SFDR and the New ESG Regulatory Framework

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The European Union’s Sustainable Finance Disclosure Regulation (SFDR) came into force in March 2021. Part of a broader Sustainable Finance Action Plan adopted by the EU, it is aligned with the European Green Deal, which aims to make the EU carbon neutral by 2050. Archie Beeching, Director of Responsible Investing, discusses the new regulations and how Muzinich is enhancing the sustainability of its product offerings.

What is the SFDR?

The SFDR is a disclosure framework for asset managers and other financial market participants. Its aims are twofold. First to ensure transparency on the degree of sustainability of financial products for end-investors in the EU. Second to ensure consistency in how asset managers describe their environmental, social and governance (ESG) credentials, helping end-investors compare the sustainability features of financial products.

It classifies financial products into three main categories, depending on how the product is presented to investors by the manager. The following are referred to as Level 1 requirements and came into effect on 10th March 2021. Article 9 funds have at least one “sustainable investment objective”. Article 8 funds promote environmental and social objectives. Funds which do not fall into either of these categories are classified as Article 6.

Level 2 SFDR requirements are expected to come into effect July 2022. These require more detailed disclosures at the holdings level such as the negative environmental and social effects or “Principal Adverse Impacts” (PAI) of portfolio companies. This will be helped by the soon-to-be-introduced Corporate Sustainability Reporting Directive (CSRD) which is anticipated to require companies to report on relevant sustainability data points.

Archie Beeching
Director of Responsible Investing

Archie joined Muzinich in March 2019. He oversees the firm’s responsible investing and internal corporate responsibility commitments. Archie joined after leading the UN-supported Principles for Responsible Investment (PRI) fixed income and private markets programmes for seven years. Previously, Archie worked as a corporate sustainability consultant with Net Balance (EY Climate Change & Sustainability Services) and ESG research and engagement specialist with Regnan. Archie holds a Master of Environmental Management from the University of New South Wales and an MA (Hons) in Hispanic studies from the University of Edinburgh. He also holds the Investment Management Certificate (IMC) from the CFA Society.

Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.
Why is SFDR important for Muzinich and its clients?

The introduction of SFDR is very relevant for our clients. It ensures they will receive detailed ESG disclosures on each financial product they invest in, and how sustainability risks are integrated into the investment process. They will also be able to compare the ESG features of financial products in a standardised framework, which we welcome. What the regulators started as a disclosure framework will, we believe, become a standard of best practice and transparency.

What area has Muzinich focused on?

We started with our UCITS platform because SFDR has the greatest impact on EU funds distributed in Europe. We are also now exploring options to apply a similar ESG policy to other Muzinich non-UCITS investment programmes. This requires engagement with issuers who have yet to disclose appropriate ESG data and we are happy to partner with them to determine the right disclosure set-up.

Although SFDR is an EU requirement, we have noticed growing international demand for more ESG related disclosure as well as promising policy moves to develop similar frameworks to the SFDR in most major financial markets. We are now exploring how to harmonize our reporting policies on funds distributed in different jurisdictions to create Article 8 and 9 equivalent strategies for US clients.

What have you seen in the asset management community since the introduction of SFDR?

We have already seen the impact of SFDR on the industry when it comes to new product generation and how quickly funds have been reclassified. What is critical is that changes in classification are in effect being reflected by asset managers’ ESG policies and their investment process.

What changes have you implemented in your ESG policy?

While we have been incorporating ESG considerations into client portfolios for more than 20 years, we are increasing our focus and commitments. Upgrading our ESG policy was the first step.

We have increased our focus on climate change and carbon emissions and will sign our commitment to the Net Zero Asset Managers Initiative later this year. At the heart of the ESG policy for majority of our UCITS funds is a commitment to reduce the carbon intensity of our portfolios with a view to ultimately becoming Paris Aligned. We measure the carbon intensity of our portfolios and aim to be at least 10% more efficient than the reference benchmark using a Weighted Average Carbon Intensity (WACI) metric.

For strategies specifically focused on decarbonisation, we will raise the minimum efficiency threshold to 40% versus the benchmark.

We apply negative screening for industries we believe are fundamentally unsustainable like controversial weapons, tobacco and thermal coal mining for energy generation. In addition, we have introduced a process to screen companies for the most severe breaches of international norms and standards on issues like human rights and corruption.

We have also added ESG data points, sustainability risk considerations and ESG intelligence into our research. We believe this is the most efficient way to highlight and engage with companies with poor ESG risk management.

What are the next steps for SFDR?

We believe and hope SFDR is here to stay, but we also believe it will evolve over time. We draw our clients’ attention to three main developments:

Firstly, the EU taxonomy is a critical step in measuring capital flows towards more environmentally sustainable business activities.

Secondly, the Non-Financial Reporting Directive will evolve to become the Corporate Sustainability Reporting Directive which will broaden corporate ESG reporting from a scope of 11,000 European businesses to 49,000. We also expect this year’s UN Climate Change Conference of the Parties (COP26) to highlight the urgency for changes needed to combat climate change, should the Paris Agreement be respected.

Finally, we will join the Net Zero Asset Manager Initiative, committing to manage a growing part of our assets in carbon neutral portfolios by 2050 or earlier. This is to support the goal of net-zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees Celsius.
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