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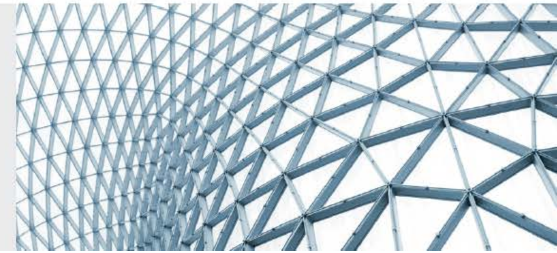

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What investors should know about SFDR

Asset managers sorting funds into different sustainability categories realise it's only the first step on a longer ESG classification journey.

Key Takeaways:

- The SFDR is designed to improve and standardise investment firms' ESG reporting, providing greater transparency for investors.
- However, the classification element of the regulation creates a hierarchy that could lead to a belief that Article 8 and 9 funds are always 'better' products. than Article 6 funds.
- The design of SFDR, and upcoming MiFID rules that will require distributors to ask clients about their ESG profile, are likely to reinforce that trend, as Article 6 products will not be deemed suitable for a client with an 'ESG preference'.
- Investors therefore need to be cautious of simply choosing funds that are categorised as Article 6, 8 or 9 and should, as ever, do their homework.

The Sustainable Finance Disclosure Regulation (SFDR), which applies since March 10, requires asset managers to sort their funds into different sustainability categories based on the product's characteristics. Funds are categorised as articles 6, 8 or 9, with 'Article 9' funds requiring 'sustainable investment' as their explicit objective.

The SFDR is designed to improve and standardise investment firms' ESG reporting and allow investors to assess and compare the ESG approaches of different investment funds – essentially, to provide greater transparency for investors and avoid 'greenwashing'. Yet questions have been raised as to whether asset managers are clear about the consequences of categorising themselves as article 8 or 9, and the amount of information they will need to produce for it.

Indeed, classification is not the endgame but rather the first step of a longer journey. Starting in 2022, funds categorised Article 8 or Article 9 will need to publish highly standardized ESG factsheets that detail the fund's ESG strategy, characteristics, benchmark and due-diligence policies. In annexes to fund prospectuses and annual reports, these templates will also include a KPI around alignment with the EU Taxonomy – a system for classifying 'sustainable economic activities' aligning with the Paris Agreement objective of carbon neutrality by 2050.

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In this short Q&A, Harald Walkate, Head of ESG at Natixis Investment Managers and Corentin Couvidat, of Natixis Investment Managers' Regulatory Affairs department, provide insight into how investors and advisors should read between the lines when assessing what SFDR means for sustainable investing.

For you, what is the single most important thing for investors to understand about SFDR?

CORENTIN COUVIDAT (CC): In this first phase, the main expectation of the regulator is that firms and funds comply with the principles of SFDR, notably leveraging existing ESG reports. Funds are classified into one of the three categories. So-called Article 9 funds are designated as having a sustainable investing objective. Article 8 is applied to funds that promote environmental or social characteristics as part of a broad investment strategy. Article 6 funds consider ESG risks as part of the investment process, or have no sustainable objectives at all.

HARALD WALKATE (HW): This system, in theory, is helpful for investors to compare funds. In practice, they need to be cautious of simply choosing funds categorised as Article 6, 8 or 9. The classification element of the regulation creates a hierarchy that could lead to a belief that Article 8 and 9 funds are always 'better' products. This is also caused by how Article 6 is drafted: it covers both funds that do ESG integration, without being promoted as 'ESG Funds' – which is what a majority of the market is doing – and funds that have no ESG approach at all. What the industry needs to avoid is a system where managers are incentivised to incorrectly label their funds as Article 8 or Article 9 to attract clients. If most or all funds are categorised as Article 8 or 9, the investor is no better off than before the regulation was implemented. In effect, this could actually incentivize the 'greenwashing' that SFDR is meant to counter.

Can SFDR help investors make sense of ESG?

CC: Although not perfect in terms of concepts and incentives, as Harald explained, SFDR has had the merit to put an important question on the agenda: what is an ESG fund? Of course, there is no one-size-fits-all answer to that complex question – and the relentless debates we had on SFDR classification are a testament to that. It gave us the occasion to screen our entire fund offering and ask ourselves crucial questions on the level of ESG integration of a fund, the binding nature of its ESG elements, its primary objectives – to name but a few. Ultimately, SFDR will put asset managers in front of their responsibilities and make us liable for 'saying what we do, and doing what we say', which is crucial for maintaining investor trust.

HW: Implementing regulations such as these, in an asset management group with our size and complexity, requires the involvement of a great number of corporate functions and many of our investment affiliates. This has really helped us expand the circle of smart people who are engaged in ESG. It includes recognizing that it means different things to different people, debating how and when ESG considerations can be relevant to investment decisions, trying to come up with guidelines to affiliates on how to classify funds and how to label, or not label, products, and challenging the ESG team on our policy and convictions. It has helped us influence the internal debate more than any corporate policy or ESG working group ever could.

SFDR certainly has its critics. What are the main areas of complaint?

CC: Let's face it, there were many iterations of the prudential banking rules before they were deemed fit for purpose. The same goes for MiFID. So it's not unreasonable for SFDR to take time to bed down. It acts as a conversation starter at global level, as we now see multiple jurisdictions thinking about designing their own ESG fund reporting rules – including the UK, US, Singapore and Hong Kong – and will draw lessons from the European experience in that space.

HW: It seems there were various drivers at the inception of SFDR, which have sometimes made it difficult to understand its main objectives, and how regulators want us to prioritize them – whether it is mobilizing more capital towards ESG goals, improving risk management, or tackling greenwashing. Yet, without a shared understanding of the problems and objectives, we fear that the proposed solutions are not optimally designed and, in some cases, might be counterproductive.

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Can SFDR achieve its purpose of providing more transparency for investors?

HW: I think the principle underpinning SFDR – there are products out there claiming to 'do' ESG and we need to help consumers make sense of them – is fine as far as it goes. However, the way that SFDR has been written and is now being interpreted is actually counterproductive. I would say that as a result consumers are less able to assess the different ESG-labelled products.

CC: Regulators have often said that SFDR categories should not be seen as labels, given they do not set 'minimum standards' for qualifying – in particular, as regards Article 8 funds. The design of SFDR, and upcoming MiFID rules that will require distributors to ask clients about their ESG profile, are, however, likely to reinforce that trend, as Article 6 products will not be deemed suitable for a client with an 'ESG preference'.

What else should investors look for when assessing the sustainability of funds?

HW: Before answering this, I should point out that asset managers and consumers often have different expectations from developing or buying ESG funds. Broadly, this can be, first, 'ethical or values-alignment', whereby the investor does not want exposure to certain companies or industries, and the activities or industries considered to be controversial can vary greatly across regions and even across different consumers. Second, 'financial' – the investor expects to better manage risks by taking into account ESG factors, or expects better financial performance, through ESG integration, best-in-class, or thematic strategies. And third, 'impact' – or making a better world. Here, an investor expects that his or her way of investing will lead to better real-world outcomes. And of course, you can have a combination of these objectives. Given that, today, there are no clear-cut metrics or accepted standards to determine whether any of these expectations are present in the investment process, we believe there are a couple of things that are key to the development of the market for ESG funds, and to avoid greenwashing. First, to provide clarity to the end-investor regarding the conviction of the investment team – its beliefs on the relevance of ESG to the investment process,. Second, a qualitative narrative on how this is implemented – how have you assembled your team, what specific expertise is needed, which data sources do you use? Over time, we would like to see regulations move in this direction by providing a classification along the lines of ethical, financial or impact, as described earlier. This would be awarded based on the conviction and narrative of the asset manager or investment team. We'd also suggest that for each category, the fund should describe clearly what it does and how it intends to achieve the goals. So, for category one, the manager should explain which sectors or companies it is excluding, and which data sources it uses to determine the companies in scope. Also, so as to not mislead consumers, it should describe clearly what this investment approach does and does not accomplish; for example, exclusions or negative screening approaches do not generally contribute as much to financial performance or solving societal problems. Investors need to know what they are buying. Finally, there should be a separate category for strategies that do not wish to market themselves as revolving around ESG objectives, but incorporate ESG considerations in their investment research and decision-making and are active owners.

What should we expect next in this area?

CC: SFDR is just the first piece of the EU's sustainable finance jigsaw puzzle. Next is the EU Taxonomy, a classification system that will determine what can officially be considered 'environmentally sustainable'. Starting in January 2022, large listed European companies will have to disclose the percentage of their revenues that stem from such activity. Article 8 and 9 funds will also have to publish their level of taxonomy alignment. In the future, we expect a mainstreaming of ESG in all financial services regulations – MiFID, AIFMD, UCITS, insurance and banking prudential rules – and a strong focus on ESG data.

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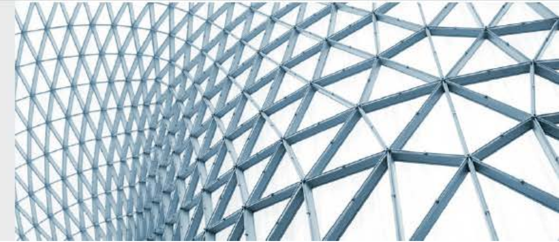

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