ESAs propose improvements to the SFDR and suggests introducing categories and/or sustainability indicators

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Related topics: Funds and asset management, Banking and finance, Sustainability

Background

On 18 June 2024, the three European Supervisory Authorities (EBA, EIOPA, and ESMA, collectively known as the **ESAs**) published an opinion (the **Opinion**) on the evaluation of the Sustainable Finance Disclosure Regulation (**SFDR**). This Opinion was initiated by the ESAs themselves and was addressed to the European Commission.

Through two consumer testing exercises, the ESAs observed that the SFDR could be perceived as “complex and difficult to comprehend”. Furthermore, its practical use as a classification tool for financial products could potentially lead to greenwashing and mis-selling risks. As a result, the ESAs strongly advise the Commission to conduct consumer testing when formulating policy options. This would provide a more robust evidence base for modifying the regulatory framework, leading to more effective outcomes.

The Opinion emphasises the benefits of introducing a categorisation system and/or a sustainability indicator for financial products. This would assist retail investors in better understanding the sustainability profile of the financial products they are considering.

This publication aims at summarising the key points of the ESAs’ recommendations to the Commission. It serves as a concise guide to understanding the ESAs’ stance on the SFDR and their suggestions for its improvement.

Key elements of the Opinion

I. Categorisation system

The ESAs highlight the challenges associated with defining products under Article 8 or Article 9 of the SFDR. They propose that these difficulties could be mitigated by introducing new categories, which should be straightforward and based on clear, objective criteria or thresholds. These proposed categories would supersede the current classification under Article 8 and 9 of the SFDR, eliminating the differentiation between products that promote environmental/social characteristics and those with a sustainable investment objective.

The proposed categories should encompass at least the following two types:

- *Sustainable product category*: This category would include products that invest in economic activities or assets that are already environmentally or socially sustainable. These products would be required to meet a minimum sustainability threshold; and
- *Transition product category*: This category would focus on investments in economic activities, assets, or portfolios that are not yet sustainable but aim to become so over time. This

proposal encourages the Commission to incorporate the concept of "transition investment" into the SFDR, facilitating the development of a transition financial product category.

The ESAs also assert that, with the introduction of clear categories, the need for detailed and extensive sustainability disclosures would be reduced.

For products that do not fit into a category, they should be divided into (i) financial products with sustainability features, which should disclose their sustainability features in regulatory documents and should face restrictions on using ESG- or sustainability-related terms in naming or marketing to prevent greenwashing, and (ii) products without sustainability features, which should include a disclaimer (similar to the disclaimer set out in Article 7 of the EU Taxonomy) and should be prohibited from using ESG- or sustainability-related terms in naming and marketing.

Lastly, the ESAs reaffirm that the requirement for disclosure on the consideration of sustainability risk should continue to apply to all products. This ensures that all financial products maintain a level of transparency regarding their sustainability risk.

II. Complementary or alternative indicator system

The ESAs propose the adoption of an indicator similar to the PRIIPS KID risk indicator, which would serve as a straightforward guide for retail investors. This indicator, subject to consumer testing, could categorise products based on the sustainability of their investments and identify which products are facilitating the transition towards sustainability.

Among the ESAs' suggestions are a contribution to climate change, represented in a system, similar to a nutri-score, and a broader indicator that would award the highest grade to sustainable investments and investments in transition.

The overall system should be based on clear and objective criteria. These could be related to the EU Taxonomy, decarbonisation targets, or indicators such as fossil fuel exposures or greenhouse gas (GHG) intensity. This approach would ensure that the sustainability of financial products is assessed in a comprehensive and transparent manner.

III. Definition of "sustainable investments" Art 2(17) of SFDR

The ESAs propose that key parameters under Article 2(17) of the SFDR should be made prescriptive. This would ensure a more consistent application across the EU financial sector and enhance the comparability of the proportion of sustainable investments across different financial products.

In addition, the ESAs believe that the relationship between sustainable investments and investments in activities aligned with the EU Taxonomy needs to be clarified. They suggest that the Commission should provide this clarification within the existing legal framework. This would help to eliminate any ambiguity and ensure a clear understanding of how sustainable investments relate to Taxonomy-aligned activities.

IV. Potential expansion of products in the scope of SFDR

The ESAs are contemplating broadening the scope of the SFDR. Specifically, they are considering applying SFDR to structured products, such as those under a Euro Medium Term Note (**EMTN**) programme. Additionally, they are looking at extending the SFDR to encompass all insurance-based investment products. This would include multi-option products, which are currently not covered in

SFDR disclosures. This proposed expansion of the SFDR's scope would ensure a more comprehensive application of sustainability regulations across a wider range of financial products.

V. Simplification of the documentation

In relation to pre-contractual disclosures, the ESAs propose a tailored approach to documentation based on the principle that differentiation does not inherently restrict standardisation. They advocate for the adaptation of the documentation to suit the recipient. This includes simplifying the documentation for retail products to make it more accessible and user-friendly. Additionally, they suggest enabling investors to access and process information electronically through a layered approach. This would allow for easier navigation and comprehension of the information, enhancing the overall user experience.

VI. Improvement to the transparency of PAI at product level

The ESAs are contemplating a distinction between "consideration" (which encompasses disclosure and mitigation) and "information" on Principal Adverse Impact (**PAI**). This differentiation would enable a more straightforward identification of the extent to which PAIs are reflected at the product level.

Furthermore, they suggest that the "statement" of Article 7 of the SFDR should be clarified to determine whether it should include quantitative information.

VII. Technical changes (Annex I) and Product type by sustainability objective (Annex II)

Beyond the core elements of the Opinion, the ESAs have identified several technical changes that the Commission should address. These include, but are not limited to, clarifying the scope of disclosures under Article 4 of the SFDR to include unit-linked products in the scope of the PAI disclosures at the entity level, harmonising website disclosures, and developing appropriate requirements for the naming and marketing of financial products under Article 13 of the SFDR.

Annex II of the Opinion provides specific examples to illustrate the potential treatment of different types of hypothetical financial products under hypothetical scenarios.

Next steps

The Opinion could serve as a valuable resource for the Commission during its assessment of stakeholders' responses to support policy considerations aimed at improving the EU framework for sustainable finance. This would be based on the experience gained from the implementation of the SFDR. The ESAs stand ready to assist the Commission by providing any necessary additional technical assistance related to the disclosure elements in the SFDR.

If you wish to further discuss this topic or have any questions, feel free to reach out to our sustainability experts: Aurélien Hollard, Julie Pelcé, Clémence Richard or Julien Robert.

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