ESG Regulatory Reporting Asset Management Survey 2022

Sustainable Finance Disclosure Regulation (SFDR) and EU taxonomy

November 2022

EY

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Introduction

The Sustainable Finance Disclosure Regulation (SFDR) forms part of the Sustainable Finance Action Plan of the European Union. It aims to reduce greenwashing and improve transparency on inherent sustainability risks in financial products (see Appendix for more information on SFDR fundamentals).

As European regulators aim to make the presentation of environmental, social and governance (ESG) considerations more uniform and comparable, the asset management industry is facing challenges in implementing SFDR. This is due to limited implementation guidance on the regulatory technical standards and varying interpretations across the market on defining a sustainable investment and managing sustainability risks effectively.

This EY survey aims to provide an industry view of how firms are approaching this regulation in preparation for the 01 January 2023 deadline, to support emerging leading-class practice sharing and to highlight key remaining issues that require further industry debate and cooperation.[1] The survey covered 25 questions on SFDR and EU taxonomy implementation. With **22 firms responding to the questionnaire, the combined firms represent ~$37 trillion of assets under management (AUM) or around 33% of the total global market.**[2] The participants include:

11 Tier A firms (firms with over $1 trillion AUM, top 30 firms)	**7 Tier C firms** (firms with over $200 billion AUM, top 100 firms)
2 Tier B firms (firms with over $500 billion AUM, top 60 firms)	**2 Tier D firms** (firms with over $100 billion AUM, top 200 firms)

As most survey respondents are among the top 100 asset management firms by AUM globally, the responses are likely to represent the more "mature" firms in their approach to SFDR implementation. Therefore, this is not necessarily representative of the approach taken by the whole spectrum of the asset management industry.

1. Survey cut-off date was 22 August 2022.
2. Based on Statista 2021, total AUM for the industry of $112.3 trillion. AUM data sourced for each company from their website based on most recent reports (typically June 2022), ADV Ratings or S&P. Ranking criteria of what is a top 30, top 100 firm, etc. are based on The world's largest 500 asset managers report, A Thinking Ahead Institute and Pensions & Investments joint study, October 2021.

Survey results

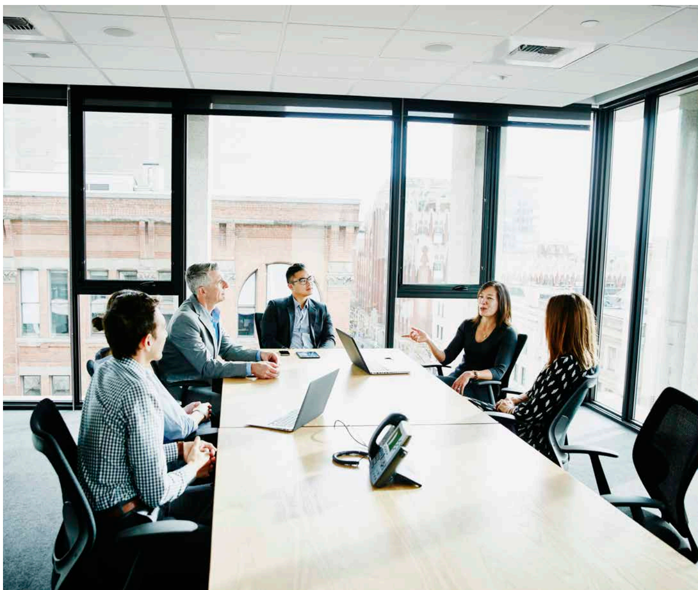
Finding 1: Strategic ambition

A large majority of firms expect to be perceived as ESG leaders in the market

77% of surveyed firms want to be perceived as leaders for their work on ESG.

Of the remaining 23%, 14% expect to be in line with peers, and 9% have set "compliant" as their level of ambition.

Surprisingly, most firms are setting high ambitions and aim to be perceived as future market leaders in ESG. There will be significant future competition in the industry as ESG becomes an increasingly critical consideration for investors, regulators and other stakeholders. Drivers considered by firms in their decision include the changing client preferences and progressively ESG-conscious investor profiles, the expected future investment performance impact of climate change and the increasing reputational risk of being perceived as a laggard in ESG. Only 23% of survey respondents are aiming for more modest ambitions such as being in line with peers or simply compliant with ESG regulations.



Finding 2: Sustainable definitions

Firms are finding it easier to define what is sustainable than to articulate what is not

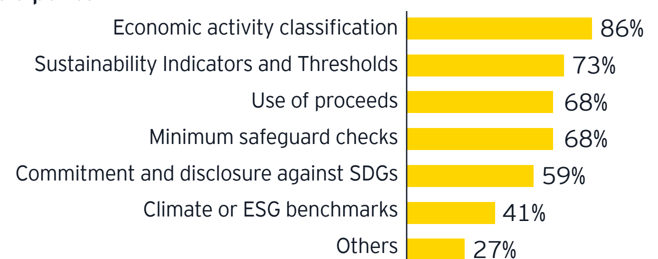
86% of respondents use the SFDR definition of sustainable investment in policies.

60% of firms have articulated the scope of activities or behaviors considered sustainable by the organization, but only 45% of firms have articulated activities or behaviors considered not sustainable.

Economic activity classification is the most widely used consideration to determine a positive contribution to a sustainable investment (used by 86% of respondents) – see Chart 1 below.

The results highlight that the industry continues to be challenged by defining what a sustainable investment is. Firms evidence a range of approaches in their sustainable investment criteria, with economic activity classification as the most popular consideration, perhaps because this is easier to embed within investment processes than other sustainability criteria. However, economic activity classification alone is not sufficient to define a sustainable investment. Participants will need to use a combination of criteria to determine whether an investment is sustainable under regulatory definitions. The survey also highlights important progress in adopting sustainability indicators and thresholds, with 73% acknowledging their use in developing their sustainable investment criteria. Numerous firms highlighted their interest in understanding how peers define sustainable investment approaches. The chart below depicts the range of considerations used by firms.

Chart 1: Sustainable investment criteria used by survey participants



SDGs – Sustainable Development Goals

Finding 3: Product classification

Asset managers are being cautious in classifying funds as sustainable (Article 9) but more lenient in their criteria to classify funds as promoting environmental and social (ES) characteristics (Article 8)

45% of firms expect to have 90% to 100% of the fund's assets with a sustainable investment objective for a product to be classified as Article 9. Only 23% of firms expect to define a threshold below 80%.

55% of firms will have no minimum proportion of sustainable investment objective for an Article 8 classification. Although this is not required from a regulatory perspective, it does mean that these products can have potentially very low ES aligned investments.

Negative screening is the most popular approach when considering ESG factors used in Article 8 funds (86% of firms apply it in Article 8 funds) – see Chart 2 to the right.

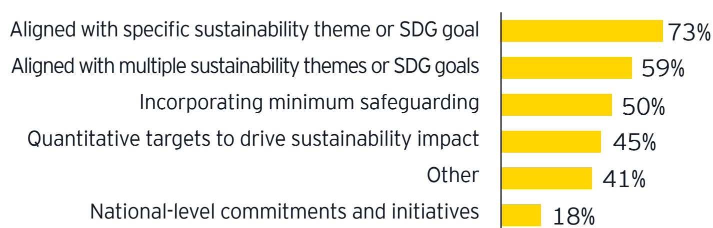
Asset allocation to companies that provide solutions to specific sustainability themes or SDG goals is the most common approach taken for determining sustainable objectives of Article 9 funds (used by 73% of firms) – see Chart 3 to the right.

The survey results demonstrate that Article 9 funds are emerging, with most assets in funds of this nature aligned with a sustainable investment objective as prescribed in the regulation. There has been debate in the industry as to whether a 100% alignment is truly achievable. It is expected that both ESMA and national regulators will publish clarifying regulatory expectations on this shortly. However, most firms we have surveyed aim for a high level of alignment, typically in the 80% to 100% range. However, a recent review of EET disclosures by Morningstar found that a much smaller number of funds are expected to be aligned to 90%.[3]

For Article 9, alignment to a specific theme is the most popular approach underpinning funds classified in this category. When looking at considerations for Article 8 fund classification, negative screening, ESG scores and minimum safeguard checks are the primary mechanisms considered. The current classification regime creates a broad spectrum of Article 8 products, ranging from products with limited negative screening for ethical considerations to products with a moderate proportion (up to ~30%) of underlying assets aligned with a sustainable investment objective and integrating sustainability indicator thresholds. Hence, there is a potential greenwashing risk for Article 8 products, given the lack of prescriptive standards.

Chart 2: ESG considerations for Article 8 funds

Chart 3: ESG considerations for Article 9 funds



3. Morningstar Q2'2022 research found that only 2.3% of funds have stated in their EET to be aiming for above 90% sustainable investments. Initial inputs into EET templates may reflect a conservative approach, and firms are aiming for higher sustainable investment alignment; however, it is also probable that our survey respondents are skewed toward firms that are leading the market in their approach to SFDR implementation.

Survey results

Finding 4: Data

The ability to source and rely on ESG data is the biggest challenge

67% of firms classified data as the first or second challenge in building their sustainable investment frameworks.

59% of firms exclusively use third-party-sourced ESG data for SFDR and EU taxonomy. 32% use a combination of internally sourced and third-party ESG data.

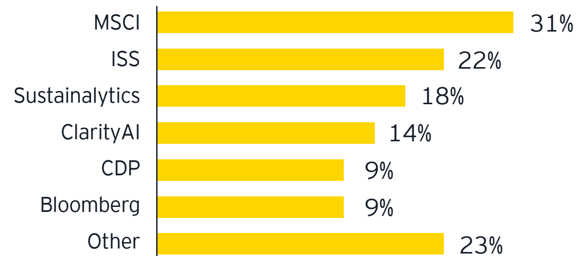
MSCI is the top referenced external provider (used by **31%** of firms responding to the survey), followed by ISS (used by 22%) – see chart 4 below.

Building an effective data model is a critical dependency to support ESG regulatory reporting challenges such as SFDR and EU taxonomy. Firms typically use a combination of external vendors for ESG data sourcing, with MSCI as the top referenced provider.[4] Many firms are also building internal capabilities to source ESG data or compare different ESG data sources to form their own opinions, with nearly a third of the respondents using a combination of internally sourced and third-party sourced ESG data. The dependency on ESG third-party data sourcing requires thorough consideration in the business model from an operational resilience and critical third-party management perspective, ensuring adequate data governance mechanisms are in place. In addition, as firms ultimately own the management of sustainability risk, firms need to consider adequate data quality controls and assurance capabilities for material decisions relying on third-party-sourced ESG data.

Once the data vendor has been identified, there are further challenges relating to the use of that data, such as:

- Implementing a resilient, automated process to get third-party data delivered promptly and creating robust systems with ingestion processes to handle any structural changes made to files by vendors after they are first ingested.
- Developing mapping solutions that combine multiple external ESG data sources and internal ESG data as a single source of truth.
- Designing a consistent data management framework to control the consumption and use case of ESG data across the business within budget constraints that do not inhibit front desk data requirements.
- Accessing data catalogs or data dictionaries. Since many vendors have not developed these or view such methodologies as their intellectual property, firms may need to develop these themselves.

Chart 4: ESG external data providers used for SFDR and EU taxonomy



*Please note participants were able to select more than one data vendor.

4. Ernst & Young LLP (EY UK) does not endorse the use of any third-party data providers in this survey. Results reflect the providers referenced by survey participants.

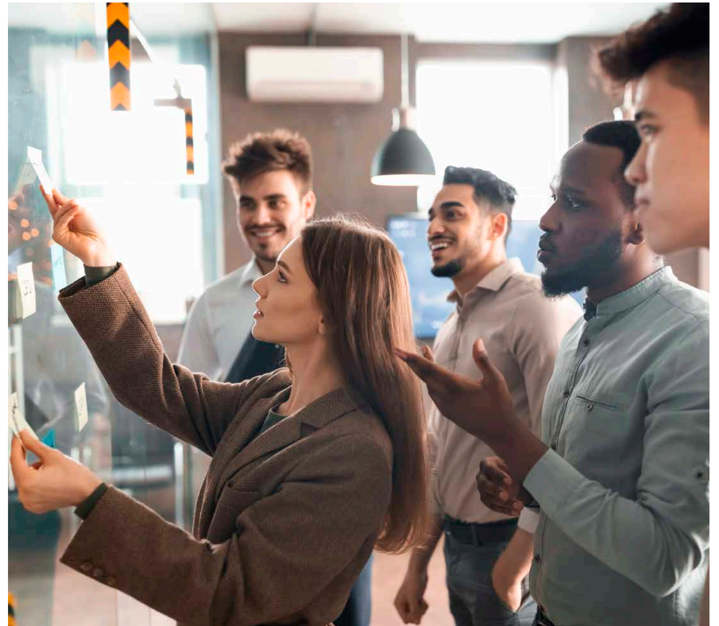
Finding 5: EU taxonomy

Low levels of EU taxonomy alignment are expected for January 2023

Only **45%** of firms aim to disclose taxonomy alignment in January 2023.

Of those aiming to disclose, **55%** aim for 0% to 5% average taxonomy alignment in Article 8 products, and 45% do not currently know their expected alignment.

On Article 9 products, **36%** aim for 0% to 5% average taxonomy alignment, and 9% expect alignment between 10% and 20%. However, the rest do not know their expected alignment.



Firms acknowledge that achieving a high level of EU taxonomy alignment is very difficult, even in Article 9 funds with an environmental objective given the highly restrictive criteria to classify an activity as substantial contribution and robust do no significant harm requirements. Therefore, firms currently expect an average taxonomy alignment of 0% to 5%. However, it is worth noting that nearly half of the survey participants are still determining their expected alignment. Low taxonomy alignment implies that the industry will struggle to offer products that have a substantial environmental contribution from a regulatory standpoint, which may raise more questions from investors on if and how Article 9 products make a material positive environmental impact.

Chart 5: Are you intending to disclose minimum levels of taxonomy alignment by 01 January 2023?

Chart 6: Taxonomy Alignment in Article 9 funds with environmental sustainable investment objectives

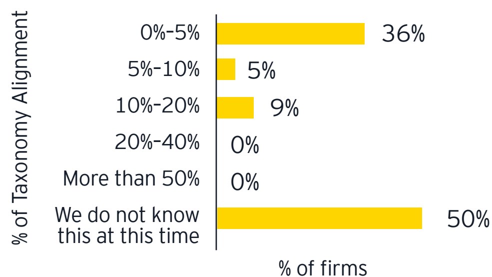
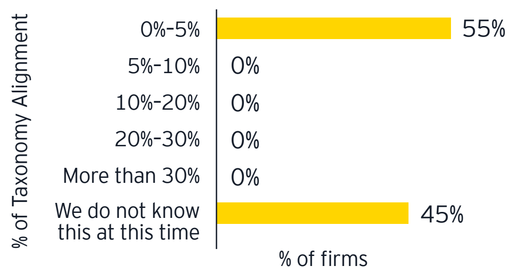


Chart 7: Taxonomy Alignment of Article 8 funds with environmental sustainable investment objectives



Survey results

Finding 6: Principal Adverse Impacts

The Principal Adverse Impacts (PAI) consideration is becoming a mainstream approach in the industry

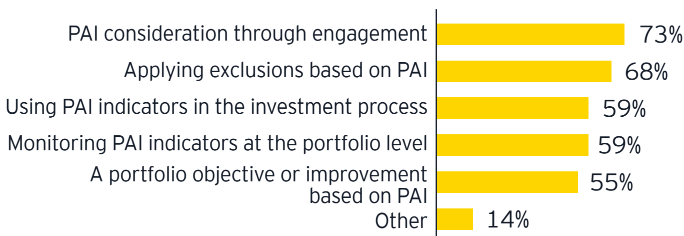
82% of firms will complete PAI reporting at the entity level, and only 14% will not complete entity reporting.

91% aim to report PAI reporting at the product level.

Engagement is the most cited use of PAI in the industry currently (73% of firms are using it) – see Chart 5 below.

Although several firms are not currently subject to mandatory PAI reporting[5], the survey evidences a growing industry trend of endorsing PAI consideration; 82% of survey participants expect to report entity-level PAI, and nearly 100% aim to report PAI at the product level. Firms acknowledge that the integration of PAI is still immature, only 55% of firms are using PAI to determine a portfolio objective or improvement, and only 59% are using PAI indicators in the investment process. PAI reporting might trigger important future changes in the industry as investors will be able to compare the E&S impact of different firms based on the entity PAI reporting and will also be able to compare products of similar characteristics. PAI integration might have significant implications on the future investment strategy of firms, particularly if future inflows and outflows are impacted by PAI indicator performance.

Chart 8: How are PAIs currently used?



Conclusion

SFDR marks an important milestone in implementing ESG regulation for the industry. The survey demonstrates that ESG is becoming a significant consideration for firms, and regulatory pressure is likely to have a material impact on strategy and product offerings.

The current state of play demonstrates that challenges persist in areas of implementation, including defining sustainable investment definitions, ESG data, EU taxonomy alignment, and the classification of Article 8 products. However, the survey also highlights industry progress in developing sustainable investment considerations, the standards for Article 9 products, the adoption of PAIs and the setting of ESG ambitions.

The survey's full results also explore other SFDR topics such as sustainable investment accounting for investees and the use of ESG and climate benchmarks. Please contact us for further information.

5. PAI applies to all EU-based financial market participants (FMPs) and financial advisors (FAs); plus FMPs and FAs who are based outside of the EU and sell products to clients in the EU. PAIs include negative, material or potentially material effects on sustainability factors that result from, worsen, or are directly related to investment choices or advice performed by a legal entity.

Are you interested in finding out more about EY teams ESG reporting capabilities?

We are helping numerous asset managers with ESG regulatory reporting requirements, including SFDR. Examples of services we offer include:

- Assessing current state policies and procedures, supporting enhancements
- Preparing disclosures on website, pre-contractual, periodic reporting and EET leveraging EY reporting capabilities
- Development of ESG book of work and project management services
- Offering our ESG Data model to support ESG measurement capabilities
- Regulatory compliance reviews and interpretation of regulatory requirements
- Product classification advisory
- PAI selection and sustainability indicators advisory
- Market benchmarking
- ESG training
- TCFD and CSRD reporting
- UCITS/MiFID II/AIFMD ESG amendments advisory
- SFDR reporting

We bring together sustainable finance experts from across the world. EY Consulting services has experience across a broad range of asset management clients in designing ESG strategies, implementing ESG regulations and developing data capabilities. We have deep market insights and experience across clients into what peers are doing and what third-party vendors can offer in the ESG space. Please contact us for further information.

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Appendix: About SFDR

Although the Level 1 text of SFDR came into force in March 2021, the Level 2 text, which has the Regulatory Technical Standards (RTS), will become effective in January 2023. SFDR requires firms to publish policies that explain how sustainability risks are managed. It also requires firms to classify financial products based on characteristics seen through an E&S lens, to complete disclosures on the performance of products against sustainability objectives and articulate how the investment strategy considers sustainability where applicable. Products with an E&S investment objective or a portion of the fund with an E&S investment objective will be required to disclose EU taxonomy alignment, Europe's emerging sustainable activities classification system.

Another important component of SFDR is the concept of PAI, which are negative or potentially material effects of the financial product (also measured across the entire financial entity) on social and environmental factors (inside-out perspective). Examples include greenhouse gas emissions, hazardous waste and board gender diversity. PAI reporting is due by the end of June 2023. Firms are expected to meet SFDR requirements via their websites, pre-contractual disclosures and periodic reporting documentation, using the templates included in the RTS. The regulation applies to all financial market participants and financial advisors marketing products to clients in EU jurisdictions.

Key SFDR requirements

Internal policies and processes

- Firms will need to publish policies that explain how sustainability risks are integrated in the investment process and investment advice.
- Firms must provide information on how current processes are consistent with the integration of sustainability risks in the remuneration policy of the entity.
- Firms should also evidence relevant engagement policies used to support E&S promotion and sustainable investment objectives.

External impact of investment activity

- Financial market participants will report on their PAIs at least at the entity level (and if desired at the product level).[6]
- PAIs are negative, material or potentially material effects on sustainability factors. The EU has identified PAI mandatory and voluntary indicators.

ESG product classification and disclosure

Firms will need to:

- Classify products through an E&S lens (6. Non E&S, 8. Promoting E&S characteristics, 9. with a Sustainable Investment Objective).
- Describe the E&S characteristics and sustainable investment objectives of these products and relevant benchmarks used.
- Detail performance against these objectives and if these have been met.
- Detail the methodologies used to assess and monitor sustainability risks and any relevant impact assessments on product return.

Output channels

Website | **Pre-contractual disclosures** | **Periodic reporting**

6. If subject to the minimum entity thresholds of SFDR >500 employees during the financial year.

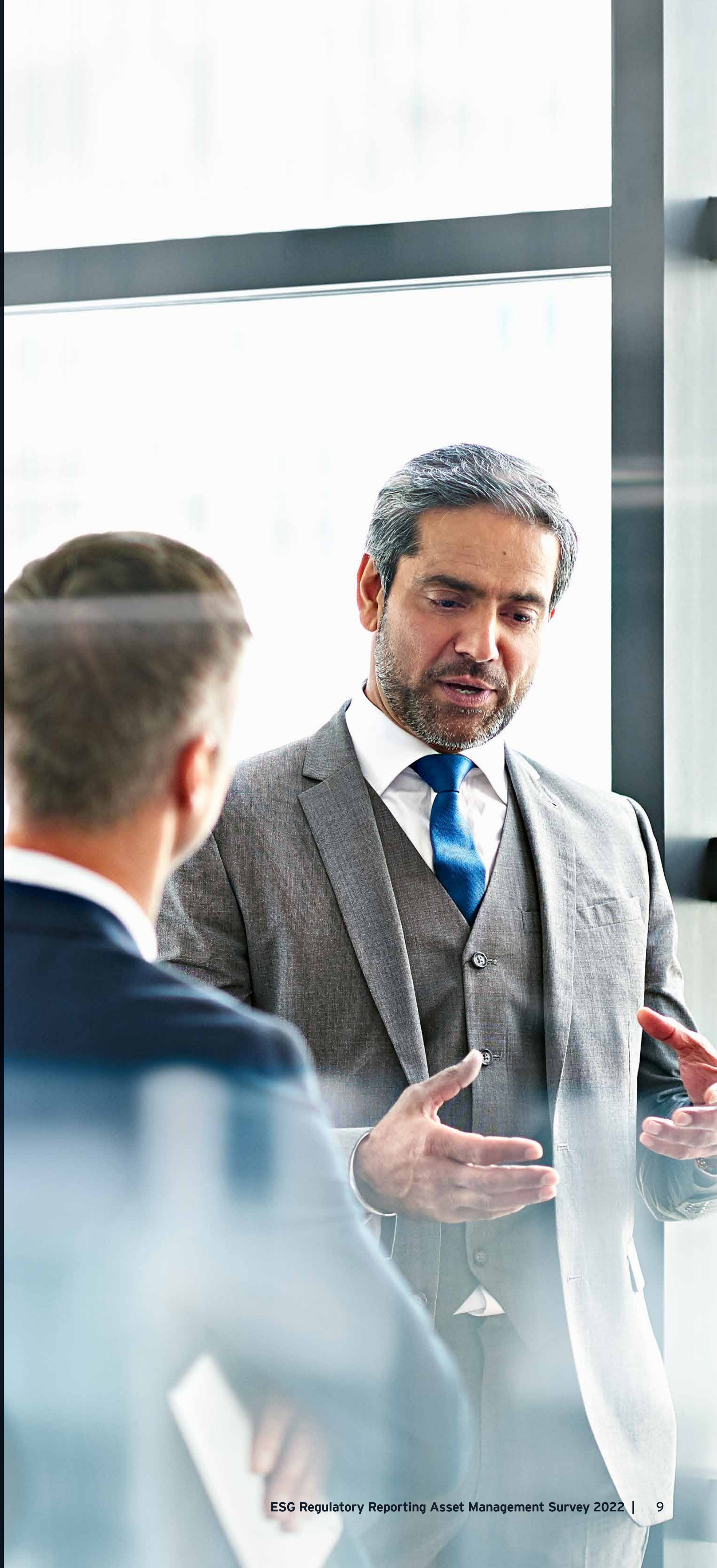
Important terms

Greenwashing: The practice of marketing a company or product, so it appears more environmentally friendly than it is in practice.

Sustainability risk: An ESG event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact.

Key implications

SFDR has important implications for how firms can manage investments and provide financial advisory services. First, it sets the expectation for firms to have the capabilities to assess if sustainability factors can impact investment value and to consider these risks across the entire product offering. This requires robust ESG data, defining sustainability risk methodologies, including risk thresholds, and considering how stewardship will be used to engage investees, among other considerations. Another important implication of SFDR is that firms can no longer purely look at ESG as a driver of risk to the firm. By introducing PAI indicators, it expects firms to look at the extent to which the firm investments can have a detrimental impact on wider society regardless of whether the financial value of the product is impacted.



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