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Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Bruxelles/Brussel
Belgium

Dear Directorate-General for Financial Stability, Financial Services and Capital Markets Union

STEWART INVESTORS RESPONSE TO ASPECTS OF THE RENEWED SUSTAINABLE FINANCE STRATEGY

On 8 April, the European Commission published a consultation on its renewed and ambitious sustainable finance strategy, which it aims to adopt in the second half of this year. The consultation comes as a follow up to the initial Sustainable Finance Action Plan which was published in March 2018. As a business, we are extremely supportive of such proactive government engagement – it is something we wouldn't have believed as little as five years ago. However, there is a risk that so much is being released with indigestible explanation and unrealistic time frames for implementation that both financial institutions and investors might in fact be dis-incentivised to engage with sustainable investment.

The consultation is extremely broad with over a 100 questions to consider on a wide range of topics including the promotion of sustainable investment products to retail investors, the usability of a sustainable finance taxonomy, the introduction of a brown taxonomy and definitions, standards and labels. There are areas in the consultation that Stewart Investors doesn't feel in a position to comment on such as insurability of climate related risks or banking regulation but there are some we feel strongly about and have focused this response on the latter.

Sustainability research and ratings

There is significant concentration in the market for ESG rating and data providers and with continued consolidation in the sector, many of them have become less amenable and able to provide detailed, bottom-up company-specific analysis that we value for our investment approach. However, it is still a relatively young industry with growing demand allowing a number of new entrants to the market whom we hope will produce more interesting research and start to compete with the larger players.

Many of those who respond to this consultation will likely point to concern over the divergence of ratings between providers. Whilst this is undoubtedly an issue, it could just be a result of different methodologies and the subjective nature of a lot of the analysis. Our bigger issue relates to the tendency of research providers to measure the wrong things. At Stewart Investors, our focus is on the social and environmental impacts of a company's products and services. There are few providers that offer anything useful in this regard, with most focused on historic disclosure, policies and processes and some coverage of operational performance but often without context. For example, because company A has a climate policy and sets an emissions reduction target, they are likely to receive full marks even if the targets are weak or their products are environmentally damaging. We instead investigate and make judgements about ESG considerations mainly by:

1. Analysing publicly available company information.
2. Commissioning bespoke research by specialists who have deeper knowledge of specific sustainability questions than us.
3. Meeting the management of companies to understand the attitude, commitment and approach of key decision makers to addressing sustainability risks, challenges and opportunities.

This enables us to make qualitative judgements on more nuanced areas and subsequently invest in the highest quality companies which contribute to and benefit from sustainable development. There is an opportunity for ESG research companies - both existing and new – to think beyond just the operational aspects of businesses and dive deeper into product and service scrutiny including lifecycle analysis independent of company disclosure, competitive dynamics, reputational issues and focus more deeply on the stewards of companies. This could support the industry to move beyond a box ticking analysis of ESG credentials to a mind-set where risk, return and ESG impact are seen as equally important. Only then can research successfully contribute to one of the EU's objectives to strengthen the foundations of Sustainable Investment and shift capital towards more productive purposes.

What action could the EU take?

There are most definitely things the EU could implement but we believe any actions should be based on principles rather than prescription. For example the EU could consider developing principles around Sustainable Development Goal (SDG) claims – whilst it is important to allow for diversity of approaches, it is currently a free-for-all and increasingly resulting in rainbow wash. To help prevent what could become the next mis-selling scandal, the EU could encourage and facilitate asset managers to agree some principles. This could help improve the credibility of SDG related claims, accommodate the diversity of approaches to sustainable investment and force funds to be transparent about how they are delivering on their sustainability targets.

The suggestion of providing a European database of ESG information is a good one assuming the validity of the data. It should be based on international standards allowing global comparisons which is still some way off. In principle though, a free, open source database could have the benefit of making ESG data more widely available for all market participants. It could also have the added benefit of boosting the standards of the existing ESG data providers so they offer more of a value add service not just commoditized box ticking ratings. The EU could also consider investment in a research institute to fund research, perhaps paid for by a levy and voted on by investors or a model similar to accounting and auditing standards for basic ESG data.

Finally - the creation of a taxonomy of approaches to ratings which providers disclose against could allow investors to more easily understand the differences, particularly when applied at the investment fund level. Research ratings are increasingly being used to rate investment funds by amalgamating the holdings in the fund to provide investors with an overall assessment. Whilst the idea of distilling the sustainability credentials of a fund into a single rating is attractive, it does not accurately reflect a fund's ESG processes, outcomes or investment horizons. A taxonomy of rating approaches could clarify whether a rating is risk based, performance based or product based, peer relative or absolute, industry weighted, weighted by expected ESG or financial impact and explain the emphasis of the rating on areas e.g. policy, disclosure, processes, operational performance, product impact and controversies as well as the impact of unrated holdings on a fund level score. Investors would then have a better chance of understanding what it is they are investing in (all sustainability funds are not created equal) and fund managers could more easily explain why their fund has been given a certain rating.

European labels

In its final report, the High-Level Expert Group on Sustainable Finance recommended the establishment of a minimum standard for sustainable investment despite their diverse methodologies, aimed at retail investors. It is of course very confusing for investors to understand the range of sustainable approaches in the market but standardization and regulation risks stifling innovation and over the longer run, limiting choice for investors. There is much being done already to improve transparency around how funds disclose their sustainability characteristics such as the Sustainable Finance Disclosure Regulation, the EU Taxonomy and industry work such as the UK Investment Association Responsible Investment Framework launched at the end of last year.

Should the EU consider launching their own ESG label for retail and institutional investors? Labels are no doubt useful to provide a summary or evidence of ESG and sustainability credentials and benefit from some qualitative input and engagement with fund managers who apply to be 'certified' unlike ratings which are just applied to funds without consultation. However, there are already a proliferation of labels well established in the European market and some are already being used by fund selectors as the basis for determining "buy" lists. They are all slightly nuanced and some less pragmatic than others making it difficult again for retail and institutional investors to make like for like comparisons.

We have recently applied for one rather less pragmatic label following a client request but despite spending a huge amount of time trying to explain and evidence our approach, our application was rejected. One of the main reasons was that we do not have a quantitative metric to evidence the integration of sustainability issues into our investment process. We are not quantitative in any aspect of our investment approach, for example, we prefer companies to manage their balance sheet strength conservatively but do not specify debt thresholds. Unfortunately though, the organisation was not able to verify our qualitative approach and we have already seen outflows in the region as a result.

We feel that had we included a third party, quantitative, ESG ratings in a holdings spreadsheet with a sentence referring to them being regularly reviewed and discussed by the investment team, we would have been successful. This feels disingenuous though and is open to greenwash. We always strive to think of ways to improve the way we articulate our approach to meet the requirements of these increasingly influential labels, however, we would not engage in misleading behaviour to achieve one despite our investment philosophy being founded on the same principles of stewardship and sustainable development that the labels promote.

If the EU decides to launch a label we recommend it incorporates as many of the features of the existing labels as possible and somehow strikes the balance between being transparent and clear and allowing investment managers some flexibility to evidence how they integrate sustainability both qualitatively and quantitatively. The ultimate goal should be the achievement of one standardised European way to label funds to provide simplified choice for all investors across regions.

Taxonomys

Should the newly created Green Taxonomy be complemented by the development of a taxonomy for economic activities that have negative environmental impacts (the so-called "brown taxonomy") at an EU level? Firstly, this feels too soon and arguably the wrong way around as starting with the brown taxonomy would have been easier (i.e. explaining negative screening has always been easier than positive). The development of the green taxonomy alone is hugely challenging and further more work needs to be done around technical guidance before expanding it further. Secondly, and more importantly, we feel it is too narrow to think along the lines of 'green' and 'brown.'

The analysis which supports green versus brown revenue splits is based on static, backward looking numbers meaning those allocating capital are still not helped to identify those investment funds supporting a transition. Standards should clearly set out how much of a contribution different funds can make when analysing a portfolio of listed-equity investments, these should be demonstrable but not necessarily measurable.

Take Unilever as an example. Their work on forest protection is at the vanguard of the business community globally. As the largest buyer of palm oil in the world their efforts can have positive impacts, but as it is 'upstream' from their operations, this important point of influence would not be considered in green or brown taxonomies which would normally only focus on the palm oil companies themselves.

In this regard, MSCI finds that our Worldwide Sustainability portfolio pleasingly has 0% exposure to 'brown' revenues but only 2.5% exposure to 'green', a number we can only reconcile if we take an extremely narrow view of what 'green' is. If asset owners would like to invest in a sustainability fund this taken alone would not be an encouraging statistic despite the deep analysis we do on the lifecycle impacts of companies like Unilever. This is also an issue with the Green Taxonomy – the activities eligible to be considered 'sustainable' will only account for a very small proportion of many sustainable investment portfolios.

This is why we have embraced the work of Project Drawdown which has rigorously analysed more than 80 climate solutions, as diverse as a shift to plant rich diets and supporting female education, to analyse our portfolios. We hope this analysis will provide our clients with a broader picture of how the companies we are investing their capital in are impacting the climate, upstream in their supply chains, in their direct operations and downstream through their products and services.

In summary, we are very supportive of the ambitious European strategy to direct more capital to sustainable investments and the timing could not be better as we hope a positive outcome of COVID will be that society challenges the social purpose of companies more as has already being seen with the growth of the Build Back Green movement. We cannot iterate enough though the importance of the EU creating a principles based approach rather than a prescriptive legislative framework allowing for diverse approaches and continued innovation in the sector. This will result in improved transparency and hopefully more rigour around sustainability claims which would be very beneficial for the industry and the long term growth of sustainable investing.

Yours sincerely,

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Stewart Investors

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