

1st September 2022

# EU SUSTAINABLE FINANCE UPDATES

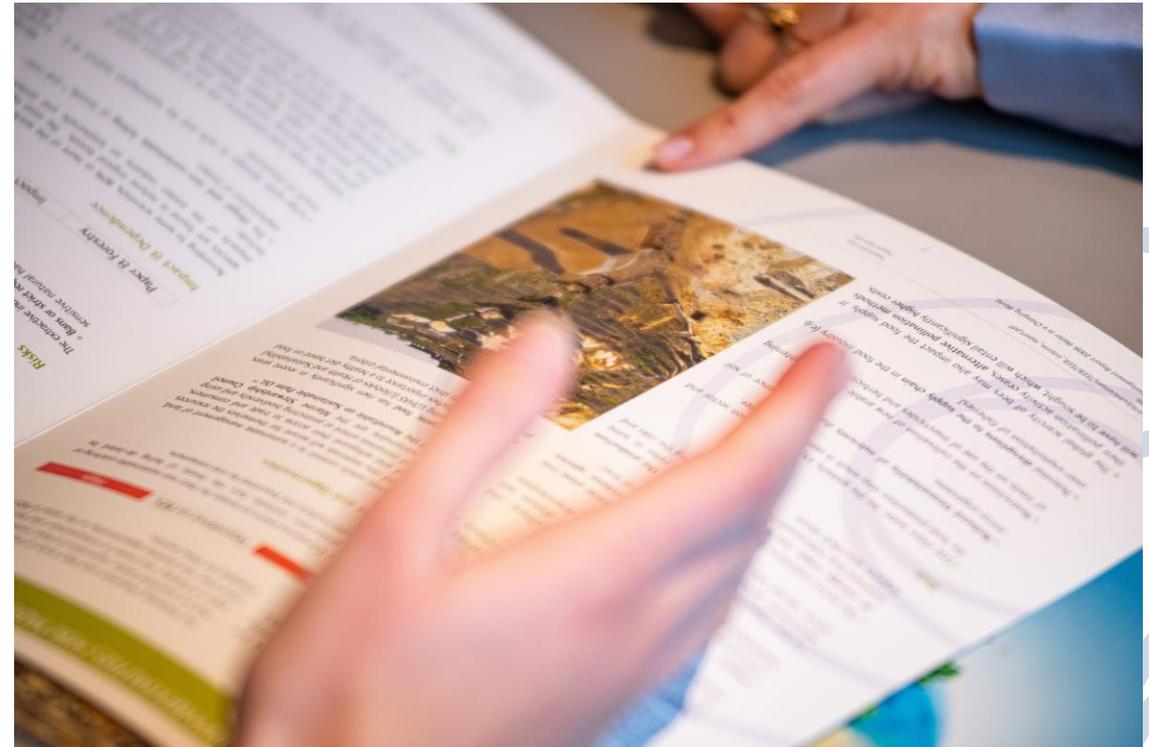
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The European Sustainable Investment Forum

# Agenda of this edition

Thursday 1 September 2022

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- **Setting the scene** – Recap of major developments before the summer
- **SFDR** – State of application
- **European Commission's call for input on greenwashing**
- **Platform report on minimum safeguards**



# Setting the scene – Recap

## ■ EU Taxonomy

On 6<sup>th</sup> July, the European Parliament voted **against an objection** to the Complementary Delegated Act (CDA) including natural gas & nuclear energy in the EU Taxonomy as **transitional activities**. The CDA was published in the [official journal](#) of the EU on 15<sup>th</sup> July.



## ■ CSRD

On 29<sup>th</sup> June, the Council [approved](#) the provisions of the Corporate Sustainability Reporting Directive (CSRD) agreed with the European Parliament in trilogues. On 14<sup>th</sup> July, the Legal Affairs Committee also voted in favour of adopting the CSRD based on the text negotiated with Council.



# Setting the scene – Recap

- SFDR

On 25<sup>th</sup> July, the [Delegated Act](#) introducing the SFDR regulatory technical standards (RTS) providing detailed ESG disclosure requirements and templates was published in the official journal.

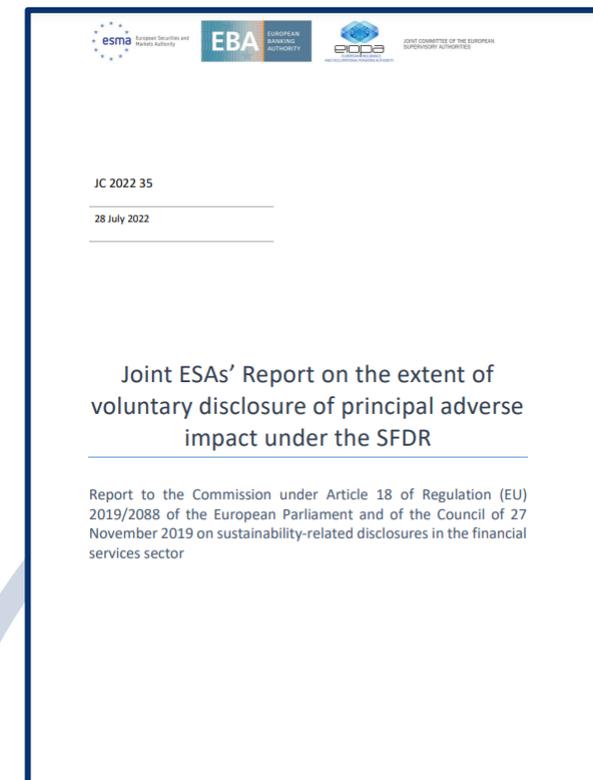


- MiFID II & IDD

On 2<sup>nd</sup> August, MiFID II & IDD provisions requiring client sustainability preferences to be gathered as part of the suitability assessment entered into application.

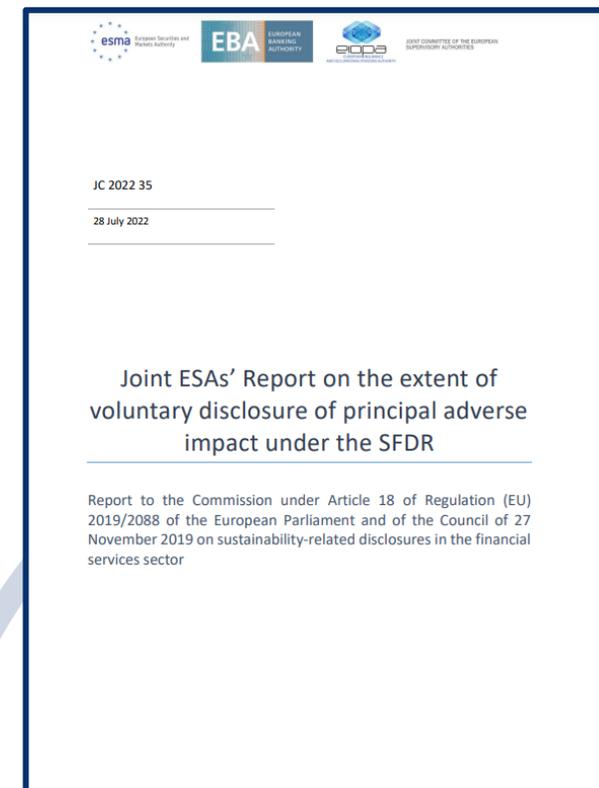
# SFDR – State of Application

- The detailed disclosure requirements and templates provided by the SFDR Delegated Regulation will be applicable as of 1<sup>st</sup> January 2023.
- In the interim, since 10<sup>th</sup> March 2021, FMPs have been attempting to comply with SFDR disclosure requirements despite delays in implementation and the limited availability of data.
- Nevertheless, on 28<sup>th</sup> July the ESAs published a [report](#) pursuant to Article 18 of the SFDR assessing the extent of voluntary disclosures of Principal Adverse Impact (PAI) at entity level.
- The report concerns the quality of PAI statements disclosed by FMPs under the 500-employee threshold stipulated in Article 4. PAI statements are mandatory for FMPs with over 500 employees.



# SFDR – State of Application

- The ESAs gathered information from national supervisors for the purposes of the report.
- The reports key findings are;
  - The **quality of voluntary disclosures varies significantly** across FMPs and national markets.
  - The PAI statements published are often vague and **do not contain sufficient detail to communicate how FMPs identify and mitigate PAIs.**
  - The voluntary disclosures of larger FMPs tend to be superior to those of smaller peers.
  - FMPs sight the **lack of data**, incomplete or pending regulatory requirements or **prohibitively high costs of disclosures** as reasons for non-disclosure.



# SFDR – State of Application



- At the end of July, Morningstar also published a report on trends in the market for products classified in accordance with SFDR.
- According to Morningstar data;
  - Article 8 & 9 products account for over 50% of assets with a collective value of 4.18 trillion EUR.
  - In Q2 2022, approximately 60% of new funds launched were classified as either Article 8 or 9.
  - Moreover, 700 funds changed status – the majority being Art. 6 products being upgraded to Article 8. However, 17 Article 9 products were ‘demoted’ to Article 8.
  - Under 50% of Art. 8 & 9 products reported consideration of PAIs and exposure to ‘sustainable investments’.

# SFDR – State of Application

- According to Morningstar data;
  - Among Art. 9 products, exposure to ‘sustainable investments’ varied dramatically. Only 2.3% of Art. 9 products have target allocations of 90% sustainable investments. Approximately 50% of Art. 9 products have committed to sustainable investment allocations of around 70%. A substantial share of Art. 9 products (40%) have only committed to achieve allocations of 50% to sustainable investment.
  - Only 25% of Art. 8 & 9 products disclosed their level of Taxonomy-alignment. Of those, over 90% indicated zero-alignment with the Taxonomy due to data reliability issues.
  - In the context of MiFID II, Morningstar notes that financial advisers will have difficulty fulfilling their obligations towards clients due to the non-comparability of products and data patchiness.



## SFDR Article 8 and Article 9 Funds: Q2 2022 in Review

Assets surpass 50% market share ahead of a challenging MiFID II amendment.

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**Morningstar Manager Research**  
29 July 2022

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**Executive Summary**

It's been more than 16 months since the European Union introduced its Sustainable Finance Disclosure Regulation, requiring for the first time that asset-management companies provide information about their investments' environmental, social, and governance risks as well as their impact on society and the planet. Since 10 March 2021, funds available for sale in the EU have been classified by their managers as Article 6, 8, or 9, depending on their sustainability objectives.

This report provides an update on the rapidly evolving landscape of Article 8 and Article 9 funds at the end of the second quarter 2022, examining flows, assets, and products. We also analyse the ESG credentials of these so-called "light green" and "dark green" funds, looking at their levels of ESG risk and controversial activities exposures, including fossil fuels and nuclear.

Additionally, with the amended Markets in Financial Instruments Directive II (MiFID II) coming into force on 2 August, we discuss the challenges we believe advisers will face to fulfill their new obligations. They will be required to consider clients' sustainability preferences when conducting suitability assessments. If clients express interest in making sustainable investments, advisers will have to source products that have a minimum proportion of sustainable investments as defined by the SFDR or EU Taxonomy. Clients may also choose only investments that consider principal adverse impacts, or PAIs.

To facilitate this process, asset managers have started to disclose this key information via a new European ESG template, or EET, developed by industry representatives (Fit2EET) to ease the exchange of data between asset managers and distributors. As of 18 July, Morningstar collected EET data on 70,580 share classes, accounting for 42% of all share classes in scope of MiFID II. In this report, we share insights on the coverage and values of PAI consideration, sustainable investment exposure, and taxonomy alignment.

**Key Takeaways**

- In the second quarter of 2022, Article 8 funds led EUR 30.3 billion, while Article 9 funds attracted inflows of EUR 5.9 billion, amid investor concerns over a global recession, inflationary pressures, and the conflict in Ukraine.
- Article 8 and Article 9 fund assets declined by 6.4% to EUR 4.18 trillion at the end of June. In comparison, Article 6 fund assets dropped by 8.9% over the period.
- Assets in Article 8 and Article 9 funds surpassed 50% market share.

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# SFDR – State of Application

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- In terms of forthcoming regulatory & supervisory interventions on SFDR;
  - By 30<sup>th</sup> September, the ESAs must propose amendments to the SFDR Delegated Regulation to ensure Taxonomy-related product disclosures reflect exposures to nuclear energy and natural gas, where investments therein qualify as transitional activities in accordance with the Complementary Delegated Act of the EU Taxonomy.
  - In October, the ESAs are expected to publish a **Q&A document** addressing practical questions that have arisen during the application of SFDR.
  - By Q2 2022, the ESAs are mandated to **propose changes to the PAI framework**. This will involve streamlining and refining existing PAIs, considering additional mandatory PAIs and introducing methodologies for the calculation of PAIs.

# European Commission's call for input on greenwashing



- In July, the ESAs (ESMA, EBA, EIOPA) published a [call for input](#) on greenwashing risks and the supervision of sustainable finance policies sent by the European Commission in May
- The Commission requests each of the ESAs, individually but in a coordinated manner, to prepare:
  - **Progress Reports:** focusing on how greenwashing is understood, and actions taken to ensure monitoring of greenwashing risks - **ready by 16 May 2023**
  - **Final Reports:** complementing the progress reports with examples of cases of greenwashing and an assessment of their impact on the financial market - **ready by 16 May 2024**
- + **Shared summary** of key horizontal aspects across all three reports in order to allow a certain degree of comparability across their findings

Request for input to the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) related to greenwashing risks and supervision of sustainable finance policies.

## 1. Context and scope

The demand for and offer of sustainable investments is growing rapidly. This is a very positive trend in line with the European Green Deal objectives. However, it should not come at the expense of greenwashing practices, affecting investors, consumers and financial market participants and potentially undermining the overall trust in sustainable finance and the capacity of the financial system as a whole to channel private capital to sustainable investments.

Greenwashing is a complex and multifaceted issue. It can occur at different stages of the financial value chain, such as at the sale or marketing of financial products. It can also occur at company level where an undertaking or a financial institution makes false or unsubstantiated sustainability claims about its products, activities or policies.

Greenwashing can generate reputational and financial risks for the actors involved. It can also negatively impact the market and system level as well as the overall trust into sustainable financial investments. For instance, greenwashing related to the sale of a financial product, can trigger legal and operational risks for the seller. Greenwashing could also create reputational risk and lead to investors withdrawing investments or funding, ultimately affecting the business and financial situation of the financial market participant.

The EU has taken important steps to address greenwashing in the financial market by adopting sustainable finance related policies and legislation. These include sustainability disclosures and (proposed) sustainability reporting requirements for companies (Taxonomy Regulation<sup>1</sup> and proposal for a Corporate Sustainability Reporting Directive<sup>2</sup>), and manufacturers of financial products and financial advisers (Sustainable Finance Disclosure Regulation<sup>3</sup>, Taxonomy Regulation, sustainability preferences of retail investors in investment advice<sup>4</sup>).

The EU has also created tools to increase transparency and help end-investors identify credible investment opportunities and potential risks. These include the SFDR and the Taxonomy disclosures, the

# European Commission's call for input on greenwashing



- What are the reports meant to cover?
- The Commission asks the ESAs to provide input in the following six areas:
  1. Greenwashing and greenwashing risks
  2. Supervisory practices, experience and capacities
  3. Implementation of sustainable finance policies and supervisory convergence
  4. Supervisory measures and enforcement
  5. Assessment of supervisory obligations and powers
  6. Proposals for improvement of the regulatory framework
- What happens next?
  - Based on the reports, the Commission will assess and monitor greenwashing risks in the financial market
  - The Commission will consider if further steps are necessary for the effective supervision and enforcement of greenwashing and its risks

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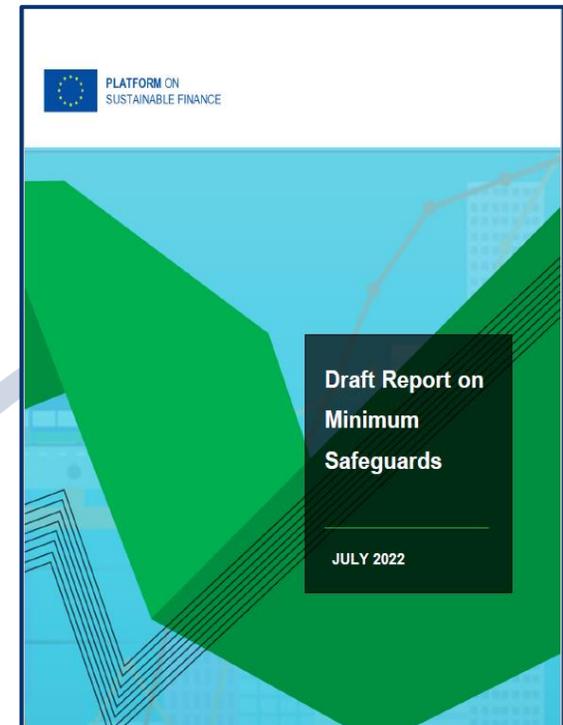
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# EU Taxonomy Minimum Safeguards

- On the 11<sup>th</sup> of July the Platform on Sustainable Finance published a **draft report with advice on how to assess compliance with minimum safeguards** according to the EU Taxonomy Regulation (TR).
- The draft report is open for **public consultation until the 6<sup>th</sup> of September**.
- After reviewing the responses, the Platform will finalise the report and submit it to the EU Commission by the end of September.

## What are minimum safeguards?

- **Art. 3 TR** – An economic activity is environmentally sustainable if it satisfies certain criteria, including being “*carried out in compliance with the minimum safeguards laid down in Article 18*”.
- **Art. 18 TR** – Minimum safeguards are “*procedures implemented by an undertaking that is carrying out an economic activity to ensure the alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (UNGPs), including the principles and rights set out in the 8 fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights”.*



# EU Taxonomy Minimum Safeguards



- The objective of the report is to **provide advice on how compliance with minimum safeguards (MS) should be assessed**.
- 4 topics pertaining to MS: 1) **Human rights** (including labour and consumer rights); 2) **Bribery**, bribe solicitation and extortion; 3) **Taxation**; 4) **Fair competition**.
- According to the UNGPs and the OECD Guidelines for Multinational Enterprises (OECD MNE Guidelines), companies have two types of expectations: **respect human rights** (performance/end-goal); **establish adequate due diligence processes** (means to achieve the goal).
- Accordingly, **compliance with MS combines considerations on processes and considerations on outcomes**. The determination of compliance or non-compliance with MS looks at:
  - ✓ whether the company has established a **proper due diligence process on human rights** (DD HR), according to the 6 steps outlined in the UNGPs and by the OECD; and
  - ✓ whether the company **respects human rights**.
- **Companies** should report on both due diligence processes & outcomes; **investors/auditors** should analyse **whether the company respect human rights**, and **whether the company has established proper DD HR**.

# EU Taxonomy Minimum Safeguards



- The Platform delineates two criteria for determining the compliance with MS:
  - ✓ **Criterion 1: Existence of adequate due diligence processes**
  - ✓ **Criterion 2: No final conviction in court on human rights** including labour rights, and **no refusal to engage in certain stakeholder dialogue mechanisms** (e.g. dialogue with OECD NCP and concerns raised by the BHRRC)
- If one of these two criteria is not satisfied, the company is non compliant with MS.
- How this system will fit the EU regulatory framework on sustainable finance?
  - ✓ **Corporate Sustainability Due Diligence Directive (CSDDD)** → provisions on the adoption of adequate DD processes
  - ✓ **Corporate Sustainability Reporting Directive (CSRD)** & reporting standards → provisions on the disclosure of information on DD processes

## Observations on current application

- Companies, investors, auditors and stakeholders are struggling with interpretation & data availability.
- Different approaches by data & research providers; controversy screening are useful tools, but not enough to assess MS.

# Thank you & see you in October!

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