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Die Deutsche Kreditwirtschaft

Comments on the SFDR review – the path to a better regulation

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Executive summary

Initial situation

The objective of the Sustainable Finance Disclosure Regulation (SFDR) is to steer capital flows into sustainable investments and prevent greenwashing by creating transparency for investors.

As a result, harmonised disclosure rules apply across the EU, making it easier for investors, in particular, to compare different financial products. Creating transparency as to how sustainable financial products are and how financial market participants deal with sustainability risks was and remains the correct approach. The review, which was initiated by the EU Commission in September 2023, must be used to better implement these guiding principles within SFDR and, at the same time, to strengthen the role of the EU as a “global leader in sustainable finance”.

The goal

Investors – and retail investors in particular – must be clearly at the centre of SFDR disclosures. They need to be able to make informed decisions about sustainable investments without being overwhelmed with too much information.

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. This is where we need relief.

The path

In order to support the successful transformation of the economy to more sustainability, private money is needed. It is therefore important to consider the SFDR review from the point of view of the retail investor.

The SFDR should be less complex and more user-friendly. This aim can be achieved by setting out clear and comprehensible product categories and by reducing and simplifying the disclosure requirements. At the same time, the review must not prevent financial market participants from driving forward innovation in the field of sustainability.

The German Banking Industry Committee is therefore calling for the following dos and don’ts from the review:

Dos:

- Create three clear and juxtaposed product categories:
  - Sustainable
  - Transition
  - ESG Basic
- Simplify information for investors:
  - Considerably shorten and simplify the ESG templates
  - Scrap the PAI statement
  - Considerably reduce the 64 mandatory indicators (PAIs) and – where relevant – only use them for categorised financial products with sustainability features
  - Scrap or simplify website requirements for financial products
  - Only disclose information on sustainability factors for categorised financial products with sustainability features

Don’ts:

- Sustainability scale: Don’t introduce a sustainability scale
- Scope: Critically scrutinise an extension of the scope of application of SFDR to other financial instruments
- Defer ESA’s proposed amendments to the RTS review (final report from 4 December 2023)

In detail, this would mean the following:

Dos

In its SFDR review, the legislator should take into account the following points in order to offer investors real added value. These measures will contribute to increasing the transparency and comprehensibility of sustainable financial products and simplify decision-making for investors.

Introduce three product categories

In order to take account of all the relevant approaches and/or investment strategies, three product categories should be introduced: “Sustainable”, “Transition” and “ESG Basic”. It is essential that these product categories should be perceived by investors as equivalent to each other and in no way hierarchical.

The product categories should be as comprehensible as possible, yet less complex. Innovation should continue to be possible so that different sustainability approaches and goals can be taken into account. The product categories must be designed in such a way that greenwashing risks are avoided. The legislator should define clear, principle-based and less rule-based requirements for the product categories. Certain provisions of the ESMA guidelines on fund names, such as the exclusion of CTBs and PABs, could provide suggestions on this.

A new product classification should be subjected to a consumer test before it is introduced; its practicability on the supplier side should also be examined. This will ensure that sustainable financial products can be offered in all designated categories.

Sustainable

The Sustainable category should be introduced for financial products that are already sustainable.

In addition to the taxonomy, it must also be possible to include other criteria in this category: the definition of a "sustainable investment" as outlined in the SFDR. This means that financial products in this category should refer either to the taxonomy or to a "sustainable investment".

Financial products in this category should have a minimum share in either:
- taxonomy-aligned investments or
- in "sustainable investments" (Exception: hedging and liquidity instruments).

It would be prudent to determine the minimum threshold for these investments wisely. If the minimum threshold – especially with an exclusive focus on taxonomy - is too high, then there is a risk that there will be no or only very few sustainable products. The reason: In the EU, currently only around 30 percent of all economic activities are taxonomy eligible.[1] As a result, the proportion of taxonomy-aligned businesses is limited.[2] We do not expect the taxonomy eligibility or the taxonomy alignment to rise significantly any time soon.

Instead of only a minimum share of taxonomy-aligned investments – as proposed by the ESAs in their Opinion from 18 June 2024 – a broad definition of the term "sustainable investment" should alternatively be considered for a "sustainable product". This is the only way for investments outside the EU and social criteria to also be considered sustainable. Since the taxonomy is very restrictive, it defines only six environmental goals and currently a small share of economic activities as sustainable. But the fact remains that other economic activities that are not subject to the scope of the Taxonomy Regulation or don`t meet the strict criteria of the taxonomy can also among others be sustainable within the meaning of the 17 Sustainable Development Goals (SDGs).

The following points are crucial for the future definition of the term "sustainable investment".

- A uniform calculation standard for determining "sustainable investment" is required,
- Financial market participants continue to develop their own methodologies geared towards their respective relevant sustainability goal,
- An environmental objective refers to an environmental goal of the taxonomy,
- A social objective is determined by the financial market participant itself,
- In both cases, an active and positive contribution to this goal is required,
- DNSH criteria do need to be sector specific and regionally adjusted,
- DNSH should be derived from activity-based PAIs,
- PAIs for harmful activities should always be used.

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

[2] See also Platform on Sustainable Finance: Categorisation of Products under the SFDR, p. 17.

The PAB exclusion criteria should only apply to environmentally sustainable products as minimum exclusions. The remaining proportion of the investment must not harm the sustainability objective.

Transition

The “Transition” category should be introduced for financial products that invest a minimum share in companies that are demonstrably in transition. This proportion should be determined at the individual investment level.

Financial products in this category should also show an improvement in PAI indicators.

The DNSH principle for social criteria must apply to financial products in this category. Otherwise, there is a risk that, for example, employee rights will not be respected or child labour is not excluded.

This category should only include investments that meet one or more of the following criteria:

- their objective is to achieve an environmental or social transition, or
- are made in portfolios that use CTBs or PABs as reference benchmark or
- they are made in buildings or infrastructure that have a credible transition plan at the individual investment level or
- they are made in government bonds that pursue climate change mitigation, adaptation, transition or other environmental objectives based on spending determined at the national level.
- they are made in companies that meet one or more of the following criteria:
  - have a credible transition plan
  - demonstrate taxonomy-aligned capital expenditure or transition-relevant income or expenditure
  - comply with regulatory requirements, such as decarbonisation in accordance with the Benchmark Regulation
- Provided they do not conflict with the underlying transition objective, investments that meet the requirements of the “Sustainable” category can be included.
- CTB minimum exclusions should apply to all investments.

It is also important that the criteria for this category should not be set out as an exhaustive list because this category is still under development.

ESG Basic

The “ESG Basic” category should be introduced for financial products that take into account ESG factors, but cannot be included in the “Sustainable” or “Transition” categories.

A large proportion of financial products on offer today disclose their sustainability criteria in accordance with Article 8 SFDR. These financial products largely apply exclusion criteria and/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 "Transition Product" and "Sustainable Product" categories only cover a small share of all investment opportunities in the area of sustainability.

In addition, sustainability has many facets. Investors do not think in terms of black and white. They are not interested exclusively in investment solutions that are already sustainable or those that are aimed at an "explicit" sustainability impact. Many investors with a sustainability preference consciously want to invest in financial products that "only" take into account general ESG factors. This requires a separate "ESG Basic" category – also to take into account the broad range of investor knowledge and to maintain existing investor confidence.

These financial products should promote environmental and/or social characteristics or aim to achieve an environmental objective. Though, promoting a certain environmental and/or social objective is not at the centre of the investment.

For financial products in the "ESG Basic" category, the following corresponding minimum criteria should apply:

- they should avoid harmful activities and
- a minimum proportion of investments should at least pursue one environmental objective or promote environmental and/or social characteristics.
- in the investment process, qualitative ESG factors, such as best-in-class approaches, should be taken into account.

In addition, materiality can be determined through one or more of the following criteria:

- the financial product performs better on ESG than a reference benchmark.
- the financial product invests in businesses whose transition plans are not suitable for inclusion in the "Transition" category.
- the investment universe is effectively reduced to guarantee that the product corresponds with the intended ESG strategy.
- provided they do not conflict with the underlying investment strategy, investments that meet the requirements of the "Sustainable" and "Transition" categories can be included accordingly.
- CTB minimum exclusions should apply to all investments.

Simplify client information and limit it to the essentials

Investors need relevant information so they can make informed decisions. However, more information is not better but counterproductive. The guiding principle for future client information should therefore be "quality over quantity".

The SFDR review should be used to provide investors with only the information they need in the future. Including new and additional information and therefore an ‘information overload’ should be urgently avoided. In the current SFDR, there are plenty of examples that should be revised accordingly. In detail, the following is important:

Scrap the PAI statement at entity level

Transparency about the inclusion of sustainability aspects at financial market participant and/or financial advisor level is fundamentally an important source of information for investors. Nevertheless, the added value of this information for retail investors should not be overestimated. In particular, the contents of the PAI statement are unsuitable for investors to decide to invest in a sustainable investment: Investors are interested specifically in the sustainability features of their desired product. They are not interested in the sum total of all the principal adverse impacts of investment decisions on sustainability factors of the financial market participant’s financial products.

The solution: Scrap the PAI statement at entity level and only use PAIs for categorised financial products with sustainability features.

If the PAI statement at entity level were to be retained, the following alternative could be considered:

- Interlocking the PAI disclosure at entity level with CSRD reporting – the company-related reporting requirement should only be ‘in one place’ and within the framework of CSRD, provided that the financial market participant is also subject to CSRD reporting requirements.
- If the financial market participant is not a company that is subject to the CSRD, voluntary reporting could be considered, but then with a reduced set of PAIs. The framework for SFDR reporting must also be harmonised with voluntary reporting standards for smaller businesses.
- The proposed measures must in any case lead to simplification and consistency in reporting.

Reduce PAIs

It makes sense to disclose relevant data for the categorised financial products in question. However, the current number of PAIs is too high– even for the product level. The legislator should reduce the number of PAIs overall.

In future, only categorised financial products with sustainability features should have to disclose the PAIs relevant to them. It is important that the PAIs to be used should correspond to the investment strategy of the respective financial product.

The solution: Only use the mandatory PAIs from Annex I, Table 1 of Delegated Regulation SFDR and only on a product-specific basis for categorised financial products with sustainability features.

Simplify ESG templates

The current ESG templates for product information are too comprehensive and only serve to overwhelm the investor. Retail investors are regularly discouraged by excessive information. What they really need is easy to understand information that contains the key points.

The solution:

In line with the simplification concept of the Dashboard proposed by the ESAs on 4 December 2023 in their Final Report on revising the SFDR delegated regulation the ESG templates should be limited to the key points of the product's sustainability features and thus provide investors with a brief and concise summary. The current pre-contractual information and regular reports should be simplified and shortened based on a dashboard. Mandatory information should focus on the key points only.

For product information (currently pursuant to Articles 8, 9 and 11 SFDR), this would mean providing a very short summary of the most important information as part of the regular sectoral reference documents.

The key information provided in the ESG templates (currently required pursuant to Articles 8, 9 and 11 SFDR) should, in addition, match the information on sustainability to be provided in accordance with MiFID II/IDD (definition of sustainability preferences). The necessary adjustments should also be coordinated in terms of timing.

Limit product information to categorised financial products with sustainability features

Investors require relevant, product-specific information to make informed decisions. As such, financial market participants should only have to disclose sustainability criteria for sustainable financial products or those that take specific sustainability criteria into account. The SFDR should continue to set coherent provisions for information on financial products with sustainability features.

Investors who have specifically decided against a sustainable financial product will not revise their decision simply because they are presented with certain sustainability features for a financial product that is not meant to be sustainable. Extending information requirements on sustainability to financial products that are neutral in terms of sustainability will lead to an – avoidable – information overload and, in a worst-case scenario, confuse investors.

The amount of work financial market participants would have to do to implement these requirements would not be at all proportional to the limited usefulness for the investor. In general, financial market participants do not make their investment decisions based on sustainability criteria concerning “non-sustainable” financial products. Requiring disclosure of sustainability characteristics is associated with an increase in burdens. This unnecessary additional bureaucracy should be avoided.

Remove website disclosure requirements for financial products

Product specific disclosure requirements for websites should be removed entirely, without substitution (see Article 10 SFDR in conjunction with Article 23 et seq. SFDR delegated regulation).

This is because investors already receive the relevant information before concluding a portfolio management service agreement as part of the pre-contractual information, or from the sales prospectus of the capital management company before purchasing a fund.

Otherwise, 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 products or special funds set up for individual clients. 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.

In addition, the regulations in Article 10(1) points c and d SFDR are not necessary. Implementing these requirements is particularly problematic for portfolio management services (which are usually specific to the client): this is because this information is – in contrast to funds – not already included in the prospectus and annual reports published on the website, but instead must be prepared specifically for disclosure as described in Article 10 SFDR. This is not practical and extremely burdensome, particularly in light of portfolio management services, even in the event that the information can be created in a standardised manner based on standard portfolios. In addition, investors have no need for this information, as they already receive the relevant ESG information, tailored specifically to them, as part of the pre-contractual ESG information and regular reports.

Don’ts

In its SFDR review, the legislator should avoid the following points in order to offer investors real added value. These measures will prevent investors from becoming confused by excessive complexity and irrelevant information and ensure that the SFDR remains effective and expedient.

Sustainability scale:
Don’t introduce a sustainability scale

From our point of view, a scale is not a suitable instrument for the topic of sustainability: at first glance, it may seem like a sustainability scale is a reasonable means of providing investors with uncomplicated information on the sustainability of financial products. However, examined more closely, a sustainability scale simply does not work as planned: it simplifies too much and can even mislead investors.

Sustainability is multidimensional and very complex; it cannot be adequately displayed on a simplified scale. A scale only works if it has clear measurement criteria. This works, for example, in the case of the risk indicator mandated by the PRIIPs regulation or energy certificates for buildings. However, there are no such clear measurement criteria for sustainability. Even a "reduced" scale cannot be recommended, as it would not encompass sustainability as a whole.

Not only that, but a scale might also mislead investors. Every scale necessarily has a rating function. However, the fact that any future sustainable product categories are equally valuable is important. If a scale was used, there is a risk that investors will only view financial products in the "sustainable" category as particularly sustainable and might be discouraged from selecting financial products from other categories. In addition, investors' views differ when it comes to an understanding of what sustainability is. A sustainability scale could suggest to investors that a financial product is more sustainable or less sustainable than investors initially believed.

It would be better to create meaningful categories for sustainable products that can be easily compared to one another. This would give the investor the guidelines they really need.

Scope:
Critically scrutinise expanding the scope of application

We are critical of expanding the scope of the SFDR to include other financial instruments that are not covered by the SFDR. This is particularly true in light of the EU Commission's welcome efforts to reduce the regulatory burden in the EU. As a result, the plethora of requirements contained in the SFDR should be reduced and not expanded.

The most meaningful arguments against expanding the SFDR to include financial instruments are as follows:

- The scope of the SFDR currently only includes financial products (as defined in the SFDR), and specifically does not include all financial instruments within the meaning of MiFID II. The disclosure requirements are specifically tailored to financial products pursuant to SFDR.
- The SFDR transparency requirements are not directly transferrable to other investment products, e.g. due to the specific features of the product or to existing sectoral disclosure requirements.
- Expansion would thus require a comprehensive, extremely nuanced revision of current disclosures.
- This, in turn, would increase the complexity of the SFDR, making implementation more difficult.

Beyond the SFDR, there are also requirements for taking account of sustainability factors contained in MiFID II and in subsequent ESMA Guidelines on Product Governance and Suitability. These also apply to financial instruments with sustainability features that do not fall under the SFDR. This should definitely be retained, although a better alignment of SFDR and

MiFID II is fundamentally important in order to stimulate the market for sustainable investments. It must also remain possible to offer non-SFDR products with sustainability features to investors with sustainability preferences. In this respect, a corresponding clarification could be useful as part of the review.

Important additional considerations

- **Consumer testing and practical tests**
  In order to ensure that future product categories are as practical as possible, there should be consumer testing and practical tests carried out with market participants.

- **Implementation deadlines**:
  The SFDR should provide for an adequate implementation period for the extensive amendments required. This should be at least 18 months.

- **Level II amendments:**
  The planned Level II review should be based on the underlying Level I legislation. In order to avoid unnecessary bureaucracy, the European Commission should therefore refrain from adopting the ESA's proposed amendments on the SFDR RTS review (final report from 4 December 2023).