EFAMA
European Fund and Asset Management Association

MARKET INSIGHTS

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THE EUROPEAN ESG MARKET AT END Q1 2021
– INTRODUCING THE SFDR –

The EU's **Sustainable Finance Disclosure Regulation (SFDR)**, introduced in March 2021, put in place a set of sustainability-related disclosure obligations for financial market participants, including financial advisers. Among other obligations, the SFDR requires asset managers to make specific sustainability-related disclosures across their product range.

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- SFDR Article 6: requires all fund managers to make disclosures on the integration of sustainability risks and their impacts on the returns of the financial products they make available.

- SFDR Article 8: requires funds that promote sustainability characteristics to specify in pre-contractual disclosures how they will promote environmental or social characteristics, or a combination of both, and that the companies in which the investments are made follow good governance practices.

- SFDR Article 9: requires funds with a sustainability objective to specify in pre-contractual disclosures on how they will attain such objective and whether an index has been designated as a reference benchmark.

Although it was not the regulators' intention for these Articles to be treated as product labels, this has, in practice, split the EU fund universe into three categories. Each category is named after the relevant Article in SFDR: Article 6 are funds that integrate sustainability risks, Article 8 are funds with sustainability characteristics and Article 9 are funds that have sustainability objectives.

Based on the EFAMA survey results featured in this publication, net assets of SFDR Article 8 and Article 9 funds amounted to EUR 3.7 trillion and EUR 340 billion respectively, at the end of March 2021, with a relatively high concentration in a limited number of countries. Domestic market shares of SFDR Article 8 and 9 funds vary widely across European countries. These differences are not only driven by variations in actual amounts of ESG investing across countries but also by national regulators' divergent interpretations of the SFDR Level 1 text.

An ESG investment approach may not be restricted to the fund level, it can also be applied at the level of the firm or across part of the firm's assets, for instance by excluding certain types of businesses, sectors, countries, or behaviours, or by integrating certain

ESG risks and opportunities in the investment decision-making process. Looking at the firm-level, asset managers in Europe were managing EUR 11 trillion of assets using an ESG investment approach as at the end of Q1 2021. This includes assets invested in funds and discretionary mandates.

In the absence of Level 2 measures, the fund industry has so far implemented SFDR on a best-effort basis. The evolving legal interpretation of the regulation especially in regards to the Taxonomy products disclosures in SFDR risk creating confusion amongst investors, as it will already apply on 1 January 2022 despite missing investee company disclosures and taxonomy screening criteria. Regulators need to take a common approach and avoid piecemeal changes for SFDR to raise investor confidence and increase transparency in a relatively new and fast-growing part of the European fund market.

DATA COLLECTION – THE FACTS

Over April-June 2021, EFAMA, together with its national associations, conducted a survey to estimate the size of the European ESG market altogether, looking at funds and discretionary mandates. This was the second edition of this survey. The results of the first survey, which estimated the level and nature of ESG investments by European asset managers at end of 2019, were published in **Market Insights #3**. Since then, the ESG market has seen significant changes, both at the regulatory and the market level.

The outbreak of the pandemic, the sharp market downturn that followed the first lockdown measures and the subsequent market recovery gave a boost to ESG investing in 2020, as highlighted **in Market Insights #4**. However, the biggest change happened on the regulatory level, with the introduction of the **Sustainable Finance Disclosure Regulation (SFDR)** in March 2021.

This was the first time EFAMA collected data on SFDR Article 8 and 9 funds. This data collection offers a more complete picture of the UCITS and AIF markets compared to data from commercial data providers. Commercial data providers tend to have a good overview of the UCITS market (covering mainly the retail investment products). The AIF market, which includes mostly the institutional funds, is generally less well covered. This can clearly be seen when comparing the figures for SFDR Article 8 funds in countries with big institutional markets such as France or the Netherlands, where net asset amounts are significantly higher than commercial providers' data suggest.

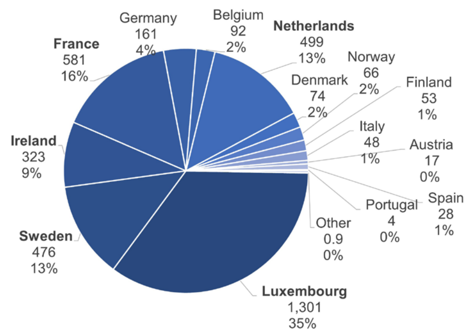
The survey results provide a first picture of a market that remains in full flux and should therefore, be treated with some caution. The ESG market has already undergone significant changes since the SFDR introduction and will undoubtedly undergo further changes in the coming months and years.

A key finding of our survey is that the coverage of funds by Articles 8 and 9 is uneven across Europe. This can be explained by various factors, such as different interpretations by national regulators of the SFDR Level 1 text, the delayed implementation of the Level 2 measures and varying maturity levels of ESG fund markets between Member States. Once the regulatory uncertainty and outstanding operational issues of SFDR and the Taxonomy-related disclosures are resolved, we can expect a better investor experience, especially for retail investors with sustainability preferences based on the recently introduced ESG amendments under MiFID II.

SFDR ARTICLE 8 FUNDS: FUNDS PROMOTING ENVIRONMENTAL AND SOCIAL CHARACTERISTICS

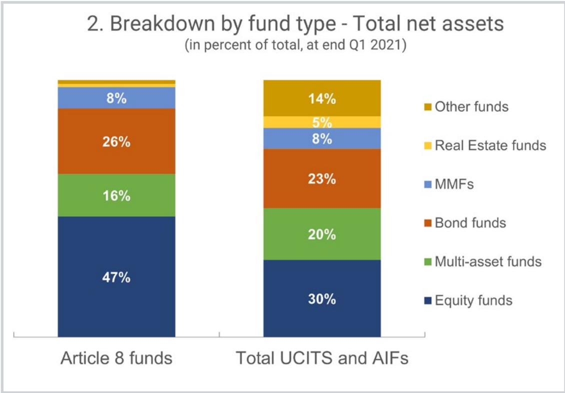
Net assets of SFDR Article 8 funds totalled EUR 3.7 trillion, making up 22% of the European fund market at the end of Q1 2021[1]. The main domiciles of SFDR Article 8 funds are Luxembourg (35%), France (16%), the Netherlands (13%), Sweden (13%) and Ireland (9%). Combined, the net assets of these five domiciles amounted to 85% of the total net assets of SFDR Article 8 funds.

1. The SFDR Article 8 market at end Q1 2021
(EUR billions and % of total)



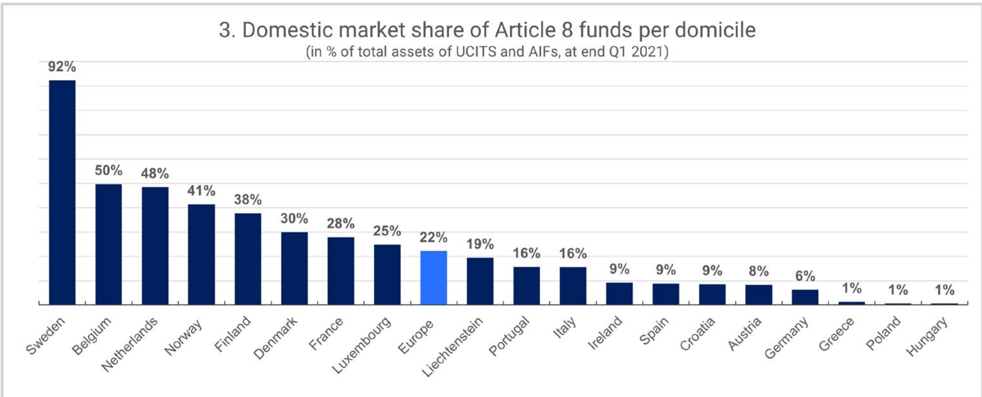
Source: EFAMA and Morningstar

Equity funds represented half of the total universe of SFDR Article 8 funds (47%) at the end of March 2021. Bond funds accounted for 26%, followed by multi-asset funds (16%) and money market funds (8%). Compared to the total net assets of UCITS and AIFs, the market share of equity funds is higher among SFDR Article 8 funds. Market shares of bond funds and multi-asset funds are similar.



Source: EFAMA and Morningstar

The chart below shows the domestic market share of SFDR Article 8 funds per domicile, expressed as a % of the total net assets of UCITS and AIFs domiciled in each country.



Source: EFAMA and Morningstar

The following points are worth highlighting:

- The high share of SFDR Article 8 funds in the Nordic countries, Belgium and the Netherlands reflects the fact that these countries have a long tradition in ESG investing.

- Sweden's high market share can also be explained by a pre-existing legal requirement on ESG-information for funds and a less strict interpretation of what is meant by "promote" in SFDR Article 8 (in line with the European Commission's own interpretation, which came up later in response to a question by the ESAs).

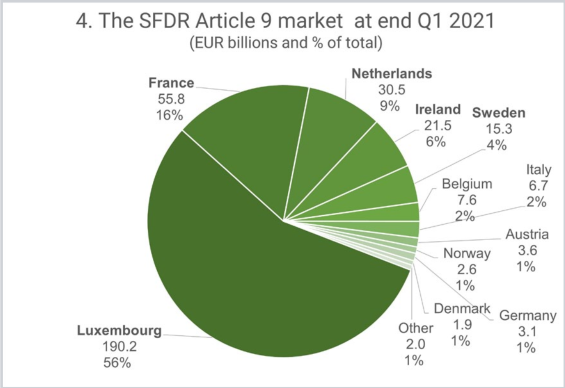
- The relatively low share of SFDR Article 8 funds in Germany can be explained by the importance of 'Spezialfonds' for institutional investors, for which the SFDR classification is of less relevance. Another possible reason is the strict interpretation of the SFDR Level 1 text by the BaFin, Germany's Federal Financial Supervisory Authority.

- In Luxembourg, SFDR Article 8 funds represent about 25% of total net fund assets, whereas in Ireland they account for only 9%. The difference reflects the fact that equity, bond and multi-asset funds, which have a higher share in Article 8 funds, are more predominant in Luxembourg than in Ireland.

- The ESG market is still at a very early stage of development in the Eastern European domiciles for which data is available.

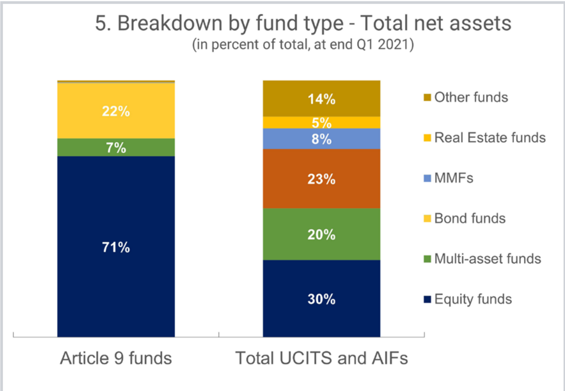
SFDR ARTICLE 9 FUNDS: FUNDS WITH A SUSTAINABILITY OBJECTIVE

SFDR Article 9 fund net assets amounted to EUR 340 billion, or about 2% of the European fund market at the end of Q1 2021. Luxembourg accounted for more than half of the total SFDR Article 9 fund net assets, followed by France (16%) and the Netherlands (9%).



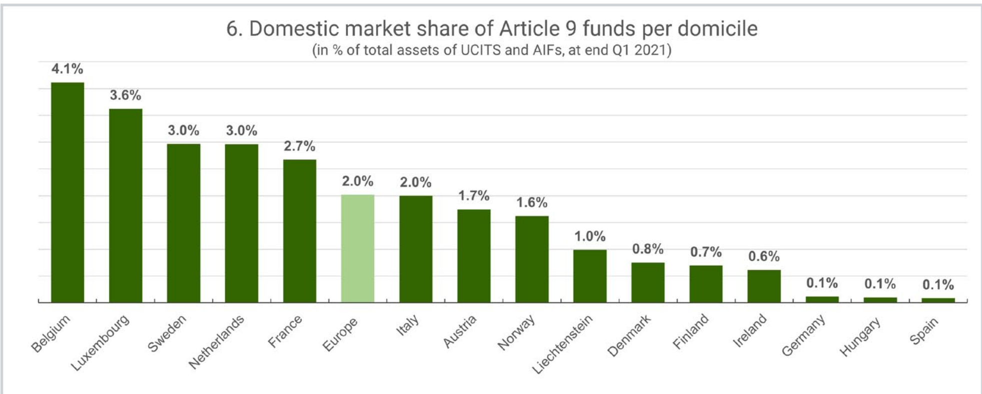
Source: EFAMA and Morningstar

Equity funds are even more predominant in SFDR Article 9 funds than in Article 8 funds, accounting for 71% of all SFDR Article 9 funds at the end of March 2021. This is more than twice the share of equity funds across all UCITS and AIFs assets (30%). Bond funds and multi-asset funds represented 22% and 7%, respectively.



Source: EFAMA and Morningstar

As the total net assets of SFDR Article 9 funds are quite low, it is unsurprising that the market share of these funds at national level is correspondingly low. The next chart shows the domestic market share of SFDR Article 9 funds per domicile, expressed as a % of the total net assets of UCITS and AIFs domiciled in the different countries. SFDR Article 9 funds accounted for 0% to 4% of national domiciled funds.



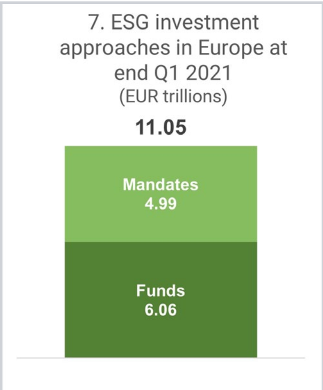
Source: EFAMA and Morningstar

BROADER ESG INVESTMENT APPROACHES AND ESG VOTING

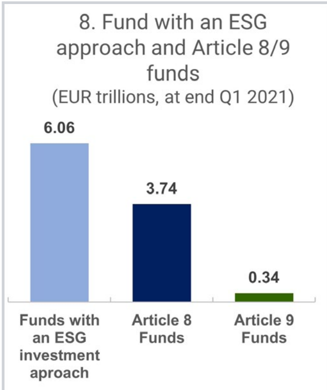
An ESG investment approach is not always restricted to the fund level. It can also be applied at the level of the asset management companies or across part of their assets, for instance by excluding specific types of businesses, sectors, countries, or behaviours, or by integrating certain ESG risks and opportunities in the investment management of funds and discretionary mandates.

Asset managers in Europe applied an ESG investment approach to a total of EUR 11 trillion of assets at the end of Q1 2021[2]. This figure is slightly higher than the 2019 estimation (EUR 10.7 trillion). The relatively limited growth (3%) of these total ESG assets since the end of 2019 could indicate that the introduction of the SFDR has prompted asset managers to be more cautious when reporting the amount of assets for which they use some form of ESG investment approach.

Assets in discretionary mandates that take an ESG investment approach amounted to EUR 5 trillion, whereas AuM in funds using some form of ESG features accounted for EUR 6 trillion. The significant difference between the total of EUR 6 trillion in European funds applying an ESG approach and the total AuM in Article 8 and Article 9 funds (slightly above EUR 4 trillion), is due to the inclusion of UK and Swiss data. However, it is also explained by the fact that some asset managers apply an overall ESG approach for all their (fund) assets without necessary labelling or registering their whole fund range as SFDR Article 8 or 9.

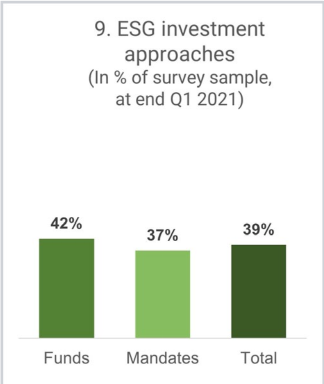


Source: EFAMA

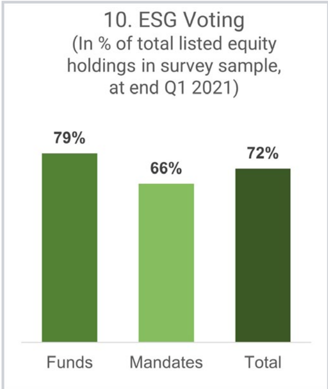


Source: EFAMA and Morningstar

European asset managers in the countries covered by the survey applied an ESG investment approach to about 40% of the total assets they managed at the end of Q1 2021, compared to 45% at the end of 2019. This percentage is higher for funds (42%) than for mandates (37%). ESG voting is an approach through which the asset manager makes active use of any voting rights they possess to influence ESG practices of investee companies. In the survey, ESG voting is only considered in relation to the listed equities an asset manager is holding. Similar to the overall ESG investment approaches, the percentage of ESG voting is higher across funds than in mandates.



Source: EFAMA



Source: EFAMA

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CURRENT LIMITATIONS OF SFDR AND ITS FUTURE POTENTIAL

EFAMA fully supports the SFDR objectives to reduce information asymmetries, prevent divergent national disclosures, enhance the comparability of ESG disclosures, and foster a level playing field for ESG products within the internal market. The industry has full confidence in the ability of SFDR to deliver on these objectives once the regulation is entirely in place, the corresponding templates become applicable, and as European authorities clarify outstanding legal interpretation issues. However, there is still some way to go and a few obstacles along the way.

Evolving nature of SFDR. A coherent and consistent application of SFDR since it became applicable on 10 March 2021 has not proved possible due to the absence of the necessary Level 2 measures (Regulatory Technical Standards). This awkward situation has been further exacerbated by legal uncertainties identified by the industry, and subsequently raised with the European Commission by the ESAs[3]. While asset managers have done their best to comply with the incomplete regulation on a principle-based approach, SFDR´s evolving nature could be a source of regulatory fragmentation and confusion for end-investors, distorting trust and confidence in the new regime.

For example, in the absence of the specific harmonised templates, the potential to promote standardisation and comparability of different financial products is limited. The market has also experienced different implementation approaches stemming from legal uncertainty on which funds are covered by SFDR Articles 6, 8 or 9 and the general tendency to treat Articles 8 and 9 as labels, rather than disclosure requirements.

Need to address the legal uncertainty. The legal uncertainty around the categorisation of funds and the SFDR´s application to non-EU AIFMs persists even after the **deferral** of the implementation date of the SFDR Level 2 measures by six months and the publication of **the Commission's response** to **the ESA´s letter** requesting clarification from the European Commission with respect to several priority issues under SFDR.

Unfortunately, the European Commission's response has not fully addressed all the legal interpretation questions. For instance, it remains unclear whether complying with a national obligation, such as a ban on investments in cluster munitions, brings a product into the scope of Article 8. It is also unclear whether a binding, firm-wide ESG exclusion suffices to bring a fund within the scope of Article 8 even if this is not a characteristic promoted by the product. Moreover, the Commission's broad definition of promotion of ESG characteristics in its response to the ESAs' questions makes the delineation between Article 8 and Article 6 products even more difficult. In particular, it is not clear how a fund can avoid creating the impression that it considers ESG characteristics when it is required under Article 6 to describe how sustainability risks are integrated into the decision-making process and the impact those risks have on returns.

For the application of Article 9, the industry needs guidance on whether the "sustainable investments" analysis must be conducted at the entity level or at the level of the economic activity, given that the two approaches produce different percentage results for the same ESG portfolio. Uncertainty also remains concerning the "sustainable investments" requirement for Article 9 passive funds that have an objective of low carbon emission exposure in line with the Paris Agreement objectives.

National divergences. The prolonged absence of detailed EU harmonised rules relating to fund transparency is also causing significant national divergences, to the detriment of end investors. In recent months, a number of Member States have adopted national guidelines under SFDR to ensure the compatibility of national laws and regulations with the new EU disclosure regime. Because of the continuing uncertainty regarding the upcoming Level 2 measures under the SFDR and the Taxonomy, national regulators developed these rules with little information on the direction of travel of the EU framework. Consequently, these national guidelines have imposed different requirements for sustainable financial products, significantly reducing the comparability of these products. This has not only created concerns for product manufacturers regarding the cross-border distribution of their ESG products, but also created risks for end investors who might not be able to access comparable information for the sustainable products of their interest.

By imposing different minimum requirements for Article 8 products, they are becoming less comparable from one Member State to another concerning their environmental, social and governance risks or their sustainable investments objectives. This creates fragmentation in the EU market and is a barrier to the development of a large and liquid sustainable investment market that would facilitate and accelerate the transition to a net-zero economy. Such market fragmentation also runs contrary to one of the core objectives of SFDR.

LOOKING AHEAD

The most immediate milestone is 1 January 2022, with the application of the Taxonomy product-level disclosures in SFDR. Articles 5 and 6 of the Taxonomy create an obligation for Article 8 products with sustainable investments and all Article 9 products to report on their level of taxonomy alignment. As highlighted in the ESAs letter to Commissioner McGuiness dated 22 October 2021, the industry suffers from a lack of guidance on how to deal with the discrepancy between the 1 January 2022 obligation and the delayed application of taxonomy alignment disclosures by non-financial undertakings to 2023 under the Taxonomy Article 8 Delegated Act. This implies that SFDR products referred to in Articles 5 and 6 of the Taxonomy will not be able to disclose against the taxonomy based on actual company disclosures before 2023.

Asset managers will have to continue to apply SFDR on a Level 1-only basis until 1 July 2022 following the decision of the European Commission to defer the SFDR Level 2 measures by six months. This delay complicates the harmonised operationalisation of the upcoming distribution rules for ESG products to retail investors, which rely on information stemming from the Level 2 measures under SFDR and the Taxonomy Regulation[4].

As of 1 July 2022, the industry expects to fully apply the SFDR legislation. While the fund management industry may face some difficulties and uncertainties in the implementation process, we are confident that these challenges will fade once the regulatory framework is complete and stakeholders become more familiar with the new obligations. By implementing the SFDR, the European Union is taking a global lead in standardising funds´ sustainability disclosures, contributing to the redirection of capital flows towards sustainable projects and businesses. This new legislation will reduce the information asymmetries on ESG issues, empowering end-investors to play a role in financing pressing societal challenges.

The Commission´s recently published **Strategy to Financing the Transition to a Sustainable Economy** has introduced the possibility for further changes to the SFDR in 2022. The strategy considers the development of 'minimum sustainability criteria, or a combination of criteria for financial products that fall under SFDR Article 8, to guarantee a minimum sustainability performance of such products and further strengthen a harmonised application of the Regulation, as well as incentivising transitional efforts.

A key challenge relates to the reporting of ESG metrics in SFDR, the so-called principal adverse impacts (PAI) of investments decisions on sustainability factors. Here, the industry faces significant data reliability and availability problems. While the number of mandatory and optional PAIs, as well as their metrics and definitions, remain to be clarified by the final RTS, the coverage of several of the PAI indicator remains insufficient, "with a wide range of variance in the reported data" and "low levels of comparability"[5]. Asset managers will need to adopt a best-efforts approach to PAI reporting until the data challenge is addressed through the development of European mandatory sustainability reporting standards under the proposed Corporate Sustainability Reporting Directive (CSRD).

These expected regulatory developments will no doubt have an impact on the uptake of SFDR Article 8 and 9 funds and will be reflected in the next issue of the EFAMA ESG survey results in 2022.

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FOOTNOTES

[1] The results of this year's survey are based on data collected from EFAMA member associations representing Belgium, Croatia, Denmark, France, Hungary, Greece, Germany, Italy, Liechtenstein, the Netherlands, Norway, Poland, Portugal, Slovakia, Sweden, and Spain. The reported data covers both UCITS and AIFs. To assess the overall size of the European market, we used data from Morningstar Direct to include the following other countries: Austria, Finland, Ireland, and Luxembourg.

The UK and Switzerland are not covered as they did not implement the SFDR.

[2] Based on data collected from EFAMA member associations representing Belgium, Croatia, Denmark, France, Hungary, Greece, Germany, Italy, Liechtenstein, the Netherlands, Norway, Poland, Portugal, Slovakia, Switzerland, Sweden, Spain and the UK. Swiss and UK is included in this estimation. Swiss data of end 2019 was used due to a lack of up-to-date figures.

*[3] **ESA´s letter** on priority issues relating to SFDR application*

[4] Implementation of the recent ESG amendments to MiFID II and IDD scheduled to apply as of 2 August 2022.

*[5] Irish Funds (2020, p.16): **Principal Adverse Impacts Reporting - Practical insights for the next stage of SFDR implementation***

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