SFDR review

1. The merits of SFDR and the difficulties of its implementation

An industry representative stated that SFDR has some good building blocks as starting points. Firstly, it is focused on disclosures and transparency. There is increased demand in the EU single market for environment, social and governance (ESG) investments, and more than 50% of investment funds in Europe are Article 8. For that. the regulation's core objective of transparency through accurate, consistent and robust disclosures is more relevant than ever. There is also the issue of materiality, allowing investors to make informed decisions aligned to their own sustainability preferences. One of the key pillars of the regulation is ensuring that investors understand the underlying investment strategy and the sustainability risks.

However, just having a very divergent and extensive list of requirements does not necessarily mean that someone is well-informed. Moreover, having irrelevant information could lead to people being misled or confused. What serves transparency and informed decisions is the appropriate set of information. In addition, many of the requirements for disclosures are not matched for the time being by solid data from corporates, which means many of the disclosures are based on estimates.

Moreover, it is important to keep in mind that the information with value for investors is linked to the features of a specific product in which they are considering investing. To the contrary, having aggregated information across many and different investment strategies offered by an asset manager does not say much to an investor. In terms of the merits such information can have from a public perspective, this is already addressed via the Corporate Sustainability Reporting Directive (CSRD). Having therefore aggregate entity-level references under SFDR is duplicative and potentially also misleading.

The majority of those implementing struggle with the meanings of 'sustainable investments' and 'do no significant harm' (DNSH). When internal definitions are communicated to clients, they might not align with other corporates' or regulators' definitions.

An industry representative emphasised that SFDR was a significant step forward for the industry. As with anything new, it has to be learned from. The framework has helped a great deal, although there are challenges. There are almost €8 trillion of assets under the management that are Article 8 and Article 9. There was a 28% increase in assets under management for Article 8, although some of that is due to overall exposure to the market. Article 9 is struggling somewhat. 'Sustainable investment' should have a strict definition, and not everything should be sustainable.

There is significant investor demand. There has been increased consideration of where data comes from, but data is lacking. Quality and coverage have been looked at, and there has been a realisation that coverage is not everything. There can be an estimate of everything, but the question is what something says if it is not a good representation. There is a great deal of innovation at the product and engagement levels.

SFDR should be efficient. There has been a great deal of confusion about the definition and the application of the definition. There remains confusion around applying the taxonomy DNSH for SFDR purposes. Such confusion can probably not be completely eradicated, but it can be reduced. There are also recommendations about being more prescriptive. It is hoped that CSRD will solve some of the data gaps. Some of the principal adverse impacts (PAIs) have very low coverage. There are comparability issues with estimates. For Article 4 PAI disclosure entity level, there are very different numbers for large asset managers and comparably sized global portfolios, which is concerning. With the underlying data, even for scope one emissions normalised by enterprise value including cash (EVIC) there are differences when similar numbers would be expected for large managers.

Europe has had challenges with regulatory alignment and there should be more clarity there. The way in which the European Securities and Markets Authority (ESMA) fund naming guidelines interoperate or link back to SFDR should be clarified. Different regulators apply the same rule set differently. The naming in itself is undesirable. The main objectives are quality and usability, and not just coverage.

The definition of 'sustainable investment' is effectively principle based. It involves looking at objectives, DNSH, minimum social safeguards assessments or good governance. Moving to a label regime similar to the UK Sustainability Disclosure Requirements makes sense. Most of the market already views Articles 8 and 9 as labels, so there is some disconnect there. There is a significant net flow into transition-labelled funds, so that area also needs clearer definitions.

An industry representative emphasised that SFDR is for disclosures for financial products, and CSRD is for disclosures of corporates. The sustainability preferences of customers in France, for example, are disappointing in that few want taxonomy-aligned products or sustainable investment products because they do not understand them or the definitions. Financial advisors are puzzled by the complexity of the regulation. There is also limited demand from retail customers.

Life insurance companies provide multi-option products (MOPs) that are not just funds but are also savings products with multiple funds and options. BlackRock and Amundi have different definitions of sustainable investment, for example, so disclosing sustainable investment shares at the MOP level makes no sense.

An industry representative highlighted that there are some first mover disadvantages. There is a gap in the regulation that supports transition finance, which is important due to the alignment with the objective of the Green Deal. Transition products are buried in Article 8, which is very broad compared to Article 9, which is very narrow. Labelling is sought as a way to promote transition finance. Directing capital in this way serves to de-risk the economy and society. One correction is dedicated labelling across sustainable products, with particular recognition of transition finance.

A regulator stated that SFDR's weaknesses have implications on how financial market participants implement the regulation and how supervisors supervise the implementation. The weaknesses are even more important when they touch upon the foundational concepts of SFDR, like the definitions of sustainable investment or DNSH, or the interlinkages between the taxonomy regulation and sustainable finance framework. The disclosure requirements might be too complex for retail investors, and there is a lack of guidance on how to complete the templates, which has led to diverging practices. ESG data remains scarce and lacks reliability.

The lack of clarity makes supervision difficult and complex and impairs investor protection. Clarifications have so far mostly been made through FAQs. When they are not clearly noted in level 1 or level 2 texts, there is legal uncertainty in the market and an impact on the enforcement powers of national competent authorities (NCAs).

2. The results of the consultation on SFDR

A regulator stated that the consultation is an acknowledgement that there are shortfalls that need to be fixed. It covers a broad range of topics, which will allow the European Commission to conduct an in-depth and comprehensive assessment of the framework. More work has been done at the European level in coordination with NCAs, which needs to feed into the consultation, including the joint European Supervisory Authorities' (ESAs') opinions on SFDR, the opinion issued by the ESMA Sustainability Standing Committee, and the Common Supervisory Action on sustainability risk, which is being finalised by NCAs. The replies to the consultation demonstrate major differences, but also clearly show how important SFDR has become in the ESG landscape. It is important to coordinate efforts to bring the relevant revisions, so the regime can be effective.

A policymaker confirmed that the number of replies in the consultation had been satisfactory. SFDR is contributing to making a difference, but there are weaknesses. Implementing the sustainable finance agenda has involved a significant legislative activity within a short amount of time. The whole framework will have to be looked at with some distance in order to ensure that it works.

One issue is the misinterpretation of Articles 8 and 9. These were meant to be disclosure articles, but they are being used as labelling schemes. That was not the intention of the original proposal or the legislator. That needs to be fixed. The current structure of disclosures at product or entity level leaves room for streamlining and simplification. Consistency across sustainable finance files as well as quality in transparency could be improved. Different regulators have different views about what is needed. Some are hungrier in terms of information and want to know 'everything'. Even if they do not use the information, they feel comfortable having it just in case. Others would like more filtered information. There are also comments from the consultation on definitions and the way they are interpreted and used.

There are many ways in which these problems could be addressed, as shown in the feedback statement. However, a majority of respondents seem to support the establishment of a voluntary categorisation system. The basis for choosing the criteria, how that would have to be defined and how it would work is another matter. There is not a great deal of input on this, so bilateral and multilateral discussions will likely be needed.

An official highlighted that key areas in the consultation questionnaire included current sustainable finance disclosure regulation, interactions between other sustainable finance regulation, the subject of potential changes to regulation, and a new approach to categorisation for green and dark green sustainable financial products. These demonstrate the desire for a holistic and comprehensive review. There were 324 respondents. Taking into account the number of financial market participants and advisors there are in the European market, that number is not overly impressive. It might be that the respondents did not have any sources for a proper evaluation of the regulation, or they might not have seen the sense of the consultation. However, it is the role of the public sector to encourage each interested person to take part in the consultation, as every voice counts. Consumers and the financial market should be encouraged to take part in the consultation.

The whole process has identified major weaknesses and vulnerabilities. However, responders support the main goals of the regulation. There is divided opinion about how to reach those goals, but everybody agrees that, for example, the regulation needs clarification, simplification, fewer gaps and fewer overlaps. The most challenging issue is around Articles 8 and 9, but there can be a good solution. The transition project is also important. Most responders' comments were that the regulation should have an international dimension, which is important given the international dimension of sustainable finance.

3. Recommendations to the Commission

An industry representative emphasised that the importance of transition finances, the deficiencies, and the unintended consequences of Article 8 and Article 9 are understood, and consultation presents an opportunity to make corrections. Investors are interested in financing transition. It can be seen from the ESMA data that flows into transition funds are up versus ultra-green strategies. The introduction of a labelling regime would be appreciated, including a range from ESG integrated to high impact, with the provision for transition finance.

Labelling should be harmonised across jurisdictions. Provisions for flexibility can create a fear of greenwashing, but it is preferable to have a very large, scaled-up market that finances sustainability with pockets of greenwashing and inefficiency, rather than a very small market that is perfect and has high barriers to entry. Some flexibility is sought, but with accountability in reporting. This is necessarily a qualitative process.

An industry representative highlighted that, given the consensus about transparency, the next stage will be to ask what type of transparency is most meaningful. Very targeted, meaningful information needs to be provided to investors to keep them informed and to avoid confusion. There should be a more limited set of core metrics, which could be human rights, climate and metrics that can be substantiated with existing data. As long as that is the minimum across all types of funds, then it can be built upon depending on the underlying strategy or the sustainability preferences of the investors.

The starting point should be rationalising the types of disclosures and underlying data points. There should also be rationalisation for entity-level disclosures. Unlike 2019, when SFDR entered into force, today CSRD is also in force and becomes applicable imminently for , all entities, including financial entities capturing thus sustainability considerations at entity level. In addition, SFDR can foresee a narrative on how the asset manager is looking at sustainability risks, which will be much more effective and less duplicative compared to the PAI entity-level reporting.

Caution should be taken with regard to SFDR and the current state of play in the market; moving too fast away from current categories may also have countereffects.

Although there was a first mover effort, there are now efforts across other regimes as well. Building categories that are too narrow can be very detrimental, especially in an existing market. It is already very difficult to define concepts such as Sustainable Investments and DNSH and we should seek in further clarifying them. There is also significant potential for better defining the transition path, because transitioning companies present important opportunities and are considered an important investment area for clients. Clarity is needed on how different investment strategies look into transitioning companies.

If there are voluntary categories, they need to give sufficient flexibility, simplicity and clarity. There should not be an overly rapid move using completely new categories and we should caution against replacing existing confusion with a new one.

An industry representative suggested that a two-pager would be sufficient to provide enough information to retail customers. The SFDR pre-contractual disclosure is expensive for entities to produce each year. It can be made simpler and more understandable for retail customers, and less costly for financial market players.

The definition needs to be fixed, and a good balance found between a taxonomy, with 800 pages of regulatory technical standards (RTS), and a sustainable investment that has one paragraph. The taxonomy is not applicable to sovereign bonds. It is unclear whether sustainable investment can be applied to a government bond. Life insurance companies are disadvantaged as result because much of their asset allocation is dedicated to sovereign bonds. When customers want a sustainable product, they do not know what to say.

Sometimes a unit link is offered, which is a listed equity or a listed bond from a corporate. This listed equity is not a financial product listed and subject to a SFDR, so it is not known what kind of information has to be provided to customers. There are other examples, like euro medium-term notes (EMTNs) and portfolio management. There are some loopholes in the regulations to be fixed.

A regulator recommended clarity, simplicity and a focus on investor needs. SFDR is a disclosure regulation for building the bridge between investors looking for green investment opportunities and the real economy financing need. Investor needs should be at the heart of this regulation. SFDR should give assurance to investors that they have at their disposal the necessary information for the investments they are considering.

Disclosure requirements need to be clear. The sustainability performance of investments, need to be measured against clear and objective criteria, because the responsibility of investment due diligence cannot be left to investors, as is mostly the case under the current SFDR regime. The requirements need to be simplified, focus on the essential information and be further standardised to allow for comparability. They need to provide the necessary information to allow investors to make informed judgment of the contemplated investments. They need to cater for transition finance strategies. The right balance between qualitative and quantitative disclosures needs to be found. Europe does not operate in vacuum, so easing interoperability with other sustainable finance frameworks at the international level is essential. It is also important for the various pieces of legislation to fall into place and to be sufficiently robust.

The ESMA guidelines on fund names still lack clarity on key concepts like what a meaningful investment in sustainable investments is, the list of terms that triggers the application of the guidelines, the fact that the guidelines will apply to close-ended funds, or the rules applicable to green bonds. Applying the Guidelines in the current form without more clarification could exacerbate market divergences and fragmentation. There can only be a regime that eases transition if it builds and maintains investor trust.

An industry representative emphasised that the key concepts need to be clarified more than just with Article 217.

The European Sustainability Reporting Standards (ESRS) will help with the gaps. There should not be further delays in the ESRS sector specific implementation and guidance. The materiality and sector specific aspects are missing in the PAI disclosures. Investors are not just sourcing the data for reporting; reporting informs the outside world, but much of the data is being used for downstream alpha generation or investment decisions. Fewer metrics with more quality and better coverage could have more impact.

The links with ESRS and CSRD are important. For any PAI recommendations, there are the draft RTSs, including new social metrics, all of which should be covered by mandatory reporting from ESRS.

There should be clarity about application. The cost of change is large. Although system updates are costly, legal updates or prospectus updates are far more costly. The industry wants to help the economy to finance the transition and give the best available data. Product categorisation will help. There is also room to better define what transition, sustainable and impact are. Global interoperability is genuinely important. All partners are needed in this journey, so having a level playing field and similar types of definition approaches makes sense.

Some sectors, like utilities, have very high numbers of reported taxonomy data. The situation is improving and with CSRD it will only improve further. There is a role for e-taxonomy to play in sustainable investments, which should be clarified.

An official emphasised that a complete change of the current framework would be inefficient. Financial market participants and advisors, as well as consumers and investors, have become used to the current framework.

A policymaker stated that the timeline for a potential future review is not yet known. There is a need to correct the weaknesses, there are many good suggestions and some emerging trends. Although there are some commonalities, there are also nuances. The new Commission will try to focus on implementation and avoid putting forward too much legislation.

The direction, in terms of the substance, is more or less known. Suggestions to improve EU legislation usually imply simplification. The complexity of the legislation is often linked to the complexity and uniqueness of the EU construction. For the College of Commissioners there are 27 different opinions, 27 different nationalities and several different political parties. The result of that first discussion then gets into the hands of the Council and the Parliament, and what was planned always becomes more complex, because everyone puts in what is important for them. Nonetheless, in the next mandate we should see more convergence of views towards simplicity and flexibility.