September 2022

SFDR: A new regulatory landscape for Sustainable Investing in Europe

Part 2: From SFDR Level 1 to SFDR Level 2

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Looking for a compass

In our previous SFDR research paper "*5 things to know about SFDR in June 2022*" we gave a high-level explanation of the 5 most important elements to know about the implementation of the EU Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation as they stand today, mid 2022. This second paper focuses on the entry into force, early 2023, of the SFDR Level 2 Regulatory Technical Standards (RTS).

As a reminder, *SFDR Level 1 became effective in March 2021*. As usual when it comes to the implementation of EU regulation, the first layer of implementation was primarily focused on the application of the high-level principles of the framework. Financial market participants were asked to disclose their Sustainability Risk Policies *at entity level*, and to state how their Remuneration Policies take sustainability into consideration. SFDR 1 also introduced a certain number of mostly qualitative disclosures *at product level*, the most important ones being :

- whether the product has sustainable investing as its main objective('article 9' product classification), or
- whether the product merely promotes, among others, Environmental or Social characteristics ('article 8' product classification), or
- none of the above, meaning the product does not take into account ESG aspects, or at least not in a meaningful way ('article 6' product classification)

These product definitions being rather vague, they are open to interpretation. This is why the industry was looking forward to the publication of the Regulatory Technical Standards (RTS), referred to as SFDR Level 2, complementing the Level 1 text, and giving further guidance regarding the content, methodologies and presentation of information of the SFDR disclosure obligations. Initially expected by December 2021, *the RTS were finally published on July 25th 2022 and will enter into force on January 1st, 2023*. Hence, preparations for their implementation are in full swing, and now is a good time to share our thoughts on the essential elements of these Level 2 Regulatory Technical Standards.

Disclosure Templates: describing the minimum share of Sustainable Investments

The disclosure templates are among the most important items within the RTS. There are five of them:

- One covering the disclosure obligations at entity level on the *Principal Adverse Impact indicators* (PAIs)
- Two covering the *pre-contractual disclosure obligations at product level*, including any taxonomy-related information needed (one for Article 8 and one for Article 9 products)
- And two *periodic reporting disclosure templates at product level* (one for Article 8 and one for Article 9 products)

We will provide more information on the ins-and-outs of the Principal Adverse Impact indicators in our next paper, for now we will focus on the Article 8 and Article 9 product disclosure templates.

Let's have a closer look at the pre-contractual disclosure template for Article 9 products. Article 9 product pre-contractual documentation will need to *state the minimum level (percentage-wise) of Sustainable Investments within the product*, i.e. investments in economic activities that contribute to environmental or social objectives, provided that the investments do not significantly harm any environmental or social objective[1] and that the investee companies follow good governance practices.

1 On a side note, for SFDR lovers, it is interesting to note that the Do No Significant Harm (DNSH) principle is coupled with the Principal Adverse Impacts (PAIs) and minimum safeguards.

Template pre-contractual disclosure for the financial products referred to in Article 9, paragraphs 1 to 4a, of Regulation (EU) 2019/2088 and Article 5, first paragraph, of Regulation (EU) 2020/852

Product name: *[complete]*

Legal entity identifier: *[complete]*

Sustainable investment objective

Does this financial product have a sustainable investment objective?
[tick and fill in as relevant, the percentage figure represents the minimum commitment to sustainable investments]

☒ YES

- ☐ It will make a minimum of **sustainable investments with an environmental objective:** ___%
  - ☐ in economic activities that qualify as environmentally sustainable under the EU Taxonomy
  - ☐ in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy
- ☐ It will make a minimum of **sustainable investments with a social objective:** ___%

☐ NO

- ☐ It **promotes Environmental/Social (E/S) characteristics** and while it does not have as its objective a sustainable investment, it will have a minimum proportion of ___% of sustainable investments
  - ☐ with an environmental objective in economic activities that qualify as environmentally sustainable under the EU Taxonomy
  - ☐ with an environmental objective in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy
  - ☐ with a social objective
- ☐ It promotes E/S characteristics, but **will not make any sustainable investments**

Source : European Commission
C_2022_1931_3_EN_annexe_acte_autonome_cp_part1_v5.pdf (europa.eu)

This 'Sustainable Investments' percentage is one of the most scrutinised and debated items since it is now clear that *the EC expects SFDR article 9 products to contain almost exclusively Sustainable Investments*. This recent clarification has significant consequences since Level 1 SFDR provided no such strict interpretation. As a result, some product manufacturers may have to adapt or enhance their sustainable investment strategies to maintain compliance with article 9 classification requirements, while some others may have to reclassify existing funds from article 9 to article 8. This may be the case for example for index-tracking products replicating Paris-Aligned or Climate Transition Benchmarks. There has been a lot of confusion throughout the industry in the past months about this eligibility. Under SFDR Level 1, their sustainable investment objective (linked to that of the index they track) was enough to classify them in Article 9 category. SFDR Level 2 however indicates that eligibility will need to be analysed line by line, i.e. at the level of each underlying company. And since Paris-Aligned and Climate Transition benchmarks do not fulfill this requirement, products that simply track these benchmarks can no longer be classified article 9.

But this clarification won't suffice to ensure true homogeneity within the Article 9 product category, since an analysis of various asset managers' European ESG reporting Templates (EETs) shows the percentage of 'Sustainable investments' within Article 9 products ranging from 20% to 100%. One reason for such a large range is the fact that *it is not clear whether the level of sustainable investments should be calculated at investee company level, or at the underlying economic activities level* of investee companies. If at investee company level, the calculation is binary (100% or 0%), i.e. the whole company is either considered as being sustainable or not. If the calculation is done at the underlying economic activities level, a company can have a split percentage (for instance 20% sustainable and 80% not sustainable) in function of the sustainable classification of its underlying economic activities. Besides, *assessment of each company's eligibility as 'Sustainable Investments' will be subject to the asset managers' chosen method*: internal ESG analysis or use of external data providers. This will create further discrepancies.

In this matter, Candriam will use its internal ESG analysis, and calculate the level of sustainable investments at company level. We have decided on a 75% threshold to define Article 9 eligibility for our products: they will hold a minimum of 75% of 'sustainable investments'.

Clarifying sustainable indicators

The next section of the pre-contractual disclosure template for Article 9 products aims to clarify exactly *which indicators should be used to define and measure the sustainable investment objective of the product*: possibly an improved ESG-scoring versus a broad-market benchmark, or an improved carbon footprint, or an improved contribution to one of the Sustainable Development Goals, etc.

What is the sustainable investment objective of this financial product? *[indicate the investment objective pursued by the financial product, describe how the sustainable investments contribute to a sustainable investment objective and indicate whether a reference benchmark has been designated for the purpose of attaining the sustainable investment objective. For financial products referred to in Article 5 , first paragraph, of Regulation (EU) 2020/852, in respect of sustainable investments with environmental objectives, list the environmental objectives set out in Article 9 of that Regulation to which the sustainable investment underlying the financial product contributes. For financial products referred to in Article 9(3) of Regulation (EU) 2019/2088, indicate that the financial product has the objective of reducing carbon emissions and where the methodology used for the calculation of that benchmark can be found.*

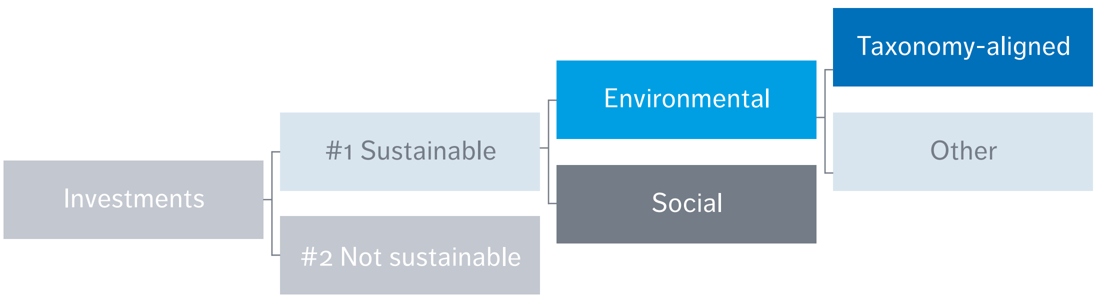
- What sustainability indicators are used to measure the attainment of the sustainable investment objective of this financial product?
- How do sustainable investments not cause significant harm to any environmental or social sustainable investment objective?
  - How have the indicators for adverse impacts on sustainability factors been taken into account?
  - How are the sustainable investments aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights?

Source : European Commission
C_2022_1931_3_EN_annexe_acte_autonome_cp_part1_v5.pdf (europa.eu)

More precisions on the calculation of the share of Sustainable Investments

The next section jumps back to the topic of the minimum level (percentage-wise) of Sustainable Investments within the product, adding further details using the below asset allocation framework, meaning that sustainable investments need to be split between (A) those aiming to achieve (an) Environmental Sustainable Objective(s) and (B) those aiming to achieve (a) Social Sustainable Objective(s). The Environmental Sustainable Investments then need to be split further between (i) those that are EU Taxonomy aligned and (ii) those that are not.

What is the asset allocation and the minimum share of sustainable investments?



#1 Sustainable

covers sustainable investments with environmental or social objectives.

#2 Not sustainable

includes investments which do not qualify as sustainable investments.

Source : European Commission
C_2022_1931_3_EN_annexe_acte_autonome_cp_part1_v5.pdf (europa.eu)

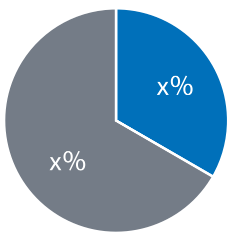
And then the template goes even more down the details of EU Taxonomy Alignment calculations (see below), requiring among others to calculate the percentage of taxonomy alignment both with and without taking into account sovereign exposures, etc.

To what minimum extent are sustainable investments with an environmental objective aligned with the EU Taxonomy? .

The two graphs below show in blue the minimum percentage of investments that are aligned with the EU Taxonomy. As there is no appropriate methodology to determine the taxonomy-alignment of sovereign bonds*, the first graph shows the Taxonomy alignment in relation to all the investments of the financial product including sovereign bonds, while the second graph shows the Taxonomy alignment only in relation to the investments of the financial product other than sovereign bonds.

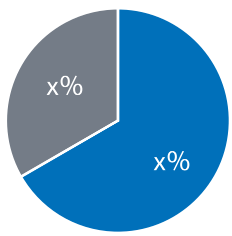
1. Taxonomy-alignment of investments **including sovereign bonds***

- Taxonomy-aligned
- Other investments



2. Taxonomy-alignment of investments **excluding sovereign bonds***

- Taxonomy-aligned
- Other investments



***For the purpose of these graphs, 'sovereign bonds' consist of all sovereign exposures**

What is the minimum share of investments in transitional and enabling activities? *[include section for the financial products referred to in Article 5, first paragraph, of Regulation (EU) 2020/852]*

Transparent, ... or clear?

Although we are strongly in favour of more transparency regarding the exact 'what-abouts' of sustainable investment products, it is our view that the above level of compulsory disclosure details will, in all likelihood, drown the average investor in the sea of confusion. But, do not panic, in times of doubt, just call on our ESG-experts who will be more than happy to guide you through the SFDR and Taxonomy jungle.

As another means to guide our clients, we have also started to publish the industry-developed European ESG reporting Templates (EET) on all our funds. This template has been designed to ease communication of key ESG data between product manufacturers and distributors/ end investors, in order for the latter to fulfil the new regulatory requirements. Thus, it brings together several regulations, including SFDR, MiFID and the Taxonomy. For example, the EET should enable distributors and fund selectors to access and filter products based on ESG criteria that are linked to the MiFID sustainability preferences assessment of their clients.

Watch out for the upcoming papers in this series to make sure you know the regulatory waters you are in.

€158 B
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600
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sustainable investing

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