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Why do Regional Discrepancies and Cross-Border Regulatory Differences affect the ESG Landscape?

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Executive Summary

The following report aims to explore the effects of regional discrepancies and cross-border regulatory differences on the global ESG landscape. While there is increasing pressure for harmonisation currently, this process has been time-consuming. This may largely be attributed to factors such as the lack of investor confidence, disparate regional growth, and inconsistent reporting standards when coupled with the lack of transparency in the sector. While technological evolution continues to push the sector forward, it is important to note that regional disparities may continue to persist due to the dynamic nature of regulatory systems as we continue to uphold the tradition of progress.

Pressure for Harmonisation

Within the current landscape, it is evident that firms with a global presence consider ESG as a part of their core strategies in their overarching investment frameworks. According to a recent report from Morningstar, **Global ESG Fund Assets[1] reached about $2.5 trillion at the end of 2022 with 89% percent of global investors considering ESG issues in some form as part of their investment approach**.[2] But, even with increased interest and demand from the market, the current ESG framework from a global regulatory reporting perspective is disjointed, to say the least.

The divergence of ESG reporting standards and implementation requirements has raised compliance and regulatory questions for firms and investors alike. According to the 2022 Capital Group ESG Global Study, **53% of asset managers want more consistent data and 70% of NORAM investors agree the standardisation of tools and data is what's needed to analyze and implement ESG**.[3] With the consensus being that the standardisation of tools, data and regulatory frameworks would harmonise the global ESG landscape, what's taking so long, and what is currently being done?

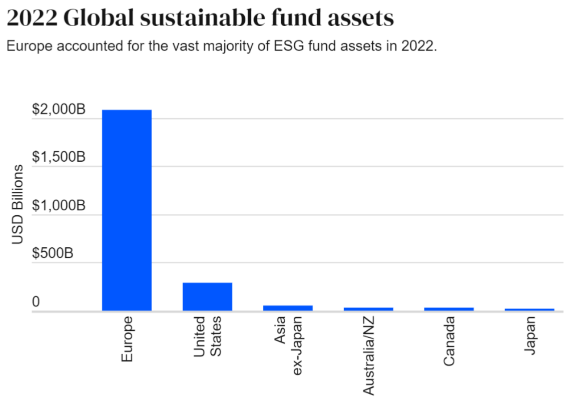
What's needed to better analyze and implement ESG	% of North American investors who agree
Expanding/diversifying use of outside experts	18 percent
Ongoing ESG training/education	23 percent
Larger team of ESG employees	24 percent
More automated analysis tools for ESG	30 percent
More reporting from asset managers	32 percent
Greater portfolio cross-industry integration of ESG factors	34 percent
Consistent data from asset managers	53 percent
Standardization of tools and data	70 percent

Source: Capital Group ESG Global Study 2022

Lack of Investor Confidence in Regulation

Within the US, the fragmented policies between the state and federal governments have already led to confusion and uncertainty about ESG policy implementation. In March 2022, the US Securities and Exchange Commission (SEC) released its long-awaited proposed rules on mandating certain climate-related disclosures for listed companies. We are still waiting for the finalisation of the proposed rules with the expectation of receiving guidance by the end of 2023.

Though ESG-related pushback has been evident at many levels of the US government, a recent court ruling decided in favour of the Department of Labor, allowing ESG metrics into the investment decision process for EIRSA-governed plans. While rulings such as this support the expected upcoming requirements regarding sustainability and regulatory reporting within the US, the demand for ESG-focused investments continues to grow and investors and firms have been forced to look elsewhere for exposure. So, where are they going?



Source: Morningstar Global Sustainable Fund Flows: Q2 2022 in Review

[1] We use the term "Global ESG fund Assets" in reference to Morningstar's definition of "Global Sustainable Funds", which encompasses open-end funds and ETFs that, by prospectus or other regulatory filings, claim to focus on sustainability; impact; or environmental, social, and governance factors. More details on this can be found in the aforementioned source.

[2] Source: Morningstar Global Sustainable Fund Flows: Q2 2022 in Review

[3] Source: Capital Group ESG Global Study 2022

Disparate Regional Growth

In the second quarter of 2022, global sustainable funds added $32.6 billion in net new money, with Europe accounting for 94% of the growth.[4] With this increased demand for ESG exposure comes increased cross-border regulatory exposure as well. In the EU, the policy environment and subsequent implementation of ESG regulations have been more unified and led to smoother adoptions. Yet ongoing hurdles for EU and non-EU market participants remain.

Inconsistent Reporting Standards

SFDR, CSRD, SDR II, PRIIPS, MiFID II, AIFMD, IDD, ESAD, IFR, CRD, CR II, IPD, EU Climate Benchmark, EU Ecolabel Regulation, Green Finance Standard… the list could go on. These are many of the regulatory policies and bodies that make up the ESG governance within the EU. Non-EU market participants are subject to similar disclosure requirements and similar implementation timeframes as their EU counterparts.

As one can imagine, with these many regulatory policies and regulatory bodies, changes are constantly in flux with reporting and disclosing. The limited taxonomy disclosures and lack of consistency of data are a constant struggle for global market participants. Indeed, many non-EU firms may not be compliant at all, due to uncertainty of what they are subject to and what policies need to be adopted. This is important as **more than half of global investors think clarity on the role of ESG in a fund's investment process is one of the most important parts of reporting**, according to the 2022 Capital Group ESG study.[5] This results in complications and confusion for market participants, making cross-border alignment on ESG standards all that much more important. However non-EU firms are not the only ones struggling with issues related to taxonomy and reporting.

Data and Transparency Issues

As of July 2023, it was found that a large majority of European funds marketed as sustainable said they were not fully aligned with the EU's taxonomy. MSCI found that **nearly 90% of so-called Article 8 funds – those partly focused on environmental, social or sustainability (ESG) issues – and 63% of Article 9 funds – those with clear sustainability objectives – said they did not have taxonomy-aligned investments.**[6] Many firms aiming to be compliant with EU taxonomy indicate that there simply isn't enough data to make an assessment. This begs the question of what these regulations are achieving, and what needs to change so that firms can accurately report to investors? Taxonomy alignment for both EU and non-EU firms is something that needs to be addressed within the larger framework of EU policy surrounding ESG initiatives. Even with the EU being far more advanced than other countries in the ESG landscape, it still seems that the discrepancies within reporting, policies and regulations are having a dramatic impact on investors and firms alike.

Moving Forward

While there is growth within the ESG landscape, and regulatory standardisation is slowly coming into play, standardised data and transparency remain the biggest hurdles for the foreseeable future. The evolution of the ESG landscape is inextricably linked to the effective utilisation of technology within the financial realm. Harnessing the power of fintech, particularly Cloud computing, AI and Gen AI presents a transformative opportunity for growth. By leveraging these technologies asset managers can streamline data management and help ensure compliance with regulatory standards while enhancing transparency. Integrating these fintech advancements into ESG initiatives propels us toward a future where sustainability, data standardization and technological prowess converge, fostering a landscape ripe for responsible and impactful investments, and ultimately propelling us forward into a more sustainable and transparent financial ecosystem.

[4] Source: Morningstar Global Sustainable Fund Flows: Q2 2022 in Review
[5] Source: Capital Group ESG Global Study 2022
[6] Source: Funds and the State of European Sustainable Finance

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About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

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