EFAMA

European Fund and Asset Management Association

MARKET INSIGHTS

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THE SFDR FUND MARKET – STATE OF PLAY

LATEST MARKET DEVELOPMENTS AND OUTSTANDING REGULATORY ISSUES

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INTRODUCTION

This Market Insight presents the latest trends in the Sustainable Finance Disclosure Regulation (SFDR) Article 8 and Article 9 fund markets. The first sections focus on the trends in these markets since the onset of SFDR in early 2021, with a particular focus on changes in the second half of 2022, and shed light on evolutions at a country level. This part is followed by an overview of the outstanding regulatory issues concerning the SFDR, highlighting the lack of reliable Environmental, Social, and Governance (ESG) data on investee companies, the continued uncertainty concerning standards and definitions, national fragmentation and the need to leave time for industries to transition.

SFDR DATA COLLECTION – OVERVIEW

The SFDR came into effect in March 2021 and put in place a set of sustainability-related disclosure obligations for financial market participants (FMPs), including financial advisers. Among other obligations, the SFDR requires asset managers to make specific sustainability-related disclosures across their product range.

- SFDR Article 6 requires all fund managers to make disclosures on the integration of sustainability risks and their likely impacts on the returns of the financial products they make available.
- SFDR Article 8 requires funds that promote environmental and/or social characteristics to specify in pre-contractual disclosures how they will attain the promoted environmental or social characteristics, or a combination of both, and that the companies in which the investments are made follow good governance practices.
- SFDR Article 9 requires funds with a sustainability objective to specify in pre-contractual disclosures how they will attain this objective and whether an index has been designated as a reference benchmark.

Although it was not the EU regulators' intention for these Articles to be treated as de facto product labels, the application of SFDR has, in practice, split the EU fund universe into three categories as per above.

EFAMA, together with its member associations, has already carried out three surveys to estimate the size of the European ESG market, focussing on the net assets of Article 8 and 9 funds at the end of Q1 2021, Q2 2022 and Q4 2022. The results of the first survey can be found in Markets Insights #7.

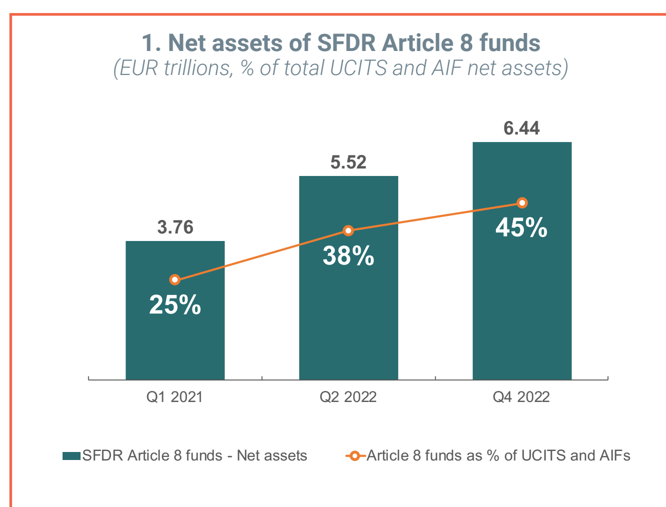
The added value of this data collection compared to data from commercial data providers is that it provides a more complete coverage of Article 8 and 9 funds in the UCITS and AIF (Alternative Investment Fund) markets across most European countries.[1] Whereas commercial data providers tend to have good coverage of the UCITS market, their coverage of the AIF market, which includes mostly institutional funds, is generally more limited. This can be clearly seen by comparing the net assets of Article 8 funds in countries with big institutional markets, such as France and the Netherlands, which are significantly larger than the data from commercial providers suggest. This survey also provides a more complete picture of the European market as it covers a number of smaller, mostly Eastern European countries, that are not covered by commercial data providers.

LATEST SFDR MARKET DEVELOPMENTS

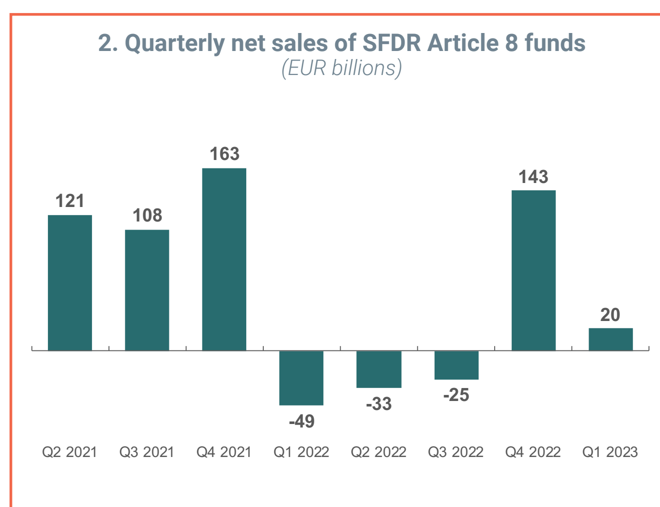
SFDR Article 8 funds (Funds promoting environmental and social characteristics)

At end Q1 2021, immediately after the introduction of the SFDR, net assets of Article 8 funds amounted to EUR 3.76 trillion, which represented about 25% of the European fund market (UCITS and AIFs).[2] By the end of June 2022, they had grown to EUR 5.52 trillion (38% of the market), and by the end of 2022, they reached EUR 6.44 trillion (45% of the market). The 17% increase in Article 8 fund net assets during the second half of 2022, which is mainly due to reclassifications, contrasts with total UCITS and AIF net assets declining by -1.7% over the same period, chiefly a result of the downturn in the wider financial markets.

Article 8 funds registered net outflows in the first 3 quarters of 2022, in line with evolutions in the overall fund market.[3] In Q4 2022, net sales returned to positive territory (EUR 143 billion), mainly thanks to strong net inflows into Article 8 money market funds (MMFs) Net inflows remained positive in Q1 2023 (EUR 20 billion), mainly due to net inflows in equity and bond funds.



Source: EFAMA and Morningstar



Source: Morningstar

There were three main drivers behind the strong growth in net assets of Article 8 funds between Q2 2022 and Q4 2022:

- The reclassification of funds from Article 6 to Article 8, which has been the most important driver. Morningstar identified 315 funds in Q3 2022[4] and 85 funds in Q4 2022[5] that were reclassified from Article 6 to Article 8.
- The reclassification of funds from Article 9 to Article 8 (see section 3.2). Morningstar identified 41 Article 9 funds in Q3 and 307 in Q4 that were downgraded to Article 8.
- New fund launches of Article 8 funds. According to Morningstar, 137 new Article 8 funds were launched in Q3 2022 and 165 in Q4 2022.

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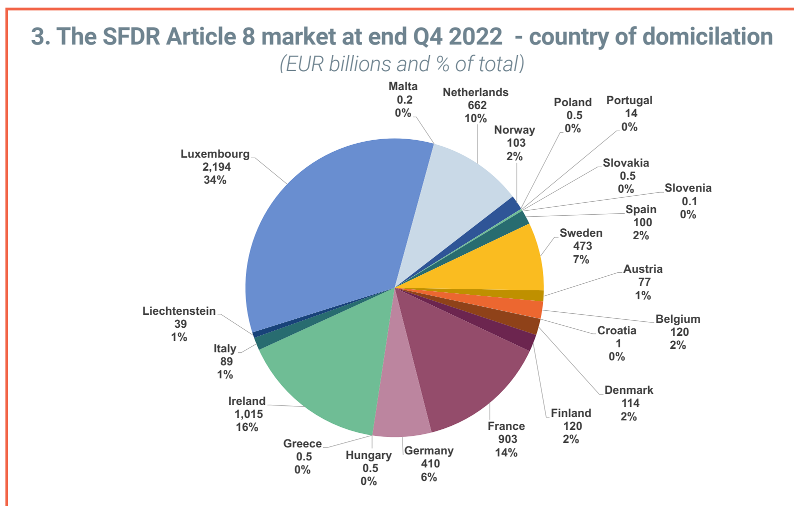
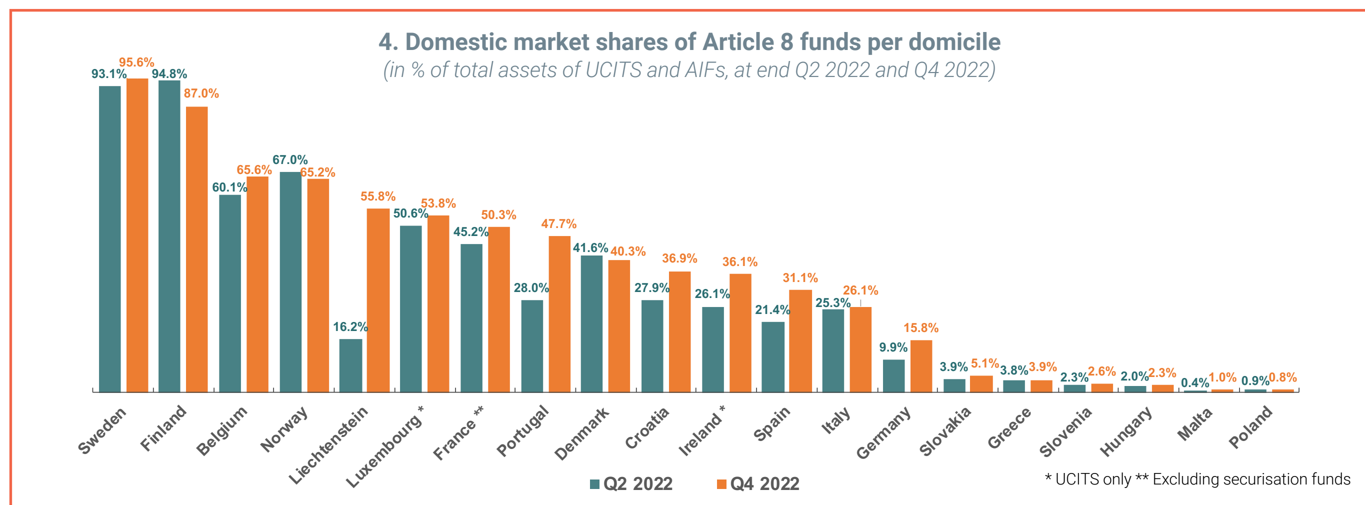
Chart 3 shows net assets of Article 8 funds by country of domiciliation at the end of 2022. The five main domiciles were Luxembourg (34%), Ireland (16%), France (14%), the Netherlands (10%), and Sweden (7%). About 82% of the total net assets of Article 8 funds were domiciled in these five countries.

Chart 4 below displays the market share of Article 8 funds in 20 EU countries, measured as a percentage of the total net assets of UCITS and AIFs domiciled in each country. It also shows how these market shares changed between Q2 2022 and end 2022.[6]



Source: EFAMA and Morningstar



Source: EFAMA and Morningstar

The following points are worth highlighting:

- The market share of Article 8 funds grew in 16 countries between Q2 2022 and Q4 2022, whereas it decreased in 4 countries. The growth in market share was primarily due to an increase in Article 8 net assets rather than a decrease in the total net assets of UCITS and AIFs.
- Nordic countries and Belgium have a long tradition in ESG investing, and hence, have high shares of Article 8 funds.
- In Luxembourg, Article 8 funds represented circa 54% of the net fund assets of UCITS at the end of last year, whereas in Ireland, despite solid growth, these funds accounted only for 36.1%. The difference reflects the fact that equity, bond and multi-asset funds, which have a higher share in Article 8 funds, are more predominant in Luxembourg than in Ireland where the share of MMFs is significantly higher.
- The ESG market is still at an early stage of development in the Eastern European domiciles for which data is available. Except for Croatia, the Article 8 market shares in these countries remain below 5 %. However, almost all Eastern European domiciles saw the market share of Article 8 funds increase over the second half of 2022.

SFDR Article 9 funds (Funds with a sustainability objective)

Article 9 fund net assets amounted to EUR 341 billion at the end of 2022, or about 2.4% of the European fund market.[7] These assets were 19% lower than at the end of Q2 2022 and similar to their level at the end of Q1 2021.

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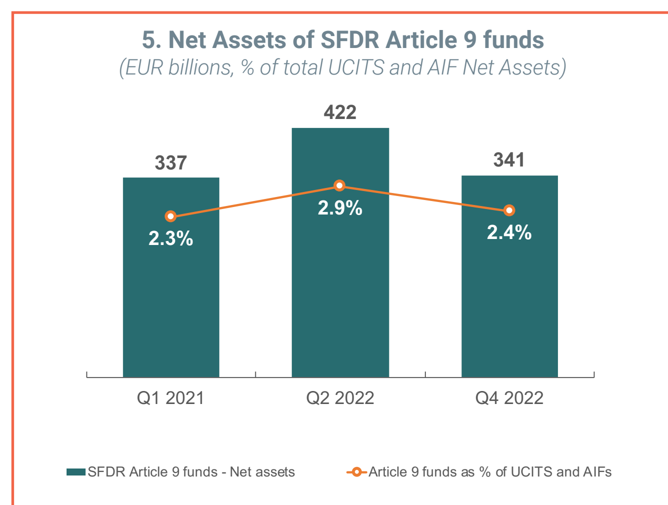
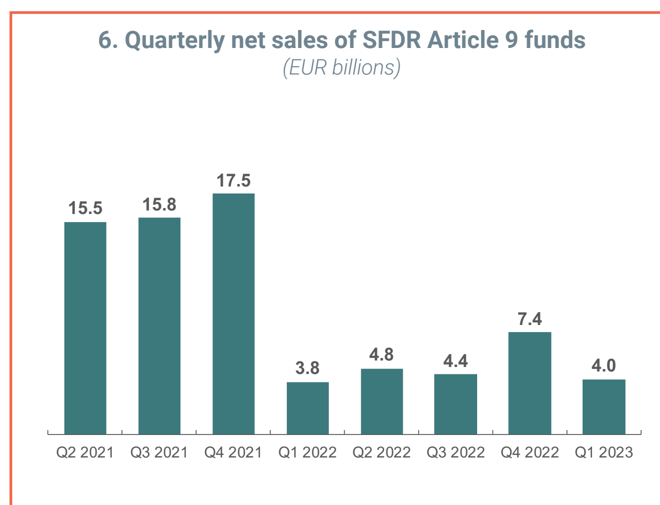
Article 9 funds performed well in terms of net sales, meaning that investors remained remarkably resilient.[8] Article 9 funds registered solid net inflows not just in 2021, but also throughout 2022, when the other segments of the fund market (Article 6 and Article 8 funds) recorded large net outflows. Also in the first quarter of 2023, net sales were positive.



Source: EFAMA and Morningstar



Source: Morningstar

We can identify several developments that impacted the net asset evolution of Article 9 funds over the second half of 2022 and new developments that could have an impact in 2023:

- By far the most significant event in the second half of 2022, responsible for the overall decline in the net assets of Article 9 funds were fund reclassifications from Article 9 to Article 8. Morningstar identified 41 Article 9 funds in Q3 2022 and 307 Article 9 funds in Q4 2022 that were reclassified as Article 8. The 'downgrades' occurred due to the fund industry's conservative interpretation of guidance issued by ESMA in June 2022, reiterating that the portfolio of Article 9 funds should exclusively consist of sustainable investments (100%). Up until then, many market participants were using a good faith assumption that a small portion of the portfolio of an Article 9 fund could also be invested in assets that are not considered sustainable, for portfolio management purposes. This strict interpretation, along with the anticipation of the European Commission's response to the ESAs' SFDR questions, in particular regarding the "sustainable investment" test and the compliance requirements for Article 9(3) funds that track EU Paris Aligned Benchmark ("PAB") / Climate Transition Benchmark ("CTB"), prompted the fund industry to adopt a highly cautious approach and to reconsider the classification of a number of Article 9 funds.
- Despite this, there were still several new launches of Article 9 funds in the second half of 2022. According to Morningstar, 52 new Article 9 funds were launched in Q3 2022 and 49 in Q4 2022. However, these new fund launches could not offset the decline in net assets due to fund reclassifications.
- The uncertainty within the industry on how to define and categorize "sustainable investments" ended with the recent (14 April 2023) response of the European Commission (EC) to the SFDR questions posed by the ESAs. The Commission clarified that it is up to fund managers to set their own definitions as long as investments fulfil three criteria (contributing to an environmental or social objective, not causing significant harm to objectives, and meeting good governance practices) and fund managers disclose their underlying assumptions.
- The Commission's responses have also shed light on a range of uncertainties regarding funds that track the EU's Paris-Aligned Benchmark (PAB) and the Climate Transition Benchmark (CTB). Passive funds tracking a PAB/CTB are deemed to have sustainable investments in line with Article 2 (17) of the SFDR, and therefore, they are not required to provide a detailed explanation of how they continue to strive towards reducing carbon emissions and align to net zero objectives according to the Paris Agreement.

  Now that there is greater clarity on the status of PABs and CTBs, which accounted for a disproportionately high number of funds that dropped their Article 9 classification in the second half of 2022, and a more flexible approach to sustainable investment definitions has been acknowledged, the question arises as to what will happen with those downgraded Article 9 SFDR funds.

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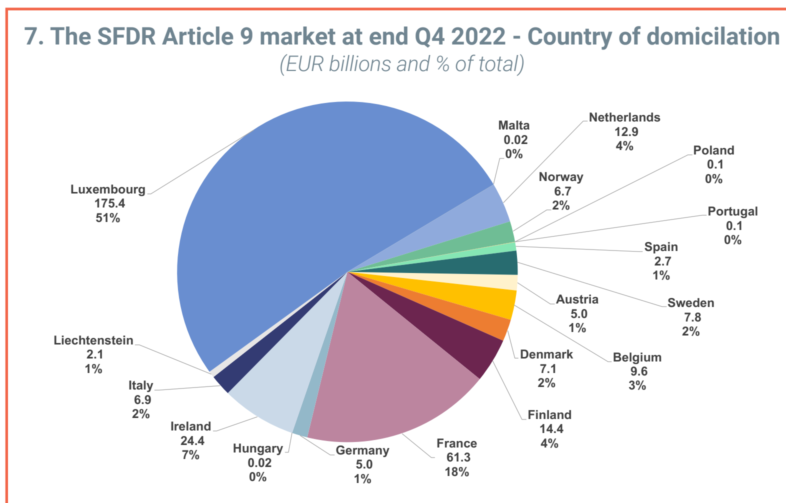
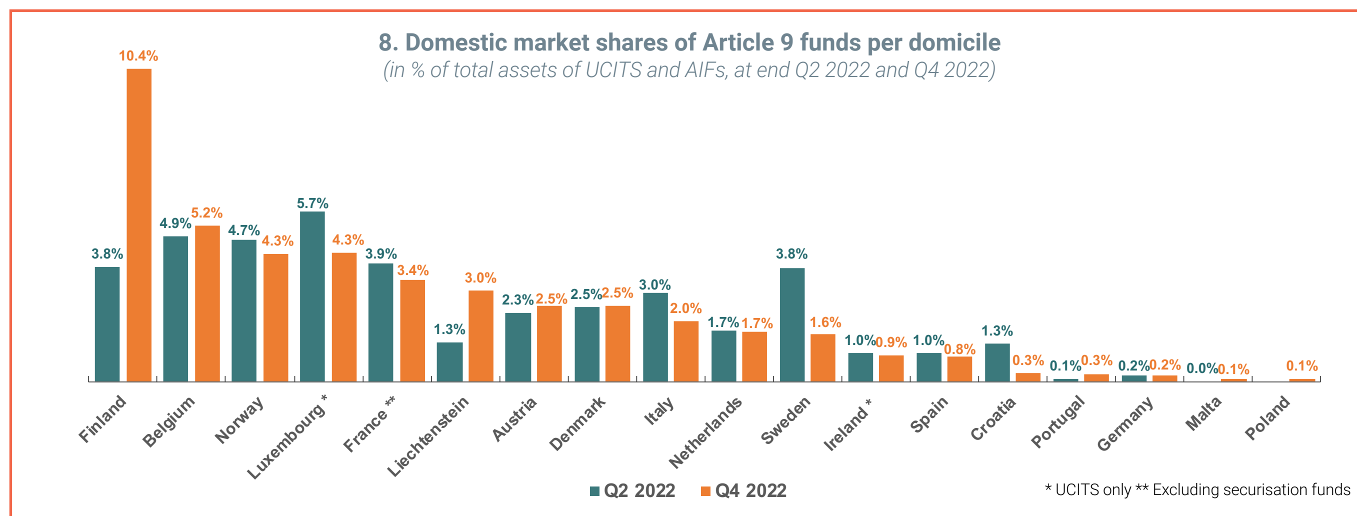
While it is still premature to pass judgment on the clarifications or anticipate possible upgrades of the downgraded Article 9 funds, we will closely monitor the situation and provide an update on the evolution of the SFDR classifications in an upcoming Market Insights.

As seen in chart 7, the SFDR Article 9 market remains very concentrated. Measured by country of fund domiciliation, Luxembourg accounted for 51% of total net assets at the end of 2022, followed by France (18%) and Ireland (7%). Other domiciles accounted for less than 5% each.[9]



Source: EFAMA and Morningstar



Source: EFAMA and Morningstar

Chart 8 illustrates the market share of SFDR Article 9 funds across different EU countries, measured as a percentage of the total net assets of UCITS and AIFs domiciled in these countries, and the evolution of this market share between Q2 2022 and Q4 2022.

Looking at the country-level figures, we can see that the overall market shares of Article 9 funds remain relatively low; with the exception of Finland and Belgium, Article 9 funds made up less than 5% of nationally domiciled funds.

Analyzing the changes in market share over the second half of 2022, we can note the following trends:

- The market share of Article 9 funds in Luxembourg declined from 5.7% at the end of Q2 2022 to 4.3% by the end of 2022. Similarly in France, the Article 9 share declined from 3.4% to 2.9% over the same period. These declines can be solely attributed to the aforementioned reclassifications.
- In smaller domiciles, the evolution over the second half of 2022 is more diverse. Market shares of Article 9 funds dropped in Sweden, Italy, Croatia, Norway, Spain, the Netherlands and Hungary. On the other hand, they rose in Finland, Liechtenstein, Belgium, Austria, Portugal and Denmark.
- Over the last six months of 2022, Article 9 funds were established in Poland and Malta. Nonetheless, at end 2022, there were still a fair number of small to medium-sized domiciles, where not a single domestic Article 9 fund was domiciled.
- The difference between the two cross-border fund domiciles is even more striking for Article 9 funds than for Article 8 funds. Article 9 funds account for 4.3% of Luxembourg-domiciled UCITS but only for 0.9% of Irish UCITS. The reasons for these differences are similar to those for Article 8 funds (see page 3).

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SFDR – OUTSTANDING POLICY ISSUES AND EFAMA RECOMMENDATIONS

The SFDR Level 2 requirements entered into effect on 1 January 2023, which resulted in European asset management companies supplying detailed sustainability-related disclosures, and completing mandatory reporting templates. We believe this will lead to a more consistent application of SFDR, as well as enhanced product transparency and comparability for investors. However, the EU sustainable finance regulatory framework remains still at an early stage of its development with regulatory uncertainty on multiple key aspects and legal concepts leading to different interpretations.

When this is combined with rapidly evolving investor and regulator expectations, it creates a difficult operating environment, even for responsible fund and asset managers.

Reliable ESG data on investee companies

The most significant issue when it comes to SFDR disclosures is the lack of reliable standardised ESG data on investee companies. While the recently adopted **Corporate Sustainability Reporting Directive (CSRD)** will play a pivotal role in delivering accurate and meaningful data on non-financial matters, the framework is still a work in progress and will only deliver in full from 2029 onwards. In the meantime, asset managers may be complying with rules and requirements in good faith but can still be criticised for greenwashing because the data is inconsistent across the market and there is a clear gap between consumer expectations and reality.

By way of example, certain SFDR Article 9 funds were alleged to be non-compliant with the regulations because they are investing in companies that have UN Global Compact (UNGC) violations and controversies. Nevertheless, there is no common and clear standard as to what constitutes a UNGC violation and the response from commercial data providers has been inconsistent. When comparing Sustainalytics and MSCI data, we see that Sustainalytics currently flags 212 issuers as being non-compliant with the UNGC, while MSCI only flags 33 issuers. However, only 8 of those issuers are common to both lists. The lack of clear standards for evaluations or comparisons has resulted in inconsistent compliance assessments, causing concerns over greenwashing and pushing Article 9 downgrades.

Moreover, if the data issued by the data providers is inaccurate, untrue or out of date, this could have adverse effects on the products or services of fund managers. While managers do undertake proper due diligence before onboarding ESG data, they are not able to fully test 100% of the information they receive, especially given the early stage of data availability across the value chain. These data providers can offer significant economies of scale and efficiencies in the research process, which is why many asset managers rely on their data to inform their own research and investment decision-making, particularly when it comes to ESG data on investee companies (which may not be covered by standard financial disclosures) and ratings, which represent a significant cornerstone of asset managers' sustainability practices. Fund manufacturers have the liability to disclose information on extra-financial criteria, however data providers are not currently required to disclose in a harmonised manner, causing major discrepancies and risks. Therefore, **ESG data and rating providers should remain liable for any errors in their data and should be subject to the same regulatory expectations as fund manufacturers**. This issue of liability should be part of the wider discussion around the upcoming regulatory framework for ESG data and rating providers.

Further regulatory guidance and precision

Despite the lack of detailed guidelines and unresolved issues surrounding the SFDR framework, asset managers have invested significant effort into complying through a principle-based approach and on a best effort basis. This includes taking full responsibility and remaining diligent in the way they set their sustainability definitions. We would appreciate **further harmonisation and clarity regarding key aspects**, as this would provide a more stable investing environment. When the Commission begins assessing the SFDR, they should identify any possible gaps and remaining interpretation issues in the existing regulation before introducing new legislative requirements, and **be consistent across the investment value chain**. Some of our recommendations include:

- not introducing any future fund naming guidelines until the Commission's SFDR review is complete, and making any guidelines interoperable with SFDR, MiFID, and other relevant regulations
- ensuring that any proposals from ESMA (level 2 measures) are able to withstand any future reviews of the SFDR
- taking already existing market and regulatory conditions into account when considering the concept of "greenwashing"

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- aligning investee companies' reporting of ESG data (under CSRD) and fund managers' ESG disclosure requirements (under SFDR)
- making sure ESG benchmark disclosures fit with user needs under SFDR/Taxonomy Regulation

At the same time, there are limits to the expertise we can require from investors when navigating through the growing range of sustainable funds. The way in which the legislation has been drafted means investors are being confronted with concepts such as "taxonomy", "DNSH", and "PAIs". To gain a comprehensive understanding of the companies they invest in and foster consumer confidence, the significance of using clear and accessible language specifically tailored for investors cannot be overstated. It is not only vital to educate investors but equally important to communicate in a language that resonates with them, rather than burdening them with regulatory jargon and an overload of information. In light of this, we strongly urge regulators to prioritize this aspect when reviewing SFDR. By doing so, we can enhance transparency and facilitate better decision-making for investors.

Supervisors and regulators could help mitigate reputational risks by acknowledging the challenging situation, including regulatory uncertainty and lack of data availability. Supporting communication efforts to explain nuances and uncertainties to the public and ensuring workable implementation timelines for new guidance would help with this.

Consistent and effective implementation across Europe

The varying market shares of Article 8 and 9 funds in different European countries indicate a significant degree of national fragmentation, to the detriment of end investors. Several EU member states have introduced their own guidelines to strengthen the sustainable disclosure regime. This includes setting different minimum requirements for Article 8 products or distinct approaches regarding how Article 8 and 9 funds should disclose their Taxonomy alignment.

Without **consistency in interpreting EU regulations** and the creation of local regulations, asset managers operating cross-border find it challenging to maintain a coherent and uniform approach at the EU level. The difficulties are not limited to fund manufacturers and distributors, as end-investors often cannot access comparable information on cross-border ESG investments. Ultimately, this hinders the development of a large and liquid ESG investment market in Europe that would facilitate the transition to a net-zero economy.

Leave time and room for industries to transition

It is a difficult balancing act to allow flexibility for industries that are transitioning while still ensuring sufficient clarity and regulatory certainty for sustainable investing. The Commission has confirmed that transition plans that pass DNSH and good governance tests would qualify an investment as sustainable under Article 9. This means that the quality of the transition plan matters, as well as the actions it is taking to meet their targets and other commitments. We believe it is essential to consider the activities of investee companies whose transition to sustainable production processes takes place over a longer period and to provide appropriate support to enable them to rethink their organisation and operations. Restrictive requirements which do not allow for gradual implementation might lead to insufficient market availability of 'sustainability compliant' financial products, running counter to the goal of reorienting capital flows towards sustainable finance.

CONCLUSION

The fund and asset management industry still faces difficulties and uncertainties in the implementation process of the SFDR framework, but there are promising signs of progress. Revisions to the SFDR RTS are underway, aiming to rectify deficiencies, while future plans include a more fundamental review of the SFDR. In parallel, the recently adopted phased-in CSRD framework should improve the accessibility and credibility of ESG data.

As fund managers will continue to adapt to new policy guidance, clearer definitions, and better ESG data, the Article 8 and Article 9 funds markets will most likely remain in full flux over the next few years.

It is still unclear whether the significant reclassifications of Article 9 funds to Article 8 funds, which we witnessed in the latter half of 2022, will persist in 2023 or whether there will be a reversal of the trend after the clarification provided by the Commission.

These evolutions, combined with the impact of other regulatory developments throughout this year, will be reflected in the next issue of our SFDR survey, capturing 2023 data.

Over the long run, EFAMA remains optimistic that the current challenges will fade once the regulatory framework is complete and asset managers have access to the necessary corporate reporting data to comply with their new obligations. We believe that, eventually, the SFDR will reduce information asymmetries, prevent divergent national disclosures, enhance the comparability of product-related ESG disclosures and foster a level playing field for ESG products within the European internal market.

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ENDNOTES

1. *The results of this year's survey are based on data collected from EFAMA member associations representing Austria, Belgium, Croatia, Denmark, Finland, France, Hungary, Greece, Germany, Italy, Liechtenstein, Malta, the Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Sweden, and Spain. The reported data covers both UCITS and AIFs (Securitization funds were excluded in France).*

   To make an estimation of the overall size of the European market, we used Morningstar Direct to include data on the UCITS Article 8 and Article 9 funds domiciled in Ireland and Luxembourg.

   The UK and Switzerland are not covered as these countries did not implement the SFDR, even though a very small number of Swiss and UK funds are classified as SFDR Article 8 funds in Morningstar Direct.
2. *Only UCITS are considered for Ireland and Luxembourg.*
3. *Net sales data is sourced from Morningstar Direct and, as such, the coverage of the net sales of the AIF market segement is incomplete.*
4. *See: Article 8 Funds Shed Another €28.7bn*
5. *See: SFDR Article 8 and Article 9 Funds: Q4 2022 in Review*
6. *To compare like with like we only included countries for which we have survey data available at end Q2 2022 and end Q4 2022. As mentioned in endnote 1, data on the net assets of Article 8 funds in Ireland and Luxembourg was sourced from Morningstar Direct. Since the coverage of the AIF market segment is limited in this database, only UCITS data was used. The market shares of Article 8 funds in these two countries are thus calculated as a percentage of the UCITS market only.*
7. *Only UCITS are considered for Ireland and Luxembourg.*
8. *The same caveats as explained in endnote 3 apply to the net sales of Article 9 funds.*
9. *We follow the same approach as explained in endnote 5.*

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EFAMA is the voice of the European investment management industry, which manages over EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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