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SFDR level 1 review

The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 700 management companies, with €4600 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

CONTEXT

AFG supports the efforts of European co-legislators towards financing a more sustainable economy, in particular legislative and regulatory initiatives to ensure greater transparency and achieve the EU Green Deal objective to reorient capital towards a more sustainable economy.

The Sustainable Finance Disclosure Regulation (SFDR) framework has been in application for few years now and we already see a positive impact.

However, the implementation of this sustainable finance regulatory framework has been raising numerous challenges and concerns among authorities, financial market participants (FMPs) and investors.

1. Inconsistencies between the different pieces of regulation

Sustainable Finance regulations are interconnected by design, and several inconsistencies impede their robust implementation and, ultimately, even their very purpose.

The most illustrative misalignment creating data gaps is in the timing, scope and content between SFDR and CSRD/ESRS. This is all the more important in the context of the European Commission having recently decided to make all ESRS standards, disclosure requirements and data points subject to the “materiality assessment”. Indeed, financial market participants depend on the information provided by their counterparts to comply with their own disclosure requirements. Hence, it is of the utmost importance that non-financial and financial regulations are fully consistent and aligned.

These data gaps lead financial institutions to engage with:

- Data providers to fill in the gap, reinforcing their dependency towards such counterparties.
- Issuers directly, increasing the burden on them as data points will be required by multiple financial market participants or providers instead of disclosing/displaying them once to all.

We believe that the SFDR review is the perfect opportunity to fix some inconsistencies in the sustainable finance framework (please see below unexhaustive examples) **and/or reflect on the opportunity to reopen other pieces of regulations to align this framework.**

- SFDR and Taxonomy Regulation (ex: coexistence of two different “Do Not Significant Harm” principles).
- SFDR and Benchmark Regulation (BMR) (ex: Information that benchmark providers are required to disclose under BMR is insufficient for the benchmark users to meet their obligations under the SFDR (i.e. PAIs, SI methodology, “good governance practices”, etc.)).

These inconsistencies both in terms of calendar and content lead to difficulties in the implementation of the sustainable finance regulatory framework, which in turn is not clear for the end investor.

The European Commission should also **take the opportunity of this level 1 review to expand the scope of financial products subject to the SFDR** (for example: banking products). An extension could for instance be considered to ensure a level playing fields between different products proposed to retail clients.

2. Lack of clarity

Some concepts introduced in the regulations seem not to be clearly defined, which may lead to different interpretations between financial market participants and to unlevel playing field across jurisdictions depending on each NCA's own interpretation.

This lack of clarity can also generate confusion among investors, for example:

- The definition of "sustainable investment" is principle-based and leaves room for different approaches between financial market participants.
- The definition of the "promotion of E or S characteristics" is very broad and captures most ESG funds with diverse degrees of ESG commitments.
- There are difficulties to reconcile the product categorisation under the SFDR ("Article 8" vs "Article 9") and questions asked by financial advisors to assess their clients' sustainability preferences under MIF and IDD (relying on taxonomy alignment, % of sustainable investments and PAI consideration).
- Complexity of the ESG concepts used by MIF and IDD (taxonomy alignment, sustainable investments, PAI) versus the market reality (very low % of taxonomy alignment of the economy or medium level of sustainable investments) does not help investors in their understanding pertaining to their informed expression of ESG preferences.

The initial objective to have a clear and understandable framework for final investors has not yet been achieved. It is hence essential to simplify and clarify the current framework to allow investors to grasp the real intentionality of offered financial products.

3. Complexity of information to be disclosed

For Article 8 and Article 9 products, FMPs are required to disclose a quite extensive range of information in both the pre-contractual template and the annual periodic report. These disclosures have proven to be quite difficult to be understood by end-investors in most instances. This complexity risks to disincentivize end-investors from re-allocating their savings towards a more sustainable economy instead of helping them to determine clear sustainable preferences that can be used to offer them most suitable products.

This point has been already addressed in the ESAs consultation on the review of the SFDR Level 2. This concern should be also taken into account when considering the potential options for the revision of the SFDR Level 1 text.

As a general rule, the ability and willingness of retail investors to carry out due diligences on the financial products in which they invest should not be overestimated by the authorities – which has been the case with the current SFDR disclosures.

4. The transition concept is not clearly recognized in the Sustainable Finance Disclosure Regulation

AFG believes it is essential to clearly express the inclusion of the transition finance in the Sustainable Finance Disclosure Regulation. In this regard, we welcome the Sustainable Finance package published by the European Commission in June 2023 and notably the recommendation on facilitating finance for the transition to a sustainable economy. Still, we believe that transition

finance should be better recognized, notably within both SFDR and MIF/IDD addendums regarding sustainability preferences.

Indeed, at this stage the "transition" notion is not clearly included in the SFDR and there is a need to clearly include this notion in the framework, notably through investment strategies which clearly include transition objective. It should be reminded that the "transition" should also include the social question ("fair transition"). This is essential to allow financial market participants to support companies in the reorientation of capital towards sustainable finance.

For all the above reasons, AFG welcomes the European Commission' consultation on the usability and application of the SFDR in Q3 2023.

MAIN OBJECTIVES OF THE SFDR LEVEL 1 REVIEW AND AFG PROPOSALS

The European Commission's objectives for the SFDR level 1 review should be the following:

- **Simplify, ensure consistency and credibility** in the sustainable finance regulatory framework,
- **Clearly include the transition concept** in the SFDR framework through financial products with a transition strategy objective,
- **Putting the final client at the centre** of the sustainable finance regulatory framework.

AFG believes that the level 1 review should particularly focus on the following points:

1. The SFDR should evolve from a transparency regime only to an approach including minimum requirements

AFG believes that SFDR should not be only a "disclosure regulation" but should evolve to a text that includes minimum investment requirements for products.

To ensure consistency between disclosures and minimum requirements we believe it is simpler to have one unique framework (as explained in paragraph 4 below).

2. "Sustainable Investment" concept

The current SFDR notions mainly based on the "Sustainable Investment" concept are too general and limited to allow asset managers transform their portfolios to trigger real-world change.

The investment solutions offering should enable the capital reallocation while embarking strategies on "Transition" and "Solutions, Impact and Contribution" .

To allow a deep reorientation of capital flows, the SFDR framework should include the right concepts in order to correctly accompany the financial market participants. We believe that Article 2(17) of SFDR applied at issuer level should be replaced by a concept built on binding and measurable objectives at the financial product level[1].

[1] In any case the financial market participant may keep the possibility to retain the "sustainable investment" as a binding KPI and the possibility to determine its own methodology when selecting the investments that effectively meet the commitment

3. Binding and measurable sustainable objectives

To allow for an alignment between financial products objectives and final clients' needs, it is essential **to clearly define the financial products' objectives** as well as the improvement of performance indicators with a benchmark reference.
Thus, the notion of "promotion of environmental or social characteristics" should be deleted.

We believe that the framework should focus on the financial products' strategies and distinguish:

- **Financial products with a "Generic focus on Environmental and/or Social objective":** products which can state and demonstrate the presence of **binding environmental and/or social factors at the heart of the investment process**, applicable to the whole investment portfolio[2].

  The financial product would be required to have one or more relevant KPI indicators relevant to the environmental and/or social objective(s) pursued that is binding on the investment portfolio. The PAI[3] indicator(s) could be used to measure the progress of the product towards attaining its objective(s) and may be used for setting engagement targets with investee companies. In the event that the fund is able to justify the absence of PAI indicator(s) linked to its ESG objectives[4], it may select another KPI indicator(s) of its choice.

- **Financial products with a "Transition"" strategy**: **the objective is measured at the "product" level** through the commitment of the investment fund. This strategy will allow to better differentiate between the financial product's objective and its underlyings' objective. Indeed, the "transitioning strategy" would be applied at the product level but not necessary at underlying level (i.e. not on line-by-line basis).

  This approach typically refers to Environmental products like to Net Zero aligned funds, decarbonation funds, transition-linked-bonds, sustainability-linked-bonds, Paris Aligned Benchmarks, Climate Transition Benchmarks, etc.

- **Financial products with a "Solutions, Impact and Contribution" strategy**: **the objective is measured at "activity" or "project level".**

  This approach typically refers to Environmental products with an EU Taxonomy alignment or products investing in green bonds, green infrastructure, green equity, impact investing funds relating to Environment. This approach also typically refers to Social products investing in social bonds or impact investing funds relating to Social, etc. This approach also refers to products that offer targeted and measurable solutions to sustainability matters.

Where widely-used/recognised frameworks, standards or agreements exist (Paris agreement, Kunming-Montreal biodiversity agreement, impact investing framework, PSF

[2] i.e. coverage of more than 80% of the investment portfolio. AFG reminds that the calculation can be done as a NAV proportion or in number of issuers. In any case, only the meaningful invested part of the portfolio is concerned, not cash nor Efficient Portfolio Management techniques. Derivatives that are entered with an ESG objective, either long or short, are part of the calculation.
[3] Regulation (EU) 2019/2088 as defined under the regulatory technical standards mentioned in paragraph 6 and 7 of article 4
[4] For example: there is no PAI link to the product's objective or data coverage is very low.

Final report on Minimum Social Safeguards[5] etc…), a reference should be made to them by the fund.

4. Financial products' level of ambition

Financial products can have different level of ambition. In this context, and to avoid drawbacks identified in the past years, we believe that financial products should clearly specify which level of ambition they are deemed to achieve:

- **Products without any ESG binding and measurable objective: such financial products won't be allowed to make any "sustainable" claims nor promotion** (apart from transparency on the integration of sustainability risks).
- **Products with a "significant" objective:** the financial product objectives exceed significantly[6] its benchmark / investment universe / threshold on the E and/or, S indicator defined as objective.
- **Products with a "very significant" objective:** the financial product objectives exceed very significantly[7] its benchmark / investment universe / threshold on the E, and/or S indicator defined as objective.

One valuable approach could be demonstrating outperformance to the reference benchmark (a financial benchmark or defined investment universe). A second valuable approach could be **an "absolute approach"** (i.e. set a minimum absolute threshold[8] of portfolio's issuers with a "significant" or "very significant objective).

The European Commission should also recognize existing labels:

- **Leverage on the existing well-known market efforts: National ESG and green labels could be maintained.** It would be very useful to have the possibility for these national labels to be recognised as EU labels. Numerous Home member states have developed national labels that are widely used and recognized by both financial market participants and final retail clients. Moreover, each label has developed detailed specifications to identify which products can have the label. For these reasons, national labels should be automatically considered as either "Transition" or "Solutions, Impact and Contribution" strategies with a "significant" or "very significant" objective depending on their level of ambition. The European Commission should adopt an equivalence decision (passporting principle across Europe) to classify these labels under the above-mentioned categories until a European label is created.
- **Funds that have equivalent strategies to the European Paris Aligned Benchmark and Climate Transition Benchmark**, that have been recognized by the European Commission to be "useful and reliable labels for investment products" and are therefore considered has having a "very significant" objective towards the transition objective (i.e. Transitioning strategy with a very significant commitment).

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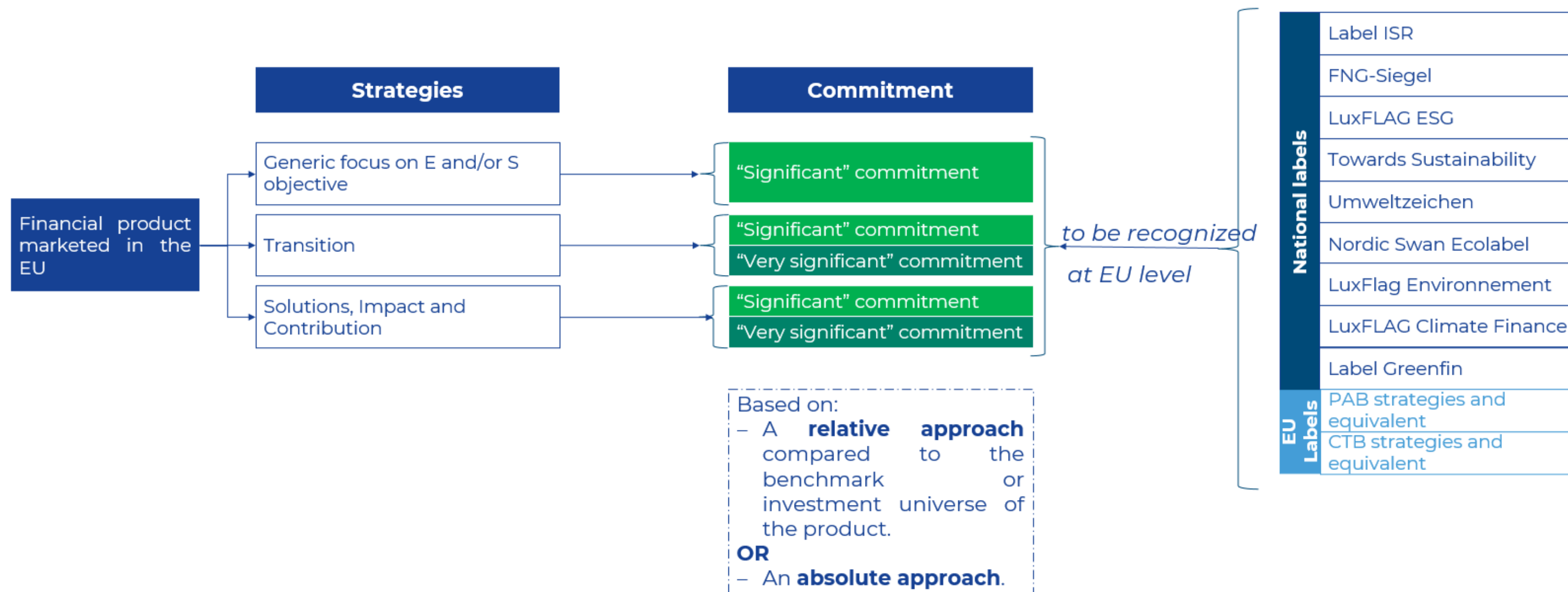
[5] Final Report on Minimum Safeguards, EU Platform on Sustainable Finance, October 2022

[6] Power should be delegated from the European Commission to ESMA to set the thresholds of the "significant objective", including a regular review.

[7] Power should be delegated from the European Commission to ESMA to set the thresholds of the "very significant objective", including a regular review.

[8] Power should be delegated from the European Commission to ESMA to set the thresholds of the "significant objective" and the "very significant objective", calculated on the meaningful part of the portfolio).

SFDR LEVEL 1 REVIEW



<u>*For example:*</u>

"Transition" on the "Environmental" pillar aim to allocate capital to "Net Zero transitioners" *: we are looking at expected reduction in GHG in the real economy thanks to the switch of carbon intensive business model to low carbon business model. These are high climate impact companies that are on a credible pathway to reducing their emissions in line with Net Zero objectives.*
Example:

- *Equity: Net Zero, PAB, CTB, etc...*
- *Fixed Income: Climate bonds, PAB, CTB, etc..*

"Solutions, Impact and Contribution" on the "Environmental" pillar aim to allocate capital to "Net Zero enablers": *we are looking at already low carbon business model. These are companies whose products and services directly or indirectly support moving the global economy toward achieving climate goals.*

SFDR LEVEL 1 REVIEW

Example:

- *EU Taxonomy aligned activities.*
- *Equity: some thematic funds (water, energy, global resources, etc…), green equities, etc..*
- *Fixed Income: green bonds, etc…*
- *Impact investing funds relating to Environment (ex:* an impact fund which is linked to decarbonisation or to green assets or green bonds or green equity).
- *Very high level of sustainable investment.*

"Solutions, Impact and Contribution" on the "Social" pillar:
Example:

- *Impact investing funds relating to funding social projects.*

5. Equivalence with the current SFDR framework

AFG strongly believes that the SFDR should focus on financial products' sustainable strategy. Should the existing "Article 6, 8 and 9 categories" remain, our proposal could read as follows:

		Commitment	
		Significant	Very significant
Sustainable strategies	Generic focus on E and/or S objective	Article 8	∅
	Transition	Article 8	Article 9
	Solutions, Impact and Contribution	Article 8	Article 9
	No binding and measurable ESG objective	Article 6	

6. Minimum requirements applicable to all sustainable strategies

SFDR level 1 should define **a common basis of minimum requirements for products with a sustainable strategy** (i.e. binding and measurable sustainable objectives).

The following criteria should be considered:

- Depending on the ambition of the product, the financial product should demonstrate a **binding and measurable objective**, which exceeds significantly or very significantly the objective of its benchmark or investment universe or demonstrate that significant or very significant objectives are set (i.e. absolute thresholds).
- Demonstrating that **all mandatory Principal Adverse Impact (PAI) are taken into account**[9] in the financial product's investment process[10].
- Applying the **CTB like exclusions**[11].

7. Realigning SFDR & MIF and IDD Sustainability Preferences

Many retail investors have difficulties understanding the disclosures with the volume and technicality of information they contain.

[9] FMPs can take PAI into account in various ways: monitoring, exclusions, or engagement for example.
[10] Subject to data availability and good coverage (notably for certain alternative asset classes).
[11] "(a) companies involved in any activities related to controversial weapons; (b) companies involved in the cultivation and production of tobacco; (c) companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises", Delegated Regulation (EU) 2020/1818

Moreover, as already explained, the inconsistency between SFDR and MIF/IDD, the complexity of MIF/IDD concepts (taxonomy alignment, sustainable investment, PAI) and the market reality (very low % of taxonomy alignment of the economy or medium level of sustainable investments) do not help investors in their understanding.

The proposed modifications under the SFDR should be reflected in the MIF and IDD Sustainability Preferences. In this context, the concept should only be explained to the client based on the financial product's strategy and commitment:

Only the three following questions should be asked to the client:

- **Question 1: Does the client have ESG preferences?**
- **Question 2: What strategy does the client want to invest in: "Generic focus on Environmental and/or Social objectives"? and/or "Transition" and/or "Solutions, Impact and Contribution".**
- **Question 3: What is the level of ambition expected from the client: significant commitment or very significant commitment?**

8. Pre contractual and periodic Reporting

AFG is aligned with the "*The Platform's principles for reporting requirements*"[12] (i.e., relevance, consistency, proportionality, applicability, and precaution) and we believe that these principles should be recognized under the Sustainable Finance regulatory framework.

As stated by the Platform on Sustainable Finance (PSF), we believe that reporting requirements should focus on "*the most relevant information for the purpose of measuring sustainability and impact, and for the benefit of investors in green and sustainable activities*".

We also agree with the need for a simplification to:

- Enable investors to make informed investment decisions and ensure a better understanding of financial products.
- Avoid a disproportionate burden on financial market participants.

The following proposals would have the merit to answer to these principles:

- Require a **single template for products with sustainable strategies** (i.e. binding and measurable objectives) for both pre-contractual and periodic disclosures (instead of different templates based on the financial product category).
- **Pre-contractual disclosures should be a maximum of 3 pages** (i.e. alignment with the current KID).
- **This template must be distributed to customers upon subscription and on a mandatory basis** (i.e. aligned with the current KID), **and be disclosed on the website.**
- **The website sustainability disclosure document[13] should be abolished and replaced by the 3-pages standard pre-contractual document.**

[12] Briefing Platform Response to the Joint ESAs Consultation on SFDR RTS, EU Platform on Sustainable Finance, 4 July 2023
[13] Article 10 of SFDR

AFG

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