How ‘responsible’ is the financial market for ESG investing?

Recent news shows that the number of Exchange-Traded Funds (ETFs) carrying an ESG label more than doubled in the past two years, reaching almost 1,300 at the end of 2022.

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While this sounds like a positive trajectory for the market, the reality behind the steep increase in ESG ETFs has come into question as appeal for these products has grown commensurably. The growing focus on ESG in the financial sector has brought with it concerns over the investments’ progress towards sustainable outcomes, otherwise known as ‘greenwashing’.

The spotlight is now on fund managers who are facing accusations around how genuine the labels on ESG products really are – with reputable strategies that adhere to environment, social, and government principles now highly sought after as the decarbonisation of the economy becomes a pressing focus.

Now, as all parties try their best to avoid responsibility over policing classification – with regulators quick to highlight their impartiality, fund managers pointing to complex frameworks, and investors relying on third party due diligence - benchmarking is made near impossible which causes major complications for investors looking for recourse.

Inadvertent greenwashing in the financial market

The strong appeal for ESG ETFs lends its hand to intentional mislabelling of products due to their intrinsic appeal – but a lot of greenwashing activity is also the result of ignorance, in which fund managers unintentionally adapt frameworks and targets that are not up to scrutiny when compared with the real changes we must make to decarbonise the economy.

The financial system faces some intrinsic limitations in meeting new ESG requirements. Ultimately, investors are capital allocators and solely focused on risk and return; the urgent need to decarbonise the economy has meant we have created market incentives to allocate capital to green investments, which has subsequently paved the way for disingenuous labelling.

A new wave of claims may be brought by investors but given their position of responsibility in assessing the legitimacy of ESG labelled products, such claims will fall flat. Fund managers should ensure that methodologies used to qualify the labels of ESG funds are as robust as possible - and based on the latest guidance from bodies such as the International Sustainability Standards Board (ISSB), Science Based Targets Initiative (SBTi), and Sustainable Finance Disclosure Regulation (SFDR).

Is a market restructure needed?

One of the fundamental issues the market currently faces is the blurred lines of responsibility when it comes to the classification of financial products.

For example, Article 9 funds – which specifically have sustainable goals as their objective – have a self-reporting mechanism where fund managers interpret the regulation. Those purchasing said funds are responsible for reviewing the ESG claims made by the product and therefore take on the risk of it failing to meet its ESG commitment. However, if a fund manager markets an Article 9 product and subsequently does not deliver on the fund's sustainable objectives, two risks present:

1. when audited, the regulator could fine them or force them to downgrade
2. the investors in the fund could withdraw their money.

The absence of a strong regulatory backing, informed by clear definitions and targets to label a product as sustainable, is the primary cause of the complications discussed. It is hoped that the market will evolve to developing products that write in legally binding decarbonisation commitments, in turn creating a direct line of accountability to the security issuer. This would help to mitigate one issue that contributes to greenwashing; however, any improvement on this front would still be hindered by the myriad of complex ESG frameworks which leave too much space for interpretation.

The introduction of the International Sustainability Standards Board (ISSB) frameworks in June 2023 will purportedly standardise methodologies for ESG labelling, marking a welcome development and one that regulators will be able to use to improve oversight of the market. As the market matures and becomes more sophisticated, better targets and minimum requirements will become the norm.

How will regulators respond over the next 12 months?

Given the recent figures showing an increase in ETFs with ESG labels, regulators are concerned about the soundness of the methodologies used by fund managers to claim a certain level of sustainability. The absence of a standardised framework has prompted regulators to call for market transparency, in which assumptions and bespoke methodologies should be disclosed so that they can be scrutinised by investors and financial regulators, as per recent guidance from the Sustainable Finance Disclosure Regulation (SFDR).

Regulators understand they have no effective way to check fund managers' ESG claims due to a lack of transparency across the market and are positioning themselves so that the responsibility of enforcing and policing regulations will fall on fund managers.

However, by lagging on action, regulators are simultaneously making the statement that current market standards are sufficient. When the criteria inevitably improve, market actors will be forced to revert and ask regulators why they did not prepare for the upcoming round of declassifications, making clear the need for imminent action to curtail the increase in mislabelling activity.

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