Umwelt Bundesamt

German Environment Agency

14. December 2023

SFDR Targeted Consultuation

The European Commission started two consultation processes on the Sustainable Finance Disclosure Regulation (SFDR) Delegated Regulation (EU) 2088/2019 on 14 September 2023. The public consultation aims at the general public, whereas the targeted consultation addresses finance experts. As such, the targeted consultation addresses four key issues: 1) the current requirements of the SFDR, 2) its interaction with other EU sustainable finance regulation, 3) potential changes to the disclosure requirements for financial market participants, and 4) the potential establishment of a categorisation system for financial products.

This brief, in addition to the survey, provides the view of the German Environment Agency.

The German Environment Agency's (UBA) task, as Germany's main environmental protection agency, is to ensure that our fellow citizens have a healthy environment with clean air and water, free of pollutants to the greatest extent possible. The UBA has conducted research in the field of Green and Sustainable Finance for over ten years. As the leading departmental research centre in this field, UBA brings forward key expert knowledge that is relevant in addressing a potential review of the SFDR.

First, we put forward some general remarks exemplifying our view of the SFDR and our thoughts on how it can be developed to serve the environmental targets of the EU coherently. Second, we specify our opinion concerning the key topics of the Consultation (see 1 – 4 above).

1 General remarks

1.1 The need for a scientific basis and clear concepts

In its current form, the SFDR does not provide clear, science-based concepts of sustainable investments**. Article 2(17) provides a definition that, while providing a logical focus that is close to the EU taxonomy, does not provide adequate minimum requirements for defining sustainable investments. Likewise, it does not provide adequate science-based criteria for the environmental or social objectives.** Rather, market actors are responsible for drawing up their own requirements.

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While they have to disclose their reasoning, this leaves market actors with a lot of space to come up with heterogenous requirements. The definition in SFDR Article 2(17) essentially leads to a broad variety of definitions and key requirements for sustainable investments in the market, which are based on activity or entity-level, as well as company practices, weighted revenue assessments, thresholds, etc.

This variety of approaches leaves the potential to lead to diverging outcomes in the assessment of sustainable activities. Such a development poses the risk of market distortions and misallocations of capital much needed for sustainable investments. It potentially increases transaction costs as market participants have to invest time and personnel to assess the reasoning behind the individual financial products‘ definition of sustainable investments. In addition, **the lack of binding criteria for sustainable investments poses the risk of misinterpretation or greenwashing of the sustainability features of classified financial products**, not least for those financial products that target retail investors.

A review of the Sustainable Finance Disclosure Regulation should therefore include the development of **robust and ambitious, science-based criteria for sustainable investments in line with the EU's environmental objectives.** The review of the SFDR should provide adequate granularity for such criteria.

What is more, a review of the SFDR should highlight the level of assessment for the sustainability of a financial product and define it clearly so that financial market participants can better implement it. As mentioned before, current market practice analyses both activity and entity levels. Article 2(17), however, already defines that a „'sustainable investment' means an investment in an economic activity that contributes to an environmental objective (...)". In light of other EU sustainable finance legislation that also focuses on the activity level, i.e. the EU Taxonomy, **the SFDR should make clear that, by definition, sustainable investments are located at activity level.**

1.2 Sustainability performance as the key component

In its current form, the SFDR does differentiate between the level of sustainability disclosure requirements of financial products through Article 8 and Article 9. While Article 9 certainly provides stronger sustainability disclosure criteria than Article 8, Article 9 still predominantly focuses on the disclosure of sustainability risk management. In itself, sustainability risk management is an important aspect of redirecting financial flows towards sustainable investments. However**, the current SFDR categories do not adequately match the perception of sustainable financial products, which is focused on the impact of sustainability strategies.** This holds true, especially for retail investors who lack a deeper knowledge of sustainable finance.

In order to meet the sustainability goals of the EU, financial flows have to be redirected towards impact-oriented sustainable investments. Here, Article 8 and Article 9 do not provide adequate guidance. **This creates a risk of misallocating financial means and a lack of financial flows redirected towards much needed high-impact sustainable investments**. Hence, we see the need to differentiate between sustainability risk disclosure and sustainability performance disclosure. Disclosure, as it is organized currently, is connected to reporting the mechanisms put in place to achieve sustainability, while not really testing the sustainability outcomes of the products. Performance relates to indicators which track the output of financial products and thereby can verify the sustainability output. Therefore, to provide a full overview of the sustainability of financial products, we regard the disclosure of sustainability strategies and disclosure of sustainability performance as necessary**. The SFDR should include science-based, robust sustainability performance criteria**.

Including sustainability performance criteria would be possible in a model with a reformed article 8 and article 9, as well as in a model based on additional categories for financial products. Clear, adequate, and science-based sustainability performance criteria would enable the SFDR to achieve two key issues: First, it would enable financial market participants to choose financial products according to their sustainability preferences and **reduce the current misinterpretation** of sustainability performance of funds. Including sustainability performance as a key indicator in categorizing financial products would furthermore **reduce transaction costs** as identifying impact-oriented financial products would become easier. Second, building upon sustainability performance indicators for categorizing financial products would **help to achieve the sustainability targets of the EU** since financial market participants are nudged to invest in financial products with sustainable impacts.

1.3 Categorising financial products

As mentioned in 1.2, we see problems with the **misinterpretation of SFDR Article 8 and 9** products. It is necessary to be able to differentiate between sustainability risk management and sustainability performance (see 1.2) which is currently not ensured in a proper manner. In its current form, the Sustainable Finance Disclosure Regulation is not designed to provide a categorization or scaling scheme for financial products. While there is substantial differentiation between Article 8 and 9, the SFDR was originally meant to provide rules for disclosing sustainability strategies of financial products. European institutions aimed at preventing such a development, but market developments show the need to adjust**. Current market practice treats the SFDR as a scaling scheme on sustainability performance for financial products.** This has to be considered as a misinterpretation of the SFDR in general and Article 8 and 9 in particular. From our perspective, this poses an important problem and could potentially lead to misallocation of financial resources and market failure. In addition, the use of article 8 and 9 in its current form as a scaling scheme has the potential to mislead retail investors.

In light of a missing European labeling scheme or additional instruments such as a sustainability scaling scheme for financial products, current market developments regarding the SFDR underline the need to adjust the regulation. **We see the need to extend the categories in order to allow for a more specific assessment of financial products based on sustainability performance disclosures.** We specifically see the need to extend the current categories towards impact assessments of financial products. In our view, a broader categorization catalogue, e.g. of four or five categories, would allow the SFDR to not only lead to disclosure on sustainability strategies, but also provide additional disclosure about the sustainability performance and impact of financial products.

In addition to extending the SFDR's current categories to allow for a stronger categorization of financial products, **we see the need for disclosure requirements for all financial products.** Currently, funds without a strategy to include sustainability risks primarily have to explain why they do not include such a strategy. In light of increasing sustainability risks as well as the need to provide a level playing field between sustainability-oriented and conventional funds, the SFDR should include disclosure requirements for all funds. Such a requirement would also make it possible to differentiate better between funds without an explicit sustainability strategy but heterogenous sustainability impacts. A review of the SFDR should thus provide a list of Principle Adverse Indicators that all funds have to disclose based on the environmental objectives put forward in the EU sustainable finance framework and in coherence with other sustainable finance regulation.

1.4 Extending competences of supervisory bodies

As an important tool in the EU sustainable finance framework, the SFDR has the potential to provide guidance on funds and thus effectively redirect financial flows towards sustainable investments. However, in its current form, the SFDR is highly reliant on the self-assessment of asset managers without adequate public supervision. Currently, we see that the strongest pressure to categorize funds correctly is coming from civil society. **The regulatory focus on self-assessments of funds leads to selective tests of scrutiny of sustainability strategies**. In addition, asset managers lack reliable assessments of their own interpretation of Article 8 and 9 and may thus have an incentive to disclose their funds as being less ambitious in order to prevent legal issues in the future, which hinders sustainable investments.

We therefore see **the need to improve the competences of European and national supervisory bodies in checking and assessing the sustainability strategies of funds and assigning the adequate categorization**. Improved supervisory competences would furthermore require binding guidance to ensure a common understanding of the underlying framework, binding documents to ensure a level playing field of regulatory implementation, as well as established obligations to countercheck environmental targets and performance of funds.[1] In addition, due to the international activities of funds, there need to be mechanisms which ensure regulatory coherence between the European and the national level.

Providing such supervisory activities requires the European and national supervisory bodies to have adequate competences on sustainability issues. While the financial aspect of sustainability strategies is an important aspect which European and national supervisory bodies already possess expert knowledge of, assessing e.g. climate mitigation or biodiversity strategies requires additional competences. Hence, **it should be ensured that European and national supervisory bodies receive adequate resources to engage in these fields**.

1.5 Consistency with the EU sustainable finance framework

UBA notices different levels of ambition in the different regulations of the EU sustainable finance framework, in particular the SFDR, CSDDD, CSRD, MiFID and the EU Taxonomy. Key aspects of the EU sustainable finance framework receive disparate interpretations, in particular with regards to DNSH criteria, minimum safeguards, and issues of Good Governance. Inconsistencies within the EU sustainable finance framework have the potential to reduce the impact of regulations and instruments as well as the market take-up. Hence, **UBA sees the necessity to minimize inconsistencies between the SFDR and other EU sustainable finance regulation in particular.** It is of key importance that a reduction of inconsistencies does not reduce the level of ambition of the EU sustainable finance framework.

UBA in particular sees the need to advance the consistency of the SFDR with the CSRD, IDD and MiFID, as well as PRIIPs. In addition, we see room to improve the consistency between PAIs and

[1] Austria has established the Green Finance Alliance as a voluntary platform which financial institutions can apply for. If they join the alliance they need to fulfill ambitious sustainability performance criteria which is supervised by the environmental agency of Austria. There could be a similar body on the European level where financial institutions can join voluntarily or the supervisory bodys could be mandated with similar tasks on a mandatory basis for all financial market participants.

the Taxonomy's DNSH criteria. We go into further detail on the interaction with key sustainable finance instruments in 2.2.

2 Targeted Consultation

2.1 The current requirements of the SFDR

UBA regards the SFDR as an important regulatory development in developing and sustaining markets for sustainable financial products. The SFDR was key in developing data-driven, quantitative strategies based on indicators as to assess sustainability strategies of financial market participants. In that regard, the SFDR has successfully enabled a single, common disclosure framework across and has thus strengthened the EU's role in sustainable finance.

Nonetheless, we see room for improvement of the current requirements of the SFDR. An in-depth review of the SFDR's current requirements as well as its gaps provides us with the possibility to improve disclosure requirements and thus provide financial market participants with additional comparable information**. While the SFDR certainly improved disclosure requirements for financial products with sustainability strategies, the comparability between products must be improved.** The required transparency of financial products is currently not consistent. While the SFDR provides disclosures on Principle Adverse Indicators, they only focus on parts of financial products. What is more, the SFDR lacks binding science-based concepts, i.e. regarding the definition of sustainable investments in Article 2(17) (see also 1.1). Furthermore, Article 8 allows for a large variety of approaches of sustainability strategies to be included, making it harder for investors to identify financial products based on their sustainability preferences.

In addition, the SFDR currently does not include adequate disclosure requirements for financial products without sustainability strategies. The lack of such requirements, however, creates market imbalances and thus reduces the EU sustainable finance framework to redirect financial flows towards sustainable growth. Hence, **all financial products should disclose a basic set of environmental and social sustainability indicators as mandatory PAIs.** This measure would provide a level playing field for all financial products and thus support the goal of redirecting financial flows. It would furthermore make financial products more comparable. The mandatory disclosure for all financial products should include a strong focus on the sustainability targets of the EU.

We furthermore highlight that **the current disclosure requirements of the SFDR do not necessarily lead to substantial contributions of financial products** to the EU's environmental objectives. While substantial contributions can be a result of the current disclosure requirements, Article 8 and 9 do not require sustainability impact. Redirecting financial flows towards the environmental goals is, however, a key task of the sustainable finance framework. As a result, while we underline that the SFDR has effectively improved disclosure on financial products, we see additional room to improve disclosure on sustainability strategies, in particular on sustainability performance and thus improve the SFDR's impact on the environmental goals.

2.2 Interaction with other EU sustainable finance regulation

A consistent, coherent and science-based EU sustainable finance framework is key to achieve the redirection of financial flows towards the EU's environmental objectives. The German

Environment Agency regards it as **vital that the EU's sustainable finance regulation provides adequate levels of ambition to achieving these objectives.** All EU sustainable finance regulations, i. e. SFDR, Taxonomy, CSRD, or MiFID II focus on a more sustainable economy and sustainable environment. However, they target different groups of market actors. For achieving the sustainability targets and transformation the EU's economies it is highly important to ensure that the regulations pave the way to introduce more sustainable processes, trigger sustainable investments, and produce data that is also relevant for a proper functioning of the economy. While we acknowledge that individual regulations aim at achieving these goals, we do, however, identify mismatches between concepts and standards. This holds true particularly for DNSH, Minimum Safeguards, as well as concepts and standards of Good Governance. The German Environment Agency therefore supports efforts to strengthen regulatory consistency and coherence while maintaining the level of ambition of the EU's sustainable finance framework.

As argued above, we see room to improve the SFDR's concept of sustainable investment. In that regard, **we highlight the necessity to align the SFDR's definition of sustainable investments with other EU sustainable finance regulations, particularly the EU Taxonomy.** In the Taxonomy regulation sustainable investments are related to specific sustainability performance requirements. Article 2(17) of the SFDR, however, does not provide a clear concept which leaves unnecessary leeway for issuers of financial products and thus creates regulatory confusion. In a similar way, the interpretation of DNSH criteria between the Taxonomy and the SFDR offers room for improvement. In our view, strengthening the interaction between the SFDR and the EU Taxonomy in these regards offers key possibilities to improve the impact of the EU sustainable finance framework and strengthen science-based concepts in the SFDR.

The German Environment Agency highlights the interconnectedness between sustainability reporting of firms and disclosure regulations for financial products, particularly for redirecting financial flows towards the transition of the real economy**. In this regard, we see additional room for improvement for the interaction between SFDR and CSRD**.

The German Environment Agency also highlights that the SFDR has played a strong role in establishing sustainability preferences concerning financial products. We particularly regard it as key to use the EU Taxonomy and Principal Adverse Indicators for assessing the credibility and substance of financial product sustainability. In terms of the **interaction between SFDR and IDD / MiFID, the German Environment Agency wants to highlight that a common understanding of what constitutes a sustainable finance product is needed**, in order to maximize regulatory impact. In our view, such a common understanding should be based on robust science-based, ambitious criteria.

2.3 Potential changes to the disclosure requirements for financial market participants

The German Environment Agency, as discussed above, appreciates the review of the SFDR's effectiveness and sees room to improve the SFDR's impact through changes to its disclosure requirements.

In its current form, the SFDR's Principle Adverse Impact indicators provide robust information concerning their negative climate and environmental impact. As such, the SFDR currently has the potential to provide financial market participants important information to adjust their investment strategies and minimize their negative impact. However, the number of PAIs financial market participants have to disclose varies. Comparing financial products based on the SFDR is thus limited.

As mentioned above, the German Environment Agency therefore sees the need to adjust disclosure requirements in two regards:

1. **A review of the SFDR should aim at including disclosure requirements for impact-related information.** For many investors, including but not solely retail investors, sustainability impact is a key aspect of their investments. In its current form, the SFDR offers the possibility to highlight negative impact reduction strategies, but lacks on including positive impact factors.

2. **A review of the SFDR should aim at streamlining the disclosure requirements across financial products in order to improve comparability.** The German Environment Agency regards a key and improved set of mandatory PAIs across different categories as an important aspect of the review of the SFDR. We furthermore see the need to set disclosure requirements for all financial products, including products without sustainability strategies.

2.4 The potential establishment of a categorization system for financial products

The German Environment Agency is in favor of establishing a common categorization system through a revised SFDR. Current market practice and the lack of a common instrument leads to two central developments.

1. We witness market confusion regarding the sustainability of financial products. While on the national level there are public and private labeling regimes in place, they often do not operate across national borders. Current market practice, however, is not bound to individual EU member states. Hence, the **national fragmentation of sustainability labels creates informational asymmetries and thus additional barriers for financial market participants**. In effect, this could reduce the success of the sustainable finance framework to finance sustainable growth and have negative impacts on the European Union's sustainability goals.

2. **The SFDR is currently used to compensate the lack of an adequate categorization instrument.** In its current form, however, using the SFDR as a labelling instrument overstrains its regulatory framework. While the SFDR was set in place to set forward adequate disclosure rules on sustainability strategies, the SFDR is not built to be used as a labelling scheme. Current market practice of using the SFDR as such thus potentially leads to misallocations of funds. The current fragmented market environment therefore makes clear that there is high demand for a common categorization tool and points towards the SFDR to provide additional guidance on the sustainability of financial products.

As mentioned above, **the German Environment Agency regards it necessary that a common categorization system distinguishes between sustainability risk management and sustainability performance.** First, there is market demand for impact-oriented sustainable financial products. Second, to achieve the sustainability targets of the EU it needs its financial market participants to invest in sustainable outcomes. In the current market environment, participants expect clarity in how far their investments contribute to sustainability targets which can only be achieved if performance indicators are put in place.

A reform of Article 8 and Article 9 without additional categories would likely not be able to deliver on these goals. A review of the SFDR should focus on transforming Article 8 and 9 into a differentiated categorization system that provides sustainability disclosure requirements for all financial products and enables financial market participants to identify funds based on their sustainability performance.

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