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SFDR: ESG 2.0 for PLCs

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The EU's Sustainable Financial Disclosure Regulation (SFDR) is the new battleground on which the asset management industry is competing. The SFDR Level 1, which entered into force on 10th March 2021, is a watershed for sustainable finance and is increasingly setting a global standard for the ESG disclosures expected of all asset classes, including equities, to address the risk of greenwashing.

For PLCs there are two key takeaways; the SDFR will dictate a new minimum levels of disclosure in key areas from greenhouse gas emission to waste, biodiversity and human rights and secondly the onus is firmly being placed on them to define their own their ESG narrative both quantitatively and qualitatively.

Spurred by client demand and an unprecedented level of product development, ESG funds are widely expected to outnumber conventional funds by 2025. However, as its star has risen, poor data and conflicting standards on ESG have opened up asset managers to potential claims of misleading clients. For this reason, the asset management industry has grasped the significance of the SFDR and recognised that its product alignment is critical to credibly compete in the 'ESG growth opportunity of the century'.

01 The impact of the new rules

The new rules have far-reaching consequences for asset managers – not just in Europe but around the world – as investment firms are forced to demonstrate that they are serious about sustainability. They will also influence the decisions of listed companies, which will find themselves under pressure to focus more on ESG issues or risk losing investor capital.

Under the SFDR, the entire universe of European funds across asset classes from bonds to equities and alternatives is being classified by managers into one of three categories – Article 6, Article 8 (Light Green) or Article 9 (Dark Green) – based on the product's sustainability objective (see Table 1). The nomenclature derives from the regulatory text, and all funds will be required to provide some ESG disclosure (Article 6), while Article 8 and Article 9 funds will be asked to provide more detailed ESG information to investors.

The SFDR also introduces the principle of 'do no significant harm'. This principle considers an investment to be 'sustainable' if it contributes to an environmental or social objective and does not significantly harm any other environmental or social objective as set out in the Regulation.

Table 1: SFDR classification

Article 6 – All Funds	Article 8 – All ESG	Article 9 - Sustainable
All managed products	'Light green' funds	'Dark green' funds
No integration of sustainability	Promotes, among other characteristics, environmental or social characteristics, or a combination but is not a main focus	Investment in economic activity that contributes to environmental objective.
Can include stocks that are excluded from ESG funds, such as tobacco and coal producers, and should be clearly labelled as non-sustainable		Fund manager may be required to track an EU climate transition benchmark
		"Do no significant harm"

Increasing level of disclosure →

02 Areas of controversy

It has not been all plain sailing since the SFDR Level 1 was introduced in March 2021. The SFDR provides for the development of regulatory technical standards to specify the disclosure requirements in detail. These 13 regulatory technical standards, which require more onerous levels of disclosure and are colloquially referred to as SFDR Level 2, have been repeatedly delayed and will now not take effect until 1st January 2023.

The main area of controversy regarding these Level 2 requirements is where asset managers must disclose on a highly challenging set of "Principal Adverse Impacts" (PAI). These PAI comprise a list of sustainability factors (e.g. greenhouse gas emissions, waste, biodiversity, human rights) that firms need to start taking into consideration in their investment policies and decisions. They consist of mandatory and voluntary indicators, both related to environmental and social topics. Managers are also expected to provide a statement on due diligence of sustainability risks and integration of sustainability factors in the remuneration policies. Read an example of a PAI statement from asset manager Nordea.

Even though the SFDR regulatory hurdles have not been fully ironed out, this has not deterred the asset management industry. According to the latest data from Morningstar for Q3 2021, Article 8 and Article 9 funds could reach 50% (from close to 37% today) of overall EU fund assets (equities, bonds, alternatives etc) by mid-2022 or sooner as managers continue to upgrade strategies and launch new products that will meet the articles' requirements.

03 The equity fund manager's perspective

As noted in Table 1, the SFDR classifies funds into three categories – Articles 6, 8 and 9.

Article 6 denotes funds that do not have a specific ESG objective and do not integrate any kind of sustainability into the investment process. These funds can include stocks that are excluded from ESG funds such as tobacco and coal producers and should be clearly labelled as non-sustainable.

Article 8 covers 'light green' funds, which promote environmental and social characteristics but do not have these as the main objective. The categorisation applies "where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices".

Article 9 covers funds that have sustainable goals as their objective. These 'dark green' funds may invest in companies where the goal is to reduce carbon emissions. In these instances, the fund manager may be required to track an EU climate transition benchmark. Additionally, these funds must "do no significant harm" and align to at least one of the criteria outlined in the EU Taxonomy Regulation.

One of the reasons that the SDFR level 2 has been delayed is that the overwhelming feedback from the asset management community was that the PAI data requirements exceeded what was currently disclosed by the vast majority of PLCs and the timeline expected to provide reporting on this data was too short. However, despite the shifting timelines and lack of clarity, the equity asset management industry is clearly building out its capabilities to be able to gather and incorporate the data into its decision making.

> ***Most investors we speak with want to be prepared in time to be able to monitor PAIs throughout 2022 and adjust their portfolios to boost their PAIs (or rather mitigate the downside, as these are adverse impact indicators). This means that PAIs may significantly impact stock selection and portfolio construction by fund managers keen to have 'good' PAI scores."***
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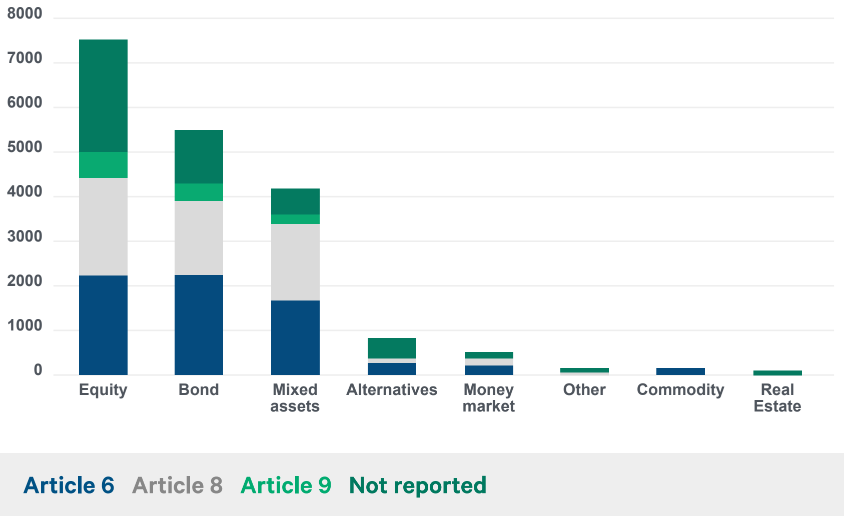
> *Source: Sustainalytics*

Figure 1: Fund flows by asset type and SFDR classification year to date (in €bn)



Source: Refinitiv Lipper

The initial expectation from institutional investors is that the bulk of equity portfolio assets are expected to migrate towards SFDR Article 8 funds. This will take place through a combination of new fund set-ups and the significant transition of existing global equity funds that have already adopted ESG criteria in their investment policies but are now formally aligning with Article 8 status. As can be seen from Figure 1 above, equity fund flows into Article 9 funds have been relatively limited year to date. From a fund manager's perspective, Article 9 funds have significant hurdles to overcome and are really looking beyond a simple investment benefit, examining the impact that the investment is having rather than the traditional focus on the return/risk perspective. Article 9 could be viewed an evolution of impact investing.

> ***“While this is very early stages for SFDR, the backlash in terms of being labelled as “greenwashing” is so punitive for the Asset Managers that while many have discounted Article 9, they have also shied away from Article 8 and have stayed at Article 6 (essentially status quo recognising ESG risks). Once the landscape has evolved, Article 8 funds are the route most fund managers will take and the significant bulk of the ESG AUM will be in likely be Article 8 funds.”***
>
> *Brian Kennedy*
>
> *ESG Fund Manager, Mediolanum*

The SFDR aims to help drive 1 trillion euros ($1.2 trillion) into green investments over the next decade providing those companies with sustainable products and those supporting the climate transition an edge. However, that funding support is also critical for the so-called 'hard-to-abate' sectors including heavy industry and long-distance transportation. These represent a third of global carbon emissions and, by 2050, could produce a majority.

At this early stage, there is a concern that the SFDR is prompting asset managers to gravitate towards very low impact, clean, defensible funds and potentially turn its back, so to speak, on the real industrial economy which needs the most support to transition. The SFDR does provide a means for investors embracing companies ‘in transition’ and are clearly articulating their pathway to a lower carbon future.

> ***“I know there's a number of companies who have real economy businesses and therefore have relatively high impact, businesses’ with products that we all continue to want and need and use and there is a concern will we get screened out of notable Article 8 and 9 funds and hopefully that shouldn't happen. Right now, there is a danger that the asset management industry could gravitate towards very low impact, clean, defensible funds and potentially turn its back, so to speak, on the real industrial economy which actually needs the most support to transition. I would like to see lots of Article 8 and 9 funds that are constructed around owning real world, real economy companies and, using the funds to help them make that critical transition journey. It’s early days, but the SFDR is an interesting point in its development and we can expect a lot more in the evolution of Article 8 and 9 funds over the next four years.”***
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> *Andrew Cave*
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> *Head of Governance and Sustainability, Ballie Gifford*

04 Key takeaways for PLCs

While the SFDR evolves, there are two key take-aways for PLCs: disclosure and narrative.

Disclosure: To meet the SFDR requirement, companies must disclose their PAI from greenhouse gas emissions to waste, biodiversity and human rights. This is becoming the minimum standard and companies who fail to do so will be very visible. The better the quality of information that fund managers have access to, the more likely they will be to confidently include companies within their Article 8 or 9 funds.

Narrative: Companies must work on building a strong narrative combined with reporting that clearly showcases the work that is being done by the organisation on ESG. Taking climate as an example, an interpretation of any company’s legacy emissions data over the last ten years can easily be sourced from a host of third-party providers and presents a certain narrative. It is critical the data disclosure provided is sufficient and clearly shows that decarbonisation is taking place through a combination of internal actions, science and commitment to innovation.

> *"My message to companies is you should disclose as much as you're really comfortable disclosing because if you don't, with the rise of natural language processing, machine learning and AI, financial analysts and others will create a narrative for you and you might not like that narrative"*
>
> *Curtis Ravenel, TCFD*

Companies should demonstrate that they are looking at introducing new technologies or spending more on research and development in this area as part of their commitment to the climate transition. Best-in-class disclosure and target setting frameworks should also be highlighted in this narrative. This may include setting carbon emission reduction targets in line with the Science Based Target Initiative (SBTi) and outlining the measures that will be taken to achieve those targets.

Reporting frameworks like the Task Force on Climate-related Financial Disclosures (TCFD) are also very helpful for companies to build context around disclosures. The TCFD framework allows companies that may be self-conscious about an optically high absolute level of environmental impact based on their disclosures to define their narrative and truly differentiate themselves from their peers.

Finally, narrative building is also a fantastic opportunity for engagement with fund managers; starting the conversation by understanding their disclosure requirements really helps to continue to evolve the detail. For example, targets like Net Zero in the distant future are all well and good, but as an organisation your investor base needs to understand the near-term pathway to meet the SFDR requirements.

For further details on non-financial reporting and the SFDR, please contact Davy Horizons at sustainability@davy.ie or visit davy.ie/horizons

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