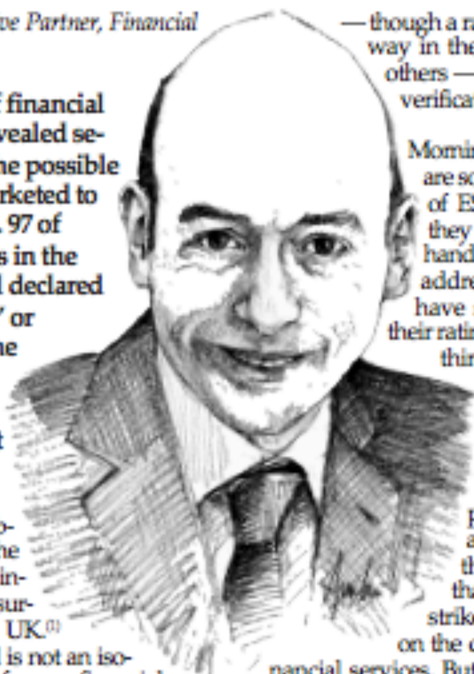
Blind Reliance on ESG Data and Rankings - The Seeds of the next Mis-selling Crisis?

By Frédéric GIELEN - Executive Partner, Financial Services, Reply



In early 2019, a survey of financial advisers had already revealed serious misgivings over the possible mis-selling of products marketed to investors as 'ESG friendly'. 97 of every 100 financial advisors in the United Kingdom (UK) had declared themselves as either "very" or "fairly" concerned about the potential for allegations of mis-selling ESG investments, according to market research firm Cicero.

Many were already making obvious comparisons between the risk of ESG mis-selling and the infamous payment protection insurance (PPI) scandal in the UK.[1] Unfortunately, the PPI scandal is not an isolated exception; it is just one of many financial product mis-selling scandals that we have experienced in the European Union and the UK over the last few years. The concerns raised by UK financial advisors are shared by their colleagues in the European Union (EU).

"The green investment funds which can make you rich… and save the planet"

Headlines such as that one are now commonplace in the EU and the UK. Given the skyrocketing interest in ESG funds,[2] there is clearly a financial incentive in attempting to label funds as 'ESG friendly' to gain a competitive advantage. The great problems with ESG data are the vast quantity of it, the lack of enforceable internationally agreed-upon standards — though a range of initiatives are underway in the EU[3] and the UK, among others — and the lack of third-party verification.

Morningstar, Bloomberg and MSCI are some of the leading providers of ESG data and rankings and they are all aware of the issue at hand. All three are trying hard to address investor concerns and have started embedding, within their rating methodology, elements of third-party verification.

These ratings remain, however, largely based on self-reported data, and blind reliance on such ratings will provide little protection against mis-selling claims in the future. Some will argue that the 'hindsight bias' will strike again; others will blame it on the dodgy moral compass in financial services. But the fact remains, blind reliance on such ratings is a risky proposition for asset managers, wealth managers, institutional investors, and platforms.

Avoiding Greenwash and its Dangers

On April 15, 2020, we celebrated the tenth year anniversary of Andrew Winston's article in Harvard Business Review: *Avoiding Greenwash and its Dangers*. The oft-cited *"it's wonderful to see companies competing on green. But there is a high risk of saying something that isn't quite true, or of overstating the truth"* still resonates with me.

Greenwashing is the name given to worries over firms marketing products as more ESG friendly than reality reveals.

Within financial services, policy-makers and regulators have awoken to this danger. The tone was given by the FAQ released by the European Commission when it issued its proposal on financing sustainable growth in May 2018:

European Commission's Proposal on Financing Sustainable Growth – Extract of the FAQ (May 2018): *"Asset managers and institutional investors who claim to pursue sustainability objectives would have to disclose how their investments are aligned with those objectives. This means greater transparency towards end-investors, ensuring comparability between products and discouraging 'green-washing' or misleading information."* (Source: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_18_373)

To manage this risk strategically, asset managers, wealth managers, institutional investors, and platforms must do more; they must do better!

In the UK, the Financial Conduct Authority has declared its stance on the issue by promising to challenge firms it believes to be «greenwashing» products in a move to protect consumers from false claims regarding the sustainability of their investments.

The FCA declared that initial findings made it clear that the ESG label has been applied to a wide range of products, many of which showed no material difference to those not considered ESG friendly.

The FCA said: *«we acknowledge that assessing this is complex. There can be legitimate causes for differences in assessments of sustainability of products, for example sectoral or regional differences, and it can be difficult to determine the net impact of a financial product in supporting sustainability goals."*

Another important figure identifying the need for some kind of regulatory role in supervising ESG standards is Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA), who, in a keynote address at the European Financial Forum in Dublin said, *"it is important that public authorities step in and establish robust ESG standards and supervise the relevant actors and products to prevent the risk of greenwashing."*

As noted above, in a serious effort to combat the lack of standards in ESG data verification, Morningstar, Bloomberg and MSCI have enhanced their data verification methodologies incorporating alternative data sources such as those from the media and NGO datasets. Nonetheless, financial institutions must do better yet than blindly rely on ratings that they may not fully understand.

Morgan Stanley, Merrill Lynch, Wells Fargo and UBS have also increased their spending, hoping to acquire better quality data regarding funds claiming social responsibility.

In 2019, Morgan Stanley unveiled a tool to help investors identify discrepancies between a portfolio's assets and its socially responsible objectives. The tool uses verified third-party data to help ensure the correct data where ESG investments are concerned.

Whatever happens next, it is clear that increasing consumer demand for ESG investment vehicles, along with increasing scrutiny over ESG practices, means that financial institutions need structures in place to secure data quality.

For additional information, do not hesitate to contact my colleagues, at Green Reply (e-mail: green@reply.com)

1) As of mid-2019, data from the Financial Conduct Authority (FCA) showed that banks had had to pay customers more than £35bn in PPI refunds and compensation to customers.
2) Last year, in the US alone, investors invested USD 20.6bn into sustainable investment funds compared with USD 5.5bn of net inflows in 2018, according to Morningstar.
3) In the European Union, the European Commission is spearheading a range of initiatives in line with the EU Action Plan on Sustainable Finance, which encompass work on a taxonomy and disclosure requirements.