FEBRUARY 2022

Sustainable investment fund labeling frameworks: An apples-to-apples comparison

Anna Georgieva, Associate Principal, Sustainable Investment, Qontigo
Saumya Mehrotra, Associate Principal, Sustainable Investment, Qontigo

Updated version, February 17, 2022

QONTIGO AXIOMA | DAX | STOXX

Table of Contents

1. Overview 3

2. Setting the scene 4

2.1. Divergence, alignment, divergence… alignment? 6

3. Analysis 9

3.1. Objectives of the labels 10

3.2. Exclusionary criteria 11

3.3. Portfolio construction 15

4. Implications for investors: “the impossible product” 21

5. The road ahead 22

5.1. The advantages and disadvantages of harmonization 22

5.2. A look beyond the EU 24

5.3. Achieving the objective of sustainable transition 24

5.4. Key takeaways for fund issuers 25

6. Appendix 26

6.1. Further reading 26

6.2. Quick links to labeling documentation 26

6.3. Updated sections 27

7. Contacts & Information 28

Copyright ©2022 Qontigo GmbH.

1. Overview

The list of sustainable investment (SI) frameworks guiding portfolio design is long and keeps growing: the EU's Sustainable Finance Disclosure Regulation (SFDR), Benchmark Regulation (BMR) and Taxonomy, Belgium's Towards Sustainability Label, France's SRI Label, and the Nordic Swan Ecolabel are just a few examples from Europe, where most of the effort to date has been concentrated. Rarely a day (or a panel) goes by without intense discussion of some or all of them, and their often-conflicting implications for fund design.

The authors of this paper[1] aim to contribute towards this intensifying debate by examining in detail (as of October 2021) the criteria used in the 12 most important European pieces of legislation, country-specific fund labels and other standards guiding SI product design (referred to collectively in this paper for simplicity as "labels"). At the same time, the paper notes that the landscape is continuing to proliferate on a daily basis.

Despite being focused on ensuring a certain quality of SI in funds, the labels have widely differing stated aims, scope and criteria. As a result, comparison on a like-for-like basis is not possible without a deep-dive analysis that manually interprets and classifies their content with reference to a common set of criteria.

The authors present such a comprehensive analysis on a like-for-like basis, after narrowing down the common set of criteria under the labels as they relate to:

- The criteria leading to companies being excluded from portfolios (negative screening), and
- The criteria for constructing portfolios above and beyond these exclusions, including integrating ESG issues in investment analysis, positive (best-in-class) screening, and the more and more important practice of thematic and impact investment.

They then discuss the resulting challenges and opportunities facing the market for listed equity investment products. Specific questions raised in the paper include:

- What are the existing labels' aims, which criteria are aligned with each other and where do they diverge, and what are the forward-looking trends?
- Is it actually feasible to design a financial product that aligns with all the label criteria reviewed in this paper? What are the implications for the scalability of SI products?
- What are the implications of attempting to limit the number of labels to the bare minimum through standardization, as opposed to encouraging divergence on the grounds that there is no one-size-fits-all solution when it comes to SI?
- What does the non-European SI labeling landscape look like?
- What are the possible implications of all this for the ultimate goal of transitioning to a more sustainable economy?

This paper does not ultimately aim to identify a specific recommended direction of travel, but rather to inform interested stakeholders, and especially investors, regulators and SI industry associations, about the intricacies of the current situation, and to raise awareness of this among them.

[1] The information in this paper has been compiled by Qontigo's Sustainable Investment team. It is designed to guide the thinking of financial market participants that provide sustainable investment products. The advice given in it is non-binding and any implications should be discussed with participants' legal counsel and other competent bodies as needed.

Copyright ©2022 Qontigo GmbH.

2. Setting the scene

> Qontigo's sustainable investment team analyzed the 12 most important pieces of legislation, country-specific fund labels and other standards guiding equity portfolio design (referred to collectively in this paper for simplicity as "labels").
> The high degree of diversity is apparent even from the labels' names, which span from "green" to "SRI"; but one thing is abundantly clear: exclusion-only approaches have become insufficient to qualify for SI, as all labels go beyond exclusions in their criteria.
> Most labels are being continuously updated, especially to better align them with the fast-moving legislative landscape in the EU. Ironically, alignment with EU rules is often in itself a source of divergence since SI is not interpreted uniformly in the different pieces of EU legislation. The EU Taxonomy, when finalized, could change this.

According to an analysis conducted by Novethic, a sustainable finance subsidiary of the Caisse des Dépôts Group,[2] almost 1,000 out of a total of nearly 60,000 European funds had been awarded one or more of nine dedicated sustainability labels representing more than EUR 300 billion in assets under management (AuM) as of March 31, 2020. Two labels were particularly popular at the time: the French SRI Label and the Belgian Towards Sustainability Label. Together, these accounted for nearly 600 labeled funds and well over EUR 250 billion in AuM. The number of funds awarded two or more labels was also increasing, pointing to the importance for national labels to conquer other local markets. "The arrival of the European Ecolabel and the entry into force of the SFDR in 2021 could be game-changing", the authors wrote in June 2020.

One year later, in June 2021, Novethic's market data showed that funds labeled with one of Europe's sustainable finance labels had reached the symbolic mark of EUR 1 trillion in AuM.[3] At the same time, Qontigo's sustainable investment team conducted its own independent deep dive, which focused specifically on the implications for equity product design of the specific thresholds for baseline exclusions and portfolio construction criteria that are embedded in major labels.

It is worth noting that a labeling approach to product design is currently an overwhelmingly European affair – indeed, such fully formed and widely used fund labels cannot yet be found beyond the European continent, although activity is intensifying (for further discussion of the international context, see Section 5.2).

Figure 1 presents the scope of the analysis performed. We reviewed the 12 most important labels guiding financial product design for SI. The classification work had two important dimensions.

First, we identified three major categories in terms of the labels' key focus: "Sustainability – broad" is used for labels focused on holistic sustainability criteria, "environment – broad" for those focused specifically on the environment, and "climate" for those narrowly focused on climate objectives.

Second, since the labels are not presented by their issuing agencies on a like-for-like basis or using common terminology, their analysis required the manual handling and interpretation of hundreds of pages of technical criteria, entailing a risk of omission. We have classified labels as belonging to one of three product design buckets:

> **Exclusions only:** For labels that only mandate exclusions
> **Minimum performance only:** For labels that do not specify mandatory exclusions but have criteria governing portfolios' minimum sustainability performance
> **Exclusions and minimum performance:** For labels combining both the approaches above. We found this is the most common approach.

[2] Novethic. Overview of European Sustainable Finance Labels 2020, 2020.

[3] Novethic. Market data – sustainable labels Europe at 30 June 2021, 2021.

Copyright ©2022 Qontigo GmbH.

Figure 1. Key characteristics of labels under review

Name	Region / country	Type	Key focus	Product design criteria
EU SFDR*	EU	Legislation	Sustainability – broad	Mixed**
EU Paris aligned Benchmark (PAB)***	EU	Legislation	Climate	Exclusions and minimum performance
EU Climate Transition Benchmark (CTB)	EU	Legislation	Climate	Exclusions and minimum performance
EU Ecolabel (under development, v. 4.0)	EU	Label	Environmental – broad	Exclusions and minimum performance
FNG-Label (FNG Siegel) for sustainable investment funds	Germany, Austria, Liechtenstein and Switzerland (private sector initiative)	Label	Sustainability – broad	Exclusions and minimum performance
Verbändekonzept** (German Association classification, under development)**	Germany (private sector initiative)	Other standard	Sustainability – broad	Exclusions and minimum performance
Ecolabel UZ 49	Austria (government initiative)	Label	Sustainability – broad	Exclusions and minimum performance
Towards Sustainability	Belgium (private sector initiative)	Label	Sustainability – broad	Exclusions and minimum performance
SRI Label	France (government initiative)	Label	Sustainability – broad	Minimum performance only
AMF Doctrine	France (government initiative)	Other standard	Sustainability – broad	Minimum performance only
Greenfin Label	France (government initiative)	Label	Environmental – broad	Exclusions and minimum performance
LuxFLAG ESG Label*****	Luxembourg (private sector initiative)	Label	Sustainability – broad	Exclusions and minimum performance
Nordic Swan Ecolabel	Denmark, Finland, Iceland, Norway and Sweden (government initiative)	Label	Sustainability – broad	Exclusions and minimum performance

* The EU's Regulation on sustainability-related disclosures in the financial services sector (also referred to as the Sustainable finance disclosure regulation, or SFDR) is now considered by the market participants to be a "de facto label" thanks to its Article 8 and Article 9 fund classifications. However, it is a disclosure regulation, and as such it is included in the table for reference only, but not factored into the deep dives later on.

** Although the SFDR is agnostic as to product design, its specifications for the promotion of environmental and/or social characteristics (Article 8) and the objective of sustainable investment (Article 9), plus the overarching need to ensure the good governance of constituents, can be seen as aligned with "Exclusions only" in the case of Article 8 and "Exclusions and Minimum Performance" in the case of Article 9.

*** The adoption of these benchmarks is voluntary, and labelling a portfolio as following either the EU CTB or EU PAB triggers disclosure obligations. The administrator must then report on the top constituents, methodology, inclusion and exclusion criteria, and type of data used to determine the decarbonization trajectory/formula for calculations used to determine if emissions meet the Paris Climate Agreement targets.

**** The "Typology for sustainable financial investments" (ESG Target Market, also known as the German target market concept) is an initiative of the German Banking Industry Committee (Deutsche Kreditwirtschaft, DK), the German Federal Association for Investment and Asset Management (Bundesverband Investment und Asset Management, BVI) and the German Derivatives Association (Deutscher Derivate Verband, DDV).

***** Other LuxFLAG labels exist for microfinance, climate and the environment, but these are outside the scope of this analysis.

Source: Qontigo.

Copyright ©2022 Qontigo GmbH.

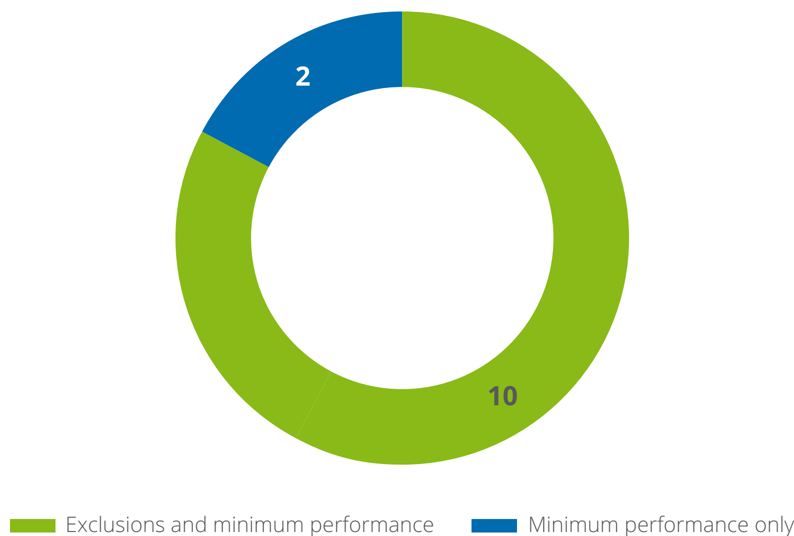
2.1. Divergence, alignment, divergence... alignment?

Rising demand for SI, in Europe as everywhere else, has led to divergent applications and accusations of "greenwashing," which can be defined as "an informal term used to refer to statements, including those made by sales personnel, that misrepresent the sustainability qualities of products, services, and practices. These claims can lead to an inaccurate assessment/perception of an entity's sustainability practices."[4] For example, a 2020 study by the 2 Degrees Investing Initiative found that, in a sample of 230 European "green-themed" funds making an environmental impact claim, up to 99% were guilty of misleading marketing.[5]

Such worries are partly behind the emergence of fund labels that aim to guarantee a certain normative quality of SI to end investors. However, the labels differ widely: A quick look at their names reveals the diversity in the approaches deployed (e.g., "SRI", "ESG", "Sustainability", "Green" and "Climate").

A summary of the prevalence of fund design criteria (which range from only mandating (different levels of) exclusions – through to specific criteria for portfolio construction) is shown in Figure 2. One thing is clear: although SI started with exclusion-only approaches, these are no longer enough for portfolios to qualify as sustainable, since all labels go beyond exclusions in their criteria.

Figure 2. Three buckets for labels: an exclusion-only approach is no longer enough



Source: Qontigo.

[4] Ecofact. Policy Outlook Briefing & Checklist. Greenwashing: What to consider from a regulatory point of view, 2021.

[5] 2 Degrees Investing Initiative. New report series and consumer-focused surveys show European retail clients are ready to invest sustainably, 2020.

Copyright ©2022 Qontigo GmbH.

Most labels are undergoing continuous updates and they are clearly being increasingly aligned with the rapidly evolving EU legislative baselines for sustainable investment, such as the SFDR, the EU Taxonomy and the MiFID II criteria. For example:

- The EU Ecolabel criteria will rely on the EU Taxonomy
- The Nordic Swan, Towards Sustainability (Belgium), the FNG Label (Germany, Austria, Liechtenstein and Switzerland), and LuxFLAG (Luxembourg) are evolving in line with the SFDR and the EU Taxonomy
- The Verbändekonzept (Germany) has been created to provide a common interpretation of the MiFID II definition of sustainability preferences
- The FNG Label (Germany, Austria, Liechtenstein and Switzerland) has also stated that it is aligned with other European initiatives such as the AMF Doctrine (France)
- The AMF is making amendments to the AMF Doctrine (France) to bring it more in line with the EU position.

Ironically, alignment with the EU rules is itself a source of divergence, since the interpretation of SI and investors' sustainability preferences is not uniform across EU legislation. This is partly due to the speed at which the rules were developed and implemented (see Figure 3 below):

- For example, the definition of “sustainable investment” under the SFDR is broader in scope than that used in the EU Taxonomy. The SFDR recognizes socially themed investments, whereas the Taxonomy does not yet have a social aspect to it. Even in the area of environmental sustainability, the SFDR's definition is less precise and therefore wider than the one given in the Taxonomy.
- At the same time, while the definition of sustainability preferences under MiFID II includes those given in both the Taxonomy and the SFDR, it also incorporates the idea of financial instruments that consider principal adverse impacts (PAIs) on sustainability factors without fully defining what this means in practice.
- Meanwhile, the product specifications for the EU's climate benchmarks – the CTB and the PAB – are not aligned with the definition of sustainable investment under the SFDR. As a result, they may be considered as either complying or not complying with the Article 8 and 9 product criteria, depending on the interpretation adopted.
- Last but not least, the Benchmark Regulation specifies ESG disclosure obligations (featuring specific reportable ESG indicators) for sustainability indices that are not aligned with the ESG data reporting criteria contained in the SFDR.

Copyright ©2022 Qontigo GmbH.

Figure 3. Misalignment in the interpretation of "sustainable investment" across EU legislative interventions

Overview	Definition of sustainable investment / investors' sustainability preferences
Legislation: Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR)	
The SFDR lays down harmonized rules on the **transparency** expected from financial market participants and financial advisers by **specifying the information they are required to communicate at the entity and product levels**. These include the integration of sustainability risks, the consideration of adverse sustainability impacts in their decision-making processes, and the provision of sustainability-related information for financial products. The SFDR was developed **because the lack of harmonized EU rules for sustainability-related disclosures** had led to inconsistent disclosures and confusion for end investors, who ulti-mately make investment decisions based on the information disclosed.	"An investment in an **economic activity that contributes to an environmental objective**, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an **economic activity that contributes to a social objective**, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments **do not significantly harm any of those objectives** and that the **investee companies follow good governance practices**, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance."
Legislation: Directive 2014/65/EU on markets in financial instruments (MiFID), plus delegated acts	
MiFID and the regulation associated with it (MiFIR) aim to provide an EU-wide framework for regulating transactions in financial instruments. The European Commission has amended the MiFID delegated acts so as to integrate sustainability risks and factors, and hence better align this directive with the goals of the European Commission's Action Plan on Financing Sustainable Growth (the "EU Action Plan"). Among other things, investment firms must identify the target market for each financial instrument, **consider the target market's sustainability preferences and identify groups of customers that are incompatible with the financial instrument because of their sustainability preferences**.	The amendment to Delegated Regulation (EU) 2017/565 incorporates a **definition of sustainability preferences (i.e., a client's choice as to whether and to what extent one or more of the following financial instruments shall be integrated into their investment)**: > A financial instrument for which the client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in the EU Taxonomy; > (...) Or in sustainable investments as defined in SFDR Article 2, point (17) (see the SFDR definition above); > Or a financial instrument that considers principal adverse impacts on sustainability factors.
Legislation: Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation)	
The Taxonomy creates a **unified classification system to define environmentally sustainable economic activities** related to the following: 1) climate change mitigation; 2) climate change adaptation; 3) the sustainable use and protection of water and marine resources; 4) the transition to a circular economy; 5) pollution prevention and control; and 6) the protection and restoration of biodiversity and ecosystems. A standardized taxonomy was proposed because EU member states **differed in their interpretation of what constitutes sustainable investment**. The Taxonomy is designed for use in disclosures as well as in standards, labels, sustainability benchmarks and other areas.	According to Article 3 of the Sustainability Taxonomy, an economic activity will be considered **environmentally sustainable if it**: **> Contributes substantially to one or more of the six environmental objectives;** **> Does not significantly harm any of these environmental objectives;** **> Is carried out in compliance with global norms; and** **> Complies with technical screening criteria (TSC) that have been established by the European Commission.** The degree to which an economic activity "sub-stantially contributes to" or "significantly harms" one of the above-mentioned environmental objectives is set out in Articles 10 to 15 of the Taxonomy Regulation.
Legislation: Directive (EU) 2016/97 on insurance distribution (IDD), plus delegated acts	
The IDD regulates the way **insurance products are designed and sold by** both insurance intermediaries and insurance providers. In April 2021, the European Commission adopted amendments that **integrate sustainability risks, factors and preferences into the product oversight and governance requirements** for insurance undertakings and insurance distributors, as well as into the rules on the conduct of business and investment advice for insurance-based investment products (IBIPs). For example, when identifying the target market, the product approval process must consider the product's sustainability factors (as defined in the SFDR).	Amendments to Commission Delegated Regulation (EU) 2017/2359 incorporate the SFDR's definition of "sustainability factors" and introduce a definition for "sustainability preferences", which are **aligned with the three-part definition under MiFID II**.

Source: Qontigo, based on Ecofact Policy Outlook.

Copyright ©2022 Qontigo GmbH.

This divergence is widely recognized as a challenge by market players, though it should be noted that there is potential for alignment over time. For example, when completed, the EU Taxonomy could foreseeably make all other product labels obsolete by providing the criteria for financial products to report alignment with the Taxonomy's sustainable activities across active and passive management strategies, including benchmark providers. With this transparency, end investors could then select those products that best fit their sustainable investment objectives and thresholds.

3. Analysis

> The labels' aims can be summarized as providing transparency and using capital to drive sustainability transition. While the first is inherent in the labeling process, effectiveness in achieving the second is less clear-cut, since the criteria are dominated by backward-looking considerations rather than forward-looking company metrics that can incentivize corporate transition.
> As regards exclusions, norms-based exclusions are now a must, and weapons and energy dominate product involvement screens. However, the thresholds applied differ vastly, ranging from a rigid 0% to more nuanced exclusions that progress over time. While there is merit in both approaches, the latter arguably does a better job of incentivizing company progress. The authors note that, while social and governance criteria are currently uncommon, they could soon grow in importance as well as the use of some highly progressive criteria, examples of which are given in the text.
> With respect to portfolio construction, the authors observe that ESG integration is necessary but not always seen as sufficient to classify as an SI strategy anymore, since it is considered a part of mainstream finance. Best-in-class is the most popular approach, and thematic and particularly impact approaches play a small but rapidly growing role. Engagement approaches are increasingly recognized as a powerful lever for any strategy that seeks to drive real-world impact.

Figure 4 presents a visual heat map of the analysis, showing the 12 labels examined on the spectrum of whether or not they have specific criteria for exclusions and portfolio construction. The nuances associated with the individual criteria are discussed in detail in the sections that follow the graphic.

Note that Appendix 6.2 provides detailed list of weblinks to the technical documents used for this analysis, alongside the date of the latest version reviewed, and an estimate of respective market uptake in terms of funds currently labelled.

Copyright ©2022 Qontigo GmbH.

Figure 4. Overview of the analysis

	Screen: norms-based	Screen: controversial weapons	Screen: conventional weapons	Screen: military equipment	Screen: tobacco	Screen: nuclear power	Screen: thermal coal	Screen: unconventional oil & gas	Screen: oil & gas	Screen: fossil fuel power	Screen: other	Portfolio construction: ESG integration	Portfolio construction: best-in-class	Portfolio construction: thematic	Portfolio construction: impact
EU PAB	Yes	Yes	NA	NA	NA	NA	Yes	NA	Yes	Yes	NA	NA	Yes	NA	NA
EU CTB	Yes	Yes	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	Yes	NA	NA
EU Ecolabel*	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	NA	NA	Yes	Yes
FNG-Label	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	NA	Yes	NA	NA	Yes	Yes	NA
Verbändekonzept*	Yes	Yes	NA	Yes	Yes	NA	Yes	NA	NA	NA	NA	Yes	Yes	NA	Yes
Ecolabel UZ 49	Yes	Yes	Yes	Yes	NA	Yes	Yes	Yes	Yes	Yes	Yes	NA	Yes	Yes	NA
Towards Sustainability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
SRI Label	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	Yes	NA	NA
AMF Doctrine	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	Yes	NA	NA
Greenfin Label	NA	Yes	NA	NA	NA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	NA	Yes	NA
LuxFLAG ESG Label	Yes	Yes	NA	NA	Yes	Yes	NA	NA	NA	NA	NA	Yes	Yes	Yes	Yes
Nordic Swan Ecolabel	Yes	Yes	Yes	NA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	NA	Yes	Yes	NA

* Labels under development

Source: Qontigo.

3.1. Objectives of the labels

While some of the labels analyzed for this paper have been created as part of larger country-level sustainability action plans and are managed by central governmental authorities, others are a direct result of private sector initiatives.

Two themes stand out from an analysis of the labels' stated objectives:
> Providing transparency in sustainable investment and
> Driving capital towards a sustainable economy

The objective of providing transparency is inherent in the labeling process, since all labels have well-defined requirements for regular disclosure of the criteria on whose basis they are awarded. It is also important to note with respect to transparency that most of the industry, as well as legislative effort is already concentrated around promoting greater transparency, with a good example being the introduction in November 2021 of the CFA Institute's Global ESG Disclosure Standards for Investment Products.[6]

[6] CFA Institute. Global ESG Disclosure Standards for Investment Products, 2021.

Copyright ©2022 Qontigo GmbH.

However, assessing the effectiveness of label designs with respect to driving capital towards a sustainable economy is less clear-cut. This is because most labels define the sustainability profiles of funds using the current (rather than the expected) sustainability performance of the underlying companies. This is based either on their existing practices or purely on the sector concerned. However, using capital allocation to drive sustainability transition should involve actively incentivizing companies to become eligible for an investment universe. There is therefore a significant danger that failure to regularly use forward-looking label design criteria – such as targets, business strategy, risk management practices and planned investments – could lead to the exclusion of companies that offer great potential to contribute to sustainability transition, while also severely restricting eligible universes.

A good example of a scheme with criteria that seek to drive change in the real economy is the EU Ecolabel (v. 4.0), even though this is currently still under development and is widely recognized as having the narrow focus on environmental sustainability. The EU Ecolabel is one of the actions of the 2018 EC Action Plan for Financing Sustainable Growth, whose main objectives include “reorienting capital flows towards sustainable investments to achieve sustainable and inclusive growth”.[7] To practically help achieve this objective, the EU Ecolabel goes beyond exclusionary and investment criteria (such as green revenue thresholds) to also set requirements relating to impact enhancement measures undertaken by investors including investor engagement with companies. The document lists possible interventions including investing in undersubscribed IPOs, actively investing in companies that seek to increase their green turnover, and bilateral or collective engagement of shareholders with the management of companies to shift their investment strategies.[8] A few other labels such as Belgium’s Towards Sustainability Label, France’s SRI Label and LuxFLAG have defined engagement-related criteria as well (see also Section 3.3.4).

3.2. Exclusionary criteria

The UN-supported Principles for Responsible Investment (PRI) define screening as the practice of using a “set of filters to determine which companies, sectors or activities are eligible or ineligible to be included in a portfolio based on an investor’s preferences, values and ethics”.[9] Approaches include, for example:

> **Negative screening**: Excluding certain sectors, companies, or projects for poor ESG performance relative to industry peers, or based on specific ESG criteria, e.g., avoiding particular products/services or business practices
> **Norms-based screening**: Screening investments against minimum standards of business practice based on international norms. Useful frameworks include UN treaties, Security Council sanctions, the UN Global Compact, the Universal Declaration of Human Rights and the OECD Guidelines for Multinational Enterprises.

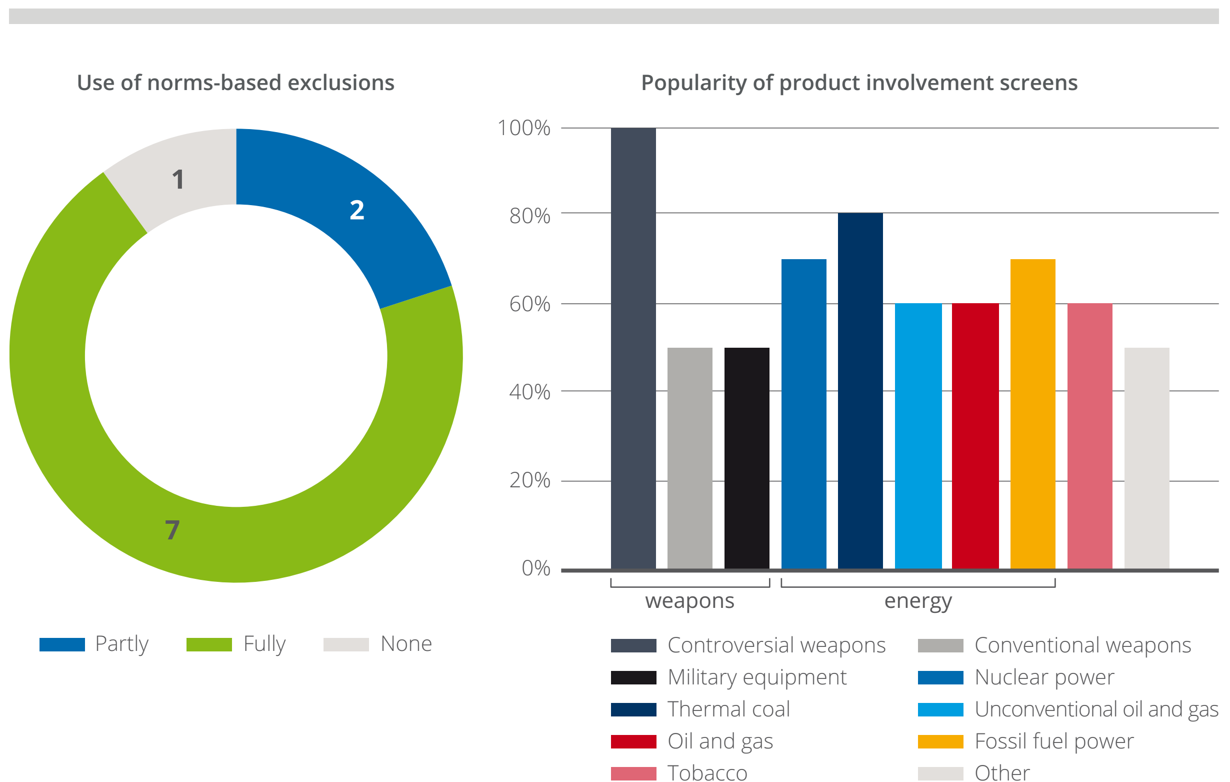
A detailed look under the labels’ hoods on a like-for-like basis reveals important nuances in the approaches that currently exist. We find that screening based on controversial weapons and norms such as the United Nations Global Compact Principles (UN GCP) has become the baseline for most of the labels analyzed.

[7] See page 2 of the EU Ecolabel document hyperlinked in Appendix 6.2.
[8] See Table 1 on page 104 of the EU Ecolabel document hyperlinked in Appendix 6.2.
[9] PRI. An introduction to responsible investment: listed equity, 2019.

Copyright ©2022 Qontigo GmbH.

Most labels also have exclusions related to fossil fuels including thermal coal as well as conventional and unconventional oil and gas, although there is considerable divergence in terms of revenue thresholds. The latter range from 5% to higher percentages, which are allowed where companies also have publicly announced transition plans. The details are described in the following sections. Other themes for exclusion that were identified include nuclear power, tobacco and in some isolated cases more niche criteria such as land-use practices. Overall, it can be said that norms-based exclusions are a must, and that weapons and energy dominate product involvement screens (see Figure 5).

Figure 5. Norms-based exclusions are a must, and weapons and energy dominate product involvement screens, but exclusion-only approaches as a whole are outdated



Source: Qontigo.

3.2.1. Deep dive on fossil fuel-related exclusions

Exclusions related to fossil fuel production, distribution and power generation range from absolute values based on current metrics, to ambitious over time thresholds:

> On the one hand, the Austrian Ecolabel UZ 49, the draft EU Ecolabel, the Nordic Swan, the FNG Label and Greenfin all set a fixed 5% threshold for most fossil fuels.

> On the other hand, Belgium's Beyond Sustainability Label sets more nuanced over time exclusions.[10] As an example, companies directly involved in the conventional oil and gas sector are excluded if they don't have a governance strategy to reduce the adverse impact of their activities and to increase their

[10] See page 26 of the Towards Sustainability document hyperlinked in Appendix 6.2.

Copyright ©2022 Qontigo GmbH.

contributing activities, and if they also do not meet at least one of the following criteria:
- Have a science-based target (as defined by the Science-Based Targets Initiative, or SBTi) that is well below 2°C OR 1.5°C OR have an SBTi "Business Ambition for 1.5°C" commitment
- Derive less than 5% of their revenues from oil- and gas-related activities
- Have less than 15% of their capital expenditure (CapEx) dedicated to oil and gas-related activities and not with the objective of increasing revenue
- Have more than 15% of their CapEx is dedicated to contributing activities

> Another comprehensive example comes from the draft EU Ecolabel (v. 4.0) criteria for energy sector companies, including both fossil fuel production and power generation.[11] These are excluded unless:
  - The company's revenue from these excluded activities is below 30%, and
  - The company has published a strategic plan to reduce its GHG emissions to a level that is aligned with the 1.5°C Paris Agreement and to achieve net zero carbon emissions by 2050. The plan shall include the phase-out, closure or fuel-switching of the excluded activities on a ten-year time frame. If the plan includes fuel-switching to biomass, the biomass activity shall be EU Taxonomy-aligned, and
  - The company has dedicated zero CapEx to the expansion of activities (…) and zero operational expenditure (OpEx) to maintenance costs that increase either the lifetime or the value of the assets used in excluded activities during the last financial year, and
  - The company's greenhouse gas (GHG) emissions (at a minimum its Scope 1 emissions) are decreasing annually by at least 7%.

> In addition, the draft EU Ecolabel includes provisions covering the fossil fuel value chain.[12] For example, companies involved in the production, distribution and sale of vehicles with engine technology based on the combustion of fossil fuels are excluded, unless:
  - The company's revenue from these excluded activities is below 30%, and
  - The company has published a strategic plan that aims at phasing out the production of new passenger cars and light commercial vehicles with engine technology based on fossil fuel combustion by 2030, and
  - The company has dedicated zero CapEx to the expansion of activities above.

While there is merit in both approaches, it could be argued that the "over time" approach allows investors to accompany companies on, and incentivize them to perform, their transition, instead of excluding them outright due to their historical performance. It is also in line with best-practice guidance on fossil fuel exclusion. Examples of such best practice include:

> Urgewald's well-known and publicly available Coal Exit List,[13] which sets out forward-looking exclusion criteria across the coal value chain. These go beyond simple revenue thresholds to include companies expanding thermal coal mines, power plants and infrastructure projects.

> Going beyond coal, French think tank Reclaim Finance[14] calls for the exclusion of oil and gas companies that, among other criteria, are not planning a rapid reduction to zero of all capital expenditures on oil and gas production and transportation projects, and for increased investment in non-GHG-emitting technologies.

---

[11] See page 71 of the EU Ecolabel document hyperlinked in Appendix 6.2.

[12] See page 73 of the EU Ecolabel document hyperlinked in Appendix 6.2.

[13] Urgewald, 2021. Global Coal Exit List (GCEL), 2021. Notably, as of November 2020, institutions with over USD 16 tn AuM were already using one or more of the three GCEL criteria to screen coal companies out of their portfolios.

[14] Reclaim Finance. Our demands, 2021.

Copyright ©2022 Qontigo GmbH.

What is visibly absent, however, is a direct requirement in the labels' fossil fuel/climate-related exclusion criteria that investee entities must report in accordance with the Taskforce on Climate-related Financial Disclosure (TCFD). While TCFD is a voluntary framework, it is gaining prominence in climate-related financial regulation in numerous jurisdictions across the world. In June 2021, the G7 endorsed mandating TCFD-aligned disclosure by banks and corporations.[15] The TCFD's 2021 Status Report showed that 12 governments and dozens of central banks (including the 19 central banks in the Eurosystem[16]), supervisors and regulators have formally expressed support for the TCFD recommendations, and that more than 2,600 organizations have now endorsed them – an increase of over 70% since 2020.[17] Over time, the TCFD is expected to gain global recognition as an important signal for companies' climate preparedness.

3.2.2. Other key observations

Aside from the wide divergence in thresholds, the authors identified the following other key characteristics for labels' exclusion criteria, among others:

> **Few values-based criteria**
Criteria tend to focus on aspects related to sustainable transition, with few values-based binding criteria, such as alcohol or gambling exclusions, being applied. One exception is the Austrian Ecolabel UZ 49, which mandates specific exclusions for the "growing and marketing of genetically modified organisms and products, gene therapy in germ line cells, cloning techniques with humans and embryo research in humans".[18]

> **Social and governance criteria still uncommon, but likely to become more important**
While environmental criteria are common, specific social or governance-related baseline thresholds are less common, with the exception of tobacco and weaponry. However, this is likely to change. The "S" in ESG has become more widely appreciated following the COVID-19 pandemic, while the criteria introduced by the SFDR mean that "good governance" characteristics at investee companies will play a growing role going forward. The Belgian Beyond Sustainability Label already sets out explicit governance exclusion criteria.[19] Companies must "have a strategy to reduce the adverse impact of their activities and to increase their contributing activities, if applicable" if they are not to be excluded. In addition, the SFDR indirectly introduces an expectation that any sustainability product should ensure that its underlying constituents demonstrate "good governance", something that may represent a step change in SI product design.

> **The existence of some highly progressive criteria could pave the way for the future**
Some criteria are highly progressive and, while they may be difficult to enforce with the data that is currently available, they are paving the way to enhanced baseline performance expectations overall. For example, version 4.0 of the draft EU Ecolabel excludes "the production, distribution and use of agricultural products and livestock on land obtained as a result of conversion, fragmentation or unsustainable intensification of high-nature-value land, wetlands, peatland, forests, or other areas of high-biodiversity value or high-carbon stock in or after 2008".[20] Where a label's objectives include driving change in the real economy, exclusion-based market signaling necessarily has to include specific value chain practices, as opposed to creating blanket sector-level exclusion lists.

---

[15] Reuters. G7 backs making climate risk disclosure mandatory, 2021.

[16] ECB. Eurosystem agrees on common stance for climate change-related sustainable investments in non-monetary policy portfolios, 2021.

[17] TCFD. Status Report, 2021.

[18] See page 11 of the UZ 49 document hyperlinked in Appendix 6.2.

[19] See page 20 of the Towards Sustainability document hyperlinked in Appendix 6.2.

[20] See page 70 of the EU Ecolabel document hyperlinked in Appendix 6.2.

Copyright ©2022 Qontigo GmbH.

In addition, and while not yet the norm, over time criteria (as opposed to static, absolute thresholds) are becoming more and more common and could well become the norm, in line with the need for sustainable transition discussed in previous sections. Currently 4 out of 9 labels stipulating minimum performance levels refer to evolving over time thresholds. They include the EU PAB and CTB labels, which mandate "at least 7% self-decarbonization of the benchmark on average per annum: in line with or beyond the decarbonization trajectory from the IPCC's 1.5°C scenario (with no or limited overshoot)".[21]

Meanwhile, the Belgian Towards Sustainability Label allows for a specific "phase-out margin" that states: "Some companies are currently not yet aligned with the business criteria (...) but are nevertheless within the best of their peer group in transitioning their business model. A sustainable financial product can finance these companies selectively and to a limited extent. However: The total portfolio exposure to non-compliant companies (only concerning eligible activities) is < 5%. This margin will decrease by 1 percentage point per year as of 1/1/2023. Additionally, companies in this margin shall be subject to a best-in-class selection that selects from the 25% highest ESG-rated companies (leaders), with special attention to sustainable energy transition. Companies in this margin shall still meet the governance criteria".[22]

3.3. Portfolio construction

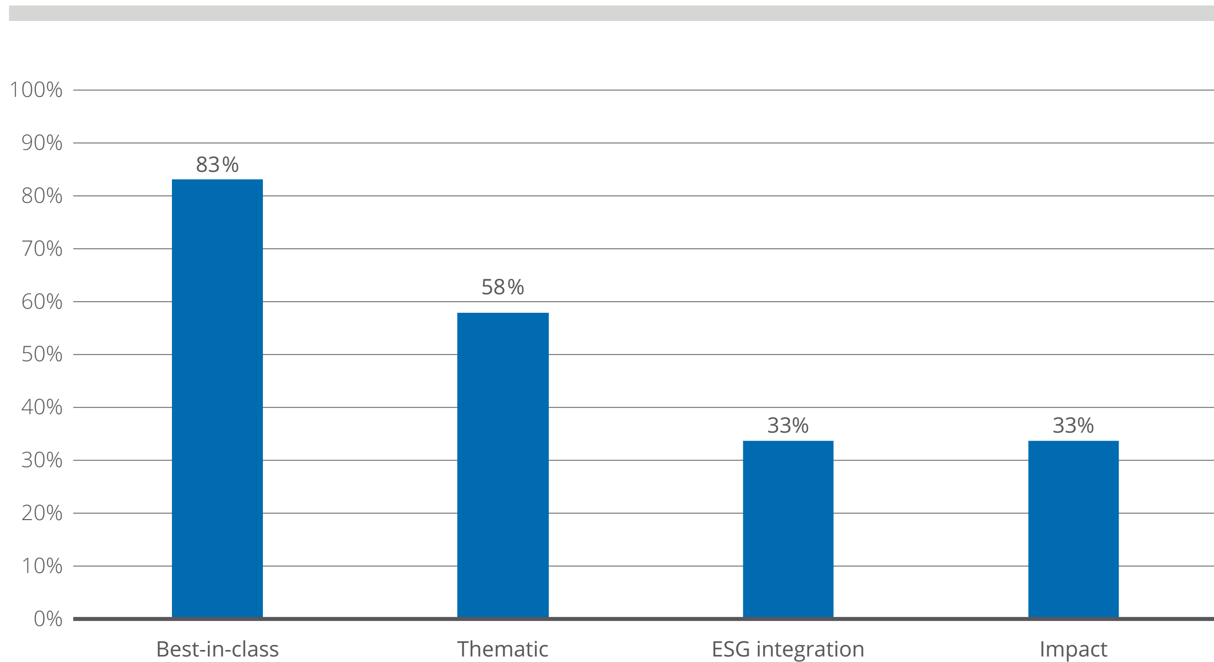
As highlighted in Figure 2, all labels reviewed go beyond exclusions to include minimum performance specifications in their mandatory or recommended criteria. A few explicitly state that the application of an exclusions-only approach is not enough and that this needs to be combined with e.g., a best-in-class or thematic approach. Our analysis identified four portfolio construction/minimum performance criteria and their PRI definitions: [23]

> **ESG integration**: Explicitly and systematically including ESG issues in investment analysis and decisions, so as to better manage risks and improve returns
> **Best-in-class**: Defined by the PRI as positive screening, this involves "investing in sectors, companies or projects selected for positive ESG performance relative to industry peers"
> **Thematic**: Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. This includes impact investing
> **Impact**: Impact investing is a subset of thematic investing that aims to ensure that investments lead to an additional impact – meaning that a social or environmental outcome would not have been achieved without that particular investment. It also requires adequate measuring and monitoring of the investment's impact on environmental or social outcomes.

[21] See page 7 of the PAB/CTB document hyperlinked in Appendix 6.2.
[22] See page 21 of the Towards Sustainability document hyperlinked in Appendix 6.2.
[23] PRI. An introduction to responsible investment: listed equity, 2019.

Copyright ©2022 Qontigo GmbH.

Figure 6. Prevalence of different criteria for portfolio construction across labels



Source: Qontigo.

Furthermore, 6 out of the 12 labels specifically specify that the use of derivatives should be focused on risk hedging and exposure use cases in the context of efficient portfolio management, while Belgium's Towards Sustainability explicitly forbids speculative activities such as those involving agricultural commodities. Complete transparency on the types of derivatives used is also required; for example, the FNG label expects explanations of the volume, level of exposure and frequency of use of derivatives, such that if a fund was using swaps on interest rates, it would need to then report that "The fund management uses swaps on interest rates to mitigate interest rate fluctuations."[24]

Going further with the examples, the EU Ecolabel states that short selling is not allowed, while the Towards Sustainability label is of the position that all portfolio management techniques are allowed if they are not contrary to the ESG objectives of the product, they do not benefit unsustainable issuers, and the decision to go short is also driven by ESG considerations and not solely with the aim to generate additional performance. Meanwhile, France's Greenfin and Towards Sustainability labels state that, if derivatives are used as a source of return, the underlying security/index must also be compliant, and that ESG due diligence must be conducted on the counterparty.

As regards cryptocurrencies, Belgium's Towards Sustainability Label explicitly states that "crypto currencies (or assets) are not allowed unless within a recognized regulatory framework. Also, given the huge energy use of Proof of Work mining (e.g., Bitcoin, Ethereum), this is considered incompatible with a sustainable product."[25]

[24] See page 21 of the FNG Label document hyperlinked in Appendix 6.2.
[25] See page 32 of the Towards Sustainability document hyperlinked in Appendix 6.2.

Copyright ©2022 Qontigo GmbH.

3.3.1. ESG integration

To give a couple of examples, the Belgian Towards Sustainability Label explicitly mandates ESG integration as a core strategy that needs to be applied, defining it as follows: "The manager shall have formal and credible policies and procedures in place to assess a) the likely impacts of sustainability risks on the return of the product, b) the risk of principal adverse impacts on sustainability factors (E+S+G) of each investment."[26] It also states that "A controversy screening (e.g., based on UN Global Compact violations) is not considered sufficient as ESG integration."

The French Greenfin Label states that "The funds applying for the label must ensure active monitoring of environmental (E), social (S) and governance (G) controversies and demonstrate their impact on the construction and life of the portfolio. They describe their process for monitoring and managing ESG controversies, and the corresponding resources mobilized."[27]

However, what is crucial to note is that, while ESG integration was considered a best practice SI strategy[28] not so long ago, the introduction of the SFDR on March 10, 2021, has led to it becoming a regulatory baseline for all investment products, whether these promote sustainability or not. Article 6 of SFDR requires financial market participants and financial advisers to include descriptions of the following in their disclosures:

> The manner in which sustainability risks are integrated into their investment decisions and/or their investment or insurance advice. Where they deem sustainability risks not to be relevant, they must provide a clear and concise explanation of the reasons why;
> The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products.

It makes sense for ESG integration to increasingly be a baseline instead of an SI strategy, since looking at financially material information, including on sustainability issues, should be seen as part of main-stream finance.

3.3.2. Best-in-class

Best-in-class criteria are the most popular category among the labels. A representative example is offered by Belgium's Towards Sustainability Label, which states that:[29]

"A best-in-class or best-in-universe strategy shall select from the 'ESG negatively screened universe' ('investable universe' after mandatory exclusions and normative screening), only the issuers with the highest ESG ratings, evaluated per industry/sector/region (best-in-class) or evaluated on the level of the universe as a whole (best-in-universe).

> The ESG ratings can be based on a quantitative or qualitative ESG rating scale.
> The issuers selection threshold can be relative (top percentile) or absolute (minimum rating).
> The manager shall disclose the calculated average selectivity (in % of issuers in/excluded) of the best-in-class/universe selection strategy.
> The manager shall describe the source of the ESG ratings, the ESG rating scale, the selection threshold and methodology used."

[26] See page 6 of the Towards Sustainability document hyperlinked in Appendix 6.2

[27] See the Greenfin Label webpage hyperlinked in Appendix 6.2.

[28] CFA Institute and PRI. Guidance and case studies for ESG integration, 2018.

[29] See page 8 of the Towards Sustainability document hyperlinked in Appendix 6.2.

Copyright ©2022 Qontigo GmbH.

Similarly, the FNG Label states that "The investment manager is looking for a high ESG portfolio quality by including only issuers with the highest ESG rating in the candidate's eligible investment universe and by discarding titles with low ESG ratings out of the initial investment universe. The higher the selectivity grade among comparable investment universes and asset classes, the better the fund will be evaluated."[30]

The French AMF Doctrine and SRI Label, which do not have exclusion thresholds but merely mandate minimum performance, state that ESG criteria must be accounted for in a "significant" manner in product design. This must result in the product sustainability score being higher than that of the investable universe after elimination of at least 20% of the values with the worst score.[31]

One obvious word of caution here is that the language used above in relation to "ESG ratings" could be seen to encourage their blanket use in fund design, while in reality the market is increasingly conscious of their shortfalls. While a deep dive on the data topic is outside the scope of this paper, the 2020 academic paper entitled "Aggregate Confusion: The Divergence of ESG Ratings" provides a comprehensive analysis of the sources of divergence between the different aggregate approaches to ESG measurement available on the market today in terms of their scope, measurement and weighting.[32]

As specifically regards climate, the EU's PABs and CTBs can also be seen as having a best-in-class approach. For example, the PABs mandate a "50% minimum Scope 1+2(+3) carbon intensity reduction compared to investable universe AND a 7% year-on year decarbonization rate AND a minimum exposure to sectors highly exposed to climate change issues is at least equal to equity market benchmark value".[33]

3.3.3. Thematic and impact

Regarding thematic criteria, 7 out of the 12 labels analyzed include thematic investment as a recommended or mandatory criteria. The draft EU Ecolabel mandates "investment in environmentally sustainable economic activities" and stipulates that "the definition proposed for 'environmentally sustainable activities' refers to the EU Taxonomy. In this sense, 'green' will mean economic activities that qualify as 'environmentally sustainable' under the EU Taxonomy."[34]

Meanwhile, the Belgian Towards Sustainability Label states that "A sustainability themed investing strategy shall select investments using one or more well-defined themes based on relevant frameworks (…) to measure contribution to sustainability factors (EU Taxonomy, SDGs, EU Green Bond Standard, ICMA Social Bond Principles, etc.). Additionally, it shall comply with at least one of the following:

> At least 70% of the assets in the portfolio (measured by company or by AuM) are related to the theme(s). An investee company is considered related to a theme if at least 50% of its revenue is related to the theme.
> At least 50% of the total portfolio (by AuM) is invested in economic activities contributing to the theme
> The product uses a best-in-universe strategy (…) selecting the top 25% highest rated issuers ('leaders') based on an ESG rating appropriate to the theme
> The product classifies as an SFDR art. 9 product and has sustainability themed investing as a strategy.

[30] See page 19 of the FNG Label document hyperlinked in Appendix 6.2.

[31] See for explanation in English e.g. AMF. Sustainable finance and collective investment management: the AMF publishes an update of its investor information policy, 2020.

[32] Berg, Kölbel and Rigobon. Aggregate Confusion: The Divergence of ESG Ratings, 2020.

[33] See page 7 of the PAB/CTB document hyperlinked in Appendix 6.2.

[34] See page 17 of the EU Ecolabel document hyperlinked in Appendix 6.2.

Copyright ©2022 Qontigo GmbH.

If the product has the EU Ecolabel then the requirements for a sustainability themed investing strategy are considered fulfilled."[35]

An example of a label that explicitly accounts for impact investment is the Belgian Towards Sustainability Label, which defines impact as a subset of thematic with stricter minimum thresholds (see above). In addition, the EU Ecolabel draft criteria now state that "The reporting on measures taken to enhance investor impact is intended to encourage fund and asset managers to identify and actively manage opportunities to enhance the investor impact of the service they provide to retail investors. It requires fund managers to report on which mechanisms for enhancing investor impact they have addressed as a result of investment decisions, as well as identification of which of the measures they are taking to actively manage their investor impact."[36]

As the SI market matures – a process that includes the evolution of regulations, client demand and an ever-higher best practice bar – investors are looking beyond risk and opportunity to focus on the real-world outcomes of their investments. We therefore expect that thematic and impact investment, along with engagement, will be the next frontier of sustainable investment and that these approaches will grow rapidly from a low base. This is illustrated in detail in Qontigo's and Clarity AI's recent report entitled "On the Way to Impact Investment: Mind the Gap between Theory and Practice".[37]

3.3.4. Engagement

A total of 7 out of 12 labels specify that engagement is either a mandatory or a desirable criterion, a recognition of its central role in SI.

The draft EU Ecolabel criteria stipulates that "The engagement criterion aims to make use of mechanisms through which investors can seek reforms that improve the quality of company activities and/or grow shareholder value. The establishment of a clear engagement policy which seeks to further the environmental objectives of the EU Taxonomy is established as the starting point. The strategy then provides the context for requiring more effective and focused use of voting rights as well as bilateral or collective shareholder dialogue with companies to request or campaign for changes in how they are managed and investment strategies."[38]

The Belgian Towards Sustainability Label states that engagement with the fossil fuel sector is mandatory, while in the case of other impactful sectors it is desirable: "The manager shall put in place an appropriate corporate engagement or shareholder action process regarding the fossil fuel sector. Corporate engagement or shareholder action is encouraged for other sectors with elevated risks for principal adverse impacts."[39] Further guidance is given on what an engagement approach must entail, while at the same time it is made clear that engagement alone does not count towards the minimal number of sustainability strategies that must be implemented for the label to be obtained.

---

[35] See page 9 of the Towards Sustainability document hyperlinked in Appendix 6.2.

[36] See page 18 of the EU Ecolabel document hyperlinked in Appendix 6.2.

[37] Qontigo and Clarity AI. On the Way to Impact Investment: Mind the Gap between Theory and Practice, 2021.

[38] See page 18 of the EU Ecolabel document hyperlinked in Appendix 6.2.

[39] See page 4 of the Towards Sustainability document hyperlinked in Appendix 6.2.

Copyright ©2022 Qontigo GmbH.

The French SRI Label states that “The voting policy must have been formalised by the asset management company and published on the asset management company's website. To this end, the fund provides the latest internal control report produced by the head of compliance and internal control on the implementation of the voting policy.”[40] Additional criteria relating to the relevant practices and reporting are also specified.

Engagement criteria should indeed be a prominent feature in any fund label that aims to contribute to sustainable transition. Active engagement is arguably the most powerful impact lever available to public market investors,[41] and we expect that its already paramount importance will only grow over time in both active and passive management. Global growth in the popularity of indexing approaches has sparked concerns and questions amongst investors over the possibility and effectiveness of passive engagement. However, it is all the more important for passive investors to engage with companies through dialogue and voting, as their discretionary powers in terms of selling individual stocks are limited. Examples of passive products with an active engagement overlay include Amundi’s Ambition Climat funds and Willis Towers Watson’s UCITS fund tracking the STOXX Climate Transition Indices.[42]

[40] See page 13 of the SRI Label document hyperlinked in Appendix 6.2.

[41] See e.g., Heeb and Kölbel. The Investor’s Guide to Impact, 2020, based on Kölbel, J., Heeb, F., Paetzold, F., Busch, T. “Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact,” Organization & Environment (2020), and PRI. An introduction to responsible investment: stewardship, 2020.

[42] See Amundi. Lancement du Fonds Objectif Climat Actions, 2020, and IPE. WTW, Qontigo launch ‘bottom-up’ climate transition risk indices, 2021.

Copyright ©2022 Qontigo GmbH.

4. Implications for investors: “the impossible product”

> This short but important section illustrates the challenges for those looking to design equity- related products that align with all criteria reviewed for this paper.

Figure 7 illustrates the huge divergence between the current thresholds for the different labels, by identifying the highest common denominator for each criterion. If designed to align with all major European labels, the thresholds a product would need to meet are unrealistically high and practically impossible. This implies a one-size-fits-none situation and a common EU market by name only when it comes to SI.

Figure 7. “The impossible product” based purely on common exclusions – one-size-fits-none

Exclusion type	“Highest common denominator” criteria
Norms-based exclusions	
United Nations Global Compact Principles (UN GCP) and related conventions	Violation of/controversies associated with all United Nations Global Compact Principles (UN GCP) and related conventions.
Product involvement exclusions	
Controversial weapons	0% revenue threshold from production or distribution
Conventional weapons (including civilian weapons and small arms)	0% revenue threshold from production or distribution
Military equipment	5% revenue threshold from production or distribution
Tobacco	0% revenue threshold from production, 5% threshold revenue from distribution
Nuclear power	5% revenue threshold from uranium production and power generation
Thermal coal	5% revenue threshold from production or distribution
Unconventional oil and gas	5% revenue threshold from production or distribution
Oil and gas	5% revenue threshold from production or distribution
Fossil fuel power	5% revenue threshold from fossil fuel power generation
Any additional exclusions	
Agriculture and forestry	Based on licensing, due diligence, and land acquisition and management practices
Waste management	Based on waste segregation practices
Chemicals and mixtures of chemicals, asbestos and asbestos-based products	Based on production, trade, distribution and use of chemicals and mixtures of chemicals that are hazardous, deplete the ozone layer or have global warming potential; as well as the mining, processing, production, trade and use of asbestos and asbestos-based products.
Passenger vehicles/light commercial vehicles production	Based on fossil fuel-based engine technology
Other miscellaneous exclusions	Based on the cultivation and marketing of genetically modified organisms and products, gene therapy in germ line cells, human cloning techniques and embryo research in humans.

Source: Qontigo.

Copyright ©2022 Qontigo GmbH.

5. The road ahead

> There are advantages and disadvantages to harmonizing the fragmented labels landscape outlined in this analysis. On the one hand, failure to establish basic common ground could result in both increased costs for fund issuers as they navigate increasingly fragmented markets and failure to channel supposedly "labeled" capital towards sustainability transition. On the other hand, existing EU legislative efforts could provide such common ground indirectly over time while leaving issuers design flexibility for innovation.
> While labeling is currently an overwhelmingly European affair, disclosure, fund naming rules and labeling schemes are rapidly emerging both within Europe and in other markets.
> The paper concludes with a reminder that those looking to future-proof their investments by trying to adhere to the highest standards should focus on ones that are not only science-based but also feature elements incentivizing the real economy towards sustainable transition.

5.1. The advantages and disadvantages of harmonization

As illustrated by the "impossible product" example in Figure 7, there is very little common ground between labels as to what constitutes a sustainable investment product. Moreover, EU regulation will likely not be the panacea that many expect it to be in terms of setting baseline expectations, but only a starting point. For example, funds disclosing information in accordance with Article 8 and 9 of the SFDR need to show that they have considered "good governance in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance".[43] However, the Regulating Technical Standards (RTSs) do not specify indicators or thresholds for any of these governance areas. Equally, as discussed in earlier sections, SI definitions and measures are currently misaligned across the SFDR, the Taxonomy Regulation, the BMR, and MiFID (see Section 2.1 and Figure 3 for a detailed discussion of this divergence).

What is more, plenty of organizations and initiatives (both voluntary and regulatory) are all too focused on advocating for systematic product transparency (the CFA Institute included[44]). While transparency is a definite must, the market has now moved on to setting baseline performance criteria thresholds for products that are labeled as "sustainable". The industry is evolving fast, with new standards being developed and existing criteria updated rapidly. These thresholds are multiplying, are not aligned across markets, and – what is worse – are often not aligned with what key stakeholders can reasonably expect from sustainable investment products in today's day and age.

Consequently, it can be argued that failure to establish basic common ground would result in major drawbacks for both investors and the SI agenda at large, including:

> **A slow-down of the mainstreaming of SI**
As suggested in a previous version of Belgium's Towards Sustainability Label, "It is evident that to have any meaningful impact on the transition towards a sustainable economy and society, the integration of sustainability considerations should also go beyond this niche and into mainstream financial products and services."[45] In essence, aligning with labels needs to be cost-effective for investors if it is to achieve the necessary momentum for creating change in the real economy. However, given the lack of harmonization, investors looking to align their products with specific labels are not easily able to replicate them

[43] See Regulation 2019/2088 on sustainability-related disclosures in the financial services sector, 2019.
[44] CFA Institute. Global ESG Disclosure Standards for Investment Products, 2021.
[45] Febelfin. A quality standard for sustainable and socially responsible financial products, 2019.

Copyright ©2022 Qontigo GmbH.

across borders or to achieve scalability in other jurisdictions. This is also because most labels require that the financial product is registered for marketing or distribution within the labeling authority's territory. This significantly affects the affordability of the process, and further obscures visibility and transparency as to product methodologies.

> **Misallocation of SI funds**
Significant net new inflows may continue to be channeled towards investments that do not meaningfully contribute towards common and urgent goals such as achieving the Sustainable Development Goals (SDGs) by 2030 and reaching net zero emissions by 2050.

> **Potential greenwashing opportunity**
Given the lack of assurance and verification standards, divergent and confusing labeling criteria will only deepen the issue of greenwashing. Instead, the focus should arguably be on developing independent institutional frameworks that can work to assure and verify the data reported by various investors under these labels. This is also necessary to achieve scalability, since the cost burdens associated with auditing and verifying data for portfolio companies can be quite significant for investors.

One plausible way in which such harmonization might work, and one that is grounded in existing developments, is for all labels to eventually become aligned with the EU Taxonomy's classification of environmentally and socially sustainable activities by disclosing their percentage of financed activities in a transparent and systematic way. This would make fund standards obsolete and enable end investors to ultimately determine what their preference is.

It is important to recognize both sides of the argument if the objective of this paper is to be met. Further harmonization will typically require legislation. Since the PABs and CTBs are voluntary and the BMR merely requires ESG disclosures, such legislation would likely take the shape of a prescriptive ESG benchmark, something that is already high on the regulatory agenda.[46]

Specifically, in 2019, highly divergent levels of ambition and fragmentation regarding different ESG benchmarks led to new EU legislation. This introduced two new climate benchmark labels: the EU Climate Transition Benchmarks (CTBs) and the EU Paris-aligned Benchmarks (PABs), plus general sustainability-related disclosures for benchmarks. However, the Benchmark Regulation also requires the Commission to assess the possibility of creating an EU ESG benchmark, considering the evolving nature of sustainability indicators and the methods used to measure them. The Commission's assessment will be supported by a study (to be completed in 2022) of existing ESG-related benchmarks, best practices and shortcomings, plus minimum standards for an EU ESG benchmark. The initiative was also included in the Commission's sustainable finance strategy, which was updated in 2021. This suggests that legislation on an EU ESG benchmark could be introduced in 2023. At that moment, the minimum standards contained in the CTB and PAB labels would also be reviewed to ensure they are aligned with the Taxonomy Regulation (TR).

Given the existing misalignment between the EU's various legislative initiatives, adding more labels and standards in this space could however be counterproductive. More specifically, an EU ESG benchmark should arguably not introduce a new set of definitions or criteria that are confined to the BMR and hence incompatible with other sustainability-related regulations such as the SFDR, the TR and the MiFID II sustainability preferences.

In addition, given that there is no one size fits all when it comes to SI, such an ESG standard could leave little freedom with respect to methodology and innovation.

[46] Responsible Investor. EU tenders for study on ESG benchmark label, 2021.

Copyright ©2022 Qontigo GmbH.

5.2. A look beyond the EU

While the EU is often credited as being the global leader in sustainable finance, rules relating to the disclosure and naming of ESG-linked funds are emerging in other markets as well.

In the UK, a government SI roadmap was published in October 2021, representing the Government's strategy for delivering on what it views as the first of three steps towards greening the financial system: informing investors and consumers.[47] The Roadmap provides more detail on the UK's Sustainability Disclosure Requirements (SDRs) and Green Taxonomy, with many of the initiatives referred to in the first document mirroring both existing legislation in the EU and upcoming plans. In the context of the SDRs, the Financial Conduct Authority (FCA) is working closely with HM Treasury to develop a sustainable investment labeling regime. This will cover the full range of investment products, classifying them objectively against specified sustainability criteria and considering not only products' objectives, policies and strategies but also how investments are allocated.

Over in Hong Kong, the regulator – the Securities and Futures Commission – issued a circular in June 2021 that also set out requirements for enhanced disclosure by ESG funds.[48]

Meanwhile, in the United States the US Securities and Exchange Commission (SEC) requested public comments in 2020 on whether the Names Rule set out in the Investment Company Act of 1940, which prevents the use of misleading product names by investors and fund managers, should be expanded to include rules governing the usage of terms such as "ESG" (environmental, social, governance), "clean", "environmental", "impact", "responsible", "social", and "sustainable". After issuing a risk alert on the use of the term "ESG" in April 2021,[49] the SEC heightened its scrutiny of ESG-labeled funds even more following greenwashing controversies in the market.[50] This topic is predicted to be on the SEC's Spring 2022 agenda.[51]

Financial authorities across different markets are increasingly collaborating on a variety of sustainable finance-related initiatives – be it through dialogue with the IFRS and IOSCO, transatlantic partnerships,[52] or global alliances such as the Network for Greening the Financial System. While ESG rules will vary across different jurisdictions due to differences in market structures and features, it is important that markets continue to align on disclosure, naming standards and minimum benchmark requirements to avoid further market fragmentation and loss of scale.

5.3. Achieving the objective of sustainable transition

As has been highlighted, the overarching objective for most of the labels analyzed in this paper is to drive capital towards a more sustainable economy.

Achieving a low-carbon, sustainable economy ultimately depends on companies changing the way in which they operate. However, the application of some highly restrictive criteria could lead to the exclusion of some systemically important companies that could be the most impactful in terms of their transition potential.

---

[47] UK Government. Greening Finance: A Roadmap to Sustainable Investing, 2021.
[48] Hong Kong SFC. Circular to management companies of SFC-authorized unit trusts and mutual funds – ESG funds, 2021.
[49] SEC. The Division of Examinations' Review of ESG Investing, 2021.
[50] Financial Times – Regulators put ESG fund names under the microscope, 2021.
[51] SEC's New Rulemaking Agenda ESG, Investor Protection and Insider Transactions, 2021.
[52] White House briefing, 2021.

Copyright ©2022 Qontigo GmbH.

While some people argue that these criteria signal a change in investor demands that companies will ultimately have to fulfill, others worry that exclusion might soften the influence investors could have on the companies' operations, management, products and services. Equally, it could divert investment away from companies that have meaningful alignment strategies, whereas such capital could help them make the necessary changes.

Investors looking to "green" their portfolios through fund labeling as a way of contributing to sustainability transition must be mindful of the fact that excluding a company with e.g. high emissions from their investment process will not automatically lead to emissions reductions in the real economy. What is more, it will not give an accurate picture of which companies can be expected to stay aligned with the low-carbon transition.

To support the transition of capital towards a more sustainable businesses, the use of forward-looking criteria in portfolio design (such as transition plans, planned CapEx and OpEx, and the existence of decarbonization or other sustainability targets) alongside stewardship and engagement, are the most effective mechanisms to incentivize the sustainability performance by the issuers under consideration.

5.4. Key takeaways for fund issuers

Based on the research conducted for this paper, the authors recommend that fund issuers:

> Stay abreast of relevant developments: this paper as well as other publications listed in the "Further reading" section of the Appendix are intended to directly help fill this need.

> Play an informed and active role in policy engagement and regulatory consultations.

> Seek to future-proof investments by aiming to adhere to standards that are both science-based and that incorporate elements incentivizing the real economy towards sustainable transition. Labeling, to the extent it is deployed as a tick-box exercise, is frequently less impactful for achieving this goal than a spectrum of other actions such as supporting sustainability R&D and participating in collaborative engagement investor initiatives. Such actions could have a more positive impact on differentiation and serve the overall industry.

Copyright ©2022 Qontigo GmbH.

6. Appendix

6.1. Further reading

> Natixis. Enabling vs Labelling in Sustainable Finance, 2021.

> Febelfin – Central Labelling Agency. Defining sustainable financial products – Sustainability labels in the context of EU sustainable finance legislation, 2021.

> Responsible Investor. National regulators' ESG fund requirements trigger SFDR fragmentation fears, 2021.

> Megaeva, Engelen and Van Liedekerke. A Comparative Study of European Sustainable Finance Labels. SSRN Electronic Journal, 2021.

> CFA Institute. Global ESG Disclosure Standards for Investment Products, 2021.

> Swiss Sustainable Finance. SSF Reporting Recommendations on Portfolio ESG Transparency, 2021.

> Sustainalytics. Sustainable Fund Labels: Diverse Definitions of Sustainability, 2020.

> Gutsche and Zwergel. Investment Barriers and Labeling Schemes for Socially Responsible Investments, 2020.

> 2 Degrees Investing Initiative. Impact washing gets a free ride: an analysis of the draft EU Ecolabel criteria for Financial Products, 2019.

6.2. Quick links to labeling documentation

Name and link to technical criteria	Technical criteria analyzed, last updated	Estimate of market uptake, as of time of publication
EU Paris-aligned Benchmark (PAB)	Annex III of Benchmarks Regulation, December 2019	N/A
EU Climate Transition Benchmark (CTB)	Annex III of Benchmarks Regulation, December 2019	N/A
EU Ecolabel (under development)	Technical Report 4.0, March 2021	N/A
FNG Label for Sustainable Investment Funds	Rules of procedure, last amended March 21, 2021	257 products
Verbändekonzept (under development, public link N/A)	September 2021	N/A
Ecolabel UZ 49	Version 5.0, January 1, 2020	200 products
Towards Sustainability Label	Revised version, May 31, 2021	607 products
SRI Label	July 23, 2020	841 products, EUR 691 bn AUM
AMF Doctrine	March 2020	N/A
Greenfin Label	April 2019; October 2021 version released after analysis for this paper was completed	71 products, EUR 20 bn AUM
LuxFLAG ESG Label	March 2021	263 products, c. EUR 150 bn AUM
Nordic Swan Ecolabel	Version 1.3, updated May 6, 2020	67 products, including 44 equity

Copyright ©2022 Qontigo GmbH.

6.3. Updated sections

Overview of changes versus version published January 7, 2022:

Page	Description
4	> Intro box: updates second bullet > Replaces link in footnote #2
5	Figure 1: amends product design criteria for Ecolabel UZ 49, LuxFLAG ESG Label and Nordic Swan Ecolabel
6	> Updates fourth line in third paragraph > Figure 2: amends product design criteria as per Figure 1
7	Adds additional examples to first list of bullets
10	Figure 4: > Changes "Screen: power generation" to "Screen: fossil fuel power" > Updates in table
12	> Updates third line > Figure 5: updates "Popularity of product involvement screens" > Updates first bullet in "3.2.1 Deep dive on fossil fuel-related exclusions"
15	Updates first sentence in "3.3 Portfolio construction"
16	Figure 6: updates values for "Best-in-class" and "Thematic"
18	Updates first sentence in "3.3.3 Thematic and impact"
19	> Updates first sentence in second paragraph > Updates first sentence in "3.3.4. Engagement"
21	Figure 7: > Updates "Highest common denominator criteria" for Nuclear power, Thermal coal, Unconventional oil and gas, Oil and gas, Power generation > Changes "Power generation" to "Fossil fuel power"
26	6.2. Quick links to labeling documentation: updates FNG label

Copyright ©2022 Qontigo GmbH.

7. Contacts & Information

Learn more about how Qontigo can help you better manage risk and enhance your investment process.
Qontigo.com

Europe

Frankfurt
Mergenthalerallee 61
65760 Eschborn, Germany
+49 69 2 11 0

Geneva
Rue du Rhone 69, 2nd Floor
1207 Geneva, Switzerland
+41 22 700 83 00

London
11 Westferry Circus
London E14 4HE, United Kingdom
+44 20 7862 7680

Paris
19 Boulevard Malesherbes
75008, Paris, France
+33 1 55 27 38 38

Prague
Futurama Business Park Building F
Sokolovska 662/136b
186 00 Prague 8, Czech Republic

Zug
Theilerstrasse 1A
6300 Zug, Switzerland
+41 43 430 71 60

Americas

Atlanta
400 Northridge Road, Suite 550
Atlanta, GA 30350
+1 678 672 5400

Buenos Aires
Corrientes Avenue 800, 33rd Floor
Office 101
Buenos Aires C1043AAU, Argentina
+54 11 5983 0320

Chicago
1 South Wacker Drive, Suite 200
Chicago, IL 60606
+1 224 324 4279

New York
17 State Street, Suite 2700
New York, NY 10004 USA
+1 212 991 4500

San Francisco
201 Mission Street, Suite #2150
San Francisco, CA 94105
+1 415 614 4170

Asia Pacific

Hong Kong
28/F LHT Tower
31 Queen's Road Central
Hong Kong
+852 8203 2790

Singapore
80 Robinson Road, #02-00
Singapore 068898, Singapore
+852 8203 2790

Sydney
9 Castlereagh Street, Level 17
Sydney, NSW 2000, Australia
+61 2 8074 3104

Tokyo
27F Marunouchi Kitaguchi Building,
1-6-5 Marunouchi Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 4578 6688

STOXX Ltd. (STOXX) and Qontigo Index GmbH (together "Qontigo") research reports are for informational purposes only and do not constitute investment advice or an offer to sell or the solicitation of an offer to buy any security of any entity in any jurisdiction. Although the information herein is believed to be reliable and has been obtained from sources believed to be reliable, we make no representation or warranty, expressed or implied, with respect to the fairness, correctness, accuracy, reasonableness or completeness of such information. No guarantee is made that the information in this report is accurate or complete, and no warranties are made with regard to the results to be obtained from its use. Qontigo will not be liable for any loss or damage resulting from information obtained from this report. Furthermore, past performance is not necessarily indicative of future results. Exposure to an asset class, a sector, a geography or a strategy represented by an index can be achieved either through a replication of the list of constituents and their respective weightings or through investable instruments based on that index. Qontigo does not sponsor, endorse, sell, promote or manage any investment product that seeks to provide an investment return based on the performance of any index. Qontigo makes no assurance that investment products based on any STOXX® or DAX® index will accurately track the performance of the index itself or return positive performance. The views and opinions expressed in this research report are those of the author and do not necessarily represent the views of Qontigo. This report may not be reproduced or transmitted in whole or in part by any means – electronic, mechanical, photocopying or otherwise – without Qontigo's prior written approval.

Copyright ©2022 Qontigo GmbH.