Puzzle pieces

With SFDR II coming into force in a matter of weeks, the regulative picture remains incomplete with major issues still unaddressed by regulators

Lucy Carter reports

Sustainable Financial Disclosure Regulation (SFDR) regulatory technical standards (RTS) come into play 1 January 2023. Firms had to have documents in order by 31 October 2022, or risk their visa stamps not being released before the implementation date. But there is still confusion around what the new regulations will actually do, how they will work, and what they mean for companies. SFDR was first introduced by the European Commission (EC) as part of its 2018 Sustainable Finance Action Plan, with its first iteration going live 10 March 2021. In the Official Journal of the European Union, it is defined as: “harmonised rules for financial market participants and financial advisers on transparency, with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes, and the provision of sustainability-related information with respect to financial products.”

In other words, SFDR requires firms to meet certain disclosure requirements regarding their ESG impacts and initiatives. This should make it easier for end-investors to understand and compare products and make more informed decisions. The regulation marks a significant shift in industry action: “Before the SFDR, there were no regulatory or legal parameters around what is considered a sustainable investment,” Colette Zoe Bebee, senior consultant at Deloitte Luxembourg, says. SFDR II is certainly a step forwards in regard to ESG consideration, but how well will it work in reality?

Unsteady implementation

It’s been a rocky road to the new RTS, with SFDR Level II implementation pushed back twice. Yet, in spite of the extra time that the EC has taken to ensure a smooth transition for the industry, market participants say there are still serious problems that are yet to be addressed.

While the original SFDR was ostensibly updated to provide more details as to what disclosures should contain and how they should be presented, a primary issue facing companies remains a lack of clarity. There are no concrete guidelines of what counts as a sustainable investment, so firms may be unsure as to whether they are complying with SFDR or not. The hazy definition of ‘sustainable’ may also allow for greenwashing to run rampant, despite it being something that SFDR II is professedly designed to prevent. While transparency is a tenet of SFDR, the vagueness of regulations and definitions make it difficult for its sustainability goals to be realised.

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However, some are more optimistic about the effects that the regulation will have. Will Chignell, chief commercial officer of ESG at Apex, suggests that with SFDR II implementation "the ethical, proactive and strategic companies will realise that assessing with rigour, in a meaningful, measurable way, so they can prove competence, will eradicate any accusations of greenwashing, cutting them apart from competitors who might not be so thorough". Although there is currently a scramble for clarity, the regulation could lead to a more competitive and ESG-engaged market.

Nevertheless, confusion is still a serious issue and could cause market fragmentation rather than competition, according to a Eurosif paper published earlier this year (EU Sustainable Finance & SFDR: Making the framework fit for purpose). If different countries start to bring in their own standards for sustainable investment products, or take different approaches to product classification, then cross-border distributions will be disrupted, Eurosif says, prompting higher costs and operational difficulties.

Representing industry trade bodies, the European Supervisory Authorities presented the EC with a series of questions regarding the RTS changes in May this year, followed by a further eight inquiries in September. Several of these have been left unanswered, leaving those who will be significantly affected by the new regulation worried and confused.

Guessing game

There is also the question of data, which is a problem on a number of levels, from accuracy to availability. SFDR II states that principal adverse impacts (PAI) disclosures can be estimated if necessary, however there are no clear guidelines — a recurrent theme, it seems — on what needs to be included when calculating indirect exposures.

Haojin Ba, product manager and head of regulatory management at LPA, believes that "the [ESG data collection] situation is bound to improve, though it might take some time". Yet time is not a readily available asset, so it seems inevitable that SFDR II's early days will not be smooth sailing.

The current lack of information also somewhat undermines the regulation's goals. Sergio Venti, consulting partner at Deloitte Luxembourg, says that this could cause "a knock-on effect on the very nature of 'sustainable investments'".

He explains: "PAIs are used to identify harmful effects on environment and society, a precondition for any investment to be called 'sustainable'". Without further clarification around PAIs, and soon, companies will struggle to uphold ESG targets and trust in 'sustainable investments' could be impaired.

Quantity over quality?

Additionally, a large quantity of data is being requested from companies. With the sheer volume of information being handed over, there is a risk that data will be difficult to use and will ultimately be unhelpful. This, too, may make it harder to avoid greenwashing, with exposures potentially hidden in a mass of incomprehensible figures. In a classic case of quantity over quality, new SFDR regulations could end up being more performative than productive.

The market concentration that will result from new regulations will also cause fees to rise, leading to price hikes across the board. This will particularly be a challenge for smaller and moderately-sized firms, who will not have the same data cost budgets that are available to their larger counterparts.

Broadridge's Amijee does not think that this will be the biggest hurdle facing firms. "Wrestling with complex data and ambiguity has always been a part of investment analysis, so parsing through sustainability information is not very different," he says.

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> **Azfal Amijee, Broadridge**

This belief in the capability and adaptability of asset managers is shared by Daron Pearce, brand ambassador for EMEA at Goal Group, who argues that companies are used to high quantities of data being requested from them. Instead, he proposes, the question of data quality lies with regulators — "will [they] use the data provided in a meaningful way?"

Whether or not the regulators are asking for the right data will surely become apparent as SFDR II kicks in and becomes an operational reality, but as of yet, it is still up in the air whether companies will be able to provide the data in question at all.

Eliane Meziani, senior advisor for public affairs at CACEIS, agrees that data quantity may not be the problem — technology developments have made it possible for companies to keep up with increasing volumes of data demands. However, she warns that the data itself, particularly of the non-financial variety, may prompt quality, validity and transparency issues. Similarly, LPA's Ba emphasises the importance of technology for the road ahead. "The biggest challenge for firms is to implement an IT ecosystem for ESG and SFDR that includes sustainability indicator monitoring tools," she says. Finding the right technology required to effectively comply with SFDR II will be a problem in itself, with time, money and labour costs for a single regulation piling up.

An impossible task

PositionGreen's annual ESG report has already predicted that more than half of Scandinavian firms will be unable to comply with SFDR II as a result of poor Scope 3 emissions (indirect emissions that occur in the value chain) reporting. Without significant changes in data regulation, SFDR II simply will not run smoothly for a huge number of market participants.

"The poor reporting of Scope 3 is an issue of concern for all asset managers and not just for Scandinavian firms," says Afzal Amijee, commercial director at Broadridge Fund Communication Solutions, as "Scope 3 reporting is probably one of the most challenging ESG metrics to measure, track and report on a consistent basis".

He stresses the fact that SFDR is "just one piece of the sustainable finance agenda", a component meant to be complemented by other regulation and guidance. This is a sentiment that Deloitte's Venti echoes, saying that "from a regulatory perspective, the problem should be solved once the Corporate Sustainability Reporting Directive enters into force".

But of course, it is not that simple: "Unfortunately, due to a timing mismatch, SFDR reporting requirements must be implemented first. This means that asset managers are asked to report a figure that is not yet disclosed by most of their portfolio companies," he affirms.

The absence of regulation coordination in this early instance does not provide much hope for a straightforward rollout next year. Structures are not yet in place to enable many companies to comply with SFDR II, something that will doubtlessly provoke further mistrust in ESG veracity from market participants.

Time's up

Compliance timeframes may also prove difficult. The Commission de Surveillance du Secteur Financier (CSSF) has said that it aims to release data stamps by 31 December 2022, provided that companies have filed the relevant documents before 31 October. The two-month deadline is fairly tight, and the question of whether documentation will actually be ready in time for implementation remains to be answered.

Goal Group's Pearce has a positive outlook, assuring that "the industry is working towards the deadlines with great energy". However, he acknowledges that "the simple answer is that some [firms] will be ready, and some will need extra time".

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After a two-year delay, it would be easy to assume that companies and regulators alike have had time to work together and ensure a transition that is as easy as possible, but it seems that SFDR II's arrival will be no less chaotic than its predecessors'.

"Compliance with SFDR demands that managers establish entirely new risk management procedures," says CACEIS' Meziani. "This is a serious challenge for asset managers in terms of technology governance: ensuring that all the necessary systems and digital processes are implemented in a timely manner. It involves significant change to the human, technical, organisational, financial and sales sides of their business."

Further SFDR compliance requirements add more pressure to an already overloaded industry. "SFDR's objectives are clear. Whether it is actually possible to comply with its wide-ranging requirements to the full is another matter," Meziani adds.

What happens now?

Although the rise in recent years of sustainable investing demonstrates an awareness of one of the central concerns of our time, the constant regulation additions and amendments, and the lack of clear guidance, may be seen as a panicked rush to keep up with market demand rather than a genuine search for sustainability.

On top of this, as funds are rapidly reclassified — moving between SFDR's Article 6, 8 and 9 classifications — greenwashing and opaque ESG data remain concerns that the industry does not seem to be able to find a solution for.

Considering the role of regulation, Pearce concludes that "global standards are required to ensure fair and appropriate comparisons of funds from an ESG perspective. SFDR II is an important and positive step towards these standards."

Companies may be actually changing their approaches, bringing in a new era of sustainable investing. But, as Deloitte's Bebee says, SFDR is just the "first moving piece" in the regulation that is yet to come.

It is clear that SFDR II will not be the catalyst that solves every problem around sustainable investing — in fact, it may even create more along the way. However, the industry's consideration for ESG and sustainability is undoubtedly a positive shift.

Considering the broader context of ESG regulation, Apex's Chignell warns that contradicting regulatory frameworks across countries are an issue that needs to be addressed for regulations like SFDR II to be effective and efficient. "The inconsistencies between various proposed and existing disclosure regulations continue to exist," he says. "This fragmentation may increase the reporting burden for companies offering financial products across different jurisdictions."

Although the road ahead may be a little bumpy, as it has been so far, the industry is slowly but surely heading in the right direction. "The sustainable movement has much momentum behind it and there is a strong determination, especially within the EU, to transition towards a more sustainable economy," CACEIS' Meziani states. She adds that companies can "no longer just pay lip-service to green issues," a stance that could see them face serious reputational damage.

"The future of sustainable investing will be a phased journey," Bebee predicts. The development of ESG regulatory requirements, although they are not yet ironed out, is better than nothing at all.

"As investors build their knowledge not just on the topic of 'what is sustainable investing?' but also on: 'do my investments simply align, or actually enable sustainable objectives?' we would naturally hope that sustainable investing becomes a better-informed decision," she concludes. ■