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Back to the drawing board? European Supervisory Authorities' recommendations for reform of the Sustainable Finance Disclosure Regulation

24 June 2024

Key takeaways

- The European Supervisory Authorities' (ESAs) recommendations to the European Commission (the Commission) have identified a number of issues with the existing Sustainable Finance Disclosure Regulation (SFDR) regime and made proposals to remedy them.
- If adopted, the recommendations would result in major changes to the current approach and lead to a lot of work for product providers within scope.
- The ESAs recognise that, in effect, the SFDR operates as a product labelling regime rather than fulfilling its intended purpose as a disclosure regime.
- The ESAs acknowledge that the complexity and vagaries of the current regime have caused confusion for SFDR product providers and investors alike.
- In proposing improvements, the ESAs appear to have drawn on the approach taken under the UK Financial Conduct Authority's Sustainability Disclosure Requirements (SDR).
- The recommendations include doing away with the current Article 8 and Article 9 disclosure requirements and replacing them with product categories and/or sustainability indicators, underpinned by clear and objective criteria.
- Consistent with the approach taken under the SDR, the proposals recognise that the informational needs of retail investors and institutional investors differ, and so different approaches are needed for these target markets.

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Introduction

The ESAs issued an opinion: "On the assessment of the Sustainable Finance Disclosure Regulation (SFDR)" on 18 June 2024, addressed to the Commission, providing recommendations and suggestions to improve the SFDR framework.

The ESAs recognise that the SFDR, despite being designed as a disclosure regime, in practice has become a labelling regime, with investors assuming that products in the Article 8 category each make an equal contribution toward the promotion of environmental, social and governance (ESG) goals (i.e., are equally “green”). They also acknowledge that the existing framework for disclosure is complex and difficult to understand, particularly for consumers. The ESAs’ recommendations generally flow from this.

As part of their recommendations, the ESAs propose that the Commission should consider introducing a product classification system, based on regulatory categories and/or sustainability indicators, to assist consumers in navigating the broad number of sustainable products available.

The ESAs also suggest overarching principles and policy considerations for the Commission to bear in mind when considering any future changes to the SFDR framework. In particular, the ESAs highlight the importance of assessing policy changes through the lens of consumer testing that is designed according to behavioural science and examines the impact of consumers’ use of sustainability related disclosures. This is intended to ensure that information provided to consumers is simple and unambiguous, and avoids technical language.

The ESAs stress the importance of establishing a classification system that does not present a misleading impression about the sustainability of SFDR products to end investors and allows consumers to select products that meet their personal sustainability goals.

Summary of the ESAs’ recommendations to the Commission

A high-level overview of the ESAs’ key recommendations is provided below:

1. The Commission should consider the introduction of a product classification system, based on product categories and/or sustainability indicators to help consumers navigate the broad selection of sustainable products and allocate capital more efficiently toward specific goals.
2. The categories should be simple, with clear objective criteria or thresholds that identify the category into which the product falls. As a minimum, the ESAs recommend introducing “sustainability” and “transition” categories.
3. A sustainability indicator could refer to environmental sustainability, social sustainability or both, illustrating to investors the sustainability features of a product by way of a scale.
4. Options for product categorisation and/or sustainability indicators should be subject to consumer testing and consultation. With clear product categories and/or sustainability indicators, sustainability disclosures would not then need to be as detailed and extensive.
5. The Commission should revisit the coexistence of the two parallel concepts of “sustainable investment”, as defined in the SFDR and “Taxonomy-aligned investment”, as defined in the EU Taxonomy. The EU Taxonomy constitutes a science-based reference point against which to measure environmental sustainability, whereas the SFDR is more principle-based and less prescriptive in measuring sustainable investments.
6. The Commission should prioritise completing the EU Taxonomy and also extend it to social sustainability.
7. The ESAs strongly recommend that the Commission ensures that sustainability disclosures meet the needs of different investors, and any improvements in the disclosures should take into account different distribution channels, including digital ones, and ensure consistency in the information provided. The Commission should prioritise the disclosure of only essential information for retail investors while professional investors may benefit from more detailed information.

8. The Commission should carefully reflect on whether to bring other products within the scope of the SFDR to ensure harmonised disclosures for both products currently within scope and products that may subsequently be brought into scope.
9. Information on key adverse impact indicators should be considered for all financial products not currently within scope, based on a cost-benefit analysis justifying the introduction of such requirement.
10. The Commission should evaluate the introduction of a framework to assess the sustainability features of government bonds, taking into account the specificities of that asset class.

Product categories

The ESAs acknowledge that the SFDR should be improved and simplified, as the disclosures made to investors are often complex and difficult to understand (especially for retail investors). Although the SFDR was intended to enhance transparency around sustainability, in practice financial market participants have been using disclosures to classify their financial products. For example, Article 8 (for products that promote environmental or social characteristics) and Article 9 (for products with sustainable investment as their objective) of the SFDR have been used as sustainability labels by financial market participants and understood as such by investors.

This has created confusion for investors, particularly given that Article 8 products have a wide range of ESG objectives and encompass a very broad set of products due to the discretion afforded to product providers under the existing regime. It is possible for product providers to disclose products under Article 8 that have relatively modest environmental or social features. Conversely, the relatively high bar set for Article 9 products has meant that those with comparatively ambitious ESG goals are categorised as Article 8 and not Article 9.

The ESAs suggest that the introduction of categories of products, underpinned by clear and objective criteria, will enhance consumer understanding, allow them to make more informed investment choices while, at the same time, reducing the risk of both "greenwashing" and mis-selling. This new approach would replace the existing disclosure regime under the SFDR, doing away with the Article 8 and 9 categories for products with ESG characteristics or goals.

To address the deficiencies identified, the ESAs have suggested the following new categories:

Sustainable product category

For products that invest in economic activities/assets that are already environmentally and/or socially sustainable.

The Commission should consider whether there should be a single category comprising environmentally and/or socially sustainable products or a separate category for each.

For environmentally sustainable products, the threshold should be based on investments in Taxonomy-aligned environmental activities.

Investments that are not Taxonomy-aligned should nonetheless comply with a revised and clearer "do no significant harm" principle.

Transition product category

For products that invest in economic activities/assets that are not yet sustainable, but which improve their sustainability over time to become environmentally or socially sustainable.

The investment strategies for these products should build on a mix of EU Taxonomy key performance indicators, transition plans, decarbonisation targets, and measures to mitigate principal adverse impacts. Additionally, this product category should consider certain appropriate exclusions and criteria for a credible transition plan.

Product providers would be required to disclose their transition targets and anticipated performance of their products against those targets in the short and medium term.

In recognition of the fact that not all financial products will fall into the above categories, the ESAs have proposed varying disclosure requirements, calibrated depending on the type of product:

Products in the sustainable or transition product category

- Disclosures in investor documentation appropriate to the category
- Naming and marketing strategy consistent with that category

Products with some sustainability features but which do not qualify for a category

- Limited disclosures in investor documentation setting out the sustainability features of the product
- Restrictions on naming and marketing strategy

Products with no sustainability features

- Minimal disclosures on adverse impact on sustainability
- Inclusion of a disclaimer to make clear that the product has no sustainability features
- Restrictions on naming and marketing strategy

Sustainability indicators

The ESAs have also suggested the introduction of sustainability indicators to group products according to how sustainable their investments are or the extent of their transition ambitions. These indicators could act together with the product categorisation framework proposed above or as an alternative to it. This could take the form of a sliding scale, enabling investors to identify products clearly according to their ESG credentials and their alignment with the investors' own preferences.

The ESAs recognise that for such indicators to be helpful and effective, they need to be underpinned by clear and objective criteria. The development of these indicators should be carefully considered and involve extensive consumer testing.