

Did the EU Fix the SFDR?

Transcript

Mike Disabato (00:00):

What's up everyone, and welcome to the weekly edition of sustainability now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Disabato, and this week we look at whether the EU Commission kept its sustainable financial disclosure regulation, also called SFDR Intact after announcing updates to it on November 20th. Thanks as always for joining us. Stay tuned. The EU Sustainable Finance Disclosure Regulation, also called the SFDR, is a cornerstone of the eus plan to cut its carbon emissions and achieve its climate goals. It was introduced in 2018 before the pandemic and it came into application in the pandemic in 2021, and it has the stated purpose of keeping the sustainable market prosperous and in check by promoting transparency and ensuring comparability around how sustainable a financial product really is. This makes the sustainability risks more transparent and in doing so, purportedly attracts capital to transition our economies toward a more sustainable process and growth, and everyone that creates or manages investment products listed in the EU or markets their product in the EU or gives investment advice or insurance-based investment advice to participants in the EU is subject to the S FDRs disclosure requirements.

(01:29):

Now, late November of this year, those disclosure requirements change. The EU Commission came together and updated the SFDR. There was a lot of chatter around this update, mostly because elite copy was made public and everybody likes gossip, and so everyone started murmuring and whispering about the changes, but then on November 20th, the true proposal was released, and so we've had some time to digest it slowly and ponder its relevance. And so today we're going to go through the salient changes to this important regulation for sustainable finance in the eu. To help me with that, I have with me today my colleague and guest, Simone Ruez Virgo, who leads our sustainability policy research team and is also a member of the eus European Securities and Markets Authority consultative working Group on sustainable finance, which contributes to the eus process of developing European sustainable reporting standards such as the SFDR. So what I'm trying to say there is she's the person to talk to about all this, and the first thing I wanted to understand was why the EU Commission decided to make a change. They had this thing on the book since 2021, they've already gone through a lot of different changes. Why change it again now? Is it part of some big conspiracy or something? What's going on?

Simone Ruiz-Vergote (02:44):

So yeah, there is a very unexciting reason for it. Typically, you have such a review of regulation every few years and it's actually been baked in the mother legislation, so we knew there would be a review in a couple of years, and in fact, they have had two market consultations. They announced that they were going to propose it already two years ago, so there was a period of protracted waiting, and so it didn't come as a surprise. I also think it was really a clear sentiment in the market that the regulator needed to

move beyond disclosure. So everyone was expecting to see these sort of European labels of sustainable funds, and this is what we got

Mike Disabato (03:35):

A periodic review that led maybe to some soul searching by the EU commission because they could have done nothing. Again, this thing's been around since 2021. They could have let it breathe a bit more since there's been a lot of changes. But really also in the commission's own words, they wanted to simplify this regulation, and I quote, the changes are designated to address current shortcomings, making the rules simpler, more efficient and better aligned with market realities. The revised rules will be more retail friendly and usable for companies. I think that end there is what hammers home the commission's intent. They were worried the reg wasn't going to be usable, and they got maybe some pressure around that and it was going to be too burdensome, and so they updated it. Now, how were they able to do that? What did they do to make this update?

Simone Ruiz-Vergote (04:26):

So now we have three categories that it's a proposal, it could still change, but we have seen these three categories where we had Article eight and nine funds before with Article six being basically no sustainability ambition whatsoever, just plain vanilla products, and now you change them into three more palatable categories in my view. One is the ESG Basics product, which comes with the lowest amount of requirements. Then you have a transition product which allows you to also invest in fossil fuel related activities that are in a way transitioning out of high carbon into low carbon activities. And then of course the sustainable investment product where you would have the highest requirements applied,

Mike Disabato (05:10):

ESG basics, transition, and sustainable investments. Now, all these names have been agreed on, but there are levels to agreement in the eu, so all is not formally adopted, so we don't really know yet what the reporting requirements of each of these labels may entail. What we do have is some high level language on what these labels are. The sustainable category is made up of financial vehicles or products, if you will, that contribute to sustainability goals. The transition category are products making investments in companies and or projects that are not yet sustainable, but that are on a credible transition path to sustainability or investments that contribute toward improvements in things like the climate environment or social areas. And the ESG basics category, which integrates a number of ESG investment approaches that do not meet the criteria of the sustainable or transition investment categories for these funds, for these vehicles, for these products, looks at things like best in class performers on a given ESG metric, pursuing financial returns while excluding the worst ESG performers, stuff like that.

(06:20):

So not that many specific details there. That is definitely going to be hammered out in the next level of the EU final bosses, and we're going to get some more language and what the requirements are going to be for these three labels. We do know though that these products still cannot hold companies involved in tobacco or prohibited weapons or companies that are found in violation of human rights. A new aspect

though is that these products cannot invest in companies that are active in fossil fuels or high emitting energy activities that do not have a transition pathway away from those activities, and they cannot invest in companies that are actually expanding their fossil fuel activities. Basically no further pushes into fossil fuel anymore. Those are done now. That's a new one. Now, while those Article eight and Article nine funds that were previously in place here, of course there's Article six as well, those have been around for a minute.

(07:18):

The issue is those Article eight and Article nine funds cannot grandfather their categories in. They have to reregister their investment process and get to a new category that the market has to agree on and allow, and that represents according to responsible investor, around 60% of European a UM that are in article eight funds alone. So that is not a small number, that's not a small amount of changes. But for those funds, aside from the new name, how big is that reporting burden actually going to be? I know that we haven't gotten all the details yet, but really from what we've seen is this just a flashy new set of names or something more drastic?

Simone Ruiz-Vergote (07:56):

There is an element of change in that the adverse impact indicators are now no longer that central, that you don't have to disclose all of them. You had an obligation to report every year on all your investments, the adverse impact, and you had to report that also in a year on year basis. You had to compare the data over time, which created quite lengthy reports and that is now proposed to be skipped, which will be a relief to the market because we had 64 at risk impact indicators and we will probably see a few less in the future. On the other side, you see a much stronger focus on disclosures within the product so that you really have the full transparency of what the claim of the product is and whether or not that product meets this claim. And that is both on the sustainability side, so what it is actually the product would be doing, how much of the assets are subject to that strategy, how is the adverse impact measured?

(08:57):

And so there is this change. The product reporting was there before, but it was very formalized, but in my view, at least not very effective in capturing the characteristics of the product. And that is now changed. The templates for these products are supposed to be even shorter. So really, really make to the point, and that will help anyone reading these reports. I mean, you don't like to read 20 pages, right? So you actually are happy with one page at most. And so that's the aim to really bring this down to a minimum amount that you can actually digest and understand when you invest in these products. In addition to this address impact indicators, it was an expectation that you check for good governance, both in article eight and article nine, good governance meant sound management structures was relating to employee relations, ation and tax compliance. And these are now gone, not clear why, but there is this element that has disappeared.

Mike Disabato (09:59):

Okay, so the governance aspect that's pretty cut and dry because it's just gone. Remember you have those three fund types, the labels of those funds, none of them have to deal with the governance aspect

anymore, but the pairs are a bit more convoluted. So let me just explain that for a second. You had these, what are called principal adverse indicators or pairs that said for these investment vehicles, they used to be article six, eight or nine, but now they're the ESG basics sustainability transition funds. What this means is, is that those products, as Simone has been calling them, had to report on each possible problematic area for an environmental or social aspect that the company was invested in. So let me give you a concrete example of that. Let's say you had a solar company and the solar company was building solar farms on rainforest land.

(10:51):

You couldn't just say, well, it's a solar company. All of our revenue is based on lowering carbon emissions. Planet saved regardless of impact. You had to report on that specific company's problematic area there you didn't have to divest from that company. You just had to make sure investors knew that that is what this company was doing and that's what your fund was representing. And the SFDR used to say that these product owners, these vehicle owners, these asset managers, asset owners, you have to report on that for every single company that you invest in. Now, what the SFDR regulation is saying is that you just have to do that at the fund level. You do not have to go into the granularity of each individual company. You just say as a fund, here are our PAI metrics. That's what's happening to the pairs. Now, for me, taking that into account is difficult because when I think about a regulatory change, I get kind of lost in the details of the change.

(11:48):

And it's hard to understand whether the regulation itself has been strengthened or weakened because of all the weeds that you have to go through because it's not always that easy to decide. If those pairs were so burdensome, for example, and there was so little data available for them for financial market participants, would them existing in a disclosure be useful or would it just mean that people started to ignore important information that seemed like noise because the data wasn't there? I don't know the answer to that. So what I wanted to do was I wanted Simone to tell me in layperson terms what was strengthened and what was weakened by this refreshed SFDR designation.

Simone Ruiz-Vergote (12:29):

So the categories have been made stronger or one can say explicit ARTICLES eight and nine were really more legalistic terms and not proper legal categories. They were paragraphs in a regulatory text. Now they have names, the categories, as I said already, sustainable transition and ESG basics. So this is something the market can work with on top of, it's a rather principle-based framework which allows the market to adjust to find its way back from where it is today. But we will also see some more regulations and more rules coming out that are supposed to make this stronger and maybe more directional. So we'll have to see if the regulator manages to balance the urge to tell the market what to do with. I think a quite good understanding that this could also restrict the market uptake of these sustainability ambitions and potentially restrict the flow of finance into sustainable categories.

(13:34):

There is a drawback of the vagueness of course, as well as a bit the nature of regulation. So there is for instance, questions now about what is a credible transition plan, how should we assess that? So that's one. And then I think another concern we've seen emerge is that in the past or the current context with the article 17 sustainable investment assessment, you can actually go at the level of a company of an asset and you can say, well, apple has, now I'm inventing this now, but 20% sustainable revenue. And then you go to the next company and says, this company has maybe 30% sustainable revenue, and then you can actually compare them and you can aggregate that at the fund level to a percentage of investments that are in sustainable assets. That is now harder because the new rules really apply across a universe of assets within a fund. There are minimum thresholds of assets on the management that have to be covered with your sustainability strategy, so that going down on a specific investment is harder maybe than it was in the current context.

Mike Disabato (14:50):

So I think the real question to end us here is a pretty basic one. Does it seem like the EU commission kept the mission of its regulation intact in its own words? The goal of SFDR was to promote and ensure comparability between financial products that label themselves as a certain degree of sustainability, and in doing so, that will allow capital to be attracted to those types of funds and then allow the transition of the economy to a lower carbon model, which the EU does want to do. So does this simplification achieve that goal? One of the big things that seems to have changed is that there is more of estimation allowed by financial market participants that have these kind of products that the EU calls and that we've been calling them throughout the episode. Yes, there's data that is no longer required that's going to cut the non-disclosures, but you can still have and promote comparability even if you cut some of that data. But if you let everyone decide differently what is or is not considered in the bounds of these three designated sustainability labels, then that comparability might go out the window. So do those allowances, these freedoms and flexibilities, the simplification, remove the insuring comparability pillar of the SFDR, or was this something that was really necessary because it was already difficult to do that and this allows for a better version of the SFDs requirements?

Simone Ruiz-Vergote (16:16):

Yes, comparability is should be an aim of the regulator, and I think it is really driven by consumer needs and wants. But now I think from a category perspective, yes, I would expect the three categories and their related rules to improve comparability. So now you have clear instructions on the use of names for funds and what should be in it, and there's also a much more specific disclosure obligation that we expect to see with the more detailed rules next year. So for instance, if you had a software fund, we would be seeing exactly what adverse impact that fund considers. So it should be relatively similar. If you have a fund that for instance goes into financing social housing, there might be topics related to energy efficiency that is a harm indicator. But then the question, if you assess it on the materiality basis, will you always necessarily come to the same adverse impact?

(17:22):

And there might be differences how fund managers interpret that. And there is this leeway of interpretation. There is also the question of national implementation and how national regulators will look

at this. The proposal explicitly says that national supervisor shouldn't do gold plating, which means deviating from the rule in the implementation and the supervision process. But if Germany and the German regulators ask questions on the same product, they might be different from the questions you receive in France. And so that can make a difference in the implementation so that we'll have to see how this plays out. One important element is this, estimates are now explicitly allowed for as long as the methodologies made transparent. So as a result, there is some way of scrutinizing the approach taken for the estimation, and that might mean that you see different models being used, and as a result, the data might also differ.

(18:20):

So we will see some divergencies on that basis simply because this closures from the corporate side are not yet allowing you to cover a hundred percent of the assets under management. So there are still going to be data gaps Today, we just had frac release there, the new standards on sustainability disclosures to the commission, and there was a strong focus on making sure that the data would still be there for any SFDR related reporting. However, this is European companies only, and of course most investors have a global portfolio, so data gaps will still be there, estimates will still be needed, are now encouraged to be used. So comparability might still be a little bit a long way out there to have full a hundred percent comparability. Depends really on many factors,

Mike Disabato (19:12):

Many factors. Indeed, I think that point touches perfectly on what seems to be the general temperature of the market and market participants at the moment, and that is to let this SFDR regulation take hold to see if there's innovation that comes from it, better comparability if some financial market participants do better or worse in terms of disclosure and what that might mean for those that aren't attracting capital investment toward their products. If you think about it, this regulation has been around since 2018 before COVID, and there's been a myriad amount of changes to the regulation from speaking with Simone. It seems like what is desired now is time for the SFDR to be implemented, time for the market to adjust to it and time to allow it to breathe and either prove itself or disprove itself. I guess we will just have to see if it's able to do that with this iteration itself. And that's it for the week. I want to thank Simon for talking to me about the news with an ESG twist, and I want to thank you so much for listening. If you like what you heard, please don't forget to rate and review us wherever you get your podcasts. That really helps and subscribe if you'd like to hear myself or any of the other co-hosts of sustainability now each week. Thanks again and talk to you soon.

Speaker 3 (20:46):

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