Position paper

of the Association of German Banks on the
Joint ESAs Opinion on the SFDR

(JC 2024 06)

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1. Executive summary

The starting point

The transition to a low-carbon, more sustainable, resource-efficient and circular economy is one of the most important measures to significantly reduce the risks and effects of climate change. The aim of the SFDR is to contribute to this and regulate sustainability related disclosure requirements in the financial services sector since March 2021. The idea behind it is to mobilise more capital for the transformation of the economy.

As a result, disclosure standards are harmonised within the EU, making it easier for investors to compare different financial products. Creating **transparency** as to how sustainable financial products and investment firms are, **was** and **remains the correct** approach. The SFDR review, ongoing since September 2023, must be used to implement these guiding principles better and, at the same time, to strengthen the role of the EU as a "global leader in sustainable finance".

The goal

Investors – **retail investors** in particular – must be at the **centre of SFDR disclosures,** enabling them to make well-founded decisions about sustainable investments. **Simple** and **understandable categories** for sustainable financial products would help them do so.

Many retail investors nowadays complain about **excessive**, overly **complex** and **irrelevant information** (information overload). This situation inhibits them from making considered and informed decisions about sustainable investments. We need to relieve them of this **burden**.

How to get there

The EU Commission initiated the review of the SFDR in September 2023. The European supervisory authorities have published comments in their Joint ESAs Opinion (JEO).[1] In addition, the ESMA has published its own position on this issue.[2] The responsible ECON Committee of the European Parliament commissioned a study (ECON Study).[3]

Germany's private banks have examined these positions carefully. We want to contribute to making better rules that mean more capital flows into sustainable investments. The review must be used to make the SFDR better.

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[1] Joint ESAs Opinion | On the assessment of the Sustainable Finance Disclosure Regulation (SFDR), JC 2024 06

[2] ESMA-Opinion on the functioning of the Sustainable Finance Framework, ESMA, ESMA36-1079078717-2587

[3] ECON Study | The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR), PE 754.212

The most important do's:

- Create three categories for products:
  - Sustainable product
  - Transition product
  - ESG selection product

- Create clarity and provide customised information for investors:
  - Considerably shorten and simplify existing templates
  - Remove the PAI statement
  - Substantially reduce the 64 PAIs and only use them for products
  - Reduce website disclosure requirements for financial products

The most important don't:

- Don't introduce a sustainability indicator.

In detail, this would mean the following:

2 A system of product classification – inform investors meaningfully and avoid greenwashing

JEO 14-25

To date, the SFDR has focussed solely on transparency. But although there are no legally defined product categories, the current disclosures are frequently interpreted as labels. This gives rise to the risk of greenwashing. The EU Commission wants to remedy this situation and has presented two approaches as part of the SFDR review: Either to create completely new product categories, or to further develop the categories based on existing requirements.

The ESAs are in favour of the idea of **categorising products**. To do this, they recommend using the existing Articles 8 and 9 of the SFDR. Even though this proposal seems sensible, new problems would arise during implementation: The proposed **categories** do **not** fit into the **existing logic**. The review should definitely lead to a **simplification**. The **new product categories** should not, therefore, be based on the existing logic but should be **created from scratch**.

2.1 Product categories: create clarity for investors

The ESAs are proposing to introduce at least the categories "**sustainable product**" and "**transition product**". This proposal goes in the **right direction**.

However, it would be **more prudent** to also introduce **a third category**: **"ESG selection product**". This way, all the relevant approaches are covered – **taxonomy, ESG and transition**.

In addition, it is **imperative** that the **surveying** of customers' **sustainability preferences** in accordance with MiFID Delegated Regulation 2017/565 is **simplified** and **corresponds** with the **new categories to be introduced**. Only then can customers make considered and informed decisions about sustainable investments. Today this is not the case: The **vast majority** of investors have stated that they **are not interested** in **taking account** of **sustainability criteria**. The real reason is that the **surveying process is much too complex**. Various market surveys have confirmed this. But the regulation must not deter investors.

The ESAs have also proposed introducing an "**investor's impact**" category as an **additional subcategory** to the "transition product" category – or as a cross-sectional indicator for all categories. Products in this category should have a positive, measurable impact on an environmental or social objective. However, the inclusion of this criterion would unnecessarily **increase** the **complexity** of the categories. In addition, there is **no standardised interpretation** of this term. An "investor's impact" should only **ever** be used as a **voluntary criterion**.

ESG selection product

a minimum share pursues sustainability objectives or meets environmental or social criteria:

- respects exclusions, e.g. for Climate Transition Benchmarks
- takes account of qualitative ESG factors in the investment process

Transition product

pursues sustainability, is not yet environmentally and/or socially sustainable:

- investment strategy contains elements from: taxonomy, transition plans, decarbonisation goals or PAI reductions
- regularly provides information about its concrete short and long-term transformation goals
- does not apply the DNSH principle to all investments, exception: social characteristics

Sustainable product

invests in activities/assets that are already environmentally and/or socially sustainable:

- has
  - either a minimum share of taxonomy-aligned investments
  - or a share of "sustainable investments" in accordance with the SFDR taking into account the DNSH principle

2.2 Sustainable product category: make sustainable economy visible

For the "**sustainable product**" category, the ESAs have proposed **two elements**: These products should include a **minimum share of taxonomy-aligned investments**. The **remaining portion** of the investments should at least meet **SFDR's DNSH criteria** for environmental and social objectives and good governance – provided that those criteria are more precisely defined in future.

We deem it prudent to introduce a "sustainable product" category. As an **alternative** to the **taxonomy-**aligned investments, it should be possible to invest according to the **SFDR definition** of a **sustainable investment**.

While it may make **sense** to use **taxonomy-aligned economic activities** as a possible **basis** for a sustainable product, it will be necessary to carefully determine the minimum share for these investments. If the **minimum share** is **too high**, then there is a risk that there will be **no** or only very few **sustainable products**. The reason: In the EU, **only** around **30 percent** of all **economic activities** are **taxonomy eligible**. Consequently, we observe a limited quota of taxonomy-aligned businesses. We do not expect the **taxonomy eligibility** or **taxonomy alignment** to **rise significantly** anytime soon.[4]

As an alternative to using a minimum share of taxonomy-aligned investments as a basis, a **broad definition** of "**sustainable investment**" should apply to a "sustainable product". It would be best to **use the current SFDR definition**. This is the only way for **investments outside** the **EU** and **social criteria** to be considered **sustainable**.

Using the current broad definition would also be important for innovations in the area of sustainability. The **taxonomy** framework is very **restrictive**, it only defines **six environmental goals** and a **small proportion** of **economic activities** as sustainable. But the fact remains that **other economic activities** that are not subject to the scope of the Taxonomy Regulation can **also** be **sustainable**.

The ESAs also recommend either merging the two **criteria** "**sustainable**" and "**social**" into one category or splitting them into two categories. It is **better** to **differentiate between** these two **criteria** because a social goal is not necessarily ecologically sustainable and vice versa. "Sustainable products" should always include **information** as to whether they are **ecologically or socially sustainable** or both. The solution would be to include this **information in** the **templates**.

[4] See also "Analysis of the taxonomy profile of industry" of the Association of German Banks from 4 September 2023

2.3 Transition product category: support the transformation of the economy

For the "**transition product**" category, the ESAs have proposed **a mix of certain criteria**: taxonomy, transition plans, decarbonisation goals or a reduction in PAIs at product level. This makes sense, as long as the **elements** do not have to be considered **cumulatively**. It would also make **sense** for this category to disregard the **DNSH principle**, as otherwise a great many businesses could not be rated transformable. One example: a wind farm operator must use carbon-intensive steel, but it is nevertheless sustainable.

In any case, "transition products" **should comply** with certain **minimum social standards**. Of course, child labour and human rights violations must also be excluded in this category.

2.4 ESG selection product category: keep established criteria

A **large proportion** of financial products on offer today disclose their **sustainability criteria in accordance with Article 8 of the SFDR**. These financial products largely apply exclusion criteria or best-in-class approaches.

In order to allow for **sufficient global diversification**, particularly for retail investors with small investment amounts, a **category** is **needed** which takes these criteria into account. This is because financial products in the two categories "**transition product**" and "**sustainable product**" **only** cover a **small share of all investment opportunities** in the area of sustainability.

Sustainability has **many facets** and investors do not think in terms of black and white. They are not interested exclusively in investments that are already sustainable or those that are aimed at sustainability. No, many want to make investments that **take** general **ESG aspects into account**. **Investors** with a **preference for sustainability** already want to **consciously make** such investments. This requires a **separate "ESG selection product" category** – also to take into account the **broad range of investor comprehension** and to maintain **existing investor confidence**.

Products in this category must meet the following criteria:

- a minimum share of investments pursue sustainability goals or meet environmental or social criteria,
- respect exclusions, for example in connection with Climate Transition Benchmarks in accordance with Article 12 of the Benchmarks Regulation (Delegated Regulation 2020/1818),
- take account of qualitative ESG factors in the investment process, e.g. ESG ratings.

3 Sustainability indicator: preventing false solutions

JEO 26-37

The ESAs want to introduce a sustainability indicator. This indicator – in the form of a scale – is intended to illustrate the sustainability features of a financial product and thereby reduce complexity. The scale is meant to enable investors to recognise sustainable products more easily. The ESAs see the risk indicator in the PRIIPs regulation or the Energy Performance Certificate for buildings as successful examples.

Whether we share this opinion or not, we must not ignore the fact that any **scale** only **works** if it has **clear measurement criteria**. The two examples mentioned by the ESAs are based on only a **small number of parameters that can be determined specifically**.[5]

For **sustainability**, there is **nothing like it**. A **sustainability indicator** of this kind would **only appear to help investors**. In fact, a simple scale simply cannot **accurately represent** the **multifaceted** topic of **sustainability**.

The ESAs acknowledge this themselves and even list a **number of risks of using a scale**, for example, even **more complexity** for and **insecurity** among investors.

It would be better to create **meaningful sustainable product categories**. This would give investors the guidelines they need.

4 Relevant documentation for product disclosures: provide customised information

JEO 46-48

The ESAs recommend **limiting** the **degree of complexity** and **amount** of **information** to only what is **absolutely necessary**. **Investors** should **not** be **overwhelmed** or **put off**. The European Parliament has also called for the review of the framework to take account of who needs the information and for what purpose.[6]

This makes **a lot of sense**. Information must be tailored to the needs of the investor and the markets. This also means: **reducing reporting requirements** instead of increasing them.

Contrary to what the ESMA is calling for, the **disclosure** of sustainability data should be limited **solely to sustainable financial products** or those that take certain sustainability criteria into account. It is not helpful to disclose the inclusion of sustainability criteria for every financial product – especially if there is no sustainability data for it. On the contrary, such a requirement would lead

[5]ECON Study, section 6.3, paragraph 9.

[6]See also ECON Study, 6.1.2

to an **information overload** for the investor. It would also increase the administrative burden, but without the share of sustainable investments rising significantly.

Retail investors need **information** that is **easy to understand** and contains the key points. We frequently see **retail investors** being discouraged by the **excessive amount** of **information**. One example: The content of the **pre-contractual information** and the **periodic reports** is **too detailed** and too **comprehensive** for retail investors. This mandatory information should **focus** on the **key points** instead. The dashboard[7] proposed by the ESAs is a good basis for doing this. The current **pre-contractual information (templates)** should be **simplified** and **shortened** based on this dashboard.

The **requirement to publish information** on portfolio management and special funds on the **website** should be **removed** and **not replaced**. **Investors** already receive the **information before concluding** a portfolio management agreement, either **as part of the pre-contractual information** or for a special funds from the sales prospectus of the capital management company.

Alternatively, it should at least be made clear that the **disclosure obligation** under SFDR does **not** apply to **financial products** that have been **customised** according to individual specifications **for individual investors**. These include, for example, **customised portfolio management** or **special funds** set up for individual customers. Only customers for whom these financial products were set up can acquire these financial products. **Information** about such financial products does **not provide any additional value** for the **general public**. On the contrary, the additional costs of disclosing such individual financial products discourages providers from expanding their offers of such financial products.

Another example is the "statement on principal adverse impacts of investment decisions on sustainability factors", the **PAI statement**. The majority of investors find this information **difficult to understand** because it is so detailed and complex. The PAI statement does not add value for **institutional investors** either. Their use of this information is rudimentary, at best. The requirement for the PAI statement can and **should** be **removed**.

At the **product level**, the disclosure of **PAIs** can provide **useful information** for investors. But there are **far too many PAIs**, there are currently **64**. Who wants to differentiate between "emission of air pollutants" and "emissions of inorganic pollutants"? No one at all. The same applies to the mandatory disclosure of the different types of greenhouse gas emissions (Scope 1, 2 and 3). This **information** is far **too detailed for investors**. If you haven't studied this topic extensively then it is almost **impossible to understand** the **PAIs** or **distinguish** between them. The **solution**: **Reduce** the **number** of **PAIs** but increase their meaningfulness.

[7] Final Report on draft Regulatory Technical Standards, JC 2023 55

Investors are essentially interested in these mandatory indicators:

- preventing climate change,
- preserving biodiversity,
- human rights and workers' rights

and

- water, waste and resource consumption.

The **number of mandatory PAIs** should be **as low as possible** and be limited to these areas. **Optional PAIs** are **unnecessary**. This would make it easier to compare products.

5 SFDR-related audits and the role of funds' depositaries: enable more effective controls

JEO (Annex I, point d)

The ESAs raise the following questions:

- Should SFDR-related disclosure be regulated directly in the SFDR or in sectoral legislation?
- What is the role of funds' depositaries and what SFDR-related disclosure controls are they subject to?

Important to note here: **disclosure requirements**, particularly for fund products, **apply to "financial market participants"**. These include capital management companies. Depositaries neither set up nor do they sell or manage the funds. Depositaries are logically therefore **not included** in the **list** of "financial market participants" in Article 2 of the SFDR.

While capital management companies primarily make administrative decisions as to how the assets are invested, the depositaries have been allocated a variety of control functions, in addition to acting as custodians, through the relevant legislation, underlying regulatory provisions and other applicable requirements.

Any additional **blanket** regulatory **control obligation** for the depositaries with regard to **SFDR-related disclosures** would be pointless since the depositary is, as mentioned above, specifically not involved in the sales process and would have no influence here. Due to the task assigned to it by law in its role, it is inappropriate for a depositary to interfere in sales processes and doing so would undermine its control function. Controlling sales of investment funds is assigned to the supervisory authority.

As a result, the depositary is not the suitable body for controlling SFDR-related disclosures. An obligation cannot therefore be meaningfully introduced in the SFDR or in sectoral legislation. Consequently, there is no regulatory gap.