ETF Hub **Exchange traded funds**

Hundreds of funds to be stripped of ESG rating

Unpublished BlackRock research also reveals thousands more will be downgraded in wide-ranging MSCI shake-up

Swap-based synthetic funds are among those that will no longer receive an environmental, social and governance rating © DPA/AFP via Getty Images

Steve Johnson MARCH 24 2023

Hundreds of funds are about to be stripped of their environmental, social and governance ratings and thousands more will be downgraded in a shake-up being pushed through by index provider MSCI.

The impact could be particularly acute in Europe where a growing number of institutions will only invest in funds that are deemed to be compliant with ESG-investing principles. In 2022, ESG exchange traded funds accounted for 65 per cent of inflows into European ETFs, according to Morningstar.

MSCI, which has $13.5tn of assets benchmarked against its indices, is yet to publish the results of a consultation on its ESG ratings. But according to a client note from BlackRock's iShares arm, the world's largest ETF provider, seen by the FT, the number of European ETFs with a triple-A ESG rating from MSCI is set to tumble from 1,120 to just 54, while the number with no rating will surge from 24 to 462.

The changes are part of a push by index providers to tighten up the criteria for what qualifies as an ESG-compliant fund amid pressure from regulators concerned about the prevalence of so-called "greenwashing" as the sustainable finance industry expands rapidly. The sharp reduction in funds with top ratings could mean that ESG-focused investors have fewer places to put their cash, potentially driving up the price of assets with a sustainable label.

Under MSCI's changes, all "synthetic" ETFs that use swaps to track the value of assets will lose their ESG rating — even if funds that own the identical underlying assets are rated highly.

In addition, most "physical" funds, which directly hold portfolios of equities or bonds, are likely to have their rating lowered.

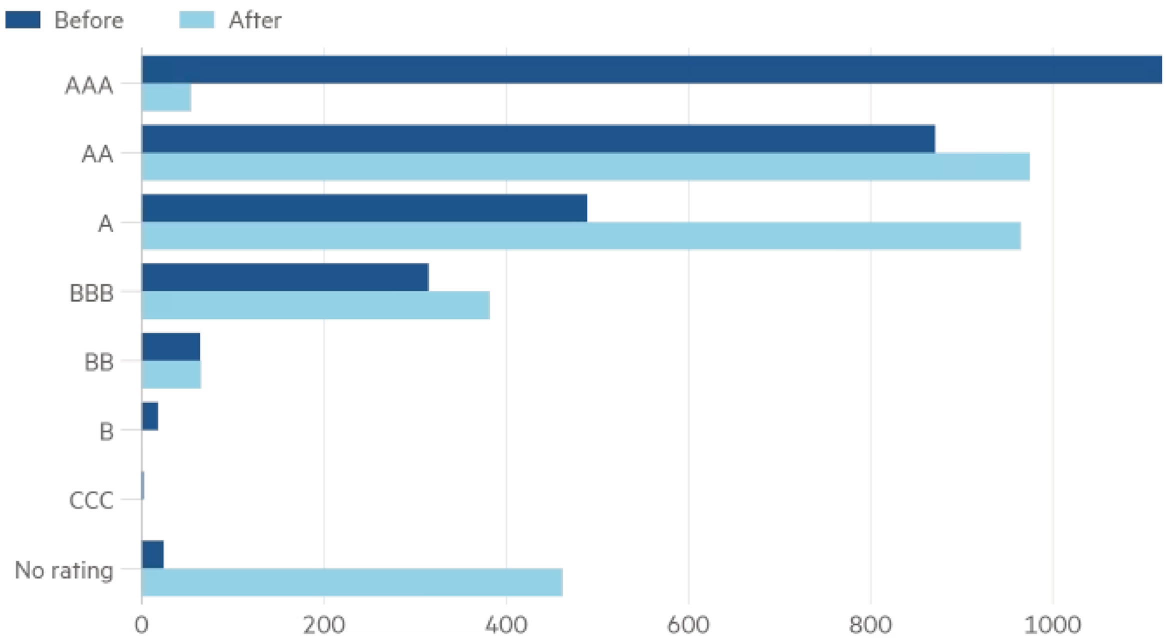
The changes, due to take effect by the end of April, will apply to all ETFs and mutual funds globally.

MSCI declined to comment on the scale of the downgrades. The company said its changes "will lead to fewer funds being rated as AAA or AA and will reduce the volatility in ESG fund ratings, which are outcomes that our client base broadly supported".

In Europe alone, 1,476 ETFs will have a lower rating, 905 will be unchanged and 78 will have a higher rating, the iShares research indicated. A further 446 funds will lose their rating entirely, including more than 400 derivative-based funds.

European-listed ETFs

ESG ratings from MSCI, before and after the impending changes



Source: BlackRock

If the same picture was replicated across ETFs and mutual funds worldwide then it is likely several thousand funds would be downgraded.

The most draconian change will affect synthetic, swap-based ETFs, which have a swap contract in place with a counterparty to replicate the performance of the underlying assets, rather than actually owning the assets themselves, as a physical ETF does.

MSCI said in its statement that "the [ESG] rating is calculated based on a fund's underlying holdings data. In the case of swap-based ETFs, the underlying data MSCI receives in most cases is the swap collateral holdings, rather than the constituents of the underlying index that is tracked.

"Therefore, we will no longer rate swap-based ETFs until we have determined a method to consistently rate a swap-based ETF based on the constituents of the underlying index that it tracks."

MSCI did add, though, that while it was moving away from rating the funds on the basis of their underlying indices, "investors in swap-based ETFs are exposed to the ESG risks and opportunities of the underlying index rather than the collateral".

By contrast, S&P Dow Jones's ESG ratings are based on indices, not funds, so a swap-based ETF tracking the S&P 500, say, would have the same rating as a physical one replicating the same index.

"The product provider has the ability to exercise discretion on how they intend to track or replicate the index, including using derivatives instead of holding an index's constituents directly," S&P said.

Jack Turner, head of ESG portfolio management at 7 Investment Management, called for "more industry guidance on how to measure the ESG risk of derivatives in portfolios".

"MSCI's change probably reflects the lack of an industry-wide approach," he added.

MSCI's second change affects the ESG rating of physical funds.

Currently, this rating is based on the ESG scores of its underlying holdings and an "adjustment factor", based in part on the fund's exposure to companies with improving versus worsening ESG ratings. MSCI is now scrapping this adjustment factor.

At present about 73 per cent of ETFs and mutual funds have a positive adjustment factor, MSCI said, so removing it "will lead to more downgrades than upgrades".

Turner said 7IM agreed with the decision to remove the adjustment factor as it will drive "meaningful differentiation in ESG ratings between funds", rather than so many being rated triple A.