INDEFI

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PERSPECTIVES

# THE SFDR REALITY CHECK

The EU's Sustainable Finance Disclosure Regulation (SFDR), which kicks in on March 10, ushers in a new level playing field in the area of sustainable investing. It is set to redefine the competitive landscape across the Continent for the investment management value chain, from asset managers to their institutional and distribution clients.

The SFDR reform aims to provide a harmonized sustainable investment framework, subjecting all financial market participants (in both public and private markets) and their products to unprecedented levels of transparency. The impact of this new regulation will reverberate throughout the asset management industry: enabling comparability, reshuffling client expectations, and overhauling established methodologies. All this will contribute to redefining the sustainable investment competitive landscape.

## Enabling comparability

The scope of SFDR is limited to disclosure. It does not enforce minimum standards for sustainable investment strategies, nor does it impose methodological approaches. However, it does provide for a set of common guidelines for transparency, following the path paved by previous European regulations (e.g. Article 173 in France). The underpinning rationale is for transparency to enhance comparability and, in turn, spur action.

At the very latest on June 30, 2023, statements and policies will need to be backed up by the publication of at least 14 mandatory and common indicators for all market participants. This will enable an unprecedented ability for asset owners, distributors, and end-clients to compare asset managers on raw non-financial indicators, thus shedding a crude light on the robustness and credibility of their hitherto proprietary ESG methodologies.

This comparability, in turn, will foster action as investors seek to one-up their peers and avoid being caught overstretching the sustainability characteristics of their products.


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## Reshuffling client expectations

Institutional investors, distributors and advisors will themselves be subject to SFDR and their compliance will by-and-large depend on their asset managers. Clients will therefore take on the role of intermediary regulator, ensuring the latter correctly report on the new requirements; an indication of SFDR's fundamental influence on the industry.

In the institutional market, SFDR will strengthen the ongoing mainstreaming of sustainable investment, which already represents more than 50% of assets managed in Europe[1]. Article 9 will become the new reference framework for the fast-growing impact investment market in both public and private assets.

Where we expect the most dramatic change is in the distribution space. Sustainability characteristics have gradually been gaining importance in fund analysis and selection leading distributors to secure enhanced control over their products. SFDR will thus further strengthen distributors' shift to managed solutions (sub-advisory, model portfolios, discretionary portfolio management), to the detriment of the traditional advisory model.

Unit-linked insurance providers and leading private banks are spearheading the post-SFDR order. They have already begun to redefine their product referencing strategy along the new product segmentation. Article 8 will likely become the baseline for their fund offering, complemented by Article 9 for showcasing impact to end-clients. While countries will differ in their adoption rate, Article 6 will be progressively phased out from product line-ups.

However, this new segmentation does not set minimum standards for eligibility. National labels will continue to play a key role in the retail market before the much-anticipated advent of a pan-European ESG stamp.

## Overhauling established methodologies

SFDR makes no explicit reference to any single ESG methodology. Yet, its focus on principle adverse impact (PAI) indicators and their required publication is bound to overhaul current market practices. Over time, ratings became the cornerstone of ESG reporting; a result of indicators aggregated through often opaque and heterogeneous methodologies. PAIs will challenge this order, potentially relegating ratings to mere inputs to filter-based investment strategies, and certainly infiltrating the priority list of rating agencies and asset managers' ESG research teams.

PAIs will become the new measuring stick, and what is measured, will be compared and subsequently managed. They will permeate across all functions of asset managers' organisations: research will seek to find material links between PAIs and financial performance, product development will design new strategies with PAIs at the core of idea generation, portfolio managers will integrate these metrics directly into investment and risk processes, marketing will showcase (or justify) the results at entity-level.

Before reaching this stage, however, the data challenge will need to be overcome. Most responses to the RTS consultation pointed at the anticipated difficulty of gathering the PAIs. Data availability and quality has often been the thorn in the side of sustainable finance, but never before has there been such a consensus around such a small number of indicators. By standardizing what data should be reported, SFDR may just have brought an actionable temporary solution to this key issue.

## Redefining sustainability's competitive landscape

SFDR should not be considered as yet another compliance effort for asset managers. The ramifications of this disclosure regulation should not be confined to legal and reporting teams. SFDR is the reality check for all asset managers who have placed sustainability at the forefront of their strategy.

At a product-level, the advent of SFDR offers an opportunity for asset managers to review, and revamp, their product line-up and assess whether they are consistent with their sustainability claims. It is also an opportunity for differentiation by clearly showcasing impact strategies which have embedded sustainability as the objective of their investment process.

At entity-level, SFDR represents an opportunity for asset managers to leverage sustainability investing as a competitiveness factor. It is the time to engage with their clients, reassess their expectations, support them in their own compliance efforts, etc. In an increasingly competitive environment, asset managers will need to demonstrate their ability to innovate, to diffuse their knowledge, both across their firm and towards clients. It is the moment to understand the new sustainable investment world and grasp the related differentiation opportunities.

The SFDR's focus on entity-level disclosure of quantified indicators will reinforce the need for asset managers to demonstrate their coherence and exemplarity. It will prove increasingly difficult to showcase innovative, yet marginal, sustainable or impact products while shielding the rest of the line-up from scrutiny. Product credibility will hinge upon asset manager consistency at the firm level.

**INDEFI is a strategy advisory partnership for the investment management business. We help the world's leading asset managers shape their development strategies, navigate the shifts in the investment landscape and build sustainable competitive advantages.**

[1]Please refer to "Beyond the tipping point: sustainable investment in institutional Europe", INDEFI (2019).

 