Institute for Energy Economics and Financial Analysis

The EU's Sustainable Finance Disclosure Regulation

For SFDR's transparency goals to be met, the EU must switch to a labelling system and apply the regulation's rules to all funds.

Factsheet

The European Union's (EU) Sustainable Finance Disclosure Regulation (SFDR) has not achieved its intended transparency goals. In response, the European Commission sought opinion on options for course correction through a public consultation. The investment management industry awaits the outcome of this consultation.

Applying SFDR reporting rules to all funds and replacing the current article system with a labelling scheme would put the **consumer first** and **give investors far more visibility over the marketplace**. By applying **broad minimum standards** for each label, these changes would also greatly increase **consistency in SFDR's application** and ultimately reduce the risk of greenwashing.

What is SFDR and how does it work?

SFDR is one of the three pillars of the EU's regulatory approach to sustainable investing. The regulation gives asset owners like pension funds the **information required to make investment decisions** based on not only financial data but also **environmental and social issues**. It delivers metrics that underscore the sustainability ambition of funds offered to potential investors, as well as information on the profiles of the managers operating them.

At the heart of SFDR is a **system of categorisation**, whereby a financial product must be qualified by the offering manager as **Article 9, 8 or 6**. The higher a fund's commitment to integrating sustainability issues, the higher the categorisation, which in turn dictates the level of sustainability-related disclosure required.

Article meanings and related disclosure requirements

		Disclosure level required
Article 9	Must have an explicit sustainable investment objective	Higher
Article 8	Must promote environmental or social characteristics	
Article 6	Other products (no environmental or social characteristic requirements)	Lower

For an interactive walkthrough of the existing regulatory system, please refer to IEEFA's EU sustainable finance regulation explainer.

What are SFDR's failings?

Problems with SFDR stem from a **disconnect** between its intended use as a framework for determining appropriate disclosure and its actual adoption as an environmental, social and governance labelling system. The latter is being used by asset managers to signal the sustainability ambition of products.

Vague definitions and a lack of minimum standards (particularly within Article 8) have given managers considerable agency over the categorisation process and resulted in huge variations in sustainability ambition within categories. What is appropriate flexibility for a disclosure regime is not suitable in a system of labelling, which should guarantee certain standards are being met. SFDR currently presents a headache for asset owners—particularly less sophisticated retail investors—trying to allocate capital to more sustainable products.

What's the solution?

Replacing the current article system with a **labelling scheme**, applying **minimum standards** and streamlining reporting requirements for **all products** would:

Greatly improve consumer understanding

Switching to labels would end a system of article naming that is entirely unintuitive for a retail audience to understand. Institutional investors may be able to sift through complex investment process documents to decide what is an appropriate investment, but it is the consumer that should be at the heart of regulatory decision-making.

Level the playing field and make comparisons easier

Currently, the most demanding disclosure requirements are only required of funds that managers wish to declare as being sustainably aware (Articles 8 and 9). That sustainably ambivalent Article 6 funds need not report in this fashion serves to mask the negative impacts of products with no sustainability ambition. Some have likened this to apples being sold with an accompanying leaflet detailing all their positive and negative effects while allowing cigarettes to be sold without health warnings.

Minimum reporting requirements on the most pivotal environmental and social metrics (adverse indicators) should be mandatory for all funds. Managers already collect information on investee companies, so the burden of increasing the scope would be minimal.

Increase consistency and reduce greenwashing risk

Applying each label with minimum, centrally decided baseline standards (such as levels of sustainable investment commitments, minimum reductions to the investible universe and/or quantifiable stewardship standards) would hugely improve clarity on what a labelled fund actually offers an investor. This in turn will greatly reduce suspicions of greenwashing.

The EU should not repeat the UK's mistake

The UK has recognised SFDR's teething issues and developed its own system of labelling under sister regulation called Sustainability Disclosure Requirements. EU policymakers should follow suit but avoid the UK's mistake of removing requirements for all funds to at least produce streamlined reporting sustainability metrics.

Read the report: [SFDR's Early-Life Crisis Presents an Opportunity to Level the Playing Field]