DVFA Statement on the EU Renewed Sustainable Finance Strategy

The DVFA Sustainable Investing Commission participated in the recent consultation on the EU Renewed Sustainable Finance Strategy. The DVFA Sustainable Investing Commission believes that additional incremental measures in targeted areas are necessary to implement the Action Plan successfully, but that many significant developments have already been made. The DVFA Commission has identified a number of priority areas.

The DVFA Commission believes that in order to achieve the objectives of the EU Sustainable Finance Strategy rapidly, a two-handed approach is needed. First, rewarding the shift of private capital to more sustainable investments and/or at the same time discouraging it from benefiting from potentially damaging activities. Next, providing the proper regulatory framework for pricing (i.e. the carbon price) and the appropriate taxation mechanisms will be essential prerequisites.

The DVFA Commission currently sees the main remaining challenges in the transformation process:

- the somewhat still existing bias of individual and business decision-makers
- insufficient training of individual and institutional actors
- insufficient internalisation (pricing) of external environmental and social costs
- general market: definition standards; data availability, quality, comparability and topicality
- Management responsibility for the integration of ESG aspects

The DVFA Commission believes that a data room for corporate ESG data could ease the implementation of the EU Action Plan, by improving access to data by financial market participants. The data presented should not suggest a qualitative or forward-looking assessment. A data interface should not replace ESG research houses but should increase the level of integrity and comparability of the required and standardised ESG data. In particular, the proposed data room should:

- serve only as a collection point, i.e. include data submitted by companies, to ensure that financial market participants have equivalent access to basic data
- also include voluntarily reported data from companies that fall outside the scope of the Non-Financial Reporting Directive (NFDR), such as smaller companies and/or companies outside the EU
- it may also include reported data from globally standardised information, in particular, TCFD and SASB

The DVFA Commission believes that ESG data is now more comparable and standardised than its reputation. The Commission took a position on this matter in the consultation and elsewhere (e.g. https://frankfurt-main-finance.com/en/esg-ratings-are-better-standardised-than-one-might-think-dvfa-guest-contribution-in-boersen-zeitung/).

The perceived lack of comparability of ESG data among investors is only partially justified. In terms of complexity, a company's ESG rating can hardly be seriously compared with a credit rating that assesses only one facet, which is the probability of coupon default and the repayment of a bond.

When assessing ESG, both the horizon and the number of criteria considered are disproportionately larger, and not only a quantitative but also a qualitative weighting is required. In this respect, a higher dispersion of results can be expected per se. However, the variance is not only due to the complexity of the topic. It also lies in the diversity of the topic. One should expect deviating results from ESG ratings.

While the argument for a low correlation between individual stocks may be justified, this does not apply to the average of companies and ESG rating agencies. Several practical and academic studies have examined the average correlation of ESG ratings by leading rating agencies. The typical average paired correlation is around 0.7. The consistency of ratings is particularly high in the E-ranges and, for the most part, in the S-ranges. However, there are larger deviations in the G-ranges and in the addition of ratings by providers who use a more financially driven sustainability methodology. For comparison, the leading bond ratings show a paired correlation of about 0.9 between Moody's, S&P and Fitch for the MSCI AC World.

The dispersion of the correlation between the providers of ESG ratings is on average quite acceptable, which is all the more surprising as the providers use different rating philosophies and include between 38 and 238 indicators in their measurements. In quantitative terms alone, they differ significantly in their methodology. While the leading providers of bond ratings do achieve a higher degree of consistency in their ratings, the correlation in ESG ratings is surprisingly high, given their complexity.

The ratings of companies, according to ESG criteria, are already better standardised than often assumed, when adjusted for outliers. However, the expert, critical handling of multiple ESG ratings and the qualitative, conclusive overall assessment by the analyst remain indispensable for sustainable investing and underline the strength of the asset manager.

Ambiguities and occasional low data quality do not call into question the concept of sustainable investing, but rather are a mandate to investors to support the diversity of rating agencies. At the same time, investors should demand better measurement methods and, through dialogue with companies, sufficiently reliable and up-to-date data. It can also be a mandate to policymakers to better standardise data on key ESG indicators.

Nevertheless, the DVFA Commission is in favour of stronger regulation of sustainability reporting. As long as the disclosure of ESG data remains voluntary, the data disclosed by companies can potentially be positively biased. To date, hardly any jurisdiction holds companies and executives liable for false or misleading extra-financial data disclosed outside of regulated traditional financial reporting. As a result, most investors and analysts tend to discount reported ESG data and have less confidence in the quality of the ESG information provided. In addition, the infrequent and delayed disclosure of ESG reports compared to a company's traditional financial reporting reduces usability. These issues need to be addressed.

The Commission's assessment of the EU Ecolabel for funds is rather wait-and-see. In its current form, the creation of an EU-regulated ESG label is debatable. There are already many existing private labels with which one can compete. At this stage, such a label is better awarded by private institutions. However, a harmonised, public, free ESG data tool for basic KPIs could provide a common basis for ESG assessment.

The DVFA Commission considers it useful to introduce ESG aspects into incentive schemes. Practitioners and academics often stress the importance of management incentives and targets to promote ESG-oriented behaviour. Currently, less than 5% of large companies typically integrate ESG aspects into their management incentives.

Additionally, it seems reasonable to be able to vote on environmental and social strategies or the performance of a company in the future. These votes would provide companies with meaningful feedback and better express the opinion of shareholders, apart from a narrowly defined, company-dominated agenda at general meetings. In many jurisdictions, there are either high legal, capital-intensive or technical barriers to getting resolutions onto the general meeting agenda. In return, shareholders cannot vote on ESG resolutions and bring about changes. Focusing on a broader range of issues, including E&S at management meetings, general meetings, and proxy voting could be an important catalyst.

DVFA would lend its support if the EU were to encourage the development of more structured actions on financial literacy and sustainability to raise awareness and knowledge of sustainable finance among citizens and financial professionals. According to various surveys, investment professionals still receive minimal ESG training. Consequently, survey practitioners often identify knowledge gaps as one of the main obstacles to better-integrating ESG aspects into investment decisions (e.g. dhttps://onlinelibrary.wiley.com/doi/abs/10.1002/bse.2346). If the EU is to promote a rigorous institutionalisation of ESG aspects in decision-making, it must also better codify these aspects in institutionalised programmes, professions or techniques. The creation and dissemination of know-how appear to be the key to increasing the speed of ESG integration among financial professionals. Integration into university finance courses, the adaptation of post-graduate training such as CIIA (www.dvfa.de/ciia) or CFA and/or special ESG training programmes for post-graduates (such as www.dvfa.de/cesga) can prove to be critical catalysts for overcoming knowledge gaps and ESG adaptation among investors.