MARKET INSIGHTS

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ESG RATINGS OF ARTICLE 8 AND 9 FUNDS:

ASSESSING THE CURRENT MARKET AND POLICY RECOMMENDATIONS FOR THE FUTURE

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INTRODUCTION

This Market Insights focuses on the ESG ratings of Article 8 and 9 funds, two fund categories that have been introduced by the Sustainability Financial Disclosure Regulation (SFDR).[1] The main purpose of ESG ratings is to evaluate the ESG credentials of a financial product using proprietary methodologies developed by specialised providers.

The market for ESG ratings is expected to grow strongly in the short and medium term following the new requirement since 2 August 2022 for financial advisors and fund distributors to consider their clients' sustainability preferences and propose products that meet such preferences.[2] In this context, distributors and advisors may decide to filter out SFDR Article 8 or Article 9 funds and then find a subset that matches their client's preferences. As part of this process, they may find it worthwhile to use third-party evaluation of the ESG characteristics of funds.

With this in mind, we have analysed the fund level ESG ratings assigned by two commercial providers – Refinitiv and Morningstar Direct – using a large sample of Article 8 and 9 funds. Specifically, we focused on two aspects: first, the dispersion between the ratings[3] given by these providers for the same funds, and secondly, the deviations between the ratings of Article 8 and 9 funds.[4] On the basis of our findings, we present some policy recommendations to help ensure that the market for ESG ratings functions well in the future.

ESG SCORES BY REFINITIV

Refinitiv has introduced ESG scores to measure a company's or fund's ESG characteristics, commitment and effectiveness across 10 main themes[5] within the three pillars: Environmental, Social and Governance. The scores are based on more than 630 ESG metrics.

There are two types of ESG scores:

- The ESG scores that are based on verifiable reported data in the public domain.
- The ESG Combined (ESGC) score that overlays the ESG score with the ESG controversies score (impact of negative events) to provide a comprehensive evaluation on the company's or fund's sustainability impact and conduct in near real time.

The scores are labeled from 0 to 100, but can also be translated into a scale from A to D.[6]

Refinitiv ESG Score Quartiles		
Score range	**Description**	
0 to 25	First Quartile	Scores within this range indicates poor relative ESG performance and insufficient degree of transparency in reporting material ESG data publicly.
> 25 to 50	Second Quartile	Scores within this range indicates satisfactory relative ESG performance and moderate degree of transparency in reporting material ESG data publicly.
> 50 to 75	Third Quartile	Scores within this range indicates good relative ESG performance and above average degree of transparency in reporting material ESG data publicly.
> 75 to 100	Fourth Quartile	Score within this range indicates excellent relative ESG performance and high degree of transparency in reporting material ESG data publicly.

Source: Refinitiv (2022). Environmental, social and governance scores from Refinitiv

Refinitiv has attributed ESG scores to 9,315 ESG-labeled funds with a total net asset value of EUR 4.3 trillion as of 9 August 2022. Roughly 70% of these funds are either Article 8 or Article 9 funds, with the rest of them not (yet) classified by Refinitiv according to SFDR.

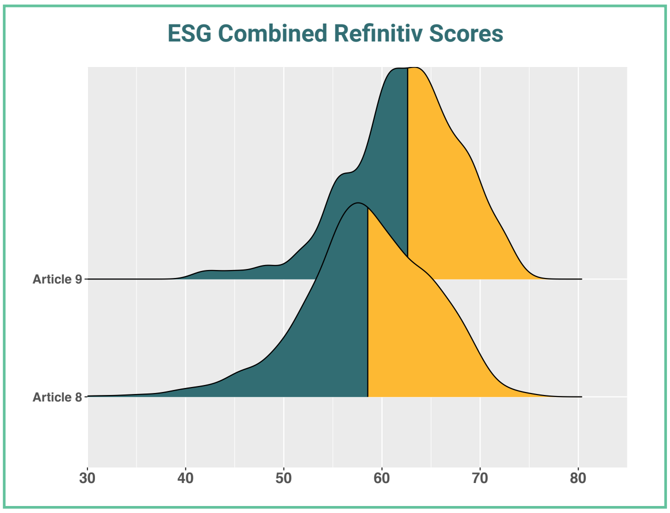
The table below shows summary statistics for the ESG scores assigned to Articles 8 and 9 funds. While the average (mean and median) scores for Article 9 funds are slightly higher than those of Article 8 funds, the difference is rather small. Moreover, the maximum scores for Article 8 funds are greater than those for Article 9 funds, which may indicate that these SFDR categories capture other criteria than those actually applied by Refinitiv. At the same time, the lowest scores given to Article 8 funds are significantly lower than those of Article 9 funds.

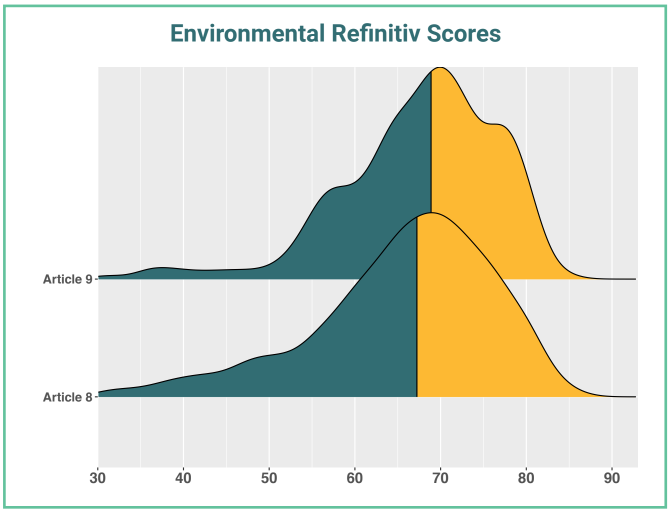
Refinitiv ESG Scores of Article 8 and Article 9 Funds								
	Article 8 funds				Article 9 funds			
	Mean	Median	Min	Max	Mean	Median	Min	Max
ESG Combined Score	58.5	58.6	30.0	76.7	62.2	62.6	41.5	74.4
Environmental Score	65.0	67.0	7.3	87.1	67.4	68.8	22.7	84.8
Governance Score	65.2	66.2	32.9	85.8	66.0	66.7	43.0	81.3
Social Score	72.0	73.7	33.0	89.0	74.2	75.3	41.8	87.6

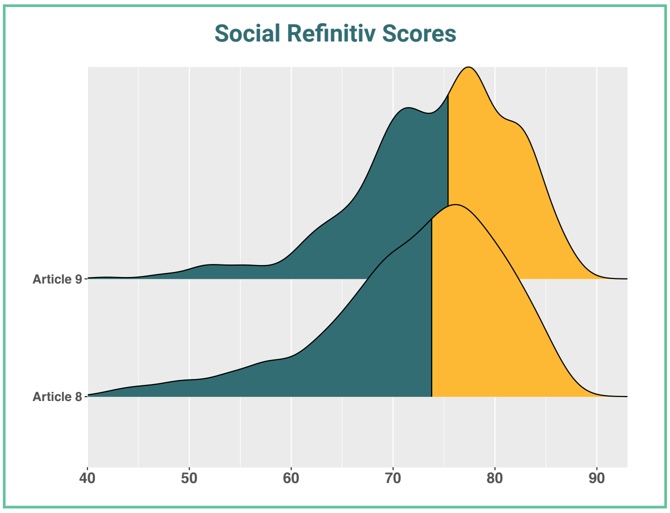
Source: EFAMA calculations based on Refinitiv's data

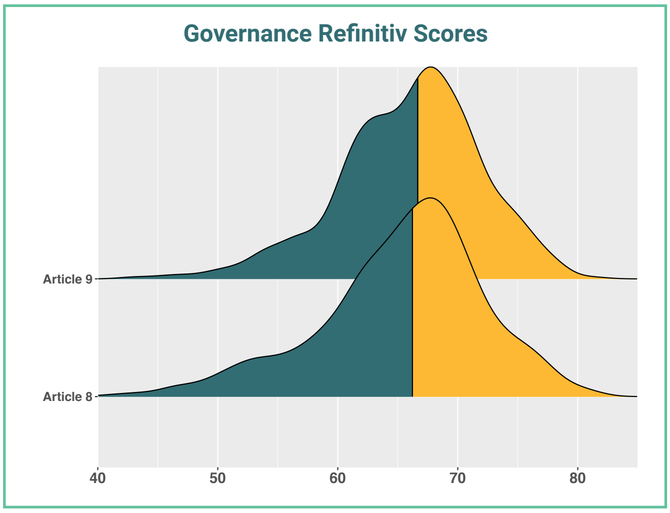
EFAMA
European Fund and Asset Management Association

The charts below show the distributions of ESG scores (Combined ESG scores, Environmental scores, Social scores and Governance scores) for both Article 8 and Article 9 funds. The distributions of the ESG scores of Article 9 funds are slightly tilted towards higher scores compared to those assigned to Article 8 funds. However, the two sets of distributions are not significantly different. We also observe that a large group of Article 8 funds have relatively high ESG scores whilst some Article 9 funds have low scores.









Note: a density chart gives a precise indication of the relative concentration of funds within a certain range of ESG scores.
The median (middle line) divides each density chart into two parts, each with an equal number of funds.
Source: EFAMA calculations based on Refinitiv's data

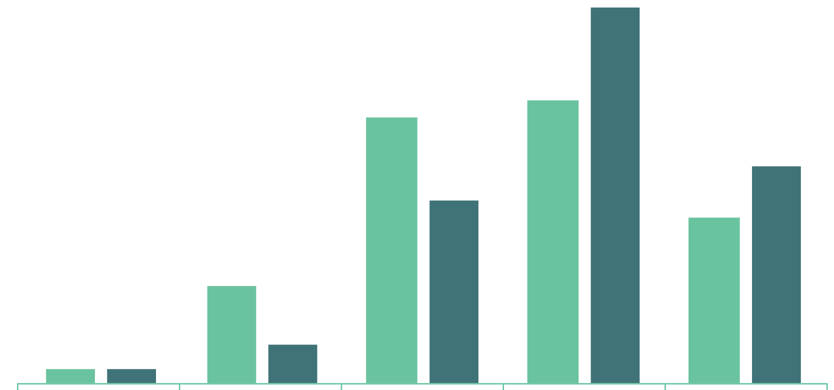
MORNINGSTAR SUSTAINABILITY RATING FOR FUNDS

The Morningstar Sustainability Rating for Funds evaluates how well ESG risk is managed at a fund level relative to its peer group as defined by Morningstar's Global Category.[7] Ratings are determined using bottom-up assessments of the underlying holdings within a fund portfolio, underpinned by methodologies for assessing corporate and sovereign ESG risk.

The output of the rating is a category of 1 to 5 «globes», whereby a higher number of globes indicates that the portfolio has lower ESG risk. Notably, the number of globes a fund receives is determined relative to other funds in the same Morningstar Global Category. This means that a fund could have more ESG risk than another fund and yet still receive a better rating if it belongs in a Global Category that has a better risk profile altogether.[8]

The chart below compares the Sustainability Rating attributed to 6,250 Article 8 and Article 9 funds, with a total net asset value of EUR 3.3 trillion as of 11 August 2022. We found that 71% of Article 9 funds have an above-average rating, compared to 54% for Article 8 funds, but there are still some Article 9 funds with a relatively low rating.

Distribution of Morningstar Ratings of Article 8 and 9 Funds



	Low	Below Average	Average	Above Average	High
Article 8	2%	12%	32%	34%	20%
Article 9	2%	5%	22%	45%	26%

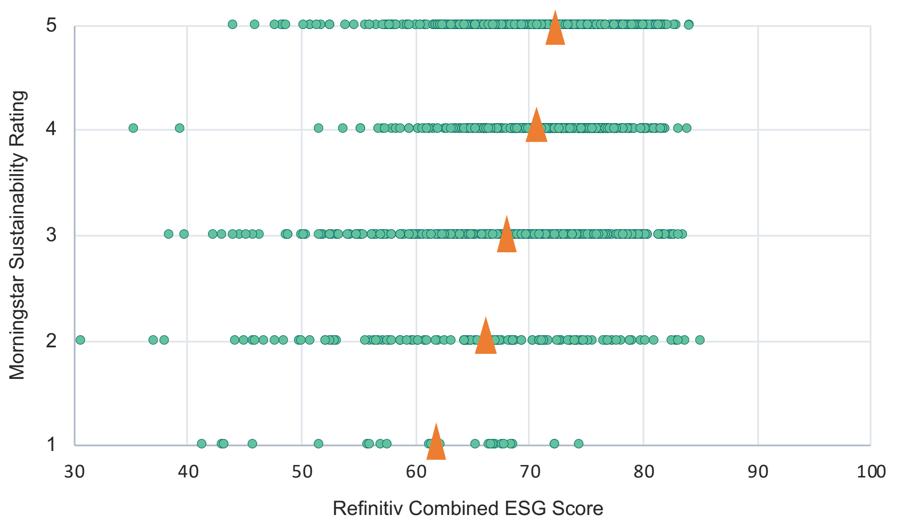
Note: the distribution shows the percentage of funds belonging to each of Morningstar's sustainability ratings.
Source: EFAMA calculations based on Morningstar Direct data

DIFFERENCES BETWEEN REFINITIV'S AND MORNINGSTAR'S ESG RATINGS

Refinitiv scores are designed to measure a fund's ESG characteristics, commitment and effectiveness, whereas Morningstar ratings are considered a measure of the financially material ESG risks in a fund when compared with similar funds.[8] Whilst recognising that Refinitiv and Morningstar use different methodologies and pursue different goals, we wanted to explore whether there is convergence between these two measures of ESG performance. In other words, we have examined whether funds with high Refinitiv ESG scores tend to have low ESG risk exposure according to Morningstar, on the assumption that both types of rating reflect the ESG credentials of a fund. We managed to do this mapping exercise for roughly 1,500 funds.

The chart below shows the Refinitiv score and Morningstar rating for each fund, represented by one green ball. It also shows the average Refinitiv score for each level of Morningstar's ratings (orange triangle).

Morningstar Ratings and Refinitiv ESG Combined Scores for 1,500 Funds



Source: EFAMA calculations based on Refinitiv and Morningstar's data

If we group all funds by the five Morningstar Sustainability Ratings and compute the average Refinitiv score for each group (orange triangle), we find that these Refinitiv-based averages tend to increase with an increase in the Morningstar rating. So, there is positive correlation. However, that correlation appears to be quite small[10], as there are many funds with a very low Refinitiv score that have a high Morningstar score, and vice versa. This is not too surprising because rating agencies base a fund's ESG rating on their own proprietary ESG assessment and the ESG ratings bear little relationship with the SFRD classification. Moreover, the SFDR defines high level principles that leave some room for a variety of approaches and requires the classification of funds under Articles 8 and 9 without really defining precisely what criteria funds would need to meet for this classification. Hence fund managers were required to classify their funds using their own, different approaches and then disclose what those approaches are.[11]

This finding implies that ratings should be used with caution, as a "good" score/rating given by one organisation does not necessarily mean a similarly good rating by another organisation.

POLICY RECOMMENDATIONS

Article 8 versus Article 9 funds

Our analysis has shown that even purposeful funds classified as Article 9 won't necessarily get high ESG ratings. So instead of using shortcuts like going for a fund with a high rating, advisers and clients should look to understand what a fund is really trying to achieve and not use information such as ESG ratings in isolation.

Against this background, we consider that **financial advisors and fund distributors should not necessarily offer only Article 9 funds to clients expressing a strong ESG preference, and national regulatory rules should refrain from imposing such a requirement.** This is even more important given that the range of Article 9 funds is currently very limited.[12]

Using ESG ratings in a thoughtful way

Advisors and distributors need to navigate through the new, complex, and growing landscape of Article 8 and 9 funds to be able to differentiate one fund from another. In this context, it is particularly important that they verify if the fund's ESG approach is aligned with the investor's ESG preferences (for example regarding controversial activities exclusions) and views on risks (for instance the risks related to specific environment or social themes in some market conditions).

When using ESG ratings, **advisors and distributors should not rely on these in isolation as there is no perfect tool to comprehend the specific ESG characteristics of a fund**. A fund with a high-quality rating may not automatically be in line with an investor's ESG preferences. Hence, to exercise their responsibilities with due care and diligence, advisors and distributors would be well advised to really understand the available product set, by using other tools such as the European ESG Template (EET)[13], national and international guidance, external assessment by consulting services, engagement with their stakeholders, benchmarking against peers, as well as the precontractual (SFDR templates, KIDs) and periodic reports that are the result of all the regulation the industry is implementing.

A regulatory framework for ESG ratings

ESG ratings aim to give an indication of the ESG quality of a fund based on a specific methodology. This allows comparison as each ESG ratings provider applies the same methodology to all the funds it assesses, but it does not allow comparison of ESG ratings across multiple providers. We expect the use of ESG ratings to increase in the future, and therefore we see the need for swift development of a regulatory framework based on the following principles.

- **Transparency:** the low degree of overlap between the ESG ratings provided by Refinitiv and Morningstar for the same funds implies that advisors/distributors and fund managers will need to have a clear understanding of the underlying methodologies used. It is therefore essential that these are well defined, transparent and robust. **The regulatory framework should impose disclosures requirements in relation to the methodologies and data sources used to provide ESG ratings.** The benefit of transparency is that advisors and distributors would then be able to utilise the data vendors who provide ratings most closely aligned to the approach/aims of the fund and goals of the investor.

The regulatory framework should also encourage ratings providers to incorporate ongoing legislative changes into their methodology to help ensure the quality and robustness of their ESG ratings processes. This being said, the regulatory framework should not standardise the underlying methodologies, in order to allow providers sufficient flexibility to use a wide range of methods and approaches.

- **EU versus non-EU providers:** a recent report published by ESMA highlights that *"the structure of the market among providers is split between a small number of very large non-EU entities on one hand, and a large number of significantly smaller EU entities on the other"*.[14] And some of these larger, more established market participants have begun to acquire smaller and more specialised ESG providers. Against this background, **the legal framework should ensure that all organisations providing ESG ratings to funds domiciled in the EU are within scope.** To ensure the necessary proportionality, providers not yet established in the EU could be considered in scope once their percentage of overall EU revenues reaches a certain threshold. This should guarantee the continuation of services from smaller non-EU providers while safeguarding the future framework and providing a level-playing field.

- **Conflicts of interest:** the results of the European Commission's consultation on ESG ratings and ESG factors in credit ratings revealed that the large majority of respondents consider the market prone to potential conflicts of interests. One of the reasons for this is that ESG ratings providers often perform consulting services for companies and funds for which they provide ESG ratings. **To preserve market integrity, the legal framework should ensure specific requirements relating to internal controls and governance processes.**

Business and cost impact

While recognising the benefit that ESG ratings can have in helping investors assess the sustainability credentials of funds and the necessity to remunerate these services, **it is essential to ensure a competitive market for ESG ratings, that does not allow a small number of providers to set excessively high fees for their services.**

In this context, we believe that the supervisory authorities should gain a good understanding of the pricing and licensing frameworks involved, which largely depend on the combination of data modules and the size of ESG assets under management of clients. To this end, policymakers could collect annual information on pricing, licenses, costs and revenues per type of ESG rating and ancillary service.

A voluntary code of conduct

In parallel to legal intervention, a voluntary code of conduct could be developed. Compared to a legal framework, a voluntary code of conduct could hopefully be set up quickly, which could help the European Commission correctly calibrate the future legal framework based on this experience.

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ENDNOTES

1. According to the SFDR, Article 8 funds promote investments or projects with positive environment or social characteristics and with good governance principles and Article 9 funds are funds that target a sustainable investment primary objective. Funds that do not have a sustainability scope should be classified as Article 6 funds.
2. See Commission Delegated Regulation. The client can express sustainability preferences in one or a combination of three criteria: a minimum proportion invested in environmentally sustainable investments as defined in the EU Taxonomy, a minimum proportion of sustainable investments as defined in SFDR, or qualitative and quantitative considerations about principal adverse impacts (PAIs) on sustainability factors. ESMA published Guidelines on certain aspects of the MiFID II suitability requirements on 23 September.
3. Although, as explained below, Refinitiv uses the term score, we will most often use the generic term ratings in this note, for the sake of simplicity.
4. This analysis could be extended to assess the extent to which Article 6 funds are receiving a "good" ESG rating.
5. The 10 themes are the following: resource use, emissions, environmental product innovation, workforce, human rights, community, product responsibility, management, shareholders and corporate social responsibility.
6. Refinitiv ESG scoring methodology is detailed in the following publication.
7. The Morningstar Global Category system groups investment vehicles across the globe that invest in similar asset classes. Those categories include Global Equity Large Cap, Currency, Europe Fixed Income, Japan Money Market and other. The list of all categories can be found here.
8. The methodology used by Morningstar is described in the following publication.
9. The goal of our research work was to understand what information is at investors' disposal when making an ESG investment decision and to understand the relation between the SFDR classification and ESG ratings offered by leading data providers. However, while we are aware that the SFDR mandates disclosures based on "Double Materiality" principles, this is nonetheless not the principle behind Morningstar Sustainability Rating System, which follows the single materiality approach (financial materiality). On the other hand, Refinitiv scores follow a complex approach of "magnitude materiality" that is neither single nor double materiality as such.
10. The correlation is equal to 0.25. The calculation was performed by mapping Morningstar's ratings into numerical values (from 1 to 5) and calculating the correlation with Refinitiv scores. Given that the Morningstar's ratings are categorical variables whereas Refinitiv's scores are numerical variable, the result should be treated as a 'rule of thumb' solution only.
11. See, for instance, this article.
12. According to Morningstar research, as of 31 March 2022, there were 6,832 Article 8 and 898 Article 9 funds available in Europe.
13. EET explanatory recordings are available here.
14. See the ESMA report which can be downloaded by clicking here.
15. The Commission's summary report is available here.

EFAMA
European Fund and Asset Management Association

THE VOICE OF THE EUROPEAN INVESTMENT MANAGEMENT INDUSTRY

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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