

EFAMA opinion on ESG fund ratings and labels

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1 Introduction - Current landscape: labels and ratings

In the past number of years, a variety of labels and ratings have emerged with a responsible investment theme. They are all aimed at either certifying and/or promoting sustainable and responsible investment and/or providing simplified choices for investors. However, labels and ratings are different in many ways.

1.1 Labels

ESG labels have been on the market in Europe for 20 years since the first sustainable investment funds made their appearance and aim to set a certain standard when it comes to sustainable funds. Their purpose is to review and assess the processes and standard of ESG integration in funds seeking to have the label certification. In return, the label confirms a certain level of transparency about said investment product and can reassure retail and institutional investors about the nature of the funds in which they are investing.

ESG labels in Europe generally take an all-encompassing sustainability approach, however thematic labels such as transition to a low-carbon economy, climate social issues, solidarity, microfinance are also making headway. Labels are mostly private sector led but governments have also started promoting national labels, such as the national SRI label in France, LuxFLAG, and Germany's FNG label, which was also adopted by other German-speaking countries.

As the number of labels increases, however, it is not always easy for retail or institutional investors to fully understand what is on offer, especially because labels do not adopt the same approach. The

Austrian eco-label, for example, rates companies, environmental investment funds and, more surprisingly, everyday consumer products. The eligibility criteria for the French national label take into account other specific factors such as an issuer's ESG analysis methodology, commitment policy (voting and dialogue) and transparency. The French selection criteria also include the limited use of derivatives in building portfolios, as well as highlighting the positive impacts on the development of a sustainable economy. LuxFLAG labels are available for funds domiciled in an EU member state or any other jurisdiction with similar supervision to the EU. LuxFLAG labels take into account review of portfolio holdings as well as incorporation of ESG factors in the investment process and decision-making.

1.2 Ratings

Alongside the development of labels, a quantitative approach has emerged in recent years, with ESG ratings of funds, similar to ratings on an investment fund's performance quality. The rating is an amalgamation of all the holdings in the fund and its objective is to provide investors with an overall assessment on the fund's environmental, social and governance holdings.

This quantitative approach uses the ratings provided by specialist analysis agencies such as Vigéo, EthiFinance, INrate, Oekom, MSCI and Sustainalytics aimed at measuring the ESG performance of companies, governments and public institutions, primarily for institutional investors and financial data providers. By weighing these ratings in each line of an investment fund's portfolio, it is possible to extrapolate an average rating that reflects the portfolio's ESG quality. In conjunction with analysis agency ESG Sustainalytics, Morningstar created the Morningstar Sustainability Rating in March 2016, covering 20,000 funds (equities and corporate bonds). The same effort led to the creation of the MSCI ESG Fund Quality Score, ultimately expected to cover 21,000 funds, including ETFs.

2 ESG labels vs ESG ratings

Both labels and ratings aim to help investors choose responsible investment products. An important difference between labels and ratings is that the fund manager takes the initiative to obtain a label, which is generally focused on certification, whereas the rating organisation unilaterally rates a fund, irrespective of whether the fund manager asks for the rating. Unlike labels, ESG ratings do not certify a fund's ESG integration process or investment inputs with a specific methodology. Rather, ESG ratings generally aim to "score" funds' portfolio on sustainability with a rating.

Whereas labels approach the certification process from both a qualitative and quantitative perspective, ESG ratings' sole focus is on quantitative. Engagement policies, for example, are often not accounted for in a fund rating, given that these ratings are generally holdings-based. Where these are in place, a fund may stay invested in an investment involved in a controversy if they are having discussions with management aimed at improving the company's ESG performance. Therefore, in a holdings-based rating method, divestment is encouraged as this would reduce the fund's rating.

Not all funds will qualify for a rating. The companies currently covered by ESG rating agencies are small against the number of possible securities. Therefore not all existing funds can be rated. As a result, it is

possible that a perfectly acceptable fund from a sustainability perspective does not have a rating. This is in particular an issue for smaller issuers or issuers in emerging markets.

Competing ratings have different methodologies, leading to a different evaluation of the many holdings of an individual investment fund. Similarly, requirements for labels are not standardised and therefore do not provide like-for-like comparison across funds. Ultimately, the methodologies of both ratings and labels vary, leading to different outcomes.

3 EFAMA opinion on ESG ratings and labels

EFAMA understands the appeal of ratings and labels, as they seem to provide a simple answer to a complicated question, namely: which ESG fund fits well with the client's ESG/RI/sustainable finance/impact demands? The recent phenomenon of ESG ratings will likely help promote responsible investing in funds, especially for retail investors. This new development in the ESG space acknowledges the growing awareness of investors in relation to how ESG criteria affects the long-term value creation and long-term economic sustainability of the companies they invest in. While ESG ratings have been described as a start of the conversation on ESG and are also another tool which can feed into the investment decision-making process for investors who are looking to be "responsible", a number of questions should be looked at in the context of ESG ratings such as: How can a rating be useful for investors? How may the rating help the client/investor select funds that fit with their objective?

The idea that the ESG information of an entire portfolio of companies can be condensed into a single number is alluring, but the reality is, in our view, more complicated. EFAMA believes that distilling sustainability into a single holdings-based rating number does not accurately reflect a fund's ESG processes or outcomes. One critical reason is the lack of standardised terminology and definitions of ESG and responsible investment. There is no consensus on the set of norms and values to follow or how to implement one such set. How can one measure sustainability of a fund when the definition of sustainability is not set in stone and can and should vary depending on the context? ESG ratings are the view of a specific research and analysis providers, rather than a conclusive measure with a consistent methodology.

The activities of companies and the methods by which these are scored are better addressed in process-based methodologies than holdings-based methodologies. Despite similar-looking approaches, the main ESG rating organisations can reach very different conclusions for the same funds. Neither is right nor wrong; both represent a perspective and may well be considering different factors, for different purposes. Ultimately, ESG ratings provide valuable analysis and insights, however they should be inputs to company evaluation rather than an answer in themselves.

Ratings and labels can both have a holdings-based approach and /or a process-based approach, though for labels a process-based approach is more common, whereas a holdings-based approach dominates for ratings. In a process-based approach, the user describes the process used to achieve responsible investing, and the label verifies that this is indeed the process which is followed. It typically does not go into the sets of values/morals/ethics that are adopted. A holdings-based approach, however, implies values-based judgements, but these are not made transparent. EFAMA believes responsible investment

should be solely defined on a process basis, not on holdings, as they entail normative opinion. Therefore both labels and ratings should ideally take a process-based approach, leaving ethical choices to clients.

EFAMA also believes it is preferable for the fund manager to take the initiative to have their fund evaluated, rather than the labelling or rating organisation, so as to insure that only relevant funds are rated.

4 General principles for ESG ratings and labels

EFAMA would like to put forward general principles which we believe should be taken into account by rating and label providers in the elaboration of ESG ratings and labels for investment funds and asset managers.

I. Initiative by the fund manager

EFAMA believes it is preferable for the fund manager to take the initiative, instead of the labelling or rating organisation, so as to insure that only funds are ESG labelled where relevant.

II. Comparability

In the interest of investor comparability, national ESG labels are not optimal. Achieving one standardised or harmonised European way of labelling or rating funds could be a mid-term goal.

EFAMA is in favour of labels and ratings based on ESG processes rather than the holdings of the fund. Holdings based ratings and labels imply ethical/moral and political choices based on a set of values that may vary, but are equal or equivalent in terms of responsible investing.

III. Process-based approach

EFAMA believes responsible investment should be defined on a process-based, rather than holdings-based methodology. Asset owners may have varying sets of values, meaning that the responsible investment process will be tailored to the end investor specific needs / beliefs, which does not translate in a holdings-based rating.

IV. All asset classes and all dimensions of ESG investing should be covered

To allow investors better compare, an ESG rating or label should generally be suitable for every fund as long as the fund manager asked for an ESG qualification. An all-encompassing rating and labelling of asset classes (equity, bonds etc) will ensure meaningful comparability. Ratings or labels focusing only on one or certain aspects of ESG (e.g. climate change) do not provide the complete picture of sustainability/responsibility.

V. ESG investment funds and RI assets under management need to be distinguished

Asset managers may integrate ESG factors in their investment process without applying a specific ESG strategy at the fund level. This approach may cover an asset manager's assets under management partly or even as a whole. Responsible investment has to be distinguished from ESG funds where asset managers are legally bound by the fund documentation to apply an ESG strategy (for example a best in class at a fund level). A sustainability rating should distinguish between responsible investment assets under management and ESG investment funds.

VI. Objective evaluation

A label denotes an objective evaluation by a third party (i.e. the label provider) of the ESG process that is followed by the fund and/or its manager.

The quality of a fund rating depends on the quality of the information used to evaluate the holdings of the fund. EFAMA believes that a fund rating should not be based on one source only. Rather, rating providers should use different varied sources to properly assess the fund's assets, or be transparent about the set of ethics/morals the rating is based on and the major choices that are made based upon that set of ethics/morals.

VII. Take ESG investment strategies into account

Given the linkages between ESG challenges, a sustainability rating or label should take all ESG related questions into account. Furthermore, sustainability ratings and labels should take into account and evaluate the different ESG investment strategies. An exclusion strategy will lead to different results than for instance impact investing or best in class.

VIII. Exclude conventional scoring aspects

ESG ratings and labels will only be able to provide investors with meaningful comparability regarding responsible investing if the rating or label focuses solely on these aspects. Conventional considerations such as costs or performance should be covered separately in conventional ratings and labels.

IX. Transparency

Providers should disclose their methodology. Only a transparent methodology can be properly assessed. Otherwise providers would be able to apply subjective criteria thereby risking inconsistent outcomes. A transparent methodology also allows the fund industry to engage with the provider and discuss any potential flaws.

Providers should have clear, transparent and objective criteria to select a specific fund for a rating.

Where a holdings-based approach is used, it should be possible to look through the providers' assessment of funds' holdings to understand the rating. In other words, in a holdings-based

approach the set of ethics/morals which lead to the scoring of individual holdings should be given.

Brussels, 9 June 2017

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