The London Institute of Banking & Finance | Centre for Sustainable Finance

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The inclusion of environmental, social and governance (ESG) factors in financial markets

Executive summary

The inclusion of environmental, social and governance (ESG) factors in financial markets has become a significant challenge. There are several drivers, such as the rising awareness of sustainability issues by investors with the consequent higher request for ESG products, and the aim of public institutions to address such trends and boost more inclusive and sustainable economic growth.

The new legal framework on sustainable finance will lead to a global rethinking of such topics and ESG inclusion will no longer be a nice-to-have process but a real compliance matter. To achieve this, a consistent approach in the methodologies and scoring of ESG factors is required. However, market fragmentation is currently still the rule.

The rising interest in sustainable finance

Sustainable finance generally refers to the inclusion of environmental and social criteria in the investment decision-making process.

Specifically, as per the environmental criteria, such considerations aim to address several phenomena related to the broad environment and related risks such as climate change, natural disasters or the depletion of natural resources. Social considerations refer to inequality, inclusiveness and, together with governance, to labour, human relations and gender diversity. Environmental and social factors are interconnected, as natural disasters can lead to new sorts of poverty and climate-related migration.

Working out how to include environmental, social and governance (ESG) factors in financial markets has become one of the main challenges.

Several drivers push in this direction, raising overall awareness of sustainability issues. This leads on the one hand to the development of ESG products by financial intermediaries that aim to interest potential investors, and, on the other, to new regulations on sustainable finance.

Where the first driver is concerned, in recent years demand from both institutional and retail clients (including ultra-high net worth clients) has increased together with the awareness that ESG factors may lead, with equivalent risks, to better performance. Indeed, firms that are more aware of ESG factors are generally less exposed to operational, legal and reputational risks, and more oriented towards innovation, whilst inappropriate business conduct may generate costs and risks not only for individual companies but for the economy as a whole, impacting on financial stability and on economic growth.

Accordingly, the development of new sustainable investment products (eg individual portfolios and investment funds) has grown with the inclusion of ESG factors in investment analysis and selection processes. Notably, this is happening not only in relation to specific products targeted as 'sustainable', 'green' or 'social', but also in the overall product development area, with the systematic inclusion of such assessment with reference to all the range of products issued or distributed, even if not explicitly labelled as 'ESG'.

Such inclusion has been realised with the selection, as per equity investments, of target companies meeting certain ESG scoring, based on the business and activities performed, the environmental impact, governance, diversity and inclusive topics.

The adoption of global benchmarks to assess the sustainability of an investment – eg, the Principles for Responsible Investment (PRI) and the Recommendations of the Task Force on Climate-related Financial Disclosures – is also a core driver of this trend and is essential to allow a circular boost of sustainability, both on the 'real economy' and on the financial one.

The European Action Plan on sustainable finance

In March 2018 – within the wider objectives of the Paris Agreement on climate change and the United Nations 2030 Agenda for Sustainable Development – the European Commission published a Sustainable Finance Action Plan. This outlined the strategy and measures to be taken to establish a financial system capable of promoting economic development that's sustainable from a social and environmental point of view.

The development of market practices based on commercially driven priorities, and with an aim of measuring the sustainability profile of target companies, demands a shared approach to such issues to avoid divergent results and market fragmentation, which could discourage investors.

However, interest in ESG has also increased a risk broadly known as 'greenwashing'. This refers to when some financial intermediaries try to qualify a product, activity or policy, as environmentally friendly when it isn't. This creates an unfair competitive advantage with the subsequent risk that unsophisticated investors may be fraudulently directed towards products that do not meet their real investment preferences.

The EU legal framework on ESG has therefore been built to bring clarity to avoid these misleading phenomena and related risks and, in the meantime, to boost the adoption of ESG criteria in the financial environment in the context of a wider promotion of a more sustainable economy.

Indeed, the European Union approach is based on awareness that sustainable finance requires a different approach and needs multiple actions to embrace all players. On one side, it is necessary to promote more comprehensive action in the real economy, encouraging firms to adopt sustainable behaviours such as reducing the environmental impact of their industrial processes, including gender diversity policies, social and human capital awareness.

On the other, the need is to ensure clear communication to investors, encouraging capital flows to sustainable companies, both from retail investors and from financial intermediaries, lenders (credit institutions), wealth and assets managers (investment services providers and asset management companies) and underwriting insurance companies.

These different needs are strictly interconnected because investors need to know what constitutes an ESG compliant firm. That would only be possible with a uniform and clear definition of what sustainability is for firms and guidance on how they can comply with those criteria. Furthermore, this would allow institutional investors (as banks or management companies) to inform clients who express ESG preferences, about the features of the products that they are purchasing and how their ESG interest is concretely achieved.

This result can be accomplished by setting up a common European-based legal framework, which offers intermediaries and investors a clear set of rules to engage with. It would also create coherence and avoid different approaches by member states and the relative national competent authorities. (See Box 1: Market fragmentation due to different approaches by EU member states: the Italian case).

In particular, such a European legal approach should move in two directions: first, to adopt new rules aimed at capturing and including new ESG topics – essentially a new definition of common ESG criteria; and second, to amend the existing legislation on financial markets to ensure co-ordination with new rules on sustainable finance.

Box 1: Market fragmentation due to different approaches by EU Member States: the Italian case

Consob is the Italian supervisory authority on financial markets. In March 2020 – before applying for the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR) and before the Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment – it issued a recommendation to Italian financial intermediaries on the inclusion of sustainability preferences by investors and, in particular, (pending the amendment to relevant European legislation) in the suitability assessment, product governance and disclosure to clients under Directive 2014/65/EU (MIFID II).

Consob also warned the Italian market about the risk of greenwashing, to prevent misleading information being shared with investors, especially in retail.

This alerted Italian investment firms, credit institutions and management companies to ESG topics. It increased the overall awareness of the issues and anticipated the measures that the European Commission would adopt some months later.

Notwithstanding, Consob's recommendation merely asked for the inclusion of ESG factors in processes that were already in place due to MIFID II provisions. It did not clarify the meaning of 'sustainability', or how internal policies and processes should be reviewed to incorporate ESG considerations. As a result, it did not lead to a significant change in a market that was still waiting for a common and clear pan-European approach.

The new European legal framework to include ESG criteria in the financial markets

The first necessary action in developing a shared approach to sustainable finance is to adopt a common definition of 'environmental, social and governance' and to define how ESG inclusion in financial activities and products may be measured.

Such a definition is essential to create transparency of matching interests between target companies and investors – allowing the latter to have comparable information on their sustainable business and to make an informed investment selection.

The use of national or market-based categories to determine which economic activities qualify as environmentally or socially sustainable could discourage investors from investing cross-border because it makes it more difficult to compare different investment opportunities. In other words, a shared common label, and a uniform measure of what ESG factors really are, is needed to overcome fragmentation.

This specific issue was addressed in the European Commission's Action Plan, when. Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 established a framework to facilitate sustainable investment (the 'Taxonomy Regulation').

The Taxonomy Regulation meets the need for a common European definition of ESG criteria – not only to encourage European investors but also extra-EU investors who would otherwise have to meet varying criteria in different member states to qualify their activities as environmentally sustainable.

The Taxonomy Regulation establishes the criteria for determining whether an economic activity qualifies as environmentally sustainable. Notably, the Taxonomy Regulation applies not only to European Union institutions, which shall adopt the criteria set by the regulation in relation to any future measure on sustainable finance, but also to companies, in assessing their sustainability, to financial markets participants, supporting them in the investment selection process and in disclosure to clients who will be the end-investors.

Accordingly, the Taxonomy Regulation also amends the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR).

SFDR sets several rules on the disclosure to clients and end-investors on: the integration of sustainability risks; the consideration of adverse sustainability impacts; sustainable investment objectives; and the promotion of environmental or social characteristics in investment decision-making and advisory processes. These rules apply to financial market participants providing investment advice or portfolio management services, including funds and pension products. (See Box 2).

Box 2: Activities within the scope of application of SFDR

The SFDR currently applies to:

- the provision of investment advice or portfolio management services according to Directive 2014/65/EU (MIFID II) included where provided by credit institutions and asset management companies
- the management of funds, according to Directive 2009/65/EU (UCITS) or Directive 2011/61/EU (AIFMD), and of EuVECA and EuSEF
- the offering or distribution of IBIPs (as defined by Directive 2016/97/EU, or IDD)
- pension products or schemes and PEPPs according to Regulation (EU) 2019/1238.

It is therefore intended that such disclosure is required not only by firms offering financial products targeted as sustainable products but to all firms which shall (as from March 2021 when the SFDR will start to progressively enter into force), disclose to investors the method of integration of sustainability risks and of adverse sustainability impacts into their investment selection processes.

This disclosure, combined with the 'comply or explain' rule (which asks intermediaries to explain why they are not taking into consideration ESG factors), is a clear demonstration of the aim of the EU legislator to boost the adoption of a more sustainable approach in finance. It transforms 'non-ESG compliance' into a risk for financial intermediaries to be accordingly monitored, managed and disclosed to the market. Sustainability is no longer a nice-to-have best practice, but a compliance matter to be handled by all financial markets participants.

The SFDR and Taxonomy Regulation therefore address the need for a common and standardised approach to the categorisation of suitable activities and ESG scoring, from both the perspectives of target companies and investors. This creates a common thread between companies to be financed, asset managers and asset owners. The latter will also benefit from a specific disclosure on ESG factors and thus invest in environmentally sustainable financial products across the European Union with higher confidence, improving the functioning of the overall internal market.

At the time of writing (March 2021) the second level measures of the SFDR have not yet been adopted, bringing uncertainty to market participants needing to comply with SFDR principles. There is still a lack of clarity on the content, methodologies and approach in relation to sustainability indicators, the promotion of environmental or social features, and on sustainable investment objectives.

The goal of a common EU approach to the scoring of sustainable activities and relative disclosure is yet to be achieved.

The amendments to MIFID II rules and other measures to be undertaken

The information required under the SFDR needs to be enclosed in communications to investors and clients, as precontractual or periodic information, according to the relevant rules (eg as in Box 2 for MIFID, UCITS, AIFMD, IDD). Such integration requires not only a formal co-ordination of the different rules, but also – to achieve a substantial alignment of provisions – it equally requires disclosure to investors. For example, in addition to the precontractual documentation it should include information on how sustainability risks are integrated into investment decisions as required by the SFDR. A wider rethinking of the impact on the risk profile of financial products due to the inclusion or non-inclusion of ESG factors will be required. This means other indicators will need to be reviewed, such as those included in the Packaged Retail and Insurance-based Investment Products (PRIIPs) 'key investment document' (KID) or in other sections of the precontractual or offering documents.

From this standpoint, another crucial issue – related to the need for a better alignment across different legislation – concerns when the scope of the financial products defined by the SFDR is not consistent with the scope defined by the text of MIFID II. The second level SFDR measures currently under review for inclusion of ESG considerations make use of the definition of 'financial instruments' set by MIFID II (and not that of 'financial products' under the SFDR). It is anticipated that such misalignment may cause problems when financial market participants respond to the ESG preferences of investors and clients with reference to financial instruments under MIFID II not falling within the scope of definition of financial products according to the SFDR. (See Box 3: the inclusion of ESG factors in the suitability assessment and product governance).

Other measures are also under discussion in the European Union to support the deployment of capital towards sustainable activities, such as: the review of the European long-term investment funds (ELTIF) Regulation (ie Regulation (EU) 2015/760). ELTIFs are European harmonised investment funds, designed for retail investors, to foster investments towards social and infrastructure projects, real estate and small to medium enterprises (SMEs). Accordingly, the European Commission is now reviewing the relative legal framework to strengthen the role of such products in smart, sustainable and inclusive growth. It is therefore clear that it will be necessary to co-ordinate investment objectives, the target investments permitted for ELTIFs and what the Taxonomy Regulation requires.

Box 3: The inclusion of ESG factors in the suitability assessment and product governance under MIFID II

The scope of the financial products defined by the SFDR is not consistent with the definition of financial instruments set by MIFID II. Such misalignment may cause problems in cases where the ESG preferences of clients, with reference to financial instruments under MIFID II, do not fall within the scope of definition of financial products according to the SFDR.

Indeed, the draft of the new MIFID II second level measures (ie Regulation (EU) 207/565) provides that the suitability assessment shall take into consideration if the financial instrument "meets the investment objectives of the client in question, including the client's risk tolerance and any sustainability preferences".

Such provision risks being ineffective if the methodology on how to calculate the sustainability preferences in relation to financial instruments, matching the clients' preferences and the features of each financial instruments, are not provided.

The same criticality may arise with reference to the product governance and the draft provision to amend Directive 593/2017/EU to include sustainability preferences in the identification of target markets for each financial instrument.

In addition, further to the need for an alignment between SFDR and MIFID II to allow a common approach in the qualification of sustainability, it is also clear that if financial intermediaries are required to include such preferences in their processes, it will be necessary to have enough sustainable products or instruments to offer investors and, ultimately, enough underlying firms and investments that may qualify as sustainable.

Conclusion

The inclusion of environmental, social and governance factors in the financial market is a milestone for more sustainable and inclusive growth, as highlighted by several institutions and policymakers in Europe and across the world.

Fostering this trend from a legal standpoint means, on the one hand, encouraging firms to adopt behaviours that are sustainable from an environmental and social perspective, through provisions that specifically force such actions – such as fiscal incentives and stricter rules on corporate governance, labour and human resources management. On the other hand, it is also necessary to direct capital towards such firms and to encourage investments from both institutional and retail investors.

Such a result may only be achieved by strengthening investors' trust in target companies and, by doing so, matching the need of financing and the willingness to finance sustainable activities. Meeting such needs requires clear and unique information to be disclosed between parties, which may be provided only by adopting a common definition of the circumstances under which an activity may be qualified as sustainable.

Further to several market-based initiatives, the European Union is trying to develop an overall legal framework to foster a sustainable economy from different points of view that's based on the needs of the many players involved. That is, target companies to be financed, institutional investors and final retail clients. Even if such initiatives are still in a very preliminary stage and need to be further co-ordinated, such an approach could lead to a virtuous circle for the overall economy – encouraging capital flows from financial markets to a more sustainable real economy and, in the end, a more sustainable world.

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