primarily addressed at financial market participants, they can also be applied to the public sector. A recent report on sustainable

[11] Explanatory document on the work of the European Commission and the Technical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard, https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/200610-sustainable-finance-teg-taxonomy-green-bond-standard-faq_en.pdf.

finance by the European Court of Auditors points out that the European Commission does not apply the 'do no significant harm' principle or the strict science-based EU taxonomy criteria consistently across the EU budget[12]. The authors of the report note that '[t]he lack of consistent application of the EU Taxonomy risks that finance raised for the climate part of the [Rescue and Restructuring Fund] will not meet the EU Taxonomy-based criteria that will apply for the EU green bond standard'[13]. To encourage the acceptance of stronger climate and environmental standards and to support the uptake of the EU taxonomy criteria, EU investments should be better aligned with its own sustainable finance principles.

3.2 Develop credible sustainability reporting standards and clarify compliance and enforcement arrangements under the forthcoming CSRD

According to Article 1 NFRD, companies can rely on high-quality, widely recognised, national, EU or international frameworks for their non-financial reports. Despite the directive not prescribing a particular reporting framework, most companies (about 90%) rely on some kind of reporting framework or standard[14]. Since the adoption of the directive in 2014, the international landscape of non-financial reporting standards has become considerably more proliferated, with different initiatives that only partially overlap and sometimes contradict each other[15]. Currently, the most commonly used reporting framework is the Global Reporting Initiative (GRI), followed by the UN Global Compact framework, European Commission Guidelines and the Carbon Disclosure Project (CDP)[16]. The fitness check of the NFRD concluded that 'the fact that the Directive does not require the use of any particular framework or standard may undermine the objective of reliability' and 'limit the potential efficiency gains for users and preparers'[17]. To address the issues related to comparability, and to avoid a race to the bottom among different reporting frameworks aiming to attract more companies, the forthcoming CSRD proposes the development of EU-wide non-financial reporting standards led by the European Financial Reporting Advisory Group (EFRAG). EFRAG will also work closely with global reporting initiatives such as the GRI – and potentially the recently announced International Sustainability Standards Board (ISSB) of the International Framework for Reporting Standards (IFRS) – to contribute to a gradual global convergence on reporting standards[18]. EFRAG's first set of draft standards are expected in October 2022. EFRAG's capacity to develop non-financial reporting standards represents a hidden treasure in the EU's toolbox: if EFRAG succeeds in its mandate, it will be able to deliver a global baseline for

[12] European Court of Auditors (2021), Special Report, Sustainable Finance.

[13] Ibid. p. 45.

[14] European Commission (2020), Study on the Non-Financial Reporting Directive.

[15] Ibid.

[16] Ibid.

[17] European Commission (2021), Fitness Check on the EU framework for public reporting by companies, April.

[18] For a detailed assessment of the various sustainability reporting frameworks, see https://www.ecmi.eu/events/webinar/international-standards-sustainability-fighting-uphill-battle.

comprehensive disclosure of sustainability and ESG data that can be taken over internationally and replace existing standards.

However, to ensure that the new standards translate into practice and create added value in the legislative framework for sustainability reporting, more action regarding credible assurance is needed. Evidence from the field of private environmental and corporate social responsibility reporting shows that despite having socially desirable goals, such reporting schemes can lead to undesirable outcomes when they lack third-party assurance and appropriate sanction mechanisms for non-compliance (Cafaggi and Renda, 2012). Lenox and Nash (2003) examined four environmental self-regulatory schemes and found that those without explicit sanction mechanisms were more likely to lead to adverse selection problems (i.e. attract more polluting firms). In this respect, even the most widely used, open and comprehensive reporting frameworks such as the GRI have produced mixed results in the past, prompting stakeholders and experts to express concerns regarding the formalistic nature of the reporting criteria, which have led to box-ticking behaviour on the side of the participating companies (Fonseca, 2010). In response to these concerns, the CSRD proposal also provides for external audit to provide limited assurance on sustainability disclosures[19]. To date, however, the Commission has not clarified the audit and compliance arrangements. In order to allow sufficient time for audit companies to shift their focus and develop new services for sustainability disclosures, and for competent authorities to have sufficient enforcement capabilities, the Commission should undertake a critical assessment of the supervisory and enforcement toolkit available to authorities to ensure that they have adequate capacities to fulfil their mandate. To effectively tackle greenwashing and hold companies accountable for any false representation of their ESG credentials – including the use of bad quality data – the enforcement capacity and sustainability expertise of national authorities needs to be reinforced.

3.3 Impose minimum transparency, organisational and conflict of interest requirements on ESG rating providers

The role and importance of ESG rating providers are increasing rapidly, yet there is currently no public scrutiny or supervision over them. Considering the challenges outlined in this paper, this is no longer optimal from the perspectives of protecting investors and tackling greenwashing. Under Action 6 of the Sustainable Finance Action Plan, the Commission has pledged to better integrate sustainability in ratings and market research, in particular by strengthening disclosures on how ESG factors are considered. The European Securities and Markets Authority (ESMA) already updated its Guidelines on disclosure requirements for credit rating agencies in 2019.

[19] According to the Commission, a reasonable assurance level (used for financial reporting) would be too demanding for companies considering the current capacity and technical ability of the market for audit services and the lack of assurance standards for sustainability disclosures (European Commission (2021), Questions and answers: Corporate Sustainability Reporting Directive proposal, 21 April).

In this context, in 2021, the Commission launched a study on sustainability ratings and research, which explored the types of products provided in ESG ratings and market research, and the main market actors. It also assessed issues related to data sourcing, transparency of methodologies and other challenges in the market. The study found various shortcomings in the market for ESG research and ratings related to transparency, timeliness, accuracy and reliability, bias and low correlation across different ratings by market participants, and potential conflicts of interest associated with providers (as they are paid advisory services whilst evaluating them). Furthermore, the study highlighted that the high number of indicators used by different rating agencies, as well as the lack of clear and consistent terminology, posed challenges to the comparability of ratings across the industry. The authors of the report made several actionable recommendations related to the development of industry standards for rating methodologies, transparency and disclosure obligations on the side of rating agencies for the management of conflicts of interest, and additional steps to be taken to clarify the terminology used in the rating industry by the various market actors. To date, the Commission has yet to act upon these recommendations.

ESMA's 2021 Report on Trends, Risks and Vulnerabilities assesses the current status of – and upcoming key issues in – ESG ratings. Based on the findings of the report, ESMA advises the Commission to implement a regulatory framework to 'match the growth in demand for these products [with] requirements to ensure their quality and reliability'[20]. We recommend that the Commission follow the three steps proposed by ESMA to regulate ESG rating providers:

i. Develop a common legal definition for ESG ratings that captures the broad spectrum of assessment tools currently available in the market. This will ensure that all products in the very complex and evolving ESG market are subject to the same minimum level of investor protection safeguards.

ii. Require any legal entity providing ESG ratings and assessments to be registered and supervised by a public authority. This way, all ESG rating providers will be subject to common organisational, transparency and conflict of interest criteria.

iii. In addition to these core requirements, product-specific requirements should be applied. Such requirements should not necessarily be of the same level of prescriptiveness as those applicable to credit ratings, but should be sufficiently stringent to ensure that ESG ratings are based on good quality, up-to-date, reliable and transparent data sources, and have robust methodologies that can, if needed, be challenged by investors.

[20] See ESMA's open letter to the European Commission at https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf and https://www.esma.europa.eu/press-news/esma-news/esma-calls-legislative-action-esg-ratings-and-assessment-tools.

3.4 Empower end investors by strengthening sustainable financial literacy

In addition to reinforcing transparency requirements and having efficient enforcement mechanisms in place, a number of further actions are needed to tackle information asymmetry and the moral hazard problem that are present in the market for sustainable investing. Reporting mechanisms and centralised data sets will not be enough for end investors to verify the sustainability credentials of funds. Therefore, as a complementary action, the Commission should propose an initiative aimed at strengthening sustainable financial literacy among the general public. This should be done in collaboration with financial market participants and investor associations. Efforts are also needed to make relevant sustainable finance legislative initiatives more understandable and accessible to non-experts.

This is supported by the European Supervisory Authorities, which, in their 2022 Annual Work Programme, outline their aim to contribute to strengthening financial education and literacy in the European population in order to enable end investors to judge and ascertain the risk-return profile of financial instruments. Increased levels of transparency and structured non-financial disclosures, complemented by sufficient understanding of the sustainability-related risks of financial instruments, can potentially tackle the moral hazard problem wherein asset managers have the incentive and ability to mislead end investors due to their inability to verify the credibility of their sustainability claims.

3.5 Boost synergies with sustainable corporate governance initiatives

Critics often argue that in a model of capitalism skewed towards shareholder interest, fiduciary duties and short-termism pose limits to the pursuance of sustainable investing (Ferrarini, 2021). In order to tackle holistically the challenges of sustainable investing outlined above, synergies between financial regulation and the regulatory framework on company law and corporate governance need to be strengthened. When comparing the application of the NFRD in five different EU Member States, Aureli et al. (2020) find divergence instead of convergence. Much of the divergence can be explained by the differences that exist in national corporate configurations and governance. The authors argue that 'historical, cultural, economic and political local contexts mould how corporate sustainability is understood'. Similarly, Jansson and Veldman (2020) find that the weakness of non-financial reporting lies not only in requirements and reporting standards, but also in the 'conceptual foundation of the corporation and in the very basis of corporate governance itself'. In many countries, company law still frames corporate purpose and stakeholder engagement in a way that is too limited, which restricts the notion of accountability[21]. Therefore, the expansion of non-financial reporting requirements must be accompanied by a critical assessment of corporate governance rules. Rules on corporate governance must support emerging financial regulations by enabling

[21] In other words, companies may be willing to integrate ESG factors into their investment decisions only to the extent that it does not jeopardise financial performance and profits. This issue is illustrated by the recent dismissal of Emmanuel Faber from his position as CEO of the global giant Danone. Faber, who made sustainability a key element of Danone's business strategy, was removed from the CEO's chair by shareholders due to profitability concerns.

a broader understanding of corporate purpose that makes reference not only to profits, but also to long-term value creation and other objectives that affect the interests of company stakeholders, such as – and especially – environmental and social issues.

In 2020, the Commission launched a public consultation on a sustainable corporate governance initiative. A legislative proposal has been releasedthis first quarter of 2022, which complements the forthcoming CSRD by ensuring that non-financial reporting requirements are met with adequate due diligence and corporate governance processes. Based on the listed policy options, the initiative imposes corporate duties to carry out due diligence for the mitigation of adverse environmental and social impacts, rather than only reporting on these processes.

In the short to medium term, EU intervention on sustainable corporate governance should introduce, on top of the duty to carry out due diligence, a comprehensive liability regime for failing to mitigate the harmful environmental and social impacts falling into the sphere of control of companies, as proposed in the European Parliament Resolution and taken up by the Commission in its recent proposal on Corporate Sustainability Due Diligence[22]. Furthermore, requirements related to directors' duties and company organisation should be introduced, including measures to enhance sustainability expertise on boards, linking director remuneration to sustainability commitments and facilitating wider stakeholder engagement. This would have the objective of tackling short-termism in the current dominant modes of corporate governance. In this respect, we consider the Commission's recent proposal on Corporate Sustainability Due Diligence to still be too general[23]. Such an intervention can compel companies to use these developments as an opportunity to drive innovation and turn sustainable corporate practices into long-term competitive advantage, rather than simply engaging in a box-ticking exercise (Kalff, 2021).

Corporate purpose represents a major theme in the area of corporate governance. Whilst an increasing number of firms make reference to sustainability and social goals in the definition of their corporate purpose, this issue meets important challenges in the competing notions of shareholder and stakeholder capitalism, which can be reconciled under the European Enterprise Model. Articles of association provide a solid legal base for holding the management and organisation of companies accountable and guiding investors towards companies that take value creation for society seriously. In moving forward, it is crucial that the EU legal framework for sustainable corporate governance recognises and creates a robust legal environment for the possibility to include environmental, social and governance objectives in corporate articles of association that can be enforced before court by both shareholders and stakeholders in a fair, reasonable and proportionate manner. In the long run, such an EU intervention could trigger debates and processes in national company laws and corporate governance codes, with the prospect of achieving greater convergence – something that is needed to achieve the EU's long-term environmental and social goals.

[22] European Commission (2022), *Proposal for a Directive on Corporate Sustainability Due Diligence*, COM(2022) 71 final, 23 February, Article 22.

[23] Article 25 of the Proposal (2022).

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