EXPERT OPINION

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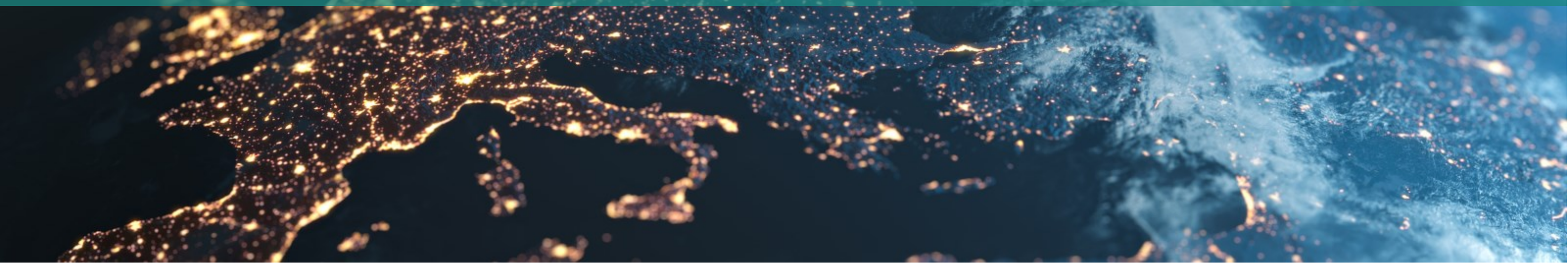
SFDR: NAVIGATING THE UNCERTAINTY

WHAT ARE THE SOLUTIONS FACING THE INCONCLUSIVE RESULTS AND WHAT ARE THE PROSPECTS FOR THE REVISION OF THE TEXT?

FEBRUARY 2024



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Introduction

Faced with the accumulated delay in financing the completion of the European sustainable objectives, pointed out in May 2023 by the ***European Central Bank***, the European Commission has launched a ***consultation*** on the revision of the SFDR regulation. I Care's sustainable finance team analyses the causes behind this situation and offers some perspectives on how to proceed in the coming months, both for regulators and for financial actors.

- Despite the numerous clarifications issued by regulators, the regulatory concepts remain unclear and their interpretation by financial actors is still too disparate;
- Reporting obligations have only partially increased the transparency and comparability of investment strategies, in particular because of their lack of readability and the limitations encountered in collecting the underlying data;
- The upcoming revision of the regulation could be an opportunity to further clarify the terms used, facilitate the articulation between regulations and streamline reporting obligations;
- Beyond transparency obligations, the mainstreaming of appropriate sustainability indicators and the development of frameworks for robust transition plans are essential;
- Finally, emphasis should be placed on reviewing asset valuation models to ensure that sustainability risks are considered more consistently.

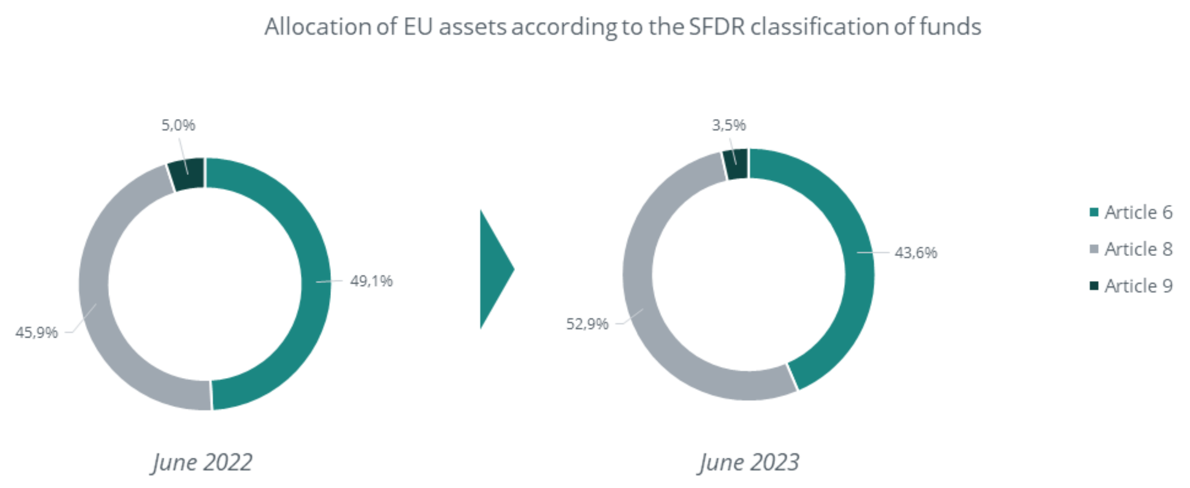
To find out more about the European Union's Sustainable Finance Action Plan and its flagship regulation, SFDR, refer to our ***Overview of European Sustainable Finance****.*

1 Nearly three years after the SFDR came into force, the reality does not (yet?) match its ambitions

A ***recently published study*** by Novethic on the practices of 183 French sustainable funds[1] reports a "lack of credible and measurable transition dynamics", noting in particular vague sustainable investment objectives, unambitious investment criteria and the large presence in the portfolios of these funds of companies with poor sustainability performance. This is partly explained by the difficulty encountered by financial actors in rigorously applying the SFDR Regulation due to the ambiguities of the text and the climate of uncertainty surrounding it, as well as the lack of reliable underlying data to calculate a large part of the required indicators.

Vague concepts that leave room for interpretation

Since its implementation in 2021, regulatory bodies at various levels have regularly published answers to questions from market participants. But the multiplication of announcements, although clarifying some aspects, may paradoxically have led to greater overall confusion. Even more so as some of the clarifications implied new obligations, often relevant but introduced at a late stage, such as the obligation to apply a common definition of sustainable investment for the entire portfolio. The market has subsequently experienced a wave of "declassifications": in June 2023, Article 9 funds accounted for 3.5% of assets invested in the European Union[2], compared to 5% a year earlier[3].



Source: I Care by BearingPoint based on Morningstar Direct data, collected from the prospectuses of 97% (June 2022) and 98% (June 2023) of funds marketed in the European Union, excluding money market funds, funds of funds and feeder funds.

[1] *The study covers a selection of 183 funds, including the 161 relevant Article 9 funds within the scope of France and some funds that are not categorized as Article 9 investing in the transition.*

[2] *SFDR Article 8 and Article 9 Funds, Q2 2023 in Review, July 2023. Study based on 98% of funds marketed in the European Union.*

[3] *SFDR Article 8 and Article 9 Funds, Q2 2022 in Review, July 2022. Study based on 97% of funds marketed in the European Union.*

In addition, the announcements of the regulatory authorities did not clarify certain fundamental concepts of the Regulation. In this respect the European Commission has stuck to its original intention. This stance leads to important differences in the robustness of investment strategies. Most financial players have not significantly revised their practices in terms of sustainability integration, preferring to adapt their interpretation of SFDR concepts to their existing practices. Another limitation of the regulation is the lack of distinction between the different asset management strategies (listed or unlisted, direct or indirect). It has made the task more complex for a number of financial actors. In particular, the requirements and concepts used appear to be better suited for direct listed investment than for unlisted and indirect investment[4].

Opacity maintained on the real practices and investments of the funds

It is also difficult for end investors to find their way around, especially non-professionals. The publication of various documents required by the SFDR Regulation to improve transparency and comparability between investment strategies is a good start, but these documents are rendered almost unreadable to the uninitiated due to their cumbersomeness, complexity, and again the vagueness of concepts. The latter is maintained by the use of the classification of funds (Article 8 or Article 9) by financial actors as a "binary" label and a marketing argument. The most virtuous practices in terms of sustainability integration are thus sit alongside the most imprecise, or even the most lax ones. In 2022, an investigation conducted by a dozen European mainstream media[5] accused "green" finance of "greenwashing". It revealed that a significant proportion of funds classified as Article 9 according to the SFDR Regulation were investing in sectors such as fossil fuels or aviation. While this practice is not in breach of the regulation and deserves an in-depth analysis, the text should at least ensure that investors are clearly informed about the real destination of their investments to live up to its ambition and the stakes involved.

Incomplete or approximate underlying data

Finally, the transparency requirements of the SFDR are out of step with the reality of sustainability data availability. Indeed, the publication by companies of CSRD-related data is not due to start until 2025[6]. Regarding the EU Taxonomy, full data on the alignment of companies' activities will only be available in the 2024 annual reports for the year 2023. To date, the data published by financial players are therefore incomplete and based on estimates that may lack consistency depending on the methodology used. A 2023 Morningstar Sustainalytics study[7] showed that only 0.4% of companies published in their annual reports 90% of the data needed by investors to publish consolidated indicators of the Principle Adverse Impacts (PAI) of their portfolio.

[4] *Direct investment consists of investing directly in assets (companies, governments, infrastructure), while indirect investment consists of investing in financial products that themselves invest in assets.*

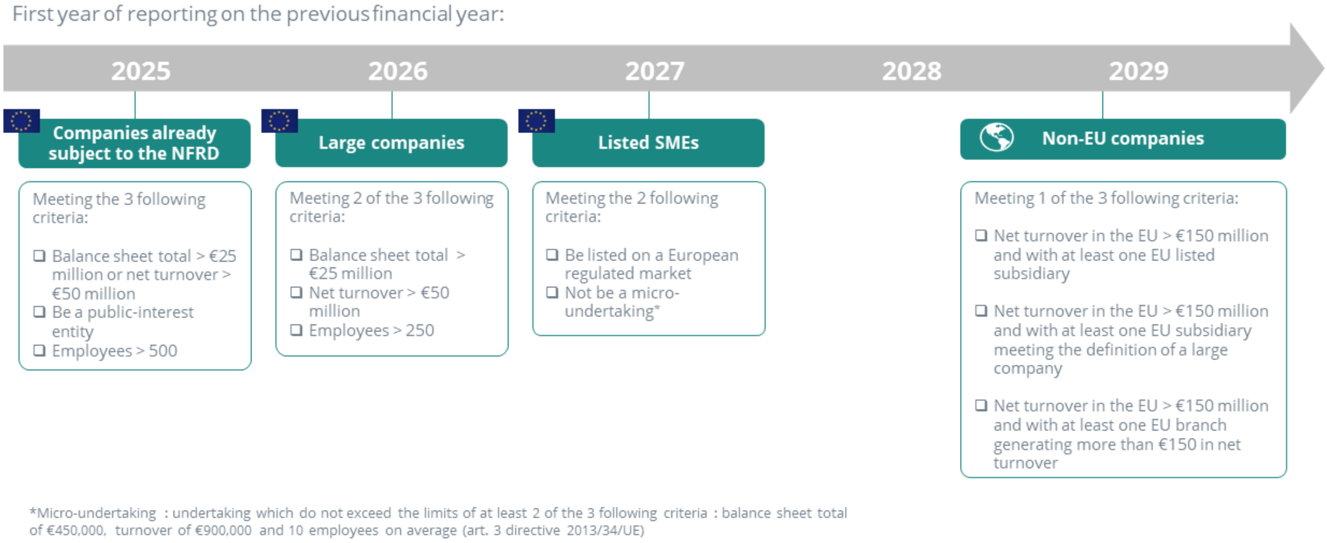
[5] **The Great Deception of "Green" Investment Funds**", *Le Monde, November 2022.*

[6] *The NFRD directive, which is less demanding and has a more restricted scope, applies to companies subject to the CSRD until the reports published in 2024 for the year 2023.*

[7] **Filling in the data gaps**, *Morningstar Sustainalytics, Mai 2023.*

Scope of the CSRD

50,000 companies will have to comply with the CSRD, whereas only 11 700 are currently covered by the NFRD



Source: I Care by BearingPoint

Recognizing and reinforcing the benefits of the regulation

However, it is important to mitigate some of the shortcomings of the SFDR Regulation. It remains a pioneering text that has made it possible to standardize the integration of extra-financial issues in mindsets and in investments. It is in this context that the recent overhaul of the French "***ISR" label*** (for Socially Responsible Investment)[8] has raised the level of requirement, in particular with new exclusion obligations in fossil fuels[9] and the request to take into account the PAIs of the SFDR Regulation.

The regulation also achieved one of its objectives: to encourage other countries to follow suit. In the United Kingdom, the ***Sustainability Disclosure Requirements (SDR)*** Regulation is inspired by the SFDR Regulation. While it is less ambitious for the moment (i.e. without any notion of mitigation of negative impacts or of alignment with the Taxonomy), it does learn, in some way, from the errors identified for its predecessor, in particular on the classification of funds. The SDR Regulation proposes a classification system by investment theme (impact fund, transition fund, ESG fund), which is more readable for the public and easier to reconcile with specific criteria (e.g. investment policy, engagement policy, etc.).

To enable the SFDR Regulation to truly achieve results in line with its ambition, the European Commission is considering making changes. It has already gathered the views of the public and professionals in the sustainable finance sector as part of a consultation conducted in the last quarter of 2023. The questions focused on:

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[8] *The "ISR" label was created in 2016 by the French Ministry of Economy and Finance to identify investment funds implementing a robust socially responsible investment methodology. The criteria for obtaining the label were revised in 2023 and will apply from 2024.*

[9] *The new criteria for the SRI label include the exclusion of new fossil fuel exploration, exploitation or refining projects and emitters whose activity is more than 5% in the coal or non-conventional fossil fuel sector.*

- The current application of the regulation and the potential difficulties encountered by financial actors;
- The articulation with the other pillars of the European Union's Sustainable Finance Action Plan (Taxonomy, MiFID II, DDA, CSRD, etc.);
- Possible options to revise the text and improve its impact (revision of the fund classification system, increase in reporting requirements, integration of criteria for fund names, etc.).

On this last point, this consultation introduces the possibility of revising the classification of financial products (currently in Articles 6, 8 and 9) by proposing a thematic categorization according to investment strategies, following the example of the SDR Regulation in the United Kingdom. The ***responses collected, published in early 2024***, lean towards this solution.

However, the revision of the text, if it does happen, will take at least 12 to 18 months, given the context of the European elections in June 2024 and the multiple other ongoing regulatory developments (CSRD, Taxonomy, etc.). This delay should not justify a weakening of efforts to rigorously apply the text by then: ***the review of the SFDR documents by the AMF*** started in July 2023 and is based on the current state of the regulations.

2 Harmonizing and improving the regulatory framework currently in place

In the context of the revision of the SFDR Regulation, and to enable the European sustainable finance regulatory framework more generally to achieve its ambitions, the following approaches, proposed by various actors in the sector, appear interesting to us.

Defining more precisely the terms introduced by the regulation

This is one of the main issues that the European Commission is tackling through its consultation, by proposing a classification of funds with a more accessible vocabulary.

However, if this new approach is indeed implemented, it will nevertheless be necessary to provide detailed clarifications so as not to fall into the same errors as before. Defining, in particular, what is an asset "in transition" can be a complex exercise and take very uneven forms. Evaluation methodologies (which focus on two pillars: the objective assessment of the starting point and the robustness of the trajectory) and the level of transparency applied to communicate on these methodologies are currently very unequal. There is an opportunity here to relate to the criteria requested for business transition plans by the CSRD. In addition, a ***set of recommendations*** published by the European Commission in June 2023, provides guidance on how to define the contours of rigorous transition plans.

Additionally, changes in fund classification will not clarify the modalities for effectively considering PAIs to mitigate the negative impacts of investments.

Aligning the reporting requirements of companies and financial players

The indicators that will have to be published by companies under the CSRD in the 2025 annual reports are currently being defined. Financial players expect a lot from this new regulation to compensate for the very significant lack of data they face today to publish indicators relating to the PAIs. Aligning the reporting requirements of companies in the real economy with those of financial institutions is a major challenge in the finalization of the CSRD.

Facilitating coordination with the various regulations at the global level

This step is essential in the current context of very strong interconnection between global markets to make the more ambitious European sustainable finance regulation an advantage rather than a handicap for European actors and so that it is not supplanted by others on the international scene. From this point of view, work on interoperability with other international repositories is essential, in particular with the ISSB[10], which adopts a simple materiality approach.

[10] *The International Sustainability Standards Board (ISSB) is affiliated with the International Accounting Standards Board (IASB), the organization behind International Financial Reporting Standards (IFRS). It is working on the development of standards for corporate sustainability disclosures. The ISSB wants its standards to become a global reference framework, competing with the EU's CSRD.*

Streamlining reporting obligations

The aim is both to provide quick and easy access to crucial sustainability information to compare fund strategies and performance, and to streamline the various reports to make them more readable. However, such simplification should not lower the level of ambition of the regulation. In December 2023, the European Supervisory Authorities[11] proposed as a recommendation a ***streamlined version of the reporting templates*** imposed by the European Commission.

One of the solutions to improve comparability, mentioned in the European Commission's consultation, is to impose the same reporting obligations for all funds, regardless of their strategy. This option would also resolve the current paradox of additional resources required to launch and manage a sustainable financial product compared to a financial product without sustainability constraints.

This streamlining could also be an opportunity to strengthen transparency obligations on engagement policies, which are increasingly identified as an essential practice and sometimes more relevant than exclusions to enable an effective transition.

[11] *There are three European Supervisory Authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). Together with the national authorities of the Member States, they supervise the application of European regulations by the financial markets. In France, the* Autorité des marchés financiers *(AMF) and the* Autorité de Contrôle Prudentiel et de Résolution *(ACPR) supervise the day-to-day application of the SFDR Regulation at the national level.*

3 Moving beyond transparency obligations to truly put finance at the service of the transition

While the harmonization of European regulations, particularly the overhaul of the SFDR regulation, could help redirect capital flows, financial actors must step up their efforts beyond transparency obligations if they are to have an actual impact. Based on our expertise and experience with our clients, we propose some best practices to accelerate the alignment of investments with the transition.

Developing relevant sustainability indicators and robust transition plans

In recent years, sustainability indicators and the methodologies used have become much more diverse and sophisticated. However, as a recent study by Novethic shows[12], the indicators used by funds to assess the sustainability performance of investments are still very general, and the robustness of the approaches applied varies. For example, the alignment with the ***Sustainable Development Goals (SDGs)*** is the most commonly used indicator for sustainable funds as defined by the SFDR. But this indicator allows for very different themes to be mixed, and the data is based on approaches that are often qualitative and vary greatly depending on the data provider. ESG rating is also still very present as an indicator of sustainability in these funds, even though it does not measure performance on a specific sustainability issue. Other widespread indicators such as the carbon footprint or the biodiversity footprint[13] only make it possible to evaluate part of the performance, in this case with a static and partial vision (without a vision of future performance and of the action plans adopted). Alignment with the EU Taxonomy, on the other hand, measures the contribution to the transition in a binary way, making it impossible to compare aligned and non-aligned activities.

It is therefore important for financial actors to be able to combine these indicators with others to accurately measure the level of contribution of companies to the transition over time and thus make greater commitments. To achieve this, the sector must continue to develop and use innovative metrics, some in such a way as to take into account future performance (e.g. 2°C alignment metrics[14]), others to obtain a more holistic and/or granular assessment (e.g. the Net Environmental Contribution or NEC[15]) in order to build environmental methodologies that are otherwise truly impactful, at least more scientifically relevant.

Additionally, following the example of the French methodology of ADEME ACT4Finance[16], tools for assessing the robustness of transition plans and the environmental performance of financial actors are gradually emerging. It responds to the demands of a clientele that is

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[12] *The transition through sustainable funds, Myths and Realities, Novethic, November 2023.*

[13] *With the same logic to the carbon footprint, the biodiversity footprint assesses the impact of societies on the environment and ecosystems. More information in the* **Novethic lexicon**

[14] *2°C alignment metrics measure the alignment of assets and portfolios with the goals of the Paris Agreement.*

[15] *The NEC is a multi-thematic indicator developed by the* **NEC initiative**. *The NEC evaluates economic activities according to their impact on the environment according to the climate-biodiversity-resources triptych on a scale between -100 and +100. The compilation of these data makes it possible to obtain an indicator at the level of enterprises and investments.*

[16] **ACT4Finance** *is a methodology being developed by ADEME to assess the transition plans and environmental performance of financial players.*

increasingly concerned about the use made of their savings. Market initiatives such as the Net-Zero alliances[17], the Science-Based Targets initiative (SBTi) for Finance[18] - which is tending to become an international standard - or the Task Force on Nature-related Financial Disclosure (TNFD),[19] which provide the financial sector with guidelines to align their business model with the environmental transition and strengthen their reporting, are still open to criticism. TNFD encourages companies to communicate on the biodiversity-related risks of their activities but does not take a clear position in favor of double materiality, and only deals with reporting without encouraging the real transformation of business models. SBTi for Finance provides a methodological framework for setting ambitious climate targets, but without then assessing the associated transition plans. Finally, Net-Zero alliances are heterogeneous, and due to their voluntary nature, can neither sanction non-compliance with the commitments set nor guarantee the robustness of the transition plans developed.

However, it is now up to banks, insurers, asset managers and other capital owners to rely on these frameworks and to thoroughly revise their environmental strategy to be more consistent and to protect against the growing reputational risk.

Updating asset valuation models for more consistent consideration of sustainability risks

Finally, aware of the fiduciary duty to which all financial actors are subject, we believe that greater transparency on sustainability data (and the financial risks associated with it) must go hand in hand with the quantification of financial impacts ("pricing") and their integration into prudential rules.

In a 2020 ***exercise to model the impacts of climate change on the financial system***, the Financial Stability Board (FSB) acknowledged that an acceleration of climate change (and the physical risks associated with it) could destabilize the financial system in the long run. We find this observation in another modelling exercise, that of the ***climate stress tests carried out in 2021*** by the ECB and their impacts on the economy as a whole, which warns of "the anticipation of potential severe losses for banks in the next 30 years" and the systemic nature of the climate risk weighing on banks. However, the FSB's estimates of the consequences of physical risks show that an average global temperature increase of +4°C would lead to a decline in asset prices[20] of only 2.9% to 9.7%, with asset price volatility remaining within normal daily ranges. Yet such a level of global warming, considered catastrophic by climate scientists, would have significant consequences for the stability of the financial system as a whole.

[17] **Net Zero alliances** *are several market alliances bringing together various types of financial players (NZBA for banks, NZIA for insurers, NZAM and NZAOA respectively for asset managers and owners, etc.) whose participants commit to defining climate objectives according to specific criteria.*

[18] *Companies that join the* **SBTi** *commit to setting their emissions reduction targets in line with methodologies specified by sector, including for the* **financial sector**.

[19] ***TNFD*** *is an international working group that is developing a framework for reporting biodiversity information. The framework for climate-related reporting has been in place since 2017 with the* **TCFD** *(Task Force on Climate-related Financial Disclosures).*

[20] *FSB estimates a total of $143 trillion in global assets managed by non-bank financial actors, focusing on market and credit risks generated by the physical risks of climate change.*

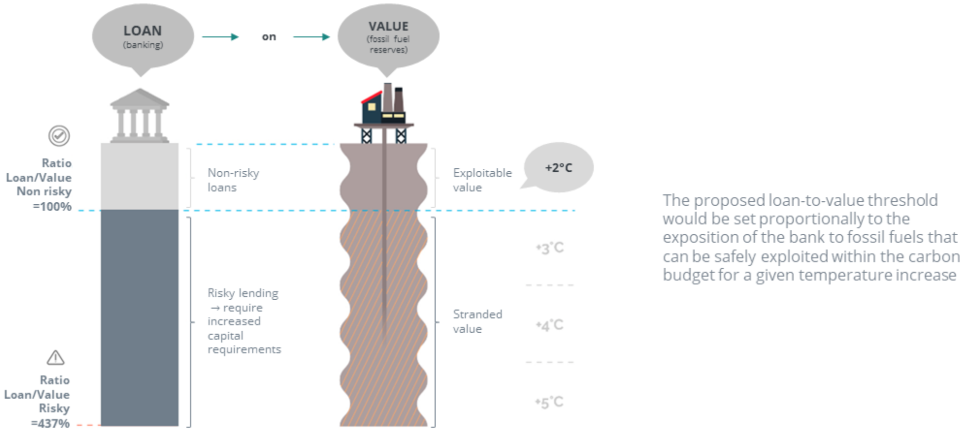
In our view, this example highlights two essential needs:

1. **Updating business models to allow for better pricing of sustainability risks.**
   - At the corporate level, we can cite as an example the proposal to introduce "climate warnings" (much like "profit warnings[21]") when a listed company believes that it will not achieve the climate objectives it has set for itself. This would allow financial actors to adopt more robust sustainability strategies and contribute to the transition while honoring their fiduciary duty, and avoid financial losses caused by undervalued sustainability risks (such as stock market crashes and long-term declines in valuation that can result from controversies).
   - At financial actors level, certain regulatory requirements point in this direction. The ***decree implementing the Article 29 of the Energy and Climate Law*** requires financial institutions to calculate and publish a "quantitative estimate of the financial impacts" of climate risks. However, this requirement has so far suffered from certain pitfalls, including the use of reassuring climate scenarios leading to incomplete risk modelling.

2. **Adopting prudential rules for financial actors consistent with the supervisors' will to protect the financial system against sustainability risks.**
   - Some regulatory developments are beginning to incorporate such rules, such as the Own Risk and Solvency Assessment (ORSA) process for insurance companies. This process has been enriched with an ***application guide on climate materiality assessments and climate scenarios*** based on two observations: (i) only a minority of companies assess climate change risks using scenarios in ORSA and (ii) most assessments carried out using scenarios take a short-term perspective.
   - Other prudential rules still need to be strengthened, such as ***Finance Watch's proposal*** to increase capital requirements for financial actors with too high exposure to fossil fuels.

[21] *A "profit warning" is the term used to refer to the warning issued by a company to alert shareholders to poor financial results. This means that the forecasts and targets previously set are likely not to be met and that the price of the stock associated with the company in question will inexorably fall.*

Using a loan-to-value ratio to assess the macroprudential risk of fossil fuel finance



Source: Finance Watch, summarised by I Care by BearingPoint

ABOUT

I Care by BearingPoint, a leader in impact transformation, is BearingPoint's sustainability centre of expertise.

From strategy to implementation, I Care's experts provide concrete and innovative transition solutions to companies, financial institutions, and public organizations.

I Care's ambition is twofold: to offer technical expertise on environmental, climate, biodiversity, social impact, circular economy, and sustainable finance issues; and to combine this expertise with transformational know-how to engage its clients in the evolution of their businesses and business models.

I Care by BearingPoint is a major player in the field of sustainability consulting and has more than 200 specialist consultants worldwide.

Because our **impact** matters

I Care by BearingPoint

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