The EU Sustainable Finance Disclosure Regulation

In order to meet its 2050 carbon-neutrality goal, the EU is further ramping up its sustainable finance efforts. Back in March 2018, the European Commission adopted a 10-point Sustainable Finance Action Plan with an aim to channel capital flows towards sustainable investment while managing financial risks stemming from Environmental, Social and Governance (ESG) issues.

While some of the legislative work has been formalised and put in place already, a lot of the implementation of the regulations will continue through 2021 and 2022. This means ESG factors will be at the forefront of every decision and no longer viewed as preferential considerations in the investment process.

At the core of the Action Plan is the EU Sustainable Finance Disclosure Regulation (SFDR).

This guide serves as a starting point for those likely to be impacted by the SFDR and its components. It will provide an overview of the key legislation and implementation dates, as well as how Morningstar is well positioned to help professionals during this transition period.

What is the Sustainable Finance Disclosure Regulation?

The Sustainable Finance Disclosure Regulation (SFDR) supplements the current rulebooks governing manufacturers of, and advisers on, financial products. Broadly, managers must disclose how sustainability risks are considered in their investment process, what metrics they use to assess ESG factors, and how they consider investment decisions that might result in negative effects on sustainability factors (or Principal Adverse Impacts [PAIs] in the regulators' language).

The SFDR will, above anything else, raise the bar for investment products - particularly those seeking to promote ESG credentials (Article 8 funds) and those with ESG objectives (Article 9 funds) by setting strict minimum-disclosure standards to prevent greenwashing.

Who Does it Affect?

The regulation applies to financial market participants (FMPs) and financial advisers. Financial market participants are defined as:

- Insurance undertakings making available Insurance-Based Investment Products (IBIPs)
- Institutions for Occupational Retirement Provision (IORPs)
- Manufacturers of pension products
- Pan-European Personal Pension Product (PEPP) providers
- Alternative Investment Fund Managers (AIFMs)
- Undertakings for Collective Investment in Transferable Securities (UCITS) management
- Investment firms or credit institutions providing portfolio management

What are the Objectives of the SFDR?

The main aim of the SFDR is to increase transparency and comparability of ESG information for end investors to minimise greenwashing.

Practically speaking, this means that manufacturers (Financial Market Participants) and advisers will need to provide a raft of 'entity level' information on their public websites. And for products (funds, managed products, models), it means additional information will need to be added to pre-contractual documents and periodic publications.

Principle Adverse Impact (PAI)s

Principle Averse Impact (PAI) indicators are at the core of the SFDR and are key to understanding its objectives. PAIs can be described as the negative sustainability factors that investments, decisions or advice might have.

There are currently 64 indicators which can be broken down into mandatory and optional. Of the optional indicators, one indicator must be chosen from both social and environmental where applicable. (Some indicators are intended to assess investments in corporate issuers, some for sovereigns and some for real estate assets.)

Exhibit 1. **The 64 Principle Adverse Impact Indicators**

	Mandatory	Optional
Corporate Investments	Environmental: **9** Social: **5**	Environmental **16** Social: **17**
Sovereigns and Supernationals	Environmental: **1** Social: **1**	Environmental **1** Social: **7**
Real Estate	Environmental: **2** Social: **0**	Environmental **5** Social: **0**

Source: https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

Mandatory indicators include greenhouse gas emissions, fossil fuel sector exposure and board gender diversity, while optional indicators include things like water recycled and reused, land degradation and incidents of discrimination.

Sustainable Finance Disclosure Regulations Requirements

Entity Level

The SFDR requires organisations to disclose how they manage the following:

- Sustainability risks in the investment decision-making process or financial advice
- PAIs on sustainability factors
- Sustainability risk integration in remuneration policies
- Precontractual disclosures including how financial products may be affected by sustainability risks

Product Level

The SFDR segments the product universe into three different types, requiring additional disclosure information depending on the objective of the product in question.

Exhibit 2. **Product Universe Types**

Product Type	Description	Requirements Detail
Dark Green (Article 9 Products)	Products with a sustainable investment strategy in activities aligned with the EU Taxonomy	Must generally invest only in 'Sustainable Investments'
	Products with a sustainable investment strategy in activities not aligned with the EU Taxonomy	Funds that have an environmental objective must additionally disclose EU taxonomic alignment
Light Green (Article 8 Products)	Products promoting environmental or social characteristics, but not sustainability	Must indicate if they invest a proportion in sustainable investments
	Products promoting environmental or social characteristics + sustainable investments in activities not aligned with the EU Taxonomy	Holdings should generally help attain the environmental or social characteristics promoted
	Products promoting environmental or social characteristics + sustainable investments in activities aligned with the EU Taxonomy	Funds that promote an environmental characteristic must additionally disclose EU taxonomic alignment
All Others (Article 6 Products)	Sometimes referred to as Article 6	

Source: Morningstar Research, https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

What is a 'Sustainable Investment'?

To deem an investment 'sustainable' in line with the SFDR, minimum requirements stipulate that products must:

- Explain how they consider Principle Adverse impacts (PAI); and
- 'Do No Significant Harm' (DNSH). DNSH is linked to the EU Taxonomy Minimum Safeguards:
  – OECD Guidelines for Multinational Enterprises
  – UN Guiding Principles on Business and Human Rights
  – Intl Labour Organisation on Fundamental Principles and Rights at Work
  – International Bill of Human Rights
- Funds investing in environmentally sustainable activities (EU Taxonomy) can state this and would not need to explain how they consider PAIs or DNSH.

When Does the SFDR Come Into Force?

The SFDR entered into force in December 2019 and was implemented on 10 March 2021 with additional disclosures following in 2022 and 2023. The table below outlines key implementation dates for various aspects of the regulation.

Exhibit 3. **SFDR Implementation Timeline**

		10 March 2021	30 June 2021	Jan 2022	June 2023
Manufacturers and Their Products	Website	PAI Policy & Impact Statement ► Sustainability Risk Policy ► Remuneration Policy ► Engagement Policy ► International Code Standards	Larger firms (500+) must state how they take PAIs into account		Present PAIs for the period 2022
	Prospectus	► Disclose fund type: – Article 8: Light Green – Article 9: Dark Green ► How Sustainability Risk is taken into account ► Potential impact on returns		Article 8/9 Funds: ► Level II template (how E/S objectives will be met)	
	Annual Report			When Published: ► More info on E/S results ► Regulatory template for annual report disclosures	
Advisers	Website	► PAI Policy & Impact Statement ► Sustainability Risk Policy ► International Code Standards		If and how FMP and PAI data is taken into account	

Source: Morningstar Research, https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

As shown in the table, by the end of June 2023, large public interest firms with more than 500 employees will be required to disclose policies, processes, and, ultimately aggregated metrics about the PAIs that their investments have on environmental and social issues.

Other firms will retain an option to do the same, or instead will need to place a prominent notice on their website that they do not consider PAIs and why that is the case – a 'comply or explain' basis applies to companies with less than 500 employees.

What Does the SFDR Mean for the UK?

As the UK officially left the European Union on 31 January 2020, the disclosures are not part of 'retained EU law' and so firms in the UK do not need to comply with the EU Action Plan and the Sustainable Finance Disclosure Regulation.

From a practical perspective however, it's likely that only firms distributing solely within the UK will remain unaffected. Those distributing within both the UK and Europe or wishing to manufacture and sell products to EU clients, would be at a disadvantage with un-comparable SFDR disclosures. In short, if a UK fund is distributed in the EU it must follow disclosure legislation.

It's expected that the UK will implement its own principles-based version of the SFDR (and the EU Taxonomy Regulation) which the FCA will disclose in due course.

How Morningstar Can Help

At a time when sustainability considerations are becoming part of every investment decision, Morningstar has a comprehensive offering to help professional investors and managers successfully consolidate ESG data into the investment process. This has been accelerated by the recent acquisition of Sustainalytics, a leading provider of ESG research and ratings. Together, Morningstar and Sustainalytics are leading the global sustainable investing landscape with ESG coverage on more than 52,000 funds and 12,000 companies.

Morningstar and Sustainalytics are committed to helping clients on every step of their EU Sustainable Finance Action Plan regulatory journey. We have further ramped up capacity to produce new research and incrementally and continuously enhance our solutions as regulatory requirements are finalised and corporate reporting improves, providing clients with a full solution at both company/security and portfolio level well ahead of regulatory deadlines.

The Sustainable Finance Disclosures Regulation Solutions

Morningstar and Sustainalytics have a broad suite of company and fund level ESG data to help clients respond to this new regulation's disclosure requirements. We currently offer the following solutions, which are likely to expand with further research through 2021.

Company-level Solutions

- A data feed with company level data on Principal Adverse Impact (PAI) indicators that can be used to calculate entity and product level disclosures.
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Fund-level Solutions

- Morningstar will collect and disseminate EU ESG Fund Type information, i.e., Article 8 & 9 flags, as well as key data points from updated SFDR compliant ESG prospectuses. An additional 30-35 data points detailing how Article 8 and 9 funds aim to meet their objectives will be sourced from the prospectus which will be published by January 2022. Morningstar will also collect and provide data disclosed on the extent to which Article 8/9 products stated goals have been met. This data will be sourced from the fund’s annual report to be published during 2022.
- Morningstar’s market leading “Full Holdings” database provides users of third-party funds, like advisers and fund-of-funds, with access to the underlying securities’ PAI assessments. The Full Holdings Look-through can be used to reduce collective investments to the underlying bond, stocks etc invested by that fund. These exposures are then mapped to underlying company PAI data enabling clients to calculate the Entity Level Disclosures required under SFDR.

Index Solutions

- Morningstar can also provide ESG Indexes for comparison purposes and benchmarking, as well as the reporting capabilities necessary to generate fund level reports flexibly and efficiently.

Learn More

Morningstar is continuing to monitor the developments of the EU Sustainable Finance Disclosure Regulation as its components start to take effect, and together with Sustainalytics, is ready to support financial services professionals during this transition period with an industry-leading set of solutions.

To learn more about the EU Sustainable Finance Disclosure Regulation and how Morningstar and Sustainalytics can help, visit the relevant resources below.

- Morningstar's EU Action Plan hub morningstar.com/en-uk/lp/eu-sustainable-finance-action-plan
- EU Action Plan solutions from Sustainalytics sustainalytics.com/eu-sustainable-finance-action-plan-solutions and resource center sustainalytics.com/eu-sustainable-finance-action-plan-resource-center

Morningstar Direct:

- Access ESG data to help meet investor preferences for sustainable investing using Morningstar's flagship investment and research platform, Morningstar Direct. Try it for free go.morningstar.com/direct-free-trial-emea

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