

AEGON INSIGHTS

European sustainable finance legislation: The journey so far

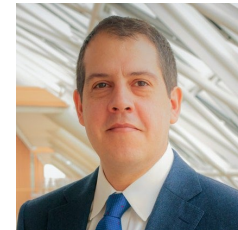
We are now in the third year of implementation of the European Union's ambitious sustainable finance regulatory agenda. The industry has made enormous progress in understanding the new requirements and coalescing around a common understanding of key concepts, such as 'double materiality'. But as Bruno Maradei explains, many challenges remain.

Launched in March 2021, the purpose of the EU's Sustainable Finance Disclosure Regulation (SFDR) was to require more standardized disclosures from market participants on their practices. The intention was to provide greater awareness of the sustainability risks that could affect the value of portfolios, along with the 'adverse impacts' on society and the environment. SFDR also attempted to standardize disclosure on the features and objectives of products promoting sustainability, by providing templates for products according to a self-classification.

Under the SFDR classification 'Article 8' products promote ESG characteristics, while 'Article 9' products must have a specific sustainable investment objective. Some asset managers refer to these classifications as 'light green' (Article 8) or 'dark green' (Article 9), although we prefer to refer to them by their article number, as 'green' does not reflect social or governance criteria.

It soon became clear that the regulator's approach to self-classification would need to be more prescriptive about acceptable disclosures, which in turn could determine acceptable features and objectives for the different classifications. The absence of a direct link between product classifications and names led the UK and US to propose rules focused on fund names, with the EU playing catch-up, while admonishing market participants for using SFDR classifications as product labels.

The 'Article 9' classification remains particularly volatile, with hundreds of products being re-classified downwards as disclosure standards and acceptable definitions of 'sustainable investments' became clearer. Aegon AM takes a more conservative approach to product classification and therefore did not need to downgrade its products. It also became clear that some products do not exclusively make sustainable investments, but instead diversify their portfolios. This led to the creation (through the regulators' technical standards) of 'Article 8+' for products promoting ESG characteristics, but also making *some* sustainable investments.



Bruno Maradei
Global Head of Responsible Investment

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The key problem with SFDR product classifications is the lack of a common understanding about what makes an investment sustainable, and, to a lesser extent, what are acceptable ESG characteristics promoted by an Article 8 fund.

Never shy of tricky regulation, the EU also attempted to coalesce the industry around a common definition of sustainable investments through its even more ambitious EU Taxonomy on sustainable activities. This focuses on economic activities and their relative alignment with sustainability goals, such as climate change mitigation, while doing no significant harm to other sustainability goals and adhering to certain minimum social and governance standards.

Deciding precisely which economic activities are sustainable is not easy and requires building a consensus around what the economy should be doing in the future. By counter-definition, it also requires agreement about which activities we should seek to discontinue. This becomes especially difficult once you begin to consider how those activities are performed. For example, an electric vehicle manufacturer making batteries using minerals extracted using slave labor could hardly be considered sustainable, according to global norms.

A technical expert group was established to guide the formulation of the taxonomy based solely on scientific evidence, but ultimately ran into the *realpolitik* of entrenched economic interests in political processes. Lobbying saw the inclusion of some natural gas and nuclear energy related activities in the definition of sustainable investments for a limited time.

Furthermore, investors have diverse sustainability preferences and priorities. Social objectives were (and remain) missing from the taxonomy, while EU regulation currently calls for significant disclosures on the climate-related aspects of sustainable investments and some experts demand that all Article 9 funds be benchmarked against Paris-aligned benchmarks. This, however, would effectively force the sustainable investment industry into the single objective of climate change mitigation. An investment in low-income housing makes a significant contribution to addressing inequality and societal sustainability, but under such rules that investment would not be considered sustainable. Of course, climate change is and should be a priority for investors, but a regulatory regime should not discourage investments which address other important sustainability challenges.

Still, after many years of work, the taxonomy was finally established for six environmental objectives. Taxonomy-alignment disclosure from companies is growing quickly, although it remains limited and may never reach non-EU companies or smaller EU companies not obliged to calculate and report it. Realizing that the taxonomy may not be fully fit-for-purpose for some time, SFDR guidance evolved to accept proprietary definitions of sustainable investments to be used in disclosures for Article 9 and Article 8+ funds, while still mandating taxonomy-alignment disclosure as a point of reference for funds that disclose under article 8 or 9.

This compromise solution may well defeat the purpose of the legislation in the short-to-medium-term, since sustainable investments claimed by market participants with widely diverging proprietary definitions remain far from comparable for their clients. Only when taxonomy alignment data becomes more widely disclosed will clients be able to objectively compare the relative sustainability of a portfolio against a benchmark regulatory definition. Additionally, the Taxonomy is activity based, while SFDR is company based, which will also create a lot of confusion and diverging outcomes between the two measures of sustainable investments. In our view comparing products targeting social sustainability objectives will not be possible for a long time.



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At Aegon AM we have been promoting our own view of what constitutes a sustainable investment portfolio for almost a decade. Our proprietary research takes a holistic approach to assessing each company's products and practices and their relative sustainability. Our team considers several sources in its research, including ESG data providers, public sources, corporate disclosures, and specialized research, helping us formulate a comprehensive opinion on an issuer's sustainability profile.

Opinion is the key word here, as until a full regulatory definition for sustainable investments exists, proprietary definitions are just that – subjective opinions. Our qualitative analysis and discussion on each issuer's profile allows us a high degree of confidence in our sustainability opinion, with limited reliance on third-party views.

Our process was built recognizing that ESG information is not subject to standardized disclosure regulation or third-party verification, so is not easily comparable. This is despite quickly multiplying creative approaches that attempt to quantify subjective information and deal with missing data. We believe there is value in developing an in-house sustainability view alongside our investment professionals, rather than outsourcing it to third parties with often opaque methodologies.

Despite the multiple and significant challenges ahead we applaud the ambition of the sustainable finance regulatory agenda taking shape in many jurisdictions around the world. We believe it will ultimately support healthy long-term growth in sustainable investment. We are at the start of a long and difficult episode in the transformation of our economy into a more climate-resilient, environmentally friendly, inclusive, and socially cohesive system.

As the industry codifies what was once considered impossible to codify, we must not lose sight of our ultimate goal, which is to direct capital flows to support those economic activities that will address sustainability challenges and create a world we all want for future generations.

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