SFDR - The First 20 Days

What the early batch of new disclosures are telling us so far

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Hortense Bioy, CFA
Global Director of Sustainability Research
hortense.bioy@morningstar.com

Elizabeth Stuart
Analyst
Sustainability Research, EMEA
elizabeth.stuart@morningstar.com

Andy Pettit
Director, Policy Research
andy.pettit@morningstar.com

Executive Summary

On 10 March, the EU Sustainable Finance Disclosures Regulation took effect, requiring fund companies to classify each fund into one of three categories, Article 6, 8, or 9, depending on the product's sustainability objective. Twenty days later, Morningstar released Article 8 and 9 SFDR data points in its database, Morningstar Direct, to allow clients to identify these funds. So far, Morningstar has collected SFDR data on close to 50% of funds (that is, 5,695) domiciled in Luxembourg, Europe's largest funds domicile. Concurrently, Morningstar Manager Research surveyed 30 asset managers and asked for their full lists of Article 8 and 9 funds. In this report, we analyze what the early batch of new disclosures are telling us so far.

Key Takeaways

- Based on preliminary data, we estimate that funds classified as Article 8 and 9 currently represent up to 21% of total European funds and up to 25% of total European fund assets.
- The European environmental, social, and governance and sustainable fund market, based on SFDR definitions, could therefore currently be worth as much as EUR 2.5 trillion.
- We expect these numbers will increase in the coming months as asset managers see SFDR as an opportunity to demonstrate their commitment to sustainable investing. Managers have plans to enhance existing strategies, reclassify funds, and launch new ones that will meet Article 8 and 9 requirements.
- In this first classification exercise, asset managers have taken different approaches based on their interpretation of the regulation, with some preferring to take a conservative approach for fear of having to downgrade funds later. Therefore, classification approaches vary widely, resulting in a wide range of investment products classified as Article 8 and 9.

Introduction

After almost three years of preparation, the EU Sustainable Finance Disclosures Regulation took effect on 10 March. The regulation aims to increase transparency about the integration of sustainability risks in the financial sector by requiring financial market participants and financial advisors to disclose both the intended positive sustainability effects as well as any negative externalities.

Under SFDR, the entire universe of European funds will be classified by their managers into one of three categories, Article 6, 8, or 9. The nomenclature derives from the regulatory text, and all funds will be required to provide some ESG disclosure, as per Article 6, while Article 8 and Article 9 funds will be required to provide more detailed ESG information to investors.

Exhibit 1 SFDR Classification

Source: Morningstar Research.

Although the industry is still adjusting to the measures and although uncertainties remain about Article 8 and Article 9 classification, Morningstar has started collecting this data from fund prospectuses. Article 8 and 9 data points were released in Morningstar Direct on 29 March.

The European ESG and Sustainable Fund Market Could Be Worth EUR 2.5 Trillion

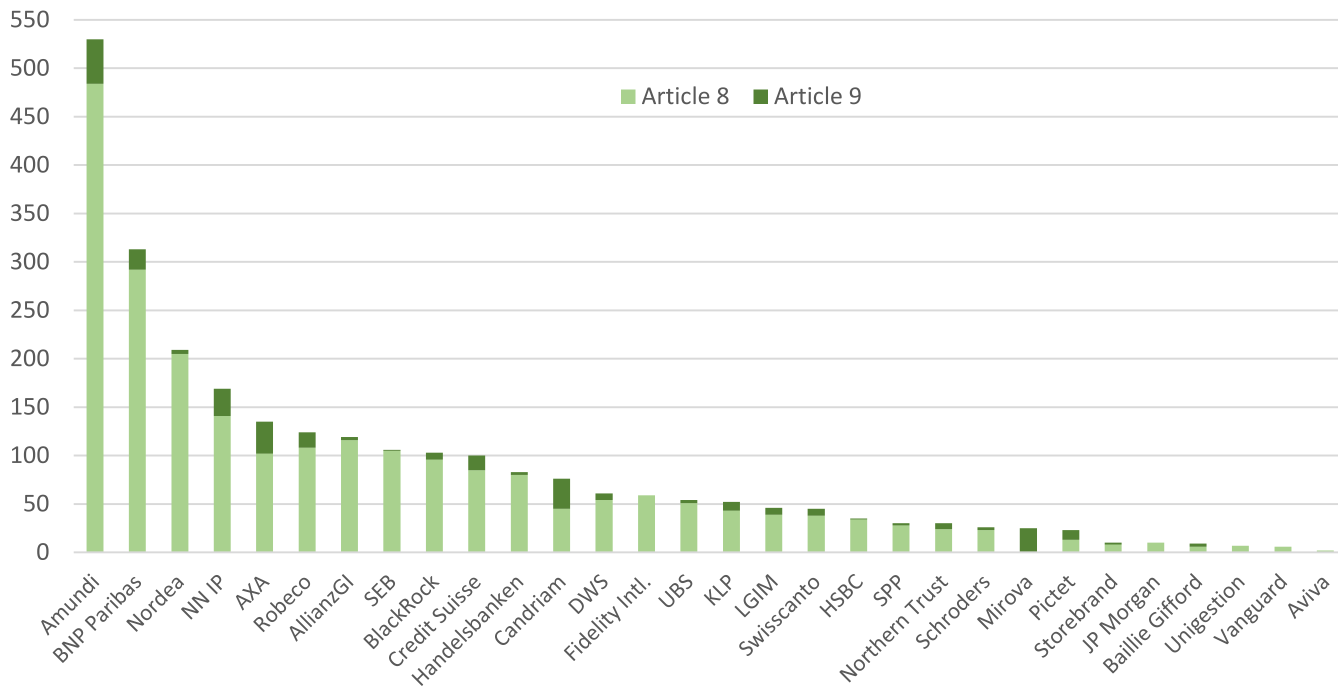
As of 29 March, Morningstar's data team had reviewed 49.3% of the 11,500 open-end funds and exchange-traded funds domiciled in Luxembourg, Europe's largest funds domicile. Of these, 18.0% and 3.6% were classified as Article 8 and Article 9, respectively, representing combined assets of EUR 768 billion, or 25% of the reviewed Luxembourg funds universe.

Based on the data collected so far, we estimate that funds currently classified under Article 8 and 9 represent up to 25% of the overall European fund market. This means that the European ESG and sustainable funds market, based on SFDR definitions, could be worth as much as EUR 2.5 trillion. And we expect this number to increase in the coming months as managers enhance strategies, reclassify funds, and launch new ones that meet Article 8 or 9 requirements.

Findings From Our Survey of 30 Asset Managers

Separately, Morningstar Research has surveyed a sample of 30 asset managers to gain insights into the early implementation of the new regulation. We have requested their full lists of Article 8 and 9 funds domiciled across Europe. The surveyed asset managers are of various nationalities and sizes, ranging from large European and US firms such as Amundi, UBS, BlackRock, and JPMorgan to boutique and sustainability-focused firms such as Candriam and Mirova. Exhibit 2 shows the number of Article 8 and 9 funds per fund manager surveyed.

Exhibit 2 Number of Article 8 and Article 9 Funds of 30 Surveyed Asset Managers

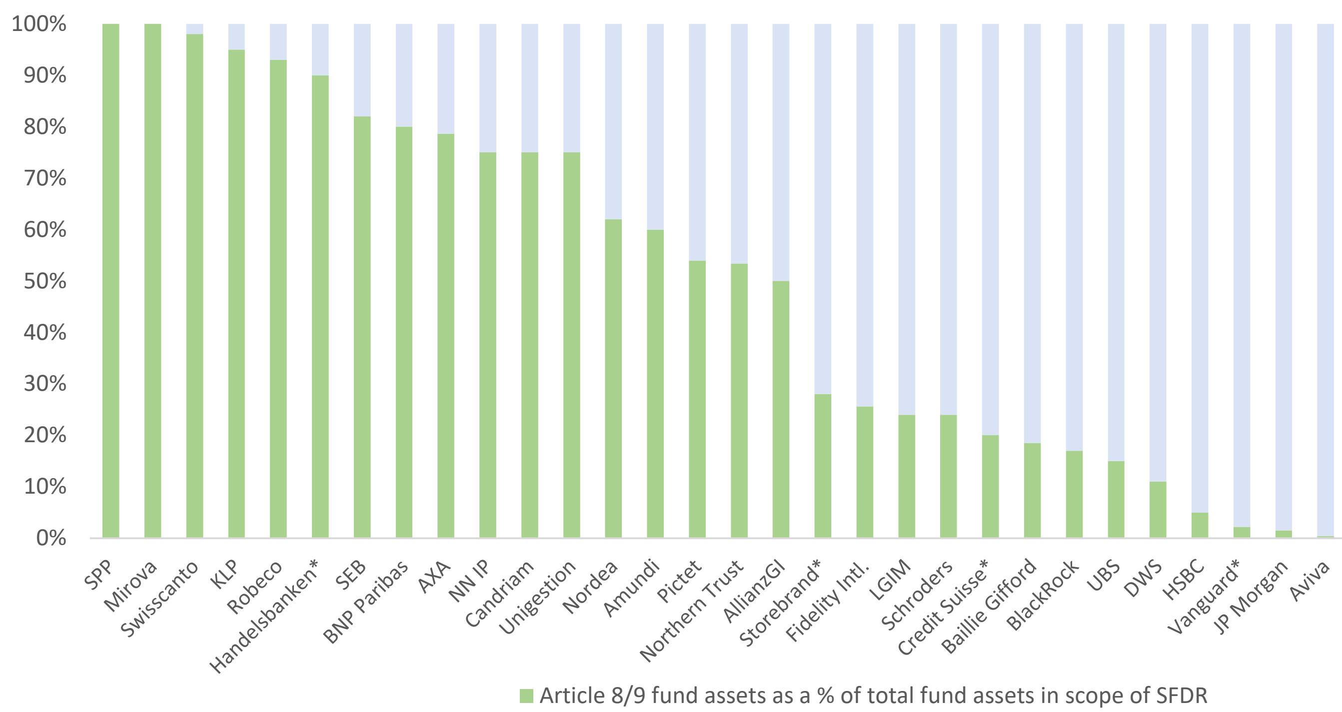


Source: Asset Managers. Data as of March 2021. Nordea's Article 8 fund number has been updated in this version.

Following the first classification exercise, we found that French managers Amundi and BNP Paribas offer some of the largest ranges of investment products classified as Article 8 or 9, with 529 and 310 funds, respectively. Other managers have chosen to classify far fewer funds as Article 8 or 9. It is the case even for firms of similar size or bigger, such as BlackRock, which has 103 classified products. UBS and JP Morgan have classified 54 and 10 of their funds as Article 8 or 9 products.

On an asset-relative basis, so correcting for size, the picture looks slightly different from when we look at absolute number of funds. Exhibit 2 shows the assets in Article 8 and 9 funds of the surveyed managers as a percentage of their total fund assets in scope of SFDR. Many of these percentages were provided to us by the asset managers, while the rest were calculated using the Morningstar Direct database and are therefore estimated.

Exhibit 3 Article 8 and 9 Fund Assets as a Percentage of Total Fund Assets in Scope of SFDR



Source: Asset Managers. (*) Estimated using Morningstar Direct. Data as of March 2021. Percentages for AXA and Unigestion have been updated in this version.

Exhibit 3 reveals a spectrum of practices, with, at one end, managers that have parked their entire or nearly entire offerings in Article 8 and 9 categories, and, at the other end, firms that have less than 1% of their fund assets in these categories.

Nordic and Dutch asset managers feature among those with the highest proportion of fund assets in Article 8 and 9. This, however, is hardly surprising given the long history and commitment to responsible investing of institutional investors in Northern European countries. For example, Robeco has classified 96% of its fund assets as Article 8 or 9, while KLP and SEB have 95% and 82% of their fund assets, respectively, in the two categories. Sustainability-focused boutique Mirova has positioned its full range of funds (25) in the Article 9 category.

Amundi and BNP Paribas, the two largest providers of Article 8 and 9 products in our sample, have classified 60% and 80% of their existing fund assets as such, respectively. Other large asset managers, including BlackRock, UBS, and JP Morgan, exhibit much lower ratios at 17%, 15%, and 1.5%, respectively.

Many of the surveyed managers, however, made it clear that this was just the first classification exercise and that they plan to bring additional funds into the Article 8 and 9 categories in the coming months. Amundi, for example, is aiming to get 75% of its total fund assets categorised under Article 8 and 9 by the end of the year.

In a press release last week, Amundi said: "*In line with our 100% ESG Integration plan, we are looking to significantly expand the scope of products categorised under Articles 8 & 9 by the end of the year, and will therefore continue to transform funds and upgrade investment strategies to meet the highest ESG standards*."

In a client presentation, JP Morgan wrote: "*J.P. Morgan Asset Management has opted for a prudent approach where only our existing sustainable funds will be classified as Article 8 or Article 9. [...] There will be an effort to uplift additional products to be classified as Article 8 and/or Article 9 in the coming months*."

Others, including DWS, UBS, Schroders, and Aviva, have shared similar plans.

While anxiously waiting for further guidance from the regulator, many managers have already identified funds that they could move up from Article 6 to Article 8. These are mostly funds that integrate ESG factors in the investment process and/or implement exclusions in a limited way. Some managers are willing to go further and make all the necessary changes to meet at least Article 8 requirements.

For many of the asset managers we spoke to, it is essential to have as many funds as possible classified under Article 8 and 9. They see SFDR as an opportunity to demonstrate their commitment to sustainable investing. They also feel pressure from some distributors and fund buyers that have said they would only consider funds in Article 8 and 9 categories going forward.

Different Approaches, Different Interpretations

Looking at how funds have been classified so far, we can see a variety of approaches, with some asset managers saying they preferred to take a conservative approach for fear of having to downgrade funds later. Asset managers have categorised their products based on their understanding of the regulator's definitions, which thus far has resulted in a wide range of investment products classified as Article 8 and 9. In the case of Article 8 products, this was expected both because the self-election in part depends on a firm's interpretation of what constitutes "promoting" and because the regulators designed Article 8 as a catchall for a wide pool of funds with varying types of ESG aims. As such, Article 8 products currently comprise a much bigger portion of the ESG product universe than Article 9 products (approximately 90% versus 10%). While the Article 9 category looks more homogeneous, we can still see some differences in the way the definition has been interpreted.

Article 8 Funds

Article 8 refers to financial products that promote “among other characteristics, environmental or social characteristics”, provided that companies in which the investments are made follow good governance practices. Quite a few asset managers have interpreted the term “promotion” as to mean there must be a "binding element" of the investment selection process.

Looking at the data collected so far, we found that, at a minimum, most funds classified as Article 8 apply some exclusions. Article 8 funds typically exclude investments in companies with business activities deemed unsustainable or with high ESG risks such as weapons, tobacco, thermal coal, and other fossil fuels. They also exclude companies that violate international norms and conventions related to human rights and labour laws, such as the UN Global Compact Principles.

Some Article 8 products promote sustainability characteristics by only applying exclusions. This is the case for passive exclusions-only products such as LGIM's and BlackRock's ranges of ESG-screened ETFs, where the exclusions form a “binding requirement” and are considered a core feature of the product.

That said, not all Article 8 funds apply exclusions. For example, Alliance Bernstein's Article 8 funds promote environmental and/or social characteristics solely through the consideration of material ESG factors and through engagement, with no explicit binding constraints. As of this writing, AB American Income and AB Global High Yield feature at the top of the league table of Article 8 funds, with over EUR 22 billion and EUR 17 billion in assets, respectively.

Active engagement is certainly a feature common to many, if not all, Article 8 products but, in itself, isn't an approach that most asset managers consider sufficient to classify a product as Article 8.

Many Article 8 funds have, in addition, explicit binding constraints such as portfolio-level ESG key performance indicators, or KPIs. They must, for example, achieve a higher aggregate ESG score or lower carbon intensity than their benchmark. This type of ESG-integrated approach is adopted by funds offered by Amundi, BNP Paribas, Robeco, and Unigestion, among others. And these are funds typically not branded as ESG (that is, they do not have "ESG" in their names).

Other Article 8 funds are broad ESG funds that employ best-in-class or positive screening strategies. They seek to invest in securities of issuers that exhibit strong or improving ESG credentials. Examples include many passive funds such as iShares MSCI USA SRI ETF and Lyxor MSCI World ESG Trend Leaders ETF but also active funds such as Nordea 1-European Stars Equity and Fidelity Funds-Sustainable Eurozone Equity Fund.

And finally, also included in the Article 8 category are funds with a sustainable theme such as gender diversity, climate change, and sustainable water. Examples include iShares Refinitiv Inclusion & Diversity ETF, Schroders ISF Global Climate Change Equity, and Fidelity-Sustainable Water & Waste Fund.

Article 9 Funds

Article 9 refers to financial products that have a “sustainable investment objective”. These are what asset managers consider “dark green”. They invest in companies with products and services that are deemed to contribute positively to environmental and social challenges, while making sure the companies don't do significant harm and do follow good governance practices. As a result, a majority of Article 9 funds have a thematic and/or impact focus. This is the case for iShares Green Bond Index Fund, BNP Paribas Funds Climate Impact, RobecoSAM Sustainable Water Equities, and Baillie Gifford Positive Change.

Looking at these examples, a sharp eye will notice that some of the names look similar to those listed in the Article 8 section. RobecoSAM Sustainable Water Equities and Fidelity Funds -Sustainable Water & Waste Fund would appear to the casual reader as very similar, with only a thematic difference (the addition of waste considerations to the latter). However, Robeco has placed its water fund into Article 9, and Fidelity has gone with Article 8. This example gets to the heart of the interpretative nature of self-classifying. Both funds target companies that contribute to sustainable water allocation, and they share 21 holdings in common.

Under Article 9, we also found sustainable fund ranges very similar to those classified as Article 8. It is the case for Candriam and NN IP. For example, Candriam's range of sustainable funds applies a best-in-class framework that comprises positive screening combined with a norms-based and controversial activities exclusion screening.

Meanwhile, Axa's approach has been to consider as Article 9 all funds that have received the French ISR label or a stronger label or that have adopted a similar (or stricter) but unlabeled approach. Examples include AXA WF-Framlington Global Small Cap, AXA WF-Euro Sustainable Bonds, and AXA WF-Framlington Clean Economy. AXA and Candriam are among the asset managers in our sample with the highest proportion of Article 9 funds: 25% and 40%, respectively.

The fact that similar strategies have been classified as either Article 8 or Article 9 suggests that some managers may have taken a too prudent classification approach or others have taken a too generous approach. It could also be the case that the managers who parked more funds into Article 9 are more confident than others in their ability to demonstrate the "sustainable" nature of their investments.

Conclusion

Despite the delayed publication of the detailed disclosure requirements and their application, asset managers have put significant time and resources to ensuring they would be compliant for the March deadline. A draft of the regulatory standards that will define the more detailed product-specific disclosures required from the end of the year appeared in February. In March, further amendments were added to incorporate and align the additional disclosures that environmentally focused funds will have to make in relation to the EU taxonomy.

With this backdrop, we expect some subset of the Article 6 funds to shift to Article 8 as managers fully assess and understand the definitional and disclosure requirements. Also, as asset managers begin to understand the approach that peers and competitors have taken for similar funds, current classifications of Article 8 and 9 funds are likely to change, too. Morningstar will continue to watch this space closely and reflect the most up-to-date classifications on Morningstar Direct.

To read more about SFDR:
EU Action Plan Policy Updates: What to Expect
EU Sustainability Disclosures

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For More Information

Morningstar Manager Research Services
ManagerResearchServices@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA