SUSTAINABLE FINANCE DISCLOSURE REGULATION: ESG IN A NEW DIMENSION

As of 10 March 2021, new sustainability reporting requirements will apply to the European financial services sector. What sounds like a topic relevant to reporting specialists only will actually affect us all. The Sustainable Finance Disclosure Regulation (SFDR) is part of the EU's action plan on financing sustainable growth – a truly mammoth project that will soon change large parts of our economies. As is typical of the EU, the subject matter is complex. But the following questions and answers will give you a compact and comprehensible overview of a project that is here to stay.

WHY DOES THE SFDR FOCUS ON THE FINANCIAL SECTOR?

The EU is seeking a fundamental transformation of the economy towards greater ecological and social sustainability. This is how it wants to meet the 17 Sustainable Development Goals of the United Nations and, above all, the commitments of the Paris Climate Agreement. However, the EU Commission is aware that this will require enormous efforts.

For example, in order for the European Union to achieve its climate goals by 2030, the EU Commission estimates an investment of trillions be required. The Union alone cannot provide these funds. It believes that the financial sector needs to play a key role in mobilising institutional and private capital for wind and solar farms, innovative technologies, electric vehicles, the hydrogen economy and, more generally, for a more ESG-oriented economy.

WHAT IS THE SFDR SUPPOSED TO ACHIEVE?

The main goal is to achieve more transparency in the area of sustainable investment. So far, for example, there are no binding rules on which investment funds can be described as sustainable – almost anything is possible. The EU Commission says that many more investors would opt for sustainable investments if they had a clear understanding of their advantages and if they could easily compare them. For this reason, product providers are now required to disclose how they deal with the subject of sustainability within their company and when making investment decisions.

WHAT DOES THE SFDR REQUIRE?

The regulation distinguishes between financial advisers and financial market participants such as fund companies, insurance companies or asset managers. The financial market participants, which also includes KGAL, have to fulfil requirements on two levels:

Disclosure at company level:

- Financial market participants must explain on their websites, in pre-contractual information and in regular reports the integration of sustainability risks into their investment decisions. Sustainability risks refer to environmental, social and governance events that can affect the value of an investment. For example, extreme weather such as flooding can threaten the value of real estate near the coast. Or social grievances at companies in a fund portfolio can damage their reputation and consequently also their business prospects.

- The second regulation concerns the disclosure of principal adverse impacts (PAI) of investment decisions on sustainability factors. The question is to what extent the investment objects can have a negative impact on the environment, social and labour issues or human rights. When buying an office building, for example, the extent to which a heating system powered by fossil fuels harms the climate would have to be determined. Or, when investing in a company, it should be checked whether it adheres to the UN Global Compact on corporate social responsibility. Financial market participants with less than 500 employees have the option of not taking PAIs into account, but have to give reasons for doing so.

Disclosure at product level:
No matter whether AIFs, mutual funds, ETFs or endowment life insurances – in future financial market participants must inform their investors about the role of ESG in all of their products, even if they do not pursue a sustainable investment strategy. The providers will list their products in one of the following three categories at their own discretion:

- Normal products according to Article 6 of the Regulation do not explicitly include sustainability criteria in investment decisions; only information on the handling of sustainability risks is obligatory.

- Light green products according to Article 8 take into account environmental-social aspects in the investment process, for example in the form of exclusion criteria and best-in-class sustainability filters.

- Dark green products according to Article 9 strive for tangible sustainability goals such as a reduction of greenhouse gases. Because of their direct effect, they are also referred to as impact funds.

Initially, the financial market participants will have to provide information on the sustainability risks of their products, as is the case at the corporate level. From 2022, the presentation of principal adverse impacts at product level will also be introduced, and comparative reporting will become mandatory in 2023. For light and dark green products, more comprehensive disclosure obligations apply than for normal products. Further information on these obigations will be available in 2021.

WHAT SPECIFIC INFORMATION ON SUSTAINABILITY SHOULD BE PROVIDED?

The Regulatory Technical Standards (RTS) deal with this core part of the Disclosure Regulation. The RTS will apply comprehensively at the so-called Level 2 from 1 January 2022. Until then, financial market participants can work with general descriptions of their sustainability activities at Level 1.

The RTS specify how to deal with adverse sustainability impacts (PAIs). They use a range of sustainability indicators such as greenhouse gas emissions, energy efficiency, biodiversity and water consumption or the quota of women on supervisory boards. For investments in companies, there are 14 mandatory and 40 voluntary indicators. Depending on the asset class, financial institutions have to consider between 4 and 16 indicators. The RTS also deal with information requirements for light and dark green financial products. For example, the financial institutions are supposed to fill out a form with detailed information about their products.

As detailed as the technical regulatory standards are, a document of almost 200 pages, there remain uncertainties. Will the financial institutions actually be able to compile all the data required by the sustainability indicators? Is the one form suitable for completely different financial products? Which criteria do light green financial products have to fulfil exactly? What distinguishes them particularly from dark green products?

Despite unanswered questions, financial institutions must already assign their products to the categories normal, light green and dark green at the current Level 1 of the Sustainable Finance Disclosure Regulation. However, whether the products really meet all the requirements for the selected category will only become absolutely clear at Level 2.

WILL THE SFDR GIVE A BOOST TO ESG?

This is to be expected in two ways. Firstly, among the financial market participants and financial advisers. While in the past there were still financial service providers who treated the topic of sustainability more as a secondary issue, this is no longer possible. From product development to the legal department and compliance to portfolio management, ESG will become front and center across all processes. This is exactly what the EU wants to achieve.

Secondly, demand from institutional and private investors should increase. With the new regulation, they will be provided with a wealth of information, more transparency and comparability, as well as a simple breakdown of financial products into three categories. With three categories available, will investors focus on the one that does not pay special attention to sustainability? There is already a recognisable trend towards the other two variants. It can therefore be assumed that financial market participants will no longer issue as many normal financial products in the future as they did in the past.

However, the success of the SFDR will also depend to a large extent on how practicable the rules will be. For example, there is still a need for clarification on the Regulatory Technical Standards.

WHAT ELSE IS THE EU DOING TO ADVANCE SUSTAINABILITY?

The Sustainable Finance Disclosure Regulation is only one part of the EU's action plan on financing sustainable growth. The Taxonomy Regulation, a kind of glossary to define which economic activities are actually considered sustainable and should be promoted, will also be of great importance over the course of this year. Initially, the Taxonomy Regulation will focus on climate and environmental protection, but later it will also shed light on other areas of sustainability. In addition, in 2022 it will become mandatory to ask clients about their sustainability preferences in investment advice, which should further stimulate interest in ESG, especially among private investors.

These and other measures of the EU action plan should provide the necessary breakthrough for enhanced sustainability in investment. As a sustainability-oriented asset manager with its own climate strategy, KGAL strongly welcomes this prospect.