Triodos Investment Management

A simple, clear and comparable system for all investors to shift capital to a sustainable economy

Position of Triodos Investment Management on a new categorisation system following SFDR

Bringing SFDR to the next level
The Sustainable Finance Disclosure Regulation (SFDR) has been an important milestone in the shift towards a sustainable economy and a big gamechanger for mainstreaming sustainable finance in the boardroom of the investment world. However, like every new regulation it has unintended effects that do not contribute to the objectives of the regulation itself.

As Triodos Investment Management, we stand firmly behind the original SFDR objectives of steering capital flows towards sustainable investments, mainstreaming sustainability into risk management and fostering transparency and long-termism. With that in mind, we see the following effects of the regulation that need to be addressed in the upcoming review of the SFDR:

- The current SFDR documentation doesn't provide clarity and comparability for investors, particularly retail investors. We see that the disclosure documents published on the product websites are hardly read and understood by investors. The market seems to rely on the Article 6, 8 or 9 categorisations mostly, which is, however, limited and not comparable.
- The SFDR currently does not provide insights in the investments in non-sustainable or even harmful activities. The lack of information on the impact of Article 6 products results in insufficient transparency for investors to make informed decisions and steer capital towards sustainable investments.
- The focus of the SFDR on disclosures for sustainable products results in an increased financial and administrative burden for those products. This results in an uneven playing field between sustainable and non-sustainable products, because it increases the costs of sustainable products only. It also leads to market participants purposely not disclosing sustainable characteristicsof their products, also known as 'green hushing'. Both stand in the way of steering capital to sustainable investments.

Proposal for a simple and clear categorisation system
To further improve the SFDR, Triodos Investment Management proposes a simple, clear and comparable categorisation system that informs all investors about the sustainability efforts of a financial product. The key principles of our proposal are that all products should be comparable, that the comparison should be easily understood, that it contributes to the original objectives of the SFDR, and that the conceptual framework can stand the time.

Our proposal includes categories that distinguish to what extent a financial product considers sustainability, based on their disclosure of:

1. the degree of sustainable investments according to either the Taxonomy Regulation and/or following art 2(17) of the SFDR[1],
2. if the Principle Adverse Impact Indicators (PAIs) are used in the investment selection process and/or the engagement strategy, and
3. whether exclusions are applied or not, with as a minimum the required exclusions of the Paris Aligned Benchmark[2].

This would imply five categories, from 'strong' to 'no' explicit consideration of sustainability in a financial product. Each financial product should be categorised and should disclose the category in the pre-contractual documentation of the product. The table below shows what such a categorisation system could look like.

Proposed categorisation system

	5	4	3	2	1
Degree of sustainable investments	High (90%)	Low (50%)	Not tracked	Not tracked	Not tracked
PAIs used in the selection process and/or engagement strategy	Yes	Yes	Yes	No	No
Exclusions applied	Yes	Yes	Yes	Yes	No
Key PAIs disclosed	Yes	Yes	Yes	Yes	Yes

On top of that, all financial products should disclose a set of key PAIs, so investors can compare the adverse impact, regardless of the categorisation of the product. As a result, sector-based benchmarks on performance can be established to increase comparability.

1 The percentage should be calculated based on the current value of all investments, excluding cash.
2 The exclusion list of the Paris Aligned Benchmark consists of the involvement with controversial weapons and tobacco, violation with the UN GP Principles or OECD Guidelines for Multinational Enterprises, and thresholds for coal, lignite, oil and gaseous fuels and GHG intensity.

Less confusion, less costs
Key in our proposal is that we use the same baseline of disclosures for every category. We strongly recommend avoiding different sets of information requirements between categories, as this would obstruct the comparability for investors. Furthermore, we deliberately use *existing* disclosure requirements that are available in the market to ensure a cost-effective implementation for financial market participants. Finally, we recommend numbers or letters over names. From our 30 years' experience in sustainable finance, we have experienced the difficulties with names, as they are time-bound and prone to interpretation.

With the key points of our proposal in mind, we regard the suggested approaches by the European Commission (EC) insufficient. Both approach 1 and 2 result in incomparable categories, whether these are based on sustainability strategy or the existing Article 8 and Article 9 approach. Furthermore, both approaches only address sustainable products and therefore doesn't address the consequence of green hushing, the uneven playing field between sustainable and non-sustainable products and most importantly, the lack of comparability for investors across all products.

Further recommendations
Apart from our proposal for a new classification system, we have the following recommendations to improve the SFDR:

- SFDR should only apply to product level disclosures. The entity level disclosures should not be based on PAIs but should follow the Corporate Sustainability Reporting Directive (CSRD).
- More alignment between supervisors is desirable as we have seen that supervisors interpret the SFDR differently. For example, in some jurisdictions, the definition of investments includes cash and in others, these are excluded. Some (more illiquid) products can have quite some cash which has a large influence on the reported % of sustainable investments. The exclusion of cash and hedging derivatives from the calculation of proportion of sustainable investments should become standard amongst all jurisdictions.
- Product related information spread across precontractual, periodic documentation and website disclosures are appropriate, although we have some concerns about the practicality, clarity and comparability of the PAI statement and annex in the precontractual disclosure. The information presented should be simplified and made more modular, especially the website disclosures.

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