Morningstar Observations and Recommendations

EC Targeted Consultation on the Sustainable Finance Disclosure Regulation

About Morningstar and Morningstar Sustainalytics

Morningstar's mission is to empower investor success. As part of this mission, Morningstar Sustainalytics helps individual investors, professional financial advisors, and institutional clients identify sustainability risks, impacts, and opportunities. Our products, offered through separate business lines and subsidiaries, include a broad range of data, tools, ratings, indexes, second-party opinions, and governance services. More recently, Morningstar Sustainalytics has taken a leadership position in helping clients respond to the various requirements of the EU Sustainable Finance Action Plan, or SFAP, including EU Taxonomy and Sustainable Finance Disclosure Regulation, or SFDR, Principal Adverse Indicators, or PAIs, data.

Summary

Morningstar appreciates the European Commission's wide-ranging and open consultation taking stock of the implementation of the SFDR. While SFDR has contributed to raising ESG awareness and consideration in the financial-services sector, it has not fully delivered on its key objectives. We believe the SFDR review should focus on combatting greenwashing and delivering insightful information to support retail investors. To that end, we recommend SFDR revisions should: (1) better help investors compare products, (2) make core regulated sustainability indicators easier to understand, and (3) create descriptive labels and eradicate Article 6, 8, and 9 distinctions.

- To enhance the comparability of data, we suggest mandating SFDR 2.0 disclosures apply to all financial products regardless of their sustainability claims and require disclosing ESG regulatory data against a benchmark (chosen by the financial market participant).
- To improve the relevancy of regulatory data, we encourage more dependence on the EU Taxonomy rather than SFDR sustainable investment, or SI, data; ameliorate the usability of the EU Taxonomy; and report on a selected number of PAIs, at product rather than entity level, among other things.
- To better guide retail investors, we support the replacement of Article 8 and 9 categories with more-specific labels.

Finally, we note that these potential changes will require a consistent adaptation of related requirements under the EU Sustainable Finance Action Plan (for example, sustainability preferences under MiFID and IDD).

(1) The Disclosures Should Better Help Investors Compare Products

So far, the SFDR disclosures are exclusively required for sustainable funds and without a point of comparison for retail investors. This makes it very difficult to truly grasp the sustainability impact of a product. We would therefore strongly recommend broadening disclosure to all products and against a benchmark.

Disclosure against a benchmark

Disclosing sustainability regulatory data against a benchmark would not only be helpful to contextualize data and to compare products, but it may also incentivize product manufacturers to disclose and commit to a certain level of Taxonomy alignment. As indicated in number two below, the current level of Taxonomy alignment figures displayed by Article 8 and 9 products are fairly low and therefore confusing for investors, but if put into the perspective of a non-sustainable market benchmark, these would look significantly higher and more meaningful to investors. The choice of benchmark should be left at the discretion of financial market participants.

Disclosure for all financial products

SFDR requires sustainability disclosures only for investment products that claim sustainable characteristics/objectives. We believe this a weakness that hinders information and the awareness of investors. It also undermines the EU objective of channelling money toward sustainable investments. As a comparison, the energy performance disclosures for cars/buildings/household equipment are mandatory for all products/assets, which allows true comparability. We see the SFDR review as an opportunity to extend a level of disclosure requirements to all SFDR products, regardless of their level of sustainability ambition and claims. The selection of standardized disclosures, such as we propose in Annex A, would convey to investors more context about the level of sustainability being achieved by products. Specifically, we propose three of the most important indicators—minimum sustainable investments (Taxonomy-based); climate; and impact—to support investment decisions and to help measure wider progress on societal issues. We would supplement these with the most meaningful PAIs to provide a broader context for investors.

(2) Core Regulated Sustainability Indicators Must Be Easier to Understand

The three main SFAP regulatory data points of Taxonomy, Sustainable Investment, and PAI, developed in part to combat greenwashing, have failed so far to deliver meaningful information to investors. The main challenges are that these regulatory datasets are sometimes lacking, complex to interpret and produce for financial entities, and challenging to grasp for retail investors, which renders the comparison of financial products difficult and sometimes unreliable.

Rely on the EU Taxonomy rather than SI to produce comparable data for investors

The lack of comparability regarding the SI data stems directly from Article 9 requirements. Article 9 requires products to (1) seek an environmental/social objective, (2) not harm other environmental/social objectives, (3) invest in companies with good corporate governance, and (4) align 100% of holdings (except for instruments held for hedging and liquidity purposes).

Given that there is no such thing as a 100% SI investee company or fund, this guidance has pushed many fund managers away from a revenue/capital-expenditures-weighted approach and forced them to use a company flag (for example, if Company X is more than 15% revenue-aligned with SI definition than the entire holding of Company X for the portfolio SI %) or qualitative/proxy assessments (for example, alignment with IIGCC net-zero framework). The heterogeneity of the data is also aggravated by the discretion left to investors to apply the do-no-significant-harm, or DNSH, concept.

The diverging approaches regarding the SI calculation render the direct comparison of products via regulatory data points almost impossible. We believe it is necessary to eliminate the Article 9 category and its artificial 100% SI requirement, which is not attained (as shown in exhibit 1) and cannot be attained.

To become a meaningful regulatory data point for investors, the SI calculation needs to be standardized. However, this would require a level of granularity similar to the EU Taxonomy. We would therefore suggest deleting the SI disclosure requirement and focus efforts on expanding the EU Taxonomy beyond environmental objectives and improving its usability (see below).

If the EU Taxonomy cannot be expanded before the SFDR review takes effect, we would be in favour of a temporary solution to capture more broadly sustainable investments. For instance, the EU could allow product disclosures to account for sustainability activities involvement that is not captured by the Technical Screening Criteria but is aligned with the United Nations Sustainable Development Goals. In essence, for any objectives not yet covered by the EU Taxonomy, an alternative methodology could be used to assess substantial contributions as long as this methodology mimics the EU Taxonomy (that is, it is [1] activities-based, [2] makes use of technical criteria, and [3] applies DNSH and minimum safeguards) and there is adequate disclosure on the methodology. In that case, it should follow the Taxonomy calculation approach, and a breakdown between EU Taxonomy and SDG alignment should be provided.

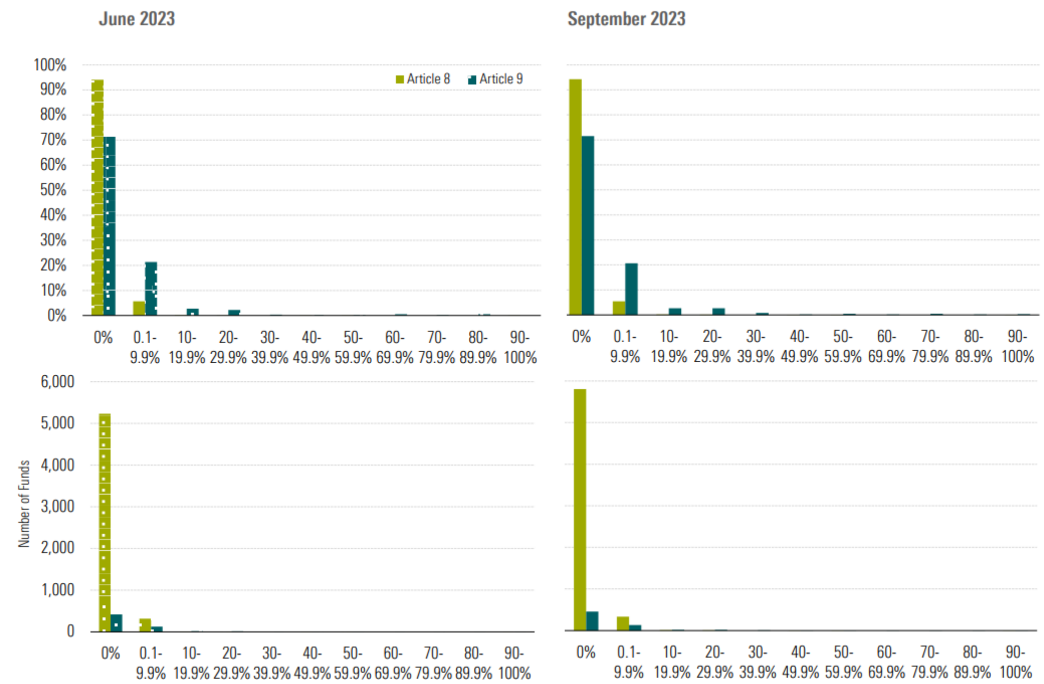
Improve the usability of the EU Taxonomy

While we believe that the EU Taxonomy should be used to demonstrate the positive contribution of financial products to sustainability objectives, as practitioners, we also call to improve its usability prior to the SFDR review implementation. Addressing the challenges flagged by the Sustainable Finance Platform is critical.

We particularly encourage the EU to improve the usability of the EU Taxonomy when considering companies not covered by the Non-Financial Reporting Directive, which constitutes a very large part of European fund portfolios in particular and markets in general. Many aggregate or portfolio-level metrics will only be useful if they are representative of the entire portfolio. Given that reporting on Taxonomy and/or PAIs will remain patchy or inconsistent for non-NFRD companies for the foreseeable future, it is critical to ensure that relevant reporting data gaps can and must be closed by using estimates or proxies. Clear principles and guidance will need to be developed to ensure that estimates generated by different data providers or asset managers themselves are consistent. Without such a consideration, Taxonomy-alignment data will be distorted and meaningless to investors and the credibility of the EU Taxonomy undermined.

In that respect, the diverging and complex regulatory guidance from the EC, the ESAs, and local supervisors on the use of estimated data regarding Taxonomy alignment (see Annex B) has created a legal uncertainty incentivizing most funds to disclose zero Taxonomy-alignment figures (see exhibit 1 below). In our opinion, the problem has been wrongly identified as a temporary challenge by the ESAs.[1] The complex and various levels of guidance on the use of estimated data (and the lack of guidance aimed at ensuring consistent estimates across providers) strongly undermines the long-term usability and relevancy of Taxonomy data by fund managers and end-clients.

Exhibit1: Proportion of Article 8 and Article 9 Funds (Y-axis) With Various Commitments to Taxonomy-Aligned Sustainable Investments (X-axis)



Source: Morningstar Direct. Data as of September 2023. June 2023 data is based on 5,564 Article 8 funds and 586 Article 9 funds that report the field. September 2023 data is based on 6,161 Article 8 funds and 635 Article 9 funds that report the field.

[1] *Once the reporting prescribed by Regulation (EU) 2021/2178 on the Taxonomy-aligned activities of nonfinancial undertakings (from January 2023) and financial undertakings (from January 2024) starts, the disclosure of Taxonomy-aligned investments is expected to become more straightforward.* [JC 2023 18 Consolidated JC SFDR QAs (europa.eu)]

Rationalize PAIs and focus on products ahead of entities

As anticipated, the first PAI statements at entity level have shown serious limitations. PAI are subject to formula errors, aggregation and interpretation challenges, and distortion by asset-allocation type (for example, cash). We also note that the statement can be done at group level or at the level of specific entity, which further undermines the usability of the information provided to investors. While entity-level data can inform investors to some level about the ESG status of an entity, investors are primarily buying individual products, and the ESG status of each product will vary considerably from the entity-level position.

Exhibit 2: Mandatory PAI Indicators Across Eight Asset Managers as Disclosed in Selected PAI Statements

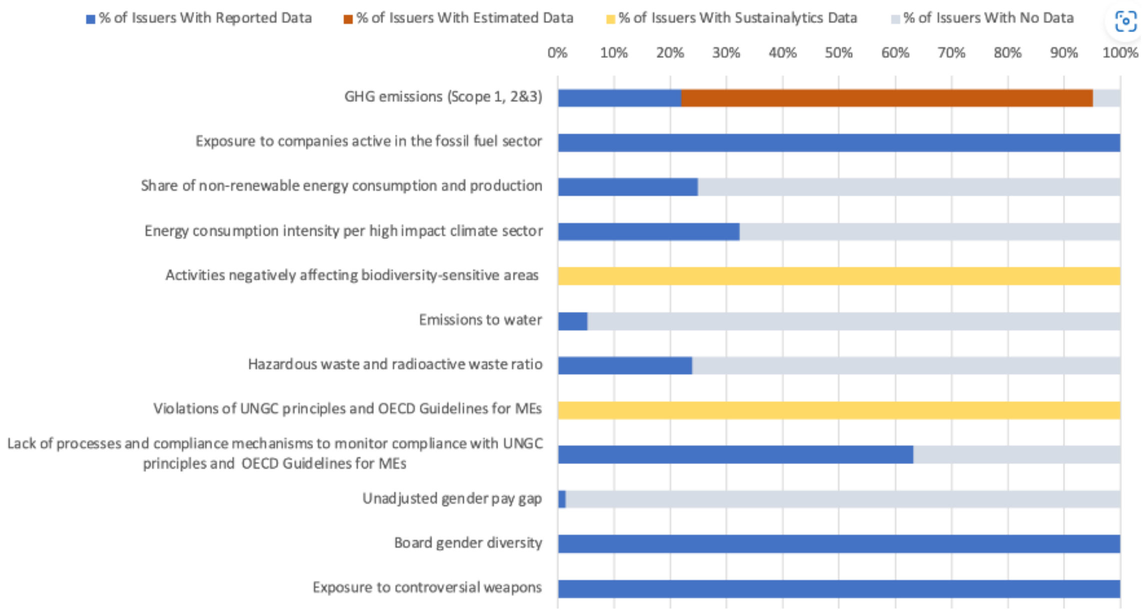
Corporate			Amundi	BlackRock	Candriam	DWS	JP Morgan	Nordea	Robeco	UBS
Greenhouse gas emissions	1	GHG emissions (tCO2e)								
		Scope 1	49,152,045	27,728,968	3,316,240	13,759,879	10,831,621	3,368,336	7,984,216	7,801,851
		Scope 2	8,513,921	6,182,890	1,014,823	3,421,136	2,763,084	983,988	2,566,216	1,863,097
		Scope 3	19,335,857	196,487,328	N/A	99,925,299	79,154,187	23,780,378	79,328, 847	60,972,922
		Total GHG emissions	77,021,824	233,064,529	4,331,064	117,087,046	88,112,702	4,352,325	89,879,279	70,499,868
	2	Carbon footprint (tCO2e/€m invested)	92.5	271	52.6	489	221	45.5	632	296
	3	GHG intensity of investee companies (tCO2e /€m revenue)	220.5	597	120.8	1,088	864	134.8	1,428	929
	4	Exposure to companies active in the fossil fuel sector (% AUM)	13.5%	9%	3.7%	17.1%	1.2%	2.9%	4.09%	6.1%
	5	Share of nonrenewable energy consumption and production (% total energy sources)	77.1% 65.1%	64% 60%	72.16%	75.1%	0.97% 0.83%	65.7% 74.6%	64.9%	75.6%
	6	Energy consumption intensity per high impact climate sector (GWh/€m revenue)	Breakdown	0.7 + Breakdown	0.54 + Breakdown	Breakdown	Breakdown	Breakdown	0.96	15.5
Biodiversity	7	Activities negatively affecting biodiversity-sensitive areas (% AUM)	0.04%	2%	2.98%	0.08%	1.12%	0.70%	5.43%	0.06%
Water	8	Emissions to water (t/€m invested)	348.4	0	59.2	238.6	1,904	0.3	0.02	2.67
Waste	9	Hazardous waste ratio (t/€m invested)	12.2	57	1.4	8.3	2.6	0.74	27.1	2.1
Social and employee matters	10	Violations of the UNGC principles and OECD Guidelines for Multinational Enterprises (% AUM)	0.27%	10%	0.65%	0.17%	0.03%	0.31%	0.11%	0.58%
	11	Lack of processes and compliance mechanisms to monitor compliance (% AUM)	13.5%	1.0%	3.8%	44.7%	32.8%	0.2%	6.1%	39.4%
	12	Unadjusted gender pay gap	12.6%	15%	12.2%	14.3%	8.3%	10.6%	15%	13.2%
	13	Board gender diversity	34.9%	32%	36%	32.9%	4.9%	34%	31%	31.3%
	14	Exposure to controversial weapons	0.02%	<0.01%	0%	0%	0.01%	0%	0.10%	0.06%

Exhibit 2 highlights the most extreme divergences between managers resulting from many of the factors quoted above.

Provided that the calculation formulas are fixed and certain types of securities (for example, cash and commodities) are disregarded from both the numerator and the denominator of PAI calculations, we believe that PAIs, for which data could be at least estimated (see below our mock-up precontractual template – Annex A), could form relevant information to investors in the context of product disclosure rather than entity disclosure. It is indeed important to note that many data points have to be estimated given the current state of ESG reporting (exhibit 3). This will likely remain the case, as the Corporate Sustainability Reporting Directive, or CSRD, is subjecting all PAIs to a materiality assessment and because of the importance of non-CSRD companies in portfolios.

Regarding entity reporting, SFDR 2.0 should review the purpose of such reporting and ensure that any entity-level reporting serves such a purpose. In its current form, we have concerns that entity-level PAI reporting does not serve any use case or investor decision-making. Information that some investors would consider relevant at entity level, which is not already covered by CSRD, includes stewardship strategy.

Exhibit 3: Data availability across PAI[2]



Climate disclosure should not be forgotten

With the EU Taxonomy expanding beyond climate and in light of the EU climate objective, we believe it is key and rather urgent to add a climate-related metric at product level. The EC should not wait for the review to operate this change (a level 1 change will only have effect approximatively five years from now).

(3) Create Descriptive Labels and Eradicate Article 6, 8, and 9 Distinctions

Currently, the Article 8/9 divide does not reflect the variety of investment strategies in use. According to Morningstar data, currently, almost 11,000 funds are classified as Article 8 and 1,000 are classified as Article 9. Arguably, Article 8 is a catchall grouping comprising funds with different ESG approaches and levels of ambition (for example, best-in-class, exclusions, tilts). Likewise, the Article 9 cohort includes a variety of strategies (for example, impact, thematic, climate objectives). We see merit in exploring more refined categories in order to help investors better navigate the current landscape.

Traditionally, investment fund categorization, or sector classification, systems have sought to strike a balance between sufficient granularity and limited proliferation to facilitate comparisons across similar types of funds and help investors navigate enormous choice. ESG factors are a consideration alongside multiple other investment factors such as asset class, geography, currency, capitalisation and issuer and well-designed labels, in conjunction with such categories or sectors could indeed help investors identify comparable products. Further, the current Article 8/9 split could be eradicated, with all products making similar ESG disclosures and inclusion of binding portfolio elements relevant to the type of product.

We are therefore supportive of the broad outline of the proposed labels, which should be optional, non-hierarchical and mutually exclusive (Category A [Impact], Category B [Focus], Category C [Exclusions], Category D [Transition or Improvers]). We do not believe product labelling is appropriate for those products who solely integrate ESG-risk considerations into their investment processes. We also see limited value in a label for products operating "exclusionary" policies. The distinction between categories A and B is very important. Further distinguishment, such as between environmental and social, could be helpful.

[2] Filling in the Data Gaps: The Current State of Reporting on Principal Adverse Impacts Disclosures for the SFDR (sustainalytics.com)

An attainable threshold that is meaningful to investors is needed

When designing criteria, it will be key to overcome the inherent tension between establishing a meaningful threshold for retail investors and attainable objectives by the investment funds. For example, the U.K. SDR Focus label requires that 70% of the fund be invested in sustainable assets, with reference to a "robust" yet largely undefined standard. This high threshold is at face value appealing and comforting from a consumer perspective, but in fact, this means that the label will most likely host strategies with very different levels of ambitions and risks running into the current issues of SFDR SI data heterogeneity discussed on Page 2. On the flip side, referring exclusively to the EU Taxonomy alignment allows more comparability, but finding a portfolio threshold both feasible and sufficiently ambitious is one of the most difficult conundrums. As highlighted on Page 3, 70% of Article 9 funds do not commit to align with the EU Taxonomy and 20% align between 0 and 10%. Considering the level of alignment of companies also argues in favour of modest thresholds (for example, considering climate mitigation, the MSCI world index is 3.93% aligned on a turnover basis and 2.53 aligned on a capital-expenditures basis). Given current Taxonomy alignment of investee companies, we encourage the EU to opt for both portfolio and company thresholds that are inherently dynamic and progressive. For Categories B and D, we would therefore suggest that a minimum of 70% of the portfolio should be invested in top Taxonomy performers according to the investment universe of the fund (for example, 70th percentile). The rest of the assets held for liquidity and hedging purposes should not harm or contradict the sustainability objective of the fund. For the identification of top Taxonomy, performers, Category B should use either turnover/operating expenses as a KPI, and Category D should use capital expenditure. This would allow the EU labels to be more stringent yet compatible with the U.K. SDR labels. This means that EU-domiciled funds sold in the U.K. will be in good position to comply with the U.K. label requirements.

Focus	**Transition**	**Impact**	**Mixed**
>70% of fund invested in top Taxonomy performer of investment universe[3] KPI: Turnover or operating expenses Exclusion: no fossil fuel	EU PAB/ EU taxonomy-aligning benchmarks Or >70% of fund invested in top Taxonomy performer of investment universe. KPI: capital expenditures. No strict exclusions.	> 70% of fund invested with an aim to achieve a predefined positive measurable impact in relation to an environmental and/or social outcome (theory of change)	> 70% of fund invested in accordance with each of the other relevant labels

If, for some reasons, the EU cannot agree on labels, we would still be favour of deleting Article 8 and 9 classification and upgrading transparency requirements as proposed above (new data point for all products and against a benchmark), as we believe the proposed enhanced comparability would be very meaningful to retail investors.

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14th December 2023

[3] > 70th percentile

Annex A- Mock-Up SFDR 2.0 Precontractual Template as per Morningstar Recommendations

What sustainable investment strategy does this financial product follow?

What are the potential positive contributions and/or negative impacts of the product?

		Product	**Point of reference/benchmark[4]**
Sustainable contribution of the product Does the product make a difference?	Minimum of sustainable investments[5]	CapEx % Revenues %	CapEx% Revenues%
	Climate transition	°C portfolio temperature scenario by 2050	°C portfolio temperature scenario by 2050
	Impact	selected KPI	if relevant
Principal adverse impacts Does the product minimize harm?	Exclusions		if relevant
	GHG emissions[6]	total GHG emissions	total GHG emissions
	Fossil fuel [7]	%	%
	Biodiversity[8]	%	%
	Water[9]	total water usage and recycling	total water usage and recycling
	UNGC/OECD guidelines violators[10]	%	%
	Board gender diversity[11]	%	%
	Controversial weapons[12]	%	%

Is the product committed to align with one of the following EU labels?

Focus	**Transition**	**Impact**	**Mixed**
tick one box			
Key features of the label	Key features of the label	Key features of the label	Key features of the label

4 If the benchmark is already ESG-optimized (often the case for passive funds), it should be explained to investors.
5 Based on EU Taxonomy alignment.
6 PAI 1 table 1
7 PAI 4 table 1
8 PAI 7 table 1
9 PAI 6 table 2
10 PAI 10 table 1
11 PAI 13 table 1
12 PAI 14 table 1

Annex B: Evolution of Regulatory Guidance Taxonomy Estimates at Product Level

March 22-ESA's supervisory statement: '*Moreover, while estimates should not be used, where information is not readily available from public disclosures by investee companies, financial market participants may rely on equivalent information on Taxonomy alignment obtained directly from investee companies or from third party providers.*'

April 22-Adoption SFDR delegated regulation by EC. '*Article 15- 3 b: "where information about the degree to which the investments are in environmentally sustainable economic activities is not readily available from public disclosures by investee companies, details of whether the financial market participant obtained equivalent information directly from investee companies or from third party providers;*'

May 22-EC'S Q&A document on interpretation of SFDR and Taxonomy regulation: '*Recital 21 to Regulation (EU) 2020/852 refers to exceptional cases where financial market participants cannot reasonably obtain the relevant information to reliably determine the alignment with the technical screening criteria established pursuant to that Regulation as far as economic activities carried out by undertakings that are not subject to that Regulation are concerned. In such exceptional cases and only for those economic activities for which complete, reliable and timely information could not be obtained, financial market participants are allowed to make complementary assessments and estimates on the basis of information from other sources. Such assessments and estimates should only compensate for limited and specific parts of the desired data elements, and produce a prudent outcome. Financial market participants should clearly explain the basis for their conclusions as well as the reasons for having to make such complementary assessments and estimates for the purposes of disclosure to end investors.*'

November 22- Q&A by the ESAs: '*The starting point for the evaluation of equivalent information, as referred to in Article 17(2)(b) of 53 the Delegated Regulation, should be considered information that provides the same content and level of granularity as that provided by the reporting of undertakings of their Taxonomy-aligned activities in Regulation (EU) 2021/2178. In this respect, equivalent information should meet these following basic principles:*
- Equivalent information should only apply to economic activities listed in the Delegated Acts of Regulation (EC) 2020/852;
- The assessment of the substantial contribution of an economic activity should rely on actual information, subject to the limited circumstances described by the European Commission in Question VII.1; and
- While it should be possible to use estimates to assess the DNSH based on equivalent information, controversy-based approaches should be discouraged and considered insufficient (as outlined in Q&A 32 below).