An update on sustainability disclosure

DID THE INVESTMENT INDUSTRY PASS THE SFDR INTERMEDIARY DISCLOSURE TEST?

10 March 2021 marked the first milestone of EU Regulation 2019/2088, also known as the Sustainable Finance Disclosure Regulation (SFDR). The SFDR aims to increase the transparency of non-financial information disclosed by financial market participants (FMPs) and financial advisers (FAs) to limit greenwashing and make it easier for investors to assess and compare sustainable and responsible investment strategies and products.

Over the past few months, Deloitte has helped various clients implement the SFDR and was involved in many discussions with FMPs, FAs and industry associations. To gain a holistic view of current practices and to take the temperature of the market's reaction to this regulation, Deloitte also conducted a benchmarking analysis and survey of the main market players entitled "Implementing the SFDR: Your views, approaches and perceived challenges".

The SFDR's lack of detail and the prolonged wait for the final regulatory technical standards ("RTS", the regulation's second-level requirements) meant concerned entities navigated an uncertain regulatory environment when preparing for the March 2021 deadline. Consequently, FMPs and FAs have approached the SFDR in different ways. Further amplifying this diversity of practices was the lack of established market standards for the policies and procedures that entities needed to establish.

This article shares the main market practices that have emerged on sustainability disclosures so far, highlighting good practices and providing guidance on how to move forward with the implementation of the SFDR.

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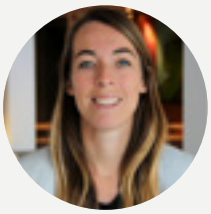

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Please note that the SFDR benchmarking analysis and survey results presented in this article capture only a fraction of the entire European market. As such, Deloitte's assessment of the identified market practices is based on its own understanding and interpretation of the regulation.

Where do we stand?
For the first SFDR application date, FMPs and FAs were required to provide entity and product level disclosures on their website. If applicable, they also had to update their pre-contractual documents to include the consideration of sustainability risks, principal adverse sustainability impacts (PASI) and, for more sustainability-ambitious financial products, how these ambitions were met.

For most concerned entities, meeting these disclosure requirements demanded the setting up of new policies and procedures to embrace a sustainability journey. Indeed, the majority of Deloitte's SFDR survey respondents confirmed this regulation pushed them to revise or even build a new sustainable investment strategy.

Approach towards sustainability disclosure
The SFDR's main objective is to maximize FMPs' and FAs' transparency towards end-investors regarding their consideration of sustainability risks and adverse impacts. This requires organizations to ensure their disclosures are easily identifiable and accessible through their website. However, this is not a given in practice; in our SFDR benchmarking analysis, we identified that while some firms do provide the required information, it is not always labeled as an SFDR disclosure.

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Based on our interpretation of the regulation, we have identified the following sustainability information website disclosures as good practices:

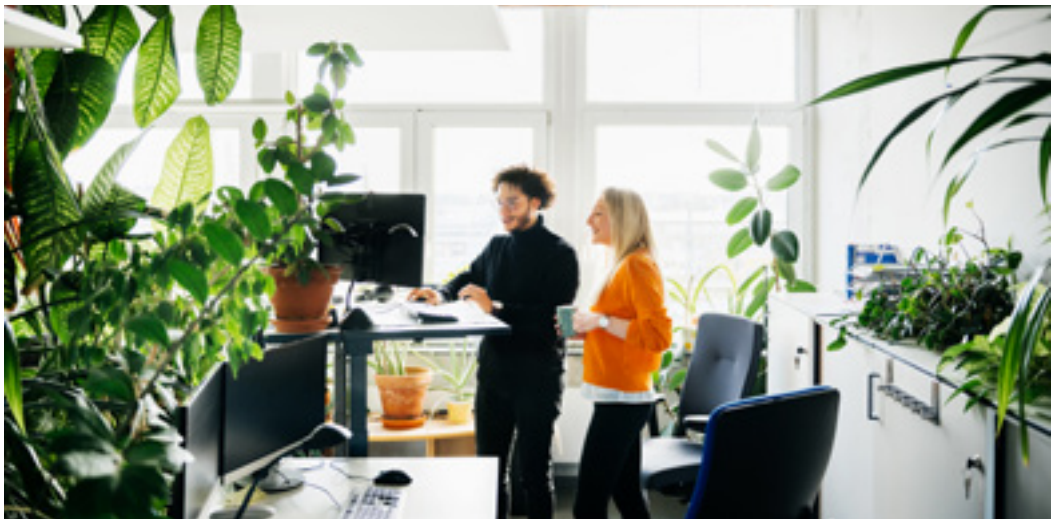
01 **Label disclosures as being required under SFDR** to allow end-investors to quickly identify what they are searching for.

02 **Group all SFDR website disclosures in one place** for clarity and completeness, be it in one website section, tab, or a single file.

03 **Adopt SFDR terminology** (e.g., "sustainability risk", "principal adverse sustainability impacts" and, "sustainability factors") to further facilitate the identification of mandatory disclosures and adopt the regulations' definitions.

04 **Refer to the specific SFDR article** that applies to the disclosure and potentially detail each article's requirements.

Sustainability risk disclosure
Before 10 March 2021, only a few players had drafted dedicated sustainability risk policies at the entity level; therefore, no well-established market practices yet existed for these policies. As the regulation does not detail which aspects these policies should present, disclosure practices particularly diverge around the transparency on the consideration of sustainability risks.



Although we observed a range of different approaches in our analysis, we have identified the following aspects of sustainability risk disclosure policies as good practice:

01 **Define key terms** (e.g., "sustainability risk") in accordance with the SFDR's definitions.

02 **Describe the governance structure** in place that continuously monitors the sustainability risk policy's execution, by identifying responsible stakeholders and their roles, disclosing information about the lines of defense, and/or referring to the risk management policy.

03 **Define and provide practical examples of the different types of sustainability risk** (e.g., physical, transitional and reputational) stemming from environmental, social and/or governance (ESG) factors that could affect investors.

04 **Explain the sustainability risk identification and prioritization process**, considering the existing types of sustainability risk, the products' management style (e.g., active, open architecture, or index-tracking), and their investment strategy and sectors (e.g., referring to the sectoral materiality matrices of internationally recognized frameworks like GRESB or SASB).

05 **Provide information about the limitations of the sustainability risk assessment** in terms of subjectivity regarding the expected likelihood and impact.

06 **Disclose how sustainability risks are monitored** (e.g., exclusion lists, controversies screening, and respecting international norms).

Regarding sustainability risks at the product level, our analysis points to an emerging market trend. While the FMPs we surveyed tended to always consider sustainability risks for their light green (Article 8) and dark green (Article 9) products, they did not consider these risks for many of their ESG neutral (Article 6) products because they were deemed irrelevant. This appears contradictory: light and dark green products are typically exposed to less material sustainability risks than ESG neutral products, due to better assessment and monitoring of ESG factors through an in-depth sustainability investing strategy.

This may be due to some market players potentially misunderstanding the regulation's intended approach towards the disclosure of product-level sustainability risks. Whereas the SFDR allows FMPs and FAs to identify that sustainability risks are not relevant, this is not an "opt-in or opt-out" option. Instead, the regulation requires players to analyze the sustainability risks before they can deem them not relevant.

PASI disclosure
The delay of the final RTS muddied market players' decisions of whether to consider PASI for 10 March 2021, and most of our survey respondents chose the SFDR's option to not consider PASI by this date. Some respondents confirmed that they are waiting for the adoption of the level 2 requirements that will, amongst others, detail the key performance indicators (KPIs) to be monitored as of January 2022.

As the SFDR provides relatively detailed provisions regarding PASI statements, FMPs' and FAs' practices are mainly aligned. We have observed these additional good practices regarding PASI policies:

01 **Specify in which stage(s) of the investment process PASI are considered.**

02 **Define and list the mix of quantitative and qualitative measures** used to assess PASI while waiting for the final list provided by the RTS.

Product classification
Morningstar performed a preliminary assessment of Luxembourg-domiciled funds' classifications and found that approximately 18% of European funds are classified as light green (Article 8) and 3.6% as dark green (Article 9), together representing approximately 25% of European fund assets. Therefore, all other European funds are classified as ESG neutral (Article 6). This classification tendency is also reflected in the results of our SFDR survey, where respondents were asked to provide their product classification ratio. The observed trend of dark green products being relatively rare can be explained by the low proportion of "impact funds" on the market.

As the SFDR does not define the precise criteria and thresholds to classify a financial product as light or dark green, differences in product classification have emerged. One example is the continuing discussions on whether investments into green bonds can automatically be considered as having a sustainable investment objective. Another example is light green products falling under the French AMF Doctrine 2020-03 on sustainability disclosures respect the 90% minimum rate of non-financial analysis, while other light green products outside the doctrine's scope adopt lower thresholds, for instance 67%.

The lack of pre-defined classification criteria, the absence of the final RTS, and gold plating attitudes from some EU member states seem to have contributed to the market's hesitancy around product categorization. We observed two main concerns when working with our clients. Firstly, some FMPs were unsure as to whether their products were ESG-ambitious enough to qualify as light or dark green. Secondly, some actors were skeptical whether they could meet the level 2 product disclosure requirements by January 2022. This uncertainty resulted in many FMPs adopting a conservative approach by "downgrading" their financial products, which is confirmed in our SFDR survey results.

Disclosures in pre-contractual documents
To apply the level 1 disclosure requirements, some FMPs decided to add SFDR disclosures across different sections of the main body of the pre-contractual documents, while others chose to provide all their SFDR product-level disclosures in one appendix. In our view, both options work equally well as long as the disclosure is clear and concise.

We observed these clear and concise disclosure practices for pre-contractual documents:

01 **Clarify the difference** between ESG integration (ESG neutral) and more sustainability-ambitious products (light and dark green).

02 **Name the product classification** in the "investment objective" or "investment policy" sections by making explicit reference to the SFDR and using its terminology.

03 **List the classification of all financial products** to provide end-investors with an overview of all the FMPs' products.

However, as the RTS were not mandatory as of March 2021, none of the entities we analyzed have adopted the proposed template of pre-contractual documents of light and dark green products yet.

The draft RTS published in February 2021 provided a template for entities to insert into the annex of pre-contractual documents. However, as the RTS were not mandatory as of March 2021, none of the entities we analyzed have adopted the proposed template of pre-contractual documents of light and dark green products yet.

Still, some respondents provide additional information linked to the level 2 requirements, such as describing the different steps of the investment process; explaining how ESG criteria are incorporated and monitored; or disclosing the percentage of net assets that do not promote environmental or social characteristics or do not have a sustainable investment objective.

CONCLUSION

Although the SFDR level 1 text leaves much room for interpretation and the level 2 requirements are still pending at the time of writing, all FMPs and FAs captured in our study managed to meet the ambitious March 2021 deadline—even in the context of the COVID-19 pandemic.

Consequently, the adopted market practices are quite varied today. However, we expect them to become more harmonious over time, as regulators provide additional details about their expectations and market actors learn from each other.

Nevertheless, the most challenging implementation period still lies ahead. Moving forward, the top concerns of our survey respondents are the pressure to implement the final RTS (once published) in time for January 2022 and the availability and quality of ESG data.

When asked how the respondents' firms plan to approach the interim implementation period between March 2021 and January 2022, "I don't know" was a relatively popular answer. Still, most respondents expected to have already integrated the draft RTS by then, which can be adapted if necessary. Only a few respondents preferred to wait for the final RTS before preparing for the January 2022 due date.

While we acknowledge that there is no "perfect answer" of how to approach the next SFDR deadline, and despite the uncertain regulatory expectations, we advise our clients to identify any gaps between their available ESG data sources and expected data needs. Based on the results of this gap assessment, actors should promptly engage with their current ESG data vendor(s) to clarify how much of the required data can be collected and identify whether these gaps could be remedied by contracting another data vendor.

Some of the FMPs we surveyed are also concerned about ensuring a smooth alignment between SFDR and the EU's Taxonomy regulation, which amends the SFDR and will also apply as of 1 January 2022. This means that pre-contractual disclosures and periodic reports of all light and dark green financial products will also need to respect the Taxonomy disclosure requirements. ESG neutral products will only have to include pre-defined statements in these documents.

Lastly, we urge FMPs not to underestimate the efforts required to meet the ongoing data collection and reporting requirements. Actors should already be assigning duties and responsibilities within their firms for preparing product periodic reports and entity-level PASI statements. They should also evaluate whether their current internal resources are sufficient to meet the disclosure requirements and take remedial action if needed.

TO THE POINT

- March 2021 marked the first milestone of the SFDR. To gauge the investment industry's reaction, Deloitte conducted an SFDR benchmarking survey and analysis.
- Our results uncovered a wide spectrum of approaches by financial market participants and advisers to tackle these new mandatory sustainability disclosures. The type of information communicated and the level of detail varied considerably from one entity or product to the other.
- This article provides a holistic view of the current SFDR market practices and addresses the challenges faced by regulated entities going forward.